PECO ENERGY COMPANY
STATEMENT NO. 12-R

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PENNSYLVANIA PUBLIC UTILITY COMMISSION

v.

PECO ENERGY COMPANY – ELECTRIC DIVISION

DOCKET NO. R-2010-2161575

REBUTTAL TESTIMONY

WITNESS: THOMAS D. TERRY, JR.

SUBJECT: TAX ACCOUNTING METHOD FOR REPAIRS

DATED: AUGUST 3, 2010

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1 **REBUTTAL TESTIMONY**
2 **OF**
3 **THOMAS D. TERRY, JR.**

4 **I. INTRODUCTION AND PURPOSE OF TESTIMONY**

5 **1. Q. Please state your full name and business address.**

6 A. My name is Thomas D. Terry, Jr. My business address is 10 South Dearborn Street,
7 51st Floor, Chicago, Illinois 60603.

8 **2. Q. By whom are you employed and in what capacity?**

9 A. I am employed by Exelon Corporation as Vice President and General Tax Officer.

10 **3. Q. Please describe your educational background.**

11 A. I received a Bachelor of Science degree in Commerce and Business Administration,
12 with a major in accounting, from the University of Alabama in 1984. I received a
13 Master of Tax Accounting degree from the University of Alabama in 1985.

14 **4. Q. Please state your professional qualifications.**

15 A. My professional qualifications are set forth in Appendix A.

16 **5. Q. On whose behalf are you submitting this testimony?**

17 A. I am testifying on behalf of PECO Energy Company ("PECO" or the "Company").

18 **6. Q. What is the purpose of your testimony?**

19 A. The purpose of my testimony is to respond to the direct testimony of David J. Effron
20 on behalf of the Office of Consumer Advocate ("OCA") concerning a change in the

1 method of tax accounting to determine the portion of expenditures that are capitalized
2 and depreciated versus deducted as repairs on a current basis for federal income tax
3 purposes.

4 **II. TAX ACCOUNTING METHOD FOR REPAIRS**

5
6 **7. Q. Mr. Effron asserts that, had the Company implemented a change in its tax**
7 **accounting method for repairs, it would have produced a very large tax benefit.**
8 **Is that true?**

9 A. While that is a reasonable supposition at this time, the Company has no way of
10 quantifying the benefit with any degree of accuracy.

11 **8. Q. Why doesn't the Company know this?**

12 A. There are three factors critical to calculating the tax benefit of a repair accounting
13 method change, all of which are, at this point, unknown to the Company. The first is
14 the acceptability of any new "units of property" definition the Company might adopt.
15 The second is the uncertain dividing line between a repair and a capital project even
16 once acceptable units of property are identified. And the third is the uncertainty
17 associated with the processes necessary to calculate the "catch-up" adjustment which
18 produces the largest part of the tax benefit. I will explain each of these.

1 **9. Q. What qualifies as a repair for tax purposes?**

2 A. Work performed on an asset to keep it in its normal working condition and which
3 does not materially extend its life, increase its value or change its use generally
4 qualifies as a repair.

5 **10. Q. What is the usual tax treatment of repair costs?**

6 A. Expenditures for incidental repairs are deductible as incurred for tax purposes.

7 **11. Q. What is a unit of property?**

8 A. The unit of property is the asset to which the "repair" test is applied. The concept is,
9 therefore, critical for distinguishing between repairs (which are currently deductible)
10 and capital costs (which are not). A simple illustration will make this clear. Take the
11 changing of a truck's spark plugs. If each spark plug is defined as a separate unit of
12 property, then the changing of 6 spark plugs represents the retirement of 6 units of
13 property and the installation of 6 new units of property. Because the removal of a
14 unit of property does not, by definition, keep that unit in its normal operating
15 condition, the installation of a new unit of property is a capital cost and not a repair.
16 Consequently, the installation of each spark plug would be a capital addition. By
17 contrast, if the truck was defined as the unit of property, then the changing of spark
18 plugs would not constitute the installation of new units of property. Because a tune-
19 up (of which the spark plug replacements are a part) keeps the truck in its normal
20 operating condition, it would meet the definition of a repair and, as such, be fully

1 deductible. Thus, the same work can produce radically different tax results
2 depending on the definition of a unit of property.

3 **12. Q. What does this example illustrate about units of property?**

4 A. It demonstrates the fundamental characteristic that the larger the unit of property, the
5 more likely it is that projects associated with that asset will qualify as deductible
6 repairs. This is the thrust of the tax strategy discussed by Mr. Effron, i.e., to use
7 larger units of property in the identification of repairs for tax purposes

8 **13. Q. Are there specific rules that govern how taxpayers must define their units of**
9 **property?**

10 A. The rules that govern how one identifies one's units of property for tax purposes are,
11 at least at this point, quite judgmental and, as a consequence, highly uncertain. There
12 exists a broad functional definition and some relatively recent court decisions that lay
13 out a number of factors relevant to the determination. However, the specific rules are
14 far from clear. This is particularly so in the case of network assets such as electric
15 lines, gas and oil pipelines, railroad track, etc.

16 **14. Q. Why is this?**

17 A. In 2006, the Internal Revenue Service ("IRS") issued proposed regulations in which,
18 for the first time, it addressed the determination of a unit of property in a systematic
19 way. In 2008, it withdrew these proposed regulations and issued a revised version.
20 While these revised proposed regulations provided principles and helpful examples

1 for many types of assets, with respect to network assets they said nothing. The

2 Preamble to these proposed regulations contained the following statement:

3 The IRS and Treasury Department generally think that the unit
4 of property rules for network assets should be addressed on an
5 industry by industry basis in Internal Revenue Bulletin
6 guidance. Industries are invited to submit requests for guidance
7 under the Industry Issue Resolution (IIR) program after these
8 regulations are finalized.

9 This invitation indicates that the final determination of units of property for network

10 assets will have to be thrashed out for each industry group interested in pursuing a

11 common definition for that industry.

12 **15. Q. In your view, what did the issuance of the proposed regulations signify relative**

13 **to the identification of network units of property?**

14 A. Nothing, really. The proposed regulations provided no insight over and above that

15 which had been available previously.

16 **16. Q. What units of property does PECO use for tax purposes?**

17 A. PECO uses, and has used for many years, the same units of property definition for tax

18 purposes that it uses for financial and regulatory reporting purposes. These units are

19 quite small.

20 **17. Q. Has the IRS ever challenged PECO's use of these units of property?**

21 A. Not to my knowledge.

1 **18. Q. If PECO had wanted to change its units of property at any time in the past,**
2 **could it have done so?**

3 A. I do not believe so, because the designation of units of property is, under the Internal
4 Revenue Code, a method of accounting. Under the Internal Revenue Code and related
5 regulations, a taxpayer is not permitted to change its method of accounting without
6 the permission of the IRS. The normal way to ask for permission is for the taxpayer
7 to file a Form 3115 Request for Change in Accounting Method with the IRS National
8 Office in Washington D.C. This form requires a good deal of information about both
9 the method the taxpayer wants to change from and the method it wants to change to.
10 The IRS then considers the request and either grants or denies consent.

11 **19. Q. If asked, would the IRS allow a taxpayer to change its units of property?**

12 A. No. It has been my experience that, historically, the IRS has been unwilling to permit
13 taxpayers to change from smaller units of property to larger units of property. I have
14 always presumed the reason for this is the larger repair deductions such a change
15 would allow for. However, recently things have changed.

16 **20. Q. Please explain.**

17 A. In late 2007 and early 2008, the tax community started to hear that the IRS had
18 allowed a few taxpayers to change their units of property. Frankly, this seemed
19 strange because it was unlike the IRS to allow a method change while it was in the
20 process of drafting regulations covering the subject matter. Nevertheless, what the
21 tax community had heard proved true.

1 **21. Q. What was the significance of this IRS change?**

2 A. It meant that the insurmountable hurdle to changing units of property, namely,
3 obtaining IRS consent, might not remain so insurmountable. In fact, the IRS actually
4 granted automatic consent to all such changes in Revenue Procedure 2009-39 referred
5 to by Mr. Effron in his testimony.

6 **22. Q. What did this Revenue Procedure do and, more importantly, what did it not do?**

7 A. The issuance of the Revenue Procedure meant that any uncertainty with regard to
8 one's ability to obtain IRS consent to change its units of property was eliminated.
9 However, it furnished no guidance whatsoever concerning what units of property
10 would be appropriate. In other words, after the Revenue Procedure, you were sure
11 you could change your units of property but you had no better idea than you had
12 before regarding what you could change them to.

13 **23. Q. Please address the uncertainty associated with identifying repairs once**
14 **acceptable units of property are identified.**

15 A. In PECO's case, much of what we are dealing with is linear property – that is, wires
16 and poles. Right now, its units of property are the same for both book and tax
17 purposes. Moreover, the book rules for identifying repairs are substantially similar to
18 the tax rules. Under these circumstances, PECO has generally relied on its book
19 characterization of projects as repairs or capital projects for use on its tax return – and
20 the IRS has generally concurred with this. However, when PECO changes its units of
21 property for tax purposes, it will effectively de-link them from its books (which will

1 not change). As a consequence, it must apply the tax rules to units of property which
2 are not reflected on its books.

3 **24. Q. Is there a tax rule that will create a particular problem for linear units of**
4 **property?**

5 A. Yes there is. One historical tax rule has been that the replacement of a material
6 portion of a linear unit of property is a capital expenditure – not a repair. When a
7 taxpayer uses large units of property, this requires that one must be able to draw a line
8 that divides a material replacement from a non-material replacement. The dividing
9 line is a percentage of the unit of property. Unfortunately, there is no specific
10 percentage that the IRS has identified as being acceptable. It could be 5% or 10% or
11 20% or some other percentage. Thus, even were the units of property certain, the
12 identification of repairs would remain problematic.

13 **25. Q. How is this tax rule relevant to the de-linking you described above?**

14 A. How one actually applies the percentage, whatever it ultimately is, to tax units of
15 property that may not be readily identifiable remains, for now, highly uncertain.

16 **26. Q. Please describe the uncertainty associated with the "catch up" adjustment.**

17 A. When a taxpayer changes a tax accounting method, its tax books and records are
18 essentially restated to conform to what they would have looked like had the taxpayer
19 always used its new method. In the case of a unit of property change for electric
20 distribution plant, the utility will restate the tax basis of its assets as if it had always
21 deducted those projects that would have been repairs had its new unit of property

1 definition been in use for all prior years. Since the tax life of electric distribution
2 assets is 20 years, it needs to go back twenty years and determine in each year what
3 projects it capitalized that would have qualified as repairs under its new unit of
4 property definition. However, since the costs of those projects had, in fact, been
5 capitalized and depreciated for tax purposes, the cumulative incremental repair
6 amount must be reduced by the tax depreciation already claimed to arrive at a net
7 amount by which the tax basis of the distribution assets will be reduced. Because
8 reducing the tax basis will deprive the utility of ever claiming a deduction for the
9 costs reflected in this basis reduction, the tax rules allow the company to claim the
10 entire amount as a deduction in the year in which the change is made. This is the
11 deduction referred to in Mr. Effron's testimony as the Section 481(a) adjustment. It
12 is, in reality, a "catch-up" adjustment.

13 **27. Q. In what way is the "catch up" adjustment uncertain?**

14 A. Even if both the acceptable units of property and the threshold for a material
15 replacement were certain, I am aware of no utility company that has the fixed asset
16 and work order records necessary to retroactively apply these new standards to its last
17 20 years of operations. Records necessary to support the identification of repair
18 projects using these new criteria were simply never created. In other words, if a
19 utility were required to prove each dollar of its "catch-up" adjustment, it could not be
20 done. Only an estimate can be produced, and such an estimate would require the use
21 of assumptions, averaging conventions, ratios, extrapolation, interpolation and
22 numerous other conventions.

1 **28. Q. Is the use of an estimate problematic?**

2 A. A general principle of tax law is that the taxpayer has the burden of justifying every
3 dollar of its claimed deductions. In practice, the IRS generally administers this rule in
4 a reasoned and practical way. In a number of contexts it allows the use of estimates
5 and of statistical analyses. However, the extent to which it does so is largely a matter
6 of administrative discretion. The problem in the calculation of the "catch up"
7 adjustment is that no one knows what estimation processes will be acceptable to the
8 IRS.

9 **29. Q. What does this mean for the level of confidence one can have with respect to the**
10 **tax benefit of the repair method change?**

11 A. The "catch-up" adjustment, which represents by far the largest portion of the tax
12 deduction generated in the year of the method change, is subject to all three
13 uncertainties described previously – the acceptable units of property, the percentage
14 threshold and the permissible processes and procedures. Thus, over all, the
15 calculation of the tax benefit of the repair method change remains uncertain.

16 **30. Q. As a result of this high level of uncertainty, what has the Company decided to**
17 **do?**

18 A. The Company has decided not to rush into a repair accounting method change until at
19 least some of the major uncertainties described above are resolved.

1 **31. Q. When will that be?**

2 A. The investor-owned electric association, the Edison Electric Institute, has accepted
3 the IRS's invitation to develop an industry-specific solution to the repair issue. It is
4 currently engaged in a dialogue that will hopefully resolve much of the uncertainty
5 described above. The people involved in that process have tentatively targeted
6 completion for sometime this fall. In other words, the resolution should be relatively
7 soon.

8 **32. Q. Can you contrast this to what would likely occur in the absence of such a**
9 **process?**

10 A. Absent such industry initiatives, all of these uncertainties would have to be resolved
11 in individual company tax audits and, perhaps, by litigation that would consume vast
12 resources in both funds and management resources and proceed over many years.

13 **33. Q. Why is it that other companies have chosen to proceed in implementing repair**
14 **accounting method changes?**

15 A. While I obviously cannot speak to each company's individual decision, I am aware of
16 two factors which may well have played a role in some of their decisions. The first is
17 access to the capital markets at a reasonable cost. The change in the IRS's position
18 on allowing taxpayers to change their units of property came in the midst of this
19 country's most significant financial crisis since the 1930s. I suspect that a number of
20 companies simply didn't have access to the additional cash they thought they needed
21 at a reasonable cost. Under these circumstances, obtaining funds from the federal

1 government through implementing this accounting method change – even if it meant
2 subsequently paying back a significant portion of those funds with interest – was
3 deemed worth the risk and the follow-on costs associated with resolving the
4 uncertainties. The other factor that may have influenced their decision is that several
5 of the consultants who were promoting this method change (and offering their
6 services to implement it) suggested that, when the proposed repair regulations
7 (referred to earlier in my testimony) were finalized, they might well not allow for a
8 "catch-up" adjustment. That is, implementation of the change would be on a
9 prospective basis only, rather than a retrospective and prospective basis. They
10 therefore encouraged companies to implement quickly in order to "beat" the
11 finalization of those regulations, which could occur at any time. I believe that these
12 two factors bore on the decision of many of the companies that implemented this
13 change. Company management considered both factors. PECO did not face the cash
14 problem because of its strong credit rating, as is discussed in the testimony of Mr.
15 Barnett. Moreover, PECO considered in depth the risk that the "catch-up" adjustment
16 would not be allowed and concluded that the risk was not substantial. Therefore,
17 PECO concluded that the prudent course was to await further clarity. It is certainly
18 not alone in taking this position.

1 **34. Q. Please summarize your conclusions.**

2 A. PECO has sound reasons for not changing its tax accounting method for repairs until
3 the IRS provides some clarity on how the accounting change may be implemented.
4 Additionally, the level of tax benefits that may accrue from implementing a tax
5 accounting change for repairs is, at this point, highly uncertain. PECO made a
6 prudent decision to forego changing its accounting method for repairs in order to
7 allow the industry initiatives now underway to be completed. PECO is actively
8 engaged in the industry processes and intends to implement a properly designed
9 strategy for making and implementing a tax accounting change for repairs when the
10 ground rules that will apply to such a change are better established.

11 **35. Q. Mr. Terry, are the ratemaking implications of Mr. Effron's proposal being**
12 **addressed by PECO?**

13 A. Yes, the implications for ratemaking of Mr. Effron's proposal are addressed by Mr.
14 Alan B. Cohn in PECO Statement No. 9-R.

15 **III. CONCLUSION**

16 **36. Q. Does that conclude your rebuttal testimony?**

17 A. Yes, it does.

Appendix A

Professional Qualifications of Thomas D. Terry, Jr.

Certified Public Accountant

- 24 years professional tax experience, including nine as Exelon's Vice President and General Tax Officer.

Prior Employers

- GE Capital 1994-2001
- Price Waterhouse 1986-1990, 1991-1994
- Coopers & Lybrand 1990-1991