139 FERC ¶ 61,112
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Jon Wellinghoff, Chairman;
Philip D. Moeller, John R. Norris,
and Cheryl A. LaFleur.

ITC Holdings Corp. Docket No. PA10-13-000

ORDER ON PAPER HEARING

(Issued May 11, 2012)

1. This case is before the Commission for review of certain audit findings and recommendations contained in the September 30, 2011 Audit Report (Report) prepared by the Division of Audits in the Office of Enforcement (OE)[1], and contested by ITC Holdings Corp.[2] and ITC Midwest[3] (collectively, ITC).[4] ITC contests the Report's findings that ITC Midwest improperly reported and recovered the tax effects of amortized

[1] The OE Director issued the Report in the above-captioned docket under delegated authority granted by the Commission pursuant to 18 C.F.R. § 375.311 (2011).

[2] ITC Holdings Corp. (ITC Holdings) is the largest independent electric transmission company in the United States. Through its wholly-owned subsidiaries – International Transmission Company (ITCTransmission), Michigan Electric Transmission Company, LLC (METC), ITC Midwest LLC (ITC Midwest), and ITC Great Plains, LLC – ITC Holdings owns high-voltage transmission systems in Michigan's Lower Peninsula and portions of Iowa, Minnesota, Illinois, Missouri, and Kansas.

[3] ITC Midwest is a transmission-owning member of the Midwest Independent Transmission System Operator, Inc. (MISO) whose transmission rates are set under the formula rate in Attachment O of the MISO Open Access Transmission, Energy and Operating Reserve Energy Markets Tariff (MISO Tariff).

[4] For the purposes of this order we refer to ITC Holdings and ITC Midwest collectively as ITC, unless it is factually necessary to distinguish the two.

goodwill.[5] ITC also contests three of the Report's recommendations related to its reporting and recovery of the tax effects of amortized goodwill. In this order, the Commission affirms the Report's findings and recommendations.

I. Background

A. Transaction Order

2. On May 11, 2007, as amended on June 5, 2007, ITC Holdings, ITC Midwest, Interstate Power and Light Company (IPL), and MISO jointly filed the referenced application under sections 203[6] and 205[7] of the Federal Power Act (FPA) seeking authorization for the acquisition by ITC Midwest of all of IPL's jurisdictional transmission facilities and related jurisdictional contracts, agreements, books and records, and approval of the rates, terms and conditions for the sale of certain services (Transaction).[8] In ITC's application, ITC Midwest committed not to recover the acquisition premium in its rates.[9] ITC explained that the acquisition premium was the difference between the total acquisition cost of IPL's transmission assets and the historical basis of the net assets acquired.[10] As relevant here, the goodwill, which represented 100 percent of the acquisition premium, was approximately $330.3 million.

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[5] The phrases "tax effects of amortized goodwill" and "goodwill-related accumulated deferred income tax (ADIT)" are used throughout the record. We find that those two terms are interchangeable and for consistency primarily refer to "tax effects of amortized goodwill" within this order.

[6] 16 U.S.C. § 824b (2006).

[7] 16 U.S.C. § 824d (2006).

[8] ITC Midwest was formed to own and operate the transmission assets that were the subject of the Transaction.

[9] ITC Holdings, Joint Application for Authorization of Acquisition and Disposition of Jurisdictional Transmission Facilities, Approval of Transmission Service Rates and Certain Jurisdictional Agreements, and Approval of Prospective Application of Attachment O, Docket Nos. EC07-89-000 and ER07-887-000, Transmittal Letter at 21 (filed May 11, 2007) (Joint Application).

[10] Joint Application at Exhibit N-1 (Narrative Explanation of Proposed Commission Accounting for the Transaction).

3. On December 3, 2007, the Commission authorized the Transaction and accepted ITC Midwest's proposed rates and agreements, subject to certain terms and conditions (Transaction Order).[11] In that order, the Commission relied in part on ITC's commitment that ITC Midwest would not recover the acquisition premium in rates.[12] The Commission also required ITC Midwest to submit accounting entries relating to the acquisition.[13]

4. On June 18, 2008, ITC Midwest submitted the required accounting entries to the Commission's Chief Accountant (Accounting Filing). In its filing, ITC Midwest reaffirmed its commitment not to recover the acquisition premium in its rates.[14] ITC Midwest also stated that goodwill and corresponding equity amounts are excluded from its Federal Energy Regulatory Commission (FERC) books and records, as it did not seek recovery of the goodwill amounts established in the Transaction. Additionally, ITC Midwest stated that any tax effects of amortized goodwill would be excluded from its FERC books and records.[15]

B. <u>Audit History</u>

5. On November 17, 2009, in Docket No. PA10-13-000, OE issued a public letter commencing the audit of ITC. The audit was to evaluate ITC's compliance with conditions established in the Transaction Order, and covered the period from December 3, 2007 to July 5, 2011.

6. On February 8, 2011, Commission Staff (Staff) sent ITC a draft audit report containing the audit findings and recommendations, as revised on June 20, 2011, to reflect comments made by ITC. The draft audit report identified three main areas of concern. First, ITC Midwest improperly recovered from transmission ratepayers through formula rate billings: (a) amounts associated with the tax effects of amortized goodwill reported in Account 211, Miscellaneous Paid-In Capital; and (b) excessive amounts of allowance for funds used during construction (AFUDC) accrued. Second, ITC Holdings did not obtain the necessary Board approval before issuing dividends and making equity

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[11] *ITC Holdings Corp.*, 121 FERC ¶ 61,229 (2007) (Transaction Order).

[12] *Id.* P 128.

[13] *Id*. at Ordering Paragraph (G).

[14] ITC Holdings *et al.*, Submission of Proposed Accounting Entries, Docket No. AC08-128-000 *et al*. (filed June 18, 2008) (Accounting Filing).

[15] *Id*.

infusions. Third, ITC Midwest did not timely notify the Commission when a shareholder had acquired more than five percent of common stock.

7. Specifically, the draft audit report found that ITC Midwest reported the tax effects of amortized goodwill related to the Transaction in Account 211 in its FERC Form No. 1 (Form No. 1).[16] The draft audit report explained that the tax effects of amortized goodwill is generated from ITC Midwest's goodwill of $330 million being amortized for tax purposes over 15 years, while it is not amortized for financial reporting purposes under Generally Accepted Accounting Principles (GAAP). Furthermore, the draft audit report explained that ITC Midwest estimated that $128 million representing the tax effects of amortized goodwill would be amortized over a 15 year period. Moreover, the draft audit report explained that ITC Midwest's reporting of the tax effects of amortized goodwill increased Account 211 (i.e., equity) by approximately $9 million in 2008 and $9 million in 2009 for a total of $18 million over this two-year period. The draft audit report found that this reporting resulted in increasing ITC Midwest's equity balances used to determine ITC Midwest's capital structure, and, therefore, applied a higher overall rate of return to rate base.[17] This higher rate was applied to formula rate billings to transmission ratepayers. For these reasons, the Report found that: (1) ITC Midwest should not have reported in its Form No. 1 the tax effects of amortized goodwill in Account 211 since it committed in the Transaction application that it would not recognize goodwill or the tax effects of amortized goodwill in its FERC books and records; (2) the accounting used by ITC Midwest overstated its equity and affected the calculation of its actual capital structure used to establish rates, which resulted in the excess billings to transmission ratepayers; and (3) ITC Midwest used the excessive amounts of equity in determining its AFUDC rate, which resulted in ITC Midwest accruing too much AFUDC and recovering excessive amounts of AFUDC from transmission ratepayers.[18]

8. Specifically, the draft audit report recommended that ITC Midwest: (1) cease recording the tax effects of amortized goodwill in its FERC books and records and refrain from reflecting the tax effects of amortized goodwill in the Form No. 1; (2) remove the overstated equity amounts associated with the tax effects of amortized goodwill reported in Account 211 and file all correcting entries and supporting documentation with the Division of Audits; (3) record and file, with supporting documentation, all correcting

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[16] *See ITC Holdings Corp.,* Docket No. PA10-13-000 at Audit Report 11, 15 (Sept. 30, 2011) (unpublished delegated letter order) (the delegated letter order is accompanied by the September 30, 2011 final audit report and ITC Holdings' July 5, 2011 response).

[17] *See* Audit Report at 15, 17.

[18] *Id.* at 16.

entries and calculations to correct all account balances affected by the over-accrual of AFUDC; and (4) adjust formula rate billings, as appropriate, for amounts inappropriately recovered from ratepayers associated with the tax effects of amortized goodwill and related over-accrual of AFUDC, including interest on the adjustments in accordance with 18 C.F.R. § 35.19a.

9. On July 5, 2011, ITC submitted to OE its written response (Response) to the draft audit report.[19] ITC stated that it agreed with the principal audit findings and recommendations for the second and third areas of concern summarized above. However, ITC did not agree to the principal audit findings regarding the first area of concern related to accounting, financial reporting, and rate recovery of the tax effects of amortized goodwill. Moreover, ITC stated that it did not agree with three of the four recommendations associated with the tax effects of amortized goodwill.

10. ITC stated in its Response that ITC Midwest's accounting for the tax effects of amortized goodwill was appropriate because it is in accordance with GAAP. ITC further stated that it was proper for ITC Midwest to recover from transmission ratepayers the tax effects of amortized goodwill since ITC Midwest's accounting for this matter was accurate. Moreover, ITC stated that had ITC Midwest not included the tax effects of amortized goodwill in rates billed to transmission ratepayers, ITC Midwest would have increased the equity portion of its capital structure to the 60 percent equity limit by obtaining the necessary monies to achieve this limit.

11. On September 30, 2011, the OE Director issued a delegated order approving the uncontested audit findings and recommendations.[20] In addition, the OE Director noticed the matters that ITC disagreed with in the Report relating to the reporting and recovery from transmission ratepayers in formula rate billings of the impacts associated with the tax effects of amortized goodwill.

C. Procedural Matters

12. On October 31, 2011, ITC officially notified the Commission of its election of the use of shortened procedures for the Commission to review the contested audit findings related to the tax effects of amortized goodwill and three out of the four recommendations. On December 29, 2011, pursuant to section 41.3 of the Commission's regulations,[21] the Commission directed the commencement of a paper hearing in the

[19] *See supra* note 16.

[20] *Id*.

[21] 18 C.F.R. § 41.3 (2011).

above captioned docket, and provided clarification on the scope of the paper hearing. Specifically, the Commission limited the scope of the paper hearing to the Report's findings and recommendations contested by ITC. The Commission further established a schedule for the filing of initial and reply memoranda.

II. Pleadings

A. Initial Memoranda

13. ITC contends that ITC Midwest honored its commitment not to recover the acquisition premium in rates.[22] ITC maintains that ITC Midwest uses accounting that reflects the current tax benefits that were contributed from ITC Holdings to ITC Midwest in the form of equity.[23] ITC asserts that ITC Midwest records the tax effects of amortized goodwill in Account 283 and removes this amount for FERC reporting purposes by recording an offset in Account 211 at each balance sheet date.[24] Therefore, ITC contends that this accounting allows ITC Midwest to reflect the economic benefits relating to the tax deduction for goodwill that ITC Holdings received for tax purposes.[25]

14. ITC asserts this is appropriate because the goodwill related to the Transaction is attributable to ITC Midwest and because ITC Holdings filed a consolidated tax return (and thus pays taxes on a consolidated basis for all of its subsidiaries), the economic benefit to ITC Midwest is recognized as a reduction in the consolidated group's federal income tax liability allocated to ITC Midwest. ITC claims that this reduction in taxes is properly recorded as an increase to equity resulting from the contribution of the tax benefits, and thus that there is also no over-recovery of AFUDC. ITC also argues that to fulfill its commitment that no acquisition premium be recovered in rates, ITC Midwest explicitly stated that it would remove goodwill and the tax effects of amortized goodwill from the FERC books and records. ITC claims that prior to the audit proceeding, the Commission never raised a concern regarding the accounting to remove goodwill and the tax effects of amortized goodwill, even though the accounting was disclosed in the Form No. 1 filings for ITC Midwest as well as METC and ITCTransmission.[26]

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[22] ITC Holdings Initial Memorandum at 7.

[23] *Id.* at 10.

[24] *Id.*

[25] *Id.* at 10-11.

[26] *Id.* at 11.

15. Therefore, ITC asserts that ITC Midwest's accounting was appropriate and consistent with the commitment made in the Transaction Order that the acquisition premium not be recovered in rates. ITC argues that the retroactive application of the Staff's proposed accounting would not be just and reasonable citing to *Golden Spread Electric Cooperative v. Southwestern Public Service Company*.[27]

16. Staff argues that in ITC's application seeking authorization to purchase IPL's transmission facilities and approval of proposed transmission service rates, ITC stated that: "[N]o recovery in rates of any acquisition premium is being sought [and] no deferral mechanism, and no recovery of [the tax effects of amortized goodwill] is being sought here."[28] Staff asserts that the Commission relied on this commitment in its determination to authorize the Transaction and accept the proposed rates. Staff adds that ITC Midwest reiterated its commitment not to recover goodwill in the compliance filing required by Ordering Paragraph G of the Transaction Order. In addition, Staff asserts that in ITC Midwest's June 18, 2008 Submission of Accounting Entries to the Chief Accountant, in Docket No. AC 08-128-000, ITC stated that goodwill and corresponding equity amounts are excluded from the FERC books and records since ITC Midwest did not seek recovery of the goodwill amounts related to the Transaction. Staff asserts that the Chief Accountant relied on ITC Midwest's commitment in approving ITC Midwest's proposed accounting, which noted that goodwill of $330.3 million and deferred income taxes relating to goodwill were not pushed down to ITC Midwest for regulatory accounting reporting to the Commission.[29] Consequently, Staff contends that amounts associated with goodwill and the tax effects of amortized goodwill should not appear on ITC Midwest's FERC books and records. [30]

17. Thus, Staff claims that the accounting for the tax effects of amortized goodwill was inappropriate. Staff notes that while goodwill is amortized and deducted from income for income tax purposes, it is not for financial reporting purposes under GAAP. Staff states that to recognize the tax effects of amortized goodwill in its GAAP books, ITC Midwest debited deferred income tax expense Account 410.1 and credited Account 283.[31] Staff

[27] *Id.* at 17-18 (citing *Golden Spread Electric Cooperative, Inc. v. Southwestern Public Service Company*, 123 FERC ¶ 61,047, at P 53 (2008)).

[28] Staff Initial Memorandum at 10 (quoting Joint Application Transmittal Letter at 21).

[29] *ITC Midwest LLC*, Docket No. AC08-128-000 (Sept. 23, 2008) (unpublished letter order).

[30] Staff Initial Memorandum at 10-11.

[31] *Id*. at 9.

adds that when deriving its FERC financial reporting amounts, ITC Midwest only debited the tax effects of amortized goodwill amounts included in Account 283 for GAAP purposes and credited 211 for FERC reporting purposes, and that ITC Midwest claims that this entry was intended to remove the tax effects of amortized goodwill from the FERC books and records. However, Staff contends that the entry to Account 410.1 in ITC Midwest's GAAP books was not reported in the FERC books and records and together the entries to Account 283 and Account 211 and the omission of the entry to Account 410.1 in the FERC books and records had the effect of increasing ITC Midwest's equity balances reported in its Form No.1.[32]

18. Staff asserts that it is concerned with the entry to Account 211 on the FERC books and records because equity amounts reported in the account in the Form No. 1 are a component of the formula rate ITC Midwest uses to calculate its transmission revenue requirement.[33] Staff explains that ITC Midwest recovers its cost of service through a formula rate and inputs to that formula rate are derived from its Form No. 1.[34] The amount in Account 211, as reflected in ITC Midwest's Form No. 1, is a component of ITC Midwest's formula calculation and is included in ITC Midwest rates. Thus, Staff contends ITC Midwest's actions are inconsistent with its representations as accepted by the Commission and Chief Accountant that it would exclude goodwill and the tax effects of amortized goodwill from its FERC books and records, and they have also impacted its transmission ratepayers. Staff contends that ITC Midwest's accounting resulted in amounts associated with the tax effects of amortized goodwill appearing in Account 211 of the Form No. 1, and flowing through ITC Midwest's formula rate.[35]

19. Staff contends that ITC Midwest's improper accounting led not only directly to improper rates by distorting the balances in Account 211 included in the capital structure used to derive ITC Midwest's weighted cost of capital in its formula rate, but also indirectly by impacting the AFUDC rate used to book carrying costs in its plant accounts.[36] In this regard, Staff states that ITC Midwest calculates its AFUDC rate according to Electric Plant Instruction No. 3(17) and ITC Midwest accounted for AFUDC in accordance with these instructions.[37] Therefore the inflated equity amounts

[32] *Id.* at 12-14.

[33] *Id*. at 14.

[34] *Id*.

[35] *Id.* at 14-17.

[36] *Id*. at 17-18.

[37] *Id*.

included in Account 211 of its Form No. 1 were used in the determination of its AFUDC rate which led to the company over-accruing AFUDC on construction work in progress costs included in Account 107.[38] Staff argues that ITC Midwest's over-accruing AFUDC capitalized into a plant that has been placed in service inappropriately inflates its rate base in its formula rate.[39] This in turn causes ITC Midwest's transmission revenue requirement to be higher than it would have been without the over-accrued AFUDC amounts. Thus, Staff argues that the Report correctly found that ITC Midwest used the inflated equity balances related to the tax effects of amortized goodwill in determining the AFUDC rate applied to construction expenditures, and that the amounts of AFUDC capitalized as a construction cost included in Account 107 were excessive. Staff adds that ITC did not refute the Report's finding that ITC Midwest used the equity and debt account balances reported in its Form No.1 to calculate its AFUDC rate.[40]

20. In addition, Staff addresses ITC's arguments in its Response that challenged the draft audit report's findings and recommendations. First, Staff argues that notwithstanding ITC's claim that it properly disclosed its intended treatment of the tax effects of amortized goodwill, ITC Midwest never submitted proposed accounting entries reflecting how the tax effects of amortized goodwill would be removed from its FERC books and records.[41] Thus, Staff argues that since ITC Midwest never submitted its proposed accounting entries associated with the tax effects of amortized goodwill to the Chief Accountant for approval, these entries were not approved.[42] Moreover, Staff adds that even assuming, for argument's sake, that the Chief Accountant had implicitly considered and approved ITC Midwest's accounting entries, the accounting approval would not be dispositive of how the accounting transaction should be treated for rate purposes.[43] Second, ITC Midwest's argument that its treatment of the tax effects of amortized goodwill is reasonable from an accounting viewpoint is irrelevant.[44] Staff

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[38] *Id*. at 18.

[39] *Id*.

[40] *Id.* at 17-18.

[41] *Id*. at 19.

[42] *Id*. at 21.

[43] *Id*. at 21-22 (citing *ITC Midwest LLC*, Docket No. AC08-128-000 (Sept. 23, 2008) (unpublished letter order)).

[44] *Id.* at 19-25.

asserts that whether an accounting treatment might be reasonable in general or in the abstract is irrelevant because ITC Midwest was under a specific obligation to exclude the tax effects of amortized goodwill from its FERC books and records.[45]

21. Staff also challenges ITC's claim that its accounting treatment had no impact because ITC Midwest would have managed its equity to debt ratio in such a way that the exact same rates would have been charged. First, Staff notes that the Commission and Chief Accountant's decisions were based on the record before them, and approval of the accounting entries or capital structure submitted in that record does not imply approval of alternative accounting entries or capital structure that was not submitted.[46] Second, Staff argues that there is an important difference between using the tax effects of amortized goodwill to achieve a 60 percent equity to 40 percent debt ratio and using actual capital to achieve that ratio.[47] Staff asserts that if ITC Midwest had complied with its obligation to exclude the tax effects of amortized goodwill from its FERC books and records, then to maintain its 60 percent equity to 40 percent debt ratio, ITC Midwest would have had to receive an infusion of capital and this would have meant that the capital was available for its operation and construction expenditures. Staff states that the inflated equity amounts do not represent a source of tangible capital for operation and construction expenditures.[48] Staff maintains that by correcting its accounting that improperly inflated equity, ITC Midwest would be reporting actual equity that represents amounts invested.[49] Thus, Staff argues that since ITC Midwest's accounting overstated equity amounts associated with the tax effects of amortized goodwill, which impacts rates, the Report correctly found that ITC Midwest should remove those amounts by correcting its accounting entries.[50] Lastly, Staff asks that the Commission affirm the Report's findings and recommendations.[51]

[45] *Id.* at 25-26.

[46] *Id*. at 26-27.

[47] *Id*. at 27.

[48] *Id*.

[49] *Id*. at 28 (citing Handy Testimony at P 48).

[50] *Id.* at 26-28.

[51] *Id.* at 28-35.

22. IPL states that it formerly owned the transmission system that is now owned and operated by ITC Midwest.[52] IPL further states that it bargained for a provision that ITC Midwest would not seek approval of the recovery of any acquisition premium in negotiation for the sale of this transmission system to ITC Midwest.[53] IPL argues that the acquisition may not have been approved by the Commission and relevant state regulatory agencies without such ratepayer protection.[54] IPL points to several Commission cases to support its argument that the acquisition premium should not be recovered in rates.[55] IPL contends that ITC's commitment to ratepayers to not include the acquisition premium in rates cannot be subservient to ITC Midwest's desire to have a capital structure that consists of 60 percent equity.[56] IPL asserts that any ambiguity between ITC Midwest's commitment and its accounting should be resolved in favor of ratepayers.[57] IPL adds that it expects the Commission will ensure that its formula rate process will not be used to undermine the customer protections that were promised in Docket Nos. EC07-89-000 and ER07-887-000.[58] IPL states that it supports the Report's conclusions and audit recommendations.[59]

23. The Iowa Utilities Board (Iowa Board) states that it supports all of the audit findings and recommendations pertaining to this contested matter. The Iowa Board adds that it supports Staff's conclusion that ITC Midwest used an accounting treatment that resulted in the tax effects of amortized goodwill being used to increase equity.[60] The Iowa Board contends that ITC's commitment to ratepayers that the acquisition premium would not be recovered in rates was a significant deciding factor in the Commission

[52] IPL Initial Memorandum at 3.

[53] *Id.* at 13.

[54] *Id.* at 13-14.

[55] *Id.* at 14-15 (citing to *MidAmerican Energy Holdings Company,* 113 FERC ¶ 61,298 (2005); *Michigan Electric Transmission Company, LLC,* 116 FERC ¶ 61,271(2006); *Consolidated Edison, Inc.*, 94 FERC ¶ 61,079 (2001)).

[56] *Id.* at 17.

[57] *Id.*

[58] *Id.* at 19.

[59] *Id.*

[60] Iowa Board Initial Memorandum at 5.

approval of the sale of IPL transmission facilities to ITC Midwest and that the accounting treatment used by ITC Midwest violated this commitment.[61] The Iowa Board also argues that, regardless of whether ITC Midwest would have used other methods to obtain a 60 percent equity to 40 percent debt ratio, there is no real dispute that ITC Midwest, through it accounting, included the tax effects of amortized goodwill in the calculation of its rates.[62] The Iowa Board admonishes ITC Midwest for employing an accounting treatment that resulted in the violation of its commitment not to charge ratepayers for the tax effects of amortized goodwill.[63]

24. The Iowa Office of Consumer Advocate (Iowa Advocate) states that it agrees with the audit findings and recommendations in the Report and asks that the Commission affirm them.[64]

25. Midwest TDUs[65] states that it supports the audit recommendations related to the contested matter. Midwest TDUs contends that the entire acquisition premium must not increase transmission ratepayers' transmission rates consistent with ITC Midwest's commitment not to recover such amounts associated with any goodwill or acquisition premium. Midwest TDUs also contends that isolating ratepayers from the acquisition premium requires that the tax effects of amortized goodwill be removed from ITC Midwest's equity balance.[66]

26. IPL, Iowa Board, the Iowa Advocate, and Midwest TDUs support the Report's finding that ITC Midwest used excessive amounts of equity in its AFUDC rate which resulted in ITC Midwest accruing too much AFUDC and recovering excessive amounts of AFUDC from ratepayers.[67] They also support the Report's recommendations 2 through 4 that required ITC Midwest to remove the excessive amount of equity and

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[61] *Id.* at 6.

[62] *Id*.

[63] *Id.*

[64] Iowa Advocate Initial Memorandum at 2.

[65] Midwest TDUs in this proceeding consist of Midwest Municipal Transmission Group, Missouri River Energy Services, and WPPI Energy.

[66] Midwest TDUs Initial Memorandum at 3.

[67] *See* IPL Initial Memorandum at 16, 19; Iowa Board Initial Memorandum at 5-6; Iowa Advocate Initial Memorandum at 2; Midwest TDUs Initial Memorandum at 3, 6.

make refunds for amounts improperly billed to transmission ratepayers through formula rate billings.

B. Reply Memoranda

27. ITC maintains that ITC Midwest upheld its commitment to exclude goodwill and the tax effects of amortized goodwill from its rates.[68] ITC also contends that Staff did not properly analyze ITC Midwest's journal entries in its Form No. 1. ITC states that it acknowledges that Account 283 and the equity accounts are relevant in this proceeding for ITC Midwest's formula rate.[69] ITC adds that ITC Midwest's accounting has a zero net effect on equity in both Account 283 and its equity accounts.[70]

28. ITC asserts that the increase to equity reported in ITC Midwest's Form No. 1 is not an improper recovery of the tax effects of amortized goodwill.[71] Rather, ITC contends that the increased equity reflects contributions from the tax effects of amortized goodwill.[72] ITC states that the contributions associated with the tax effects of amortized goodwill lowers ITC Midwest's portion of the consolidated group's tax liability, which in turn, reduces ITC Midwest's share of payments owed to its parent, ITC Holdings, for its portion of the consolidated tax liability. ITC further states that the benefit of ITC Midwest paying lower taxes allowed ITC Midwest to invest in the transmission system.[73]

29. ITC argues that ITC Midwest recorded the tax effects of amortized goodwill in Account 283 with an offsetting entry to Account 410.1, and that this amount is reported in its Form No. 1. ITC adds that ITC Midwest removed the tax effects of amortized goodwill from Account 283 with an offsetting entry to Account 211. ITC states that the net effect of these entries on equity is $0.[74] Accordingly, ITC states that ITC Midwest's accounting for the tax effects of amortized goodwill resulted in a net $0 impact on equity

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[68] ITC Holdings Reply Memorandum at 5-7.

[69] *Id.*

[70] *Id.*

[71] *Id.* at 7-8.

[72] *Id.*

[73] *Id.* at 7.

[74] *Id*. at 5-7.

and did not "inflate" equity or wrongly affect formula rate billings for the tax effects of amortized goodwill.[75]

30. ITC disagrees with Staff's statements that ITC Midwest's equity balance is "inflated" because there is no cash being generated for the tax goodwill deductions.[76] ITC counters that this is not the case because ITC Midwest received tax benefits from the amortization of tax goodwill through 2010.[77] ITC contends that the contributions of the tax benefits relating to amortized goodwill from ITC Holdings to ITC Midwest resulted in a reduction in the amount of the consolidated tax liability paid by ITC Midwest. ITC argues that Staff's assertion that the resulting increase in equity does not represent a source of tangible capital for operation and construction expenditures is incorrect. ITC further argues that the benefit of ITC Midwest paying less for its share of the consolidated tax liability has been used by ITC Midwest to invest in the transmission system.[78]

31. ITC clarifies that its argument that ITC Midwest would have achieved a 60 percent equity to 40 percent debt capital structure "relates to a scenario where ITC [Holdings] would cease contributing current tax benefits of goodwill to ITC Midwest."[79] ITC asserts that this is not a hypothetical assumption, as ITC Midwest has demonstrated that it consistently maintains such a capital structure.[80] ITC reiterates its belief that the tax effects of amortized goodwill that were allocated to ITC Midwest in the consolidated tax return were a tangible source of equity, and that it should not be required to retroactively adjust equity for those amounts based on Staff's preference, particularly when ITC Midwest maintains 60 percent equity in its capital structure.[81]

32. ITC argues that the current tax effects of amortized goodwill through 2010 were permissible to be contributed to ITC Midwest, and notes that it has submitted

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[75] *Id*. at 4.

[76] *Id*. at 7.

[77] *Id*.

[78] *Id*.

[79] *Id*. at 9.

[80] *Id.*

[81] *Id.* at 9-10.

independent expert testimony in support of this position.[82] ITC argues that there is no basis to require ITC Midwest to retroactively remove this tangible source of equity that was the result of the allocation of the current tax effects of amortized goodwill to ITC Midwest, since it did not result in ITC Midwest violating its hold harmless commitment.[83] According to ITC, requiring a change in ITC Midwest's accounting for the current tax effects of amortized goodwill could be seen as a preference of Staff for FERC reporting. ITC states that this preference is not, however, a requirement for proper ratemaking.[84]

33. ITC argues that Staff's assertions that ITC Midwest failed to submit accounting entries that should have been submitted, or to get approval to transfer balances between certain accounts have no bearing on the outcome of this proceeding because ITC Midwest's accounting entries resulted in no effect on equity from goodwill and the tax effects of amortized goodwill in the Form No. 1.[85]

34. ITC explains that it takes seriously its commitment not to recover the acquisition premium associated with the Transaction, and appreciates the Iowa Board's recognition that ITC intended to fulfill its commitment to exclude the acquisition premium and associated tax effects.[86] ITC argues that the credit to paid-in capital shown in Account 211 was not merely a "reclassification" of amounts originally recorded to Account 283, with the result that the tax effects of amortized goodwill still appear in ITC Midwest's FERC books and records.[87] ITC reiterates that the entries to Account 211 utilized by ITC Midwest offset the amounts recorded to Account 410.1 and result in $0 net effect on equity.

35. In addition, ITC contends that it did not overstate AFUDC because ITC Midwest's accounting for the tax effects of amortized goodwill had a net zero dollar impact on equity.[88] ITC states that because it has shown that goodwill and the tax effects of

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[82] *Id*. at 9.

[83] *Id*.

[84] *Id*.

[85] *Id*. at 10.

[86] *Id*. at 12.

[87] *Id*.

[88] *Id*. at 4.

amortized goodwill have not inflated ITC Midwest's equity, it follows that no over-accruing of AFUDC occurred.

36. Staff explains that the Commission's longstanding policy on acquisition premiums is to exclude rate recovery of acquisition premiums, including goodwill, unless the company is able to prove that benefits equal to the acquisition premium and measurable in dollars were conferred on its transmission ratepayers.[89] Staff states that in ITC's application seeking authorization to purchase IPL's transmission facilities and approval of proposed transmission service rates, ITC stated that: "[N]o recovery in rates of any acquisition premium [i.e., goodwill] is being sought."[90] Accordingly, Staff states that pursuant to the Commission's longstanding policy, there was no need for the Commission to evaluate the benefit of goodwill to transmission ratepayers; based on ITC's own representation, that there would be no impact on these ratepayers.[91]

37. Staff argues that notwithstanding the accounting used, ITC Midwest committed that goodwill and the tax effects of amortized goodwill would neither be included in its transmission service rates nor in its FERC books and records.[92] Staff asserts that ITC Midwest contravened these commitments by using an accounting scheme that resulted in the tax effects of amortized goodwill being recorded on its FERC books and records in order to artificially inflate its equity balances reported in Account 211 of its Form No. 1. Specifically, Staff contends that when ITC Midwest acquired IPL's transmission assets it recorded goodwill originating from the transaction in its GAAP-based books and records by debiting Account 186, Miscellaneous Deferred Debits, and crediting Account 211, Miscellaneous Paid-In Capital.[93] To remove goodwill and related equity amounts from its FERC books and records, Staff states that ITC Midwest debited Account 211 and credited Account 186. Staff maintains that this accounting was appropriate because it removed goodwill and related equity from ITC Midwest's FERC books and records, and excluded it from transmission service rate determinations.[94]

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[89] Staff Reply Memorandum at 3.

[90] *Id*. at 4 (citing ITC Holdings, Joint Application, Docket Nos. EC07-89-000 and ER07-887-000, Transmittal Letter at 21 (filed May 11, 2007); Staff Initial Memorandum at 5-6, 10-16; ITC Holdings Initial Memorandum at 2-3).

[91] Staff Reply Memorandum at 4.

[92] *Id*. at 6.

[93] *Id*. at 7.

[94] *Id*.

38. However, Staff states that after the initial removal of goodwill and related equity in 2007, ITC Midwest repeatedly made accounting entries to record and remove goodwill and related equity from its FERC books and records at each reporting period.[95] Staff argues that the only reason to record and remove goodwill and related equity on ITC Midwest's FERC books and records again in 2008, 2009, and 2010, after it was initially removed in 2007, is to support an accounting scheme to place the tax effects of amortized goodwill on its FERC books and records, something ITC Midwest committed not to do.[96]

39. Staff states that the sole purpose of ITC Midwest's accounting scheme was to improperly recover from ratepayers, through formula rate billings, amounts associated with tax benefits stemming from the amortization of the goodwill for tax purposes.[97] Staff also states that ITC did not bring this matter squarely before the Commission. Staff argues that had ITC Midwest permanently removed goodwill, and therefore excluded the tax effects of amortized goodwill, as represented in the accounting entries submitted to the Chief Accountant, rather than engaging in an accounting scheme to move these amounts in and out of its FERC books and records, there would not have been any rate impact on transmission ratepayers.[98]

40. Staff asserts that ITC's contention that the journal entries associated with the tax effects of amortized goodwill were reviewed and approved by the Commission is wrong. Staff argues that despite having been ordered by the Commission to "provide all the accounting entries related to the transfer," ITC Midwest submitted no accounting entries reflecting the removal of the tax effects of amortized goodwill associated with the Transaction.[99] Staff asserts that ITC Midwest failed to explain to the Chief Accountant that it intended to "exclude" the tax effects of amortized goodwill from its FERC books and records by first recording it there at each reporting period through a debit to Account 410.1 and a credit to Account 283, and then recording offsetting accounting entries to "remove" the amounts through a debit to Account 283 and a credit to Account 211.[100] Staff argues that ITC Midwest's refusal to submit accounting entries associated with the tax effects of amortized goodwill together with its explicit commitment to "exclude" such

[95] *Id*. at 8.

[96] *Id*.

[97] *Id*.

[98] *Id*. at 9.

[99] *Id*. at 12 (quoting Transaction Order at Ordering Paragraph (G)).

[100] *Id*. at 13.

tax effects from its FERC books and records implied that the tax effects of amortized goodwill would not be reflected anywhere in its FERC books or records.[101]

41. Staff also disagrees with ITC's arguments that ITC Midwest's accounting was consistent with accounting that had been employed in connection with the tax effects of amortized goodwill by two of ITC Holding's other subsidiaries, METC and ITCTransmission.[102] Staff states that the rate requirements of the Transaction Order are not subservient to the Chief Accountant's accounting determinations and that the Commission has held that rate treatment of a transaction is not dictated by its accounting treatment. Staff also states that to the extent that ITC Midwest's accounting scheme impacted rates contrary to the rate requirements of the Transaction Order, the accounting will be inappropriate. Staff asserts that the relevant question now before the Commission is not whether ITC Midwest's accounting is similar to that used by other ITC Holdings jurisdictional subsidiaries; it is instead, whether ITC Midwest's accounting is consistent with the rate requirements of the Transaction Order. According to Staff, it is not. Furthermore, Staff notes that the tax effects at issue here are a byproduct of goodwill. Therefore, Staff states that if there is no goodwill recorded on the FERC books and records then there should not be any tax effects of amortized goodwill recorded.

42. Staff contends that ITC's arguments that if ITC Midwest had known that it could not credit the tax effects of amortized goodwill to Account 211, ITC Midwest would have achieved an identical capital structure and rate result by some other means is irrelevant. Staff maintains that ITC Midwest had the opportunity and the obligation to do it right the first time; having failed to do so, it is not entitled to a "do-over."[103]

43. Staff disagrees with ITC's contention that it was permissible to recover the tax effects of amortized goodwill in ITC Midwest's transmission service rates because the accounting ITC Midwest employed to do so was reasonable from the perspective of GAAP. Staff contends that given ITC Midwest's obligation to keep the acquisition premium (*i.e.*, the transaction-related goodwill) out of its transmission service rates and off of its FERC books and records, the only relevant issue is whether ITC Midwest did this.

44. Staff reiterates its position that ITC Midwest's improper accounting for the tax effects of amortized goodwill also impacted the determination of its rate for AFUDC because the inflated equity amounts included in Account 211 were used in the calculation

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[101] *Id*.

[102] *Id*. at 14.

[103] *Id*. at 22.

of its AFUDC rate. Staff asserts that this led to ITC Midwest accruing excessive amounts of AFUDC on construction work in progress costs included in Account 107. Staff concludes that the Report correctly found that ITC Midwest inflated its equity balances recorded in Account 211, and used the equity in determining its AFUDC rate and transmission service rate, which resulted in it collecting amounts associated with the tax effects of amortized goodwill from transmission ratepayers.

45. Midwest TDUs contends that ITC Midwest's tax benefit from the amortization of goodwill benefits shareholders alone, and does not reduce ratepayers' tax-based charges.[104] Midwest TDUs asserts that ITC Holding transferred to ITC Midwest an intangible asset related to the tax effects of amortized goodwill and called it equity, which was detrimental to ratepayers.[105] Had ITC Holdings infused tangible capital, ITC Midwest could have used that capital for ratepayer benefits such as operation and construction expenditures, or retiring its most expensive debt sooner and reducing its short-term borrowing, thereby reducing its AFUDC accruals.[106] Midwest TDUs argues that ITC Midwest was not transparent in its rate treatment of the tax effects of amortized goodwill.[107]

III. <u>Discussion</u>

A. <u>Recovery of Goodwill and AFUDC</u>

46. ITC claims that its accounting for goodwill did not result: (1) in the recovery of goodwill in ITC Midwest's rates; (2) in inflating ITC Midwest's equity; (3) in the over-recovery of AFUDC; and (4) in the recovery of the acquisition premium in violation of ITC's commitment. Staff contends that ITC Midwest's actions are inconsistent with its representations as accepted by the Commission and Chief Accountant that it would exclude goodwill and the tax effects of amortized goodwill from its FERC books and records, and also impacted its transmission ratepayers. Staff contends that ITC Midwest's accounting resulted in amounts associated with the tax effects of amortized goodwill appearing in Account 211 of the Form No. 1, and flowing through the equity included in the capital structure used to derive ITC Midwest's weighted cost of capital in its formula rate.[108] Staff also contends that ITC Midwest's improper accounting led

[104] Midwest TDUs Reply Memorandum at 2.

[105] *Id*. at 3.

[106] *Id.*

[107] *Id*. at 3-4.

[108] *Id.* at 14-17.

directly to improper rates by distorting the balances in Account 211, and indirectly by impacting the AFUDC rate.

Commission Determination

47. We disagree with ITC and affirm the Report's findings that due to improper reporting of the tax effects of amortized goodwill in the Form No. 1, ITC Midwest incorrectly determined its actual capital structure and AFUDC rate that resulted in customers paying too much through formula rate billings. As an initial matter, we note that, in the Transaction Order, the Commission relied on ITC Midwest's commitment not to recover the acquisition premium (i.e., goodwill amounting to $330.3 million) in rates so that transmission ratepayers would not be adversely impacted by any amounts related to goodwill. Additionally, this ratepayer protection was expected to be achieved by excluding all amounts related to goodwill from its FERC books and records. In this regard, we find that in the Accounting Filing ITC Midwest represented that it would refrain from including goodwill and the tax effects of amortized goodwill in its FERC books and records.

48. The Report found that ITC Midwest failed to meet its commitments because it improperly recovered from transmission ratepayers through formula rate billings amounts associated with the tax effects of amortized goodwill and excessive amounts of AFUDC accrued on construction expenditures. We find that ITC Midwest implemented accounting and financial reporting practices that recorded, reported, and subsequently removed goodwill and the tax effects of amortized goodwill each year between 2008 and 2010. This was done in a manner that resulted in an overall increase to ITC Midwest's equity balance which it included in formula rate billings to transmission ratepayers. By increasing equity by the tax effects of amortized goodwill used to determine its formula rate billing, ITC Midwest recovered a higher return on rate base and capitalized additional amounts of AFUDC. Therefore, we agree with Staff that ITC Midwest did not meet its commitment, as ordered by the Commission in the Transaction Order, to shield transmission ratepayers from paying for the acquisition premium that resulted from ITC acquiring from IPL transmission facilities and related jurisdictional contracts, agreements, and books and records. We also agree with Staff that ITC Midwest did not fully comply with the Chief Accountant letter order by recording and reporting amounts related to goodwill in its FERC books and records when ITC Midwest represented to the Chief Accountant that it would not do so. We also affirm the Report's findings related to the rate, accounting, and financial reporting of the tax effects of amortized goodwill and AFUDC.

49. The Commission has a long-standing policy related to the recovery of acquisition premiums, including goodwill, through rates.[109] In *United Gas Pipe Line Co.*, the Commission denied rate base treatment for amounts paid in excess of the original cost of certain properties.[110] The Commission determined that such amounts could not be automatically included in rate base.[111] To hold otherwise would be to permit an increase in the rate base associated with a facility simply through a change in ownership of the facility.[112] As we have noted, a change in ownership alone does not increase the service value of a facility and provides no basis for increasing rates charged to transmission ratepayers.[113]

50. Furthermore, the Commission has explained in its Merger Policy Statement that it historically has not permitted rate recovery of acquisition premiums.[114] To receive rate recovery of any amounts related to an acquisition premium, a public utility must request Commission authorization pursuant to section 205 of the FPA.[115] Here, ITC Midwest reported amounts related to its goodwill (i.e., acquisition premium) in FERC books and

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[109] *Arkla Energy Res., Inc.*, 61 FERC ¶ 61,004, at 61,038 (1992); *Locust Ridge Gas Company*, 29 FERC ¶ 61,052 (1984); *United Gas Pipe Line Co.*, 25 FPC 26, 64 (1961), *rev'd on other grounds sub nom. Willmut Gas & Oil Co. v. FPC*, 299 F.2d 111, (D.C. Cir. 1962).

[110] *United Gas Pipe Line Co.*, 25 FPC 26, 64 (1961), *rev'd on other grounds sub nom. Willmut Gas & Oil Co. v. FPC*, 299 F.2d 111 (D.C. Cir. 1962).

[111] *Id*.

[112] *Arkla Energy Res., Inc.*, 61 FERC ¶ 61,004, at 61,038 (1992) (*citing United Gas Pipe Line Co.*, 25 FPC 26, 64 (1961), *rev'd on other grounds sub nom. Willmut Gas & Oil Co.* v. FPC, 299 F.2d 111 (D.C. Cir. 1962)).

[113] *Id*.

[114] *Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement*, Order No. 592, FERC Stats. & Regs. ¶ 31,044 (1996), *reconsideration denied*, Order No. 592-A, 79 FERC ¶ 61,321 (1997); *see also FPA Section 203 Supplemental Policy Statement*, FERC Stats. & Regs. ¶ 31,253 (2007).

[115] *Duke Energy Moss Landing*, 86 FERC ¶ 61,227, at 61,816 (1999) (*citing Mid-Louisiana Gas Company*, 7 FERC ¶ 61,316, at 61,682, *reh'g denied*, 8 FERC ¶ 61,227 (1979), *aff'd sub nom. Transcontinental Gas Pipe Line Corp. v. FERC,* 652 F.2d 179 (D.C. Cir. 1981)) (rate recovery of an existing facility is generally limited to the original cost of the facility).

records. However, ITC Midwest erred because the net effect of its accounting resulted in the tax effects of amortized goodwill being included in its formula rate calculations without Commission authorization. Therefore, we find that ITC Midwest should have protected transmission ratepayers from absorbing the impacts of the acquisition premium regardless of the accounting method used under GAAP or the Commission's accounting regulations. In addition, we find that ITC Midwest would have needed to make a filing with the Commission under section 205 if it was seeking to recover the acquisition premium from transmission ratepayers, which it did not do; under Commission policy, rate recovery of purchase accounting adjustments or goodwill in cost-based rates is allowed only if the acquisition is prudent and provides measurable, demonstrable benefits to ratepayers.[116]

51. Also, we agree with Staff that the increased equity stemming from ITC Midwest treatment of the tax effects of amortized goodwill was incorrectly used by ITC Midwest in determining the amount of AFUDC capitalized on construction expenditures. Moreover, we agree with Staff that these excessive amounts were improperly recovered from transmission ratepayers. We, therefore, affirm the Report's finding that ITC Midwest incorrectly billed transmission ratepayers for excessive amounts of AFUDC accrued as a result of using the increased equity amounts in the determination of AFUDC rates.

52. We note that ITC and Staff make several arguments concerning the proper accounting for the tax effects of amortized goodwill. These arguments are largely irrelevant because the issue of primary concern is not accounting but rather whether transmission ratepayers were affected by amounts related to goodwill. We emphasize that accounting does not drive ratemaking.[117] We will nevertheless address certain accounting arguments raised by ITC and Staff to clarify that ITC Midwest's accounting indeed resulted in an overall increase to equity, is not representative of the commitments made to the Commission and Chief Accountant, and should not have been reflected on its FERC books and records.

53. First, we note that ITC argues that ITC Midwest's accounting for the tax effects of amortized goodwill had no effects on equity by analyzing ITC Midwest's accounting to record and remove deferred income taxes related to goodwill. However, ITC states that it

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[116] *See Minnesota Power & Light Co.*, 43 FERC ¶ 61,104, at 61,342, *reh'g denied*, 43 FERC ¶ 61,502 (1988); *Duke Energy Moss Landing, LLC,* 83 FERC ¶ 61,318, at 62,304 (1988); *PSEG Power Connecticut,* 110 FERC ¶ 61,020, at P 32 (2005).

[117] *See Entergy Services, Inc*., 130 FERC ¶ 61,026, at P 89 (2010); *Southern Co. Services, Inc.*, 116 FERC ¶ 61,247, at P 23 (2006); *North Penn Gas Co.*, 13 FERC ¶ 61,084, at 61,174 (1980).

used accounting to record both the current and deferred tax effects of amortized goodwill.[118] Additionally, Staff illustrates that ITC Midwest's accounting for the tax effects of amortized goodwill affects both current and deferred income tax accounts, and when the entirety of ITC Midwest's accounting is analyzed it results in an overall increase to equity.[119] We thus find ITC's claim that its accounting for the tax effects of amortized goodwill had no effects on equity may be accurate as it relates solely to recording and removing amounts from its deferred income tax account. However, this argument is incomplete because it does not consider the entirety of ITC Midwest's accounting related to goodwill and the tax effects of amortized goodwill. When ITC Midwest's accounting for both current and deferred income taxes related to the tax effects of amortized goodwill is analyzed together, it results in an increase to equity, which was reflected in formula rate billings to transmission customers. Consequently, ITC Midwest breached its commitment not to recover the acquisition premium in rates.

54. Next, we note that ITC Midwest made commitments to the Commission and Chief Accountant that it would not seek rate recovery for the goodwill portion of the total acquisition cost and tax effects of amortized goodwill.[120] In its rate application, filed with the Commission, ITC specifically stated that "for FERC accounting, the amounts relating to goodwill and the related equity and accumulated deferred income taxes will not be pushed down to ITC Midwest. [ITC] believe[s] the most appropriate depiction of ITC Midwest's capital structure for FERC accounting and ratemaking is to remove the effects of goodwill."[121] Additionally, ITC stated that "the goodwill amounts and associated deferred income taxes are not to be recovered through rate making and the related equity amount is not representative of a capital structure for FERC accounting."[122] ITC Midwest made similar statements to the Chief Accountant in its request for approval of its accounting for the Transaction. In its Accounting Filing, ITC Midwest stated that "goodwill of $330.3 million and deferred income taxes relating to goodwill were not pushed down to ITC Midwest for regulatory accounting reporting to the Commission, as ITC Midwest is not seeking recovery of goodwill for ratemaking purposes."[123] However, ITC Midwest's proposed accounting did not present proposed

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[118] Initial Memorandum at 10.

[119] Staff Reply Testimony at 15-17.

[120] Joint Application at 19, Exhibits N-1, N-2; Accounting Filing at Entry B.1, Section I.

[121] Joint Application, at Exhibit N-1.

[122] *Id*.

[123] *Id*.

journal entries reflecting the accounting practice it subsequently implemented that we take issue with now. In light of ITC's representations to the Commission and Chief Accountant, we conclude that no amounts related to goodwill should have been reported on ITC Midwest's Form No. 1 and goodwill should have been excluded from its formula rate determinations.

55. We also note that ITC made several arguments that ITC Midwest clearly presented the Chief Accountant with its accounting process to report the tax effects of amortized goodwill. However, ITC does not present any facts to support these arguments. ITC Midwest did, however, state that "any accumulated deferred income taxes relating to this goodwill will be excluded from the FERC books and records."[124] Accordingly, ITC Midwest's FERC books and records were expected, and as a result its Form No. 1, was expected to exclude all deferred income tax amounts related to goodwill. ITC Midwest's statement did not indicate that the tax effects of amortized goodwill would be reported in equity but not in the deferred income tax liability accounts. We also point out that the Commission's accounting and financial reporting regulations are neither the appropriate vehicle nor proper forum to achieve a desired rate outcome or recover acquisition premiums from transmission ratepayers. As discussed above, we find that ITC Midwest would have needed to make a section 205 filing with the Commission to seek recovery of the acquisition premium from transmission ratepayers. ITC Midwest should have protected transmission ratepayers from absorbing the impacts of the tax effects of amortized goodwill regardless of the accounting method used to record and subsequently remove goodwill and the tax effects of amortized goodwill from the Commission's book and records.

56. Finally, we note that ITC incorrectly states that ITC Midwest's accounting for the tax effects of amortized goodwill is correct because it is in conformance with GAAP. This accounting and justification may, perhaps, be appropriate for GAAP accounting and reporting purposes but it is decidedly not for accounting and reporting to the Commission. Accounting and reporting to the Commission must be consistent with the Commission's Uniform System of Accounts and relevant Commission orders.[125] Based on the Transaction Order and Chief Accountant Order, which rely on commitments by ITC Midwest that goodwill and the tax effects of amortized goodwill would be excluded from its FERC books and records, all amounts related to goodwill and the tax effects of amortized goodwill should be excluded from ITC Midwest's FERC books and records. ITC Midwest's representations in no way explicitly stated or even implied that amounts related to the tax effects of amortized goodwill would remain on its FERC books and

[124] Accounting Filing at Entry B.1.

[125] 18 C.F.R. pt. 101 (2011).

records, and therefore, such practice was never approved by the Commission or Chief Accountant.

B. Report Recommendations

57. As explained above, ITC only agreed with the Report's first recommendation: (1) cease recording the tax effects of amortized goodwill in its FERC books and records and refrain from reflecting the tax effects of amortized goodwill in the Form No. 1. ITC did not agree with the Report's recommendations 2 through 4; (2) remove the overstated equity amounts associated with the tax effects of amortized goodwill reported in Account 211 and file all correcting entries and supporting documentation with the Division of Audits; (3) record and file, with supporting documentation, all correcting entries and calculations to correct all account balances affected by the over-accrual of AFUDC; and (4) adjust formula rate billings, as appropriate, for amounts inappropriately recovered from ratepayers associated with the tax effects of amortized goodwill and related over-accrual of AFUDC, including interest on the adjustments.

58. ITC reiterates that, even assuming *arguendo* that Staff is correct that the accounting employed by ITC Midwest violates the commitment not to recover the acquisition premium, transmission ratepayers have not been harmed because the capital structure used for purposes of rate making would have been the same 60 percent equity to 40 percent debt ratio. Thus, ITC states that no retroactive changes to ITC Midwest's accounting, or refunds, are appropriate.

59. Staff argues that the issue before the Commission is whether ITC Midwest excluded goodwill from its formula rates, regardless of accounting, consistent with its commitments to the Commission and the Commission's longstanding policy on goodwill. Staff states that since ITC Midwest failed to exclude the tax effects of amortized goodwill in its transmission service and AFUDC rates, it should be required to refund those amounts.

60. IPL asserts that ITC Midwest's contention that it would have obtained a 60 percent equity to 40 percent debt ratio through other means cannot override the commitment that IPL bargained for in the Transaction – that ITC Midwest would not charge ratepayers for the acquisition premium.[126]

61. Midwest TDUs disagrees with ITC's contention that ratepayers are indifferent as to the means by which ITC Midwest reaches its 60 percent equity to 40 percent debt capital structure.[127] Midwest TDUs states that if ITC Midwest had obtained its capital structure

[126] Accounting Filing at Entry B.1.

[127] Midwest TDUs Initial Memorandum at 5.

by an alternative method, such as retiring bonds or receiving a cash infusion from ITC Holdings, it would have presumably reduced its cost of debt.[128] Instead, the accounting treatment used by ITC Midwest cost ratepayers more than if it had undertaken different methods to achieve its 60 percent equity to 40 percent debt capital structure.[129]

62. The Iowa Advocate, IPL, Midwest TDUs, and Iowa Board state that the Report's recommendations are correct and should be affirmed by the Commission.

Commission Determination

63. ITC agrees that ITC Midwest should cease recording the tax effects of amortized goodwill in its FERC books and records and refrain from reflecting these amounts in its Form No. 1. However, we agree with Staff that, since ITC Midwest improperly included the tax effects of amortized goodwill in its transmission service and AFUDC rates, it should be required to refund those amounts. As discussed above, ITC did not honor its commitment to protect transmission ratepayers from absorbing the acquisition premium in the IPL acquisition transaction. Furthermore, ITC Midwest employed an inappropriate accounting process that was not presented to or approved by the Commission or the Chief Accountant. Staff correctly points out that jurisdictional entities that employ improper accounting are not entitled to reap the benefits of that improper accounting in rates charged to transmission ratepayers.[130] In addition, we agree with Staff that ITC Midwest accrued too much AFUDC because of the increased equity stemming from the tax effects of amortized goodwill, and that these excess amounts were billed to transmission ratepayers. Accordingly, we affirm all of the Report's recommendations related to the tax effects of amortized goodwill and AFUDC.

64. We disagree with ITC's arguments that ITC Midwest should not be required to retroactively adjust equity for the tax effects of amortized goodwill amounts in 2008-2010 because ITC Midwest maintains its actual capital structure to 60 percent equity. As discussed above, the amounts related to the tax effects of amortized goodwill should not have been recorded anywhere in ITC Midwest's FERC books and records regardless of whether such accounting might be appropriate under GAAP. Because of ITC Midwest's commitments to the Commission, the tax effects of amortized goodwill that is recognized under GAAP should not be recognized in the Form No. 1 or as a reduction to ITC Midwest's rate base. Likewise, the impact on equity for the same amount that may be

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[128] *Id.*

[129] *Id.*

[130] Staff Initial Memorandum at 33 (citing *New England Power Company*, 64 FERC ¶ 62,210, at 64,260 (1993)).

recognized under GAAP is not to be recognized in the Form No. 1 or ITC Midwest's capital structure. Accordingly, the Report's audit findings and recommendations appropriately identify and correct an error in accounting for Commission reporting purposes, and make transmission ratepayers whole for excessive amounts billed to them because of ITC Midwest's erroneous accounting and financial reporting in the Form No. 1.

65. Additionally, we point to ITC Midwest's authorized capital structure which requires that the equity portion of capital structure is not to exceed 60 percent equity for rate purposes. We note that this capital structure was approved by the Commission, and it is not a hypothetical capital structure. Furthermore, ITC Midwest's capital structure is determined by the accounting information included in its FERC books and records which is reported in the Form No. 1. ITC argues that, if ITC Midwest did not implement the accounting practice for the tax effects of amortized goodwill, ITC Midwest would have achieved 60 percent equity in its capital structure through other means. ITC's argument is irrelevant because ITC Midwest did not have a capital structure of 60 percent equity for 2008 through 2010 absent increasing equity by the tax effects of amortized goodwill. In addition, ITC's argument that it would have increased ITC Midwest's equity through other means is speculative because it is unknown as to what ITC Midwest would have actually done had it not recorded these amounts in Account 211.

66. Citing to *Golden Spread*, ITC argues application of the Report's recommendation would not be just and reasonable, and would be punitive.[131] However, we agree with Staff that *Golden Spread* is inapposite here. *Golden Spread* involved a fuel cost adjustment clause that the Commission ruled to be ambiguous. Therefore, in *Golden Spread*, the Commission exercised its discretion not to impose retroactive refunds but to apply the clarification of the fuel cost adjustment clause to take effect as of the refund effective date established in those proceedings. In this instant case, we do not find that there was any ambiguity on the proper rate and accounting treatment of the tax effects of amortized goodwill for Commission accounting, reporting, and ratemaking purposes. Moreover, ITC was obligated under the Transaction Order to not include goodwill in its rates. Therefore, consistent with our precedent, where a public utility fails to employ the proper accounting leading to the recovery in transmission service rates of money to which it is not entitled, refunds are in order.[132]

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[131] *Golden Spread Electric Cooperative, Inc. v. Southwestern Public Service Company*, 123 FERC ¶ 61,047, at P 53 (2008).

[132] *See Indianapolis Power & Light Company*, 48 FERC ¶ 61,040, *order on reh'g*, 48 FERC ¶ 61,328 (1989) (directing company to refund, with interest, all amounts overbilled as the result of its improper accounting).

The Commission orders:

(A) The Report's findings and recommendations, upon review as discussed in the body of this order, are hereby affirmed in their entirety without modification.

(B) ITC Midwest is hereby directed to implement the recommendations as discussed in the body of this order, and to submit an implementation plan outlining the steps it will take to implement the recommendations within 60 days from the date of this order.

(C) ITC Midwest is hereby directed to make non-public quarterly submissions in Docket PA10-13-000 detailing its progress in implementing the corrective actions until all corrective actions are completed. The submissions must be made not later than 30 days after the end of each calendar quarter, beginning with the first calendar quarter after submission of the implementation plan and continuing until ITC Midwest completes all recommended corrective actions.

By the Commission.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.