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Decision 96-10-037 October 9, 1996

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Investigation on the Commission's own motion into the methods to be utilized by the Commission to establish the proper level of expense for ratemaking purposes for public utilities and other regulated entities due to the changes resulting from the 1986 Tax Reform Act.

I.86-11-019
(Petition filed October 4, 1994)

ORIGINAL

O P I N I O N

In late October 1986, the federal government passed the Tax Reform Act of 1986 (1986 TRA) which significantly affected all California public utilities, especially the state's privately-held public water companies. (See Re Tax Reform Act of 1986 (1987) 25 CPUC 2d 299; CPUC Decision (D.) 87-09-026.) Until that enactment, when a real estate developer who applied to a public utility for extension of facilities to serve water to a new area paid the utility the amounts of money (or property) required to serve that area (Contributions in Aid of Construction (CIAC) and Advances-in-Aid of Construction (AIAC)), the utility did not treat such payments as "income" for income tax purposes. The 1986 TRA changed all that by converting such payments into taxable income. As the consequence, beginning in 1987, in order to have available sufficient funds to pay the actual costs to construct a proposed extension of facilities, utilities had also to collect additional sums from each applicant in the amount of money that would enable them to pay the income tax liability arising from their receipt of the funds used to pay the hard dollar cost of such projects. That additional amount of money, which results from utilities'

collecting contributions and advances "gross of federal income tax," is commonly referred to as a "tax gross-up."

In November 1986 the Commission instituted an investigation (I.86-11-019) "into the methods to be utilized by the Commission to establish the proper level of expense for ratemaking purposes for public utilities and other regulated entities due to the changes resulting from the 1986 Tax Reform Act."

After lengthy hearings, the Commission issued D.87-09-026 which settled on two alternative methods to be adopted by utilities for determining how the tax gross-ups would be calculated: a so-called "Method Two" (to be used by smaller utilities) and a "Method Five" (to be employed by the large utilities.)

In Conclusion of Law 12 of D.87-09-026, the Commission declared as follows:

> "If a utility is not in a taxable position in the year that it receives a contribution or refundable advance, there is no tax liability. The tax gross-up received from the contributor under Method 2 or Method 5 should then be refunded to the contributor. If a utility collects a gross-up using an incremental tax rate that is more than its incremental rate, as determined on a ratemaking basis, the difference between what was and what should have been collected should be refunded to the contributor."

On October 4, 1994, in a Joint Petition, Toro Water Service, Inc. (Toro), a Class D water utility, and California Utilities Service, Inc. (CUS), a small regulated sewer service company, joined with Castlerock Estates, Inc. (Castlerock), a developer of property for residential purposes in Monterey County, to request that I.86-11-019 be reopened for the purpose of modifying D.87-09-026 to clarify Conclusion of Law 12 in regard to the circumstances under which utilities might become obliged to refund tax gross-ups

The Joint Petition refers to contributions in-aid of construction made by Castlerock to both the water utility and the sewer company in 1988 which included a tax gross-up. Castlerock contends that under the language of Conclusion of Law 12, since neither regulated company paid 1988 income taxes sufficient to absorb the tax gross-up paid by Castlerock, each is liable to refund to Castlerock all excess amounts of tax gross-ups paid by Castlerock. Toro and CUS contend that under the language of the decision, and consistent with sound utility accounting and regulatory objectives for the purpose of determining possible refunds of gross-ups, any comparison of the amounts payable by developers as tax gross-ups and the proper amounts payable by them because of the utility income tax triggered by their contributions must be based upon utility income taxes calculated on a ratemaking basis, that is, without regard to the income tax actually paid by the utility in the year of receipt of the developer's payment.

On January 12, 1995, a prehearing conference was held where it was agreed that the matter would be submitted on briefs.

The Commission is concerned with the income taxes utilities can be expected to pay because the rates they are permitted to charge are set at levels designed to provide them with the opportunity to pay all their business expenses, including their income tax liabilities, and to earn a fair return on their invested capital. Utility customers therefore ultimately reimburse utilities for their income tax obligations.

Toro and CUS' Position

In a ratemaking proceeding, the actual amounts of utility income tax payments for a given year are not automatically adopted by the Commission in determining utility revenue requirements. Allowances on account of expenses in the nature of income taxes are normalized when utility rates are set. Thus, customers will not pay charges for utility services that are designed to allow a utility to recover what might be an abnormally high tax liability

in the year used as a test year for rate fixing. In short, amounts allowed by the Commission as income tax expense for ratemaking purposes, as compared to calculation of income taxes due IRS (and the State Franchise Tax Board) for tax collecting purposes, can vary significantly.

Toro and CUS submit that it was with a full realization of these differences that the Commission chose to provide in Conclusion of Law 12 that the obligation of utilities to refund any portion of tax gross-ups to applicants for new extensions must turn upon a comparison of the gross-ups actually received by the utilities as compared with their tax liabilities as determined on a ratemaking basis. The language used by the Commission in the decision was not careless; it was deliberate in light of the very purpose of I.86-11-019, viz., a determination of the methods to be used by the Commission to establish the proper level of expense for ratemaking purposes.

Toro and CUS point out that they paid taxes in 1988, the year of the contribution by Castlerock. For 1988, Toro had taxable income from operations (excluding $196,781 in contributions) of $20,476. When the taxable contributions of $196,781 are added to the taxable income from operations, and an operating loss carry forward of $58,666 is applied, Toro had 1988 federal taxable income of $137,980. All of Toro's 1988 taxable income was due to the Castlerock contribution. Castlerock therefore is not entitled to a refund of its income tax gross-up.

CUS' situation is somewhat different. In 1988, CUS had a taxable loss from operations of ($31,254), excluding $570,007 in contributions. When the taxable contributions of $570,007 are added to the operating loss, CUS had 1988 federal taxable income of $393,008 - all of which was caused by the Castlerock contribution. Therefore, Castlerock is not entitled to a refund of its income tax gross-ups to CUS.

The intent of the Commission in I.86-11-019 was to prescribe methods to be utilized to establish the proper level of expense for ratemaking purposes. The Commission recognized the vast difference between an income tax allowance for ratemaking purposes for a given year and the amount of income taxes reported on a utility's income tax return for that same year. Items like accelerated tax depreciation, tax normalization, depreciation of CIAC on tax returns but not on books and tax loss carryforwards result in significant differences in the period in which income is reported on a utility's books of accounts and in its income tax return. These differences ordinarily are of critical importance in establishing the proper level of taxes for ratemaking, but in this particular instance of Castlerock's claims against Toro and CUS they are of little importance. Under any scenario, all of the 1988 income taxes paid by Toro and CUS were due to the contributions from Castlerock. Toro claims that its tax loss carryforward of $58,666 from prior years belongs to the company and should not be used to reduce Castlerock's liability for a tax gross-up and CUS claims that its taxable loss from operations in 1988 of ($31,254) belongs to the company to be carried forward to future years.

<u>Castlerock's Position</u>

In light of what it considers to be the unambiguous language contained in the first two sentences of Conclusion of Law 12, Castlerock argues that the utility must refund amounts paid to it by Castlerock as tax gross-up if the utility did not pay income taxes in the year in which the gross-up amounts were paid. Castlerock says that first a determination of how much income tax a utility actually paid in the year it received the tax gross-up must be made. Then, in the event that the amount received from the developer for the tax gross-up is greater than the actual tax liability, the difference should be refunded to the developer.

Castlerock asserts that the first two sentences of Conclusion of Law 12 should be read independently of the last

sentence. Furthermore, Castlerock believes that there is not a conflict between the first sentence and the last sentence. The third sentence concerns the situation where a utility collects a gross-up calculated by using an incremental tax rate. Conclusion of Law 12 is intended to prevent a utility from receiving a windfall when a utility is not in a taxable position when there is no contribution is made. It argues that the tortured interpretation offered by Toro and CUS of the first two sentences in context of the last sentence should not be accepted. The interpretation of Toro and CUS violates the policy which prevents a utility from receiving a windfall to the detriment of the contributor. In this case, Castlerock contends that a utility should not receive a windfall by collecting more tax than it paid; conversely, the developer should not receive a windfall by being the beneficiary of the utility's recent tax loss. Castlerock proposes to resolve these issues by reviewing the result of the tax calculation and comparing it to the immediate preceding years, as opposed to attempting to adjust the individual tax year for unusual events. Five years is recommended as a reasonable look-back period, giving sufficient operating history while at the same time being relatively current with respect to income tax laws so that like comparisons can be made. The end result may be a calculation that is straightforward and requires no adjustment, or a calculation that eliminates one unusual year, or a calculation that averages the years to obtain a reasonable result. The ultimate decision as to reasonableness should be left to the Commission.

Other Parties

DRA asserts that the appropriate treatment to accord utility federal income tax (FIT) and California corporate franchise tax

(CCFT)[1] gross-ups received by a utility in conjunction with the receipt of taxable CIACs is that, as a matter of equity and fairness, when no FIT or CCFT is actually paid in the real world by a utility that receives tax gross-ups from CIAC contributors, then those tax gross-ups should be refunded to the contributors in conformance with Conclusion of Law 12.

DRA points out that a primary premise contained in D.87-09-026 is that the entity that creates the tax should be the entity that pays the tax. A contributor that makes a CIAC is responsible for the FIT and CCFT due on that CIAC and is required to provide a tax gross-up to the utility receiving the CIAC. By the same token, if the utility is not in a taxable position in the year that the CIAC(s) and tax gross-ups are received, then the utility is required to refund to the contributor the full gross-up received or an appropriate prorated portion of that gross-up to the extent that the CIAC is not 100 percent taxable.

It contends that the burden of proof is upon the utility to comply with D.87-09-026 and to verify each year to its contributors of CIACs and tax gross-ups that the utility was or was not in a taxable position for that year, regardless of its tax filing status. DRA believes the utility's tax filing status is not relevant, because if no tax is paid under any circumstances, then refunds should be made. If no tax was paid, the utility is obligated to notify all contributors that a tax refund is due them, and to subsequently refund the tax gross-ups received. If this is not done, contributors that are entitled to a tax gross-up refund would not be aware that their tax gross-ups were not necessary

[1] CCFT is included in this discussion because the California legislature, in 1990, made CIACs taxable for CCFT purposes, and any tax gross-up in 1990 and subsequent years will include a CCFT component, as well as an FIT component.

DRA concludes that the tax filing status of a utility should not have any bearing on the determination of whether tax was paid. Regardless of whether the utility is on a stand-alone basis, part of a consolidated return, or part of an individual return, the ultimate tax situation should be the determining factor regarding whether tax gross-ups should be refunded. The question remains was tax in fact paid in the real world and not on some artificial, theoretical basis? If it was not, it should be refunded.

Sierra Pacific Power Company takes the position that tax losses and carry forwards belong to the utility and should not be an offset to any contribution in aid of construction.

Discussion

Padific Gas and Electric Company (PG&B) reminds us that Conclusion of Law 12 was directed at the problems that small water and telephone companies would have with CIAC. It recommends, and we will adopt, a clarification that Conclusion of Law 12 be applied specifically to small water and telephone companies. This clarification is discussed below in the "Comments" section of this decision. We now turn to our analysis of the substance of Conclusion of Law 12.

There are two concepts that pervade D.87-09-026. The first, clearly articulated, is that the person who causes the tax should pay it (25 CPUC 2d at 328); the second, clearly implied, is that neither the utility nor the contributor should profit from the tax consequences of the contribution. The tax should be revenue neutral. We said, "If a utility collects a gross up calculated by using an incremental tax rate that is more than its actual incremental rate, the difference between what was collected and what should have been collected should be refunded to the contributor." (25 CPUC 2d at 327.) We also said, "Our first duty is to protect the ratepayers." (25 CPUC 2d at 329.) We are not protecting the ratepayers (or the utility) should we permit the contributor to use a utility tax benefit (e.g., a tax loss carry-

forward) to reduce the contributor's tax liability. Although a tax loss carry forward is an asset of the utility (Re Mesa Crest Water Co. (1971) 72 CPUC 645 (D.79364)), there is a derivative ratepayer benefit. The stronger the utility, the more likely the ratepayer will receive adequate service.

Applying those principles to the arguments before us, we are of the opinion that the position of Toro and CUS is untenable to the extent that it requires us to determine tax liability on a ratemaking basis. The ratemaking basis is used to determine the tax gross-up that the contributor must pay in advance. However, whether or not there should be a refund of any part of the tax gross up depends upon the utility's actual incremental rate.

Castlerock's proposal to use a five year lookback period to determine tax liability is, on its face, too cumbersome a procedure to be useful. It will just promote litigation.

Because of our duty to protect the ratepayer and our expectation that the tax gross-up should be revenue neutral, it is clear to us that (1) the contributor should not have to gross-up to a level which would create a windfall for the utility and (2) the utility's tax loss carry forward and other tax credits[2] should not be used to offset the contributor's tax liability, which would create a windfall for the contributor.

We believe the most equitable solution is to have the contributor advance a gross-up based on the utility's incremental tax rate as determined in its last ratemaking proceeding, but receive a proportionate refund if, in the taxable year, the gross-up exceeded the tax that would have been paid without consideration of a tax loss carry forward or other tax credit. For example, if the gross-up amount is $100 and the tax without consideration of

[2] Other tax credits might include loss carry backs/fuel credits, accelerated depreciation, investment tax credit, etc.

tax loss carry forwards or other tax credits is computed to be $90, then $10 is refunded, even though tax credits or tax loss carry forwards reduced the actual tax paid to $60. In this way, the contributor does not receive the benefit of the tax credits or tax loss carry forwards, which remain with the utility and its ratepayers, but does receive consideration of an estimated tax based on actual utility operations in the year of the contribution.

As a result of our conclusion in this case, it is apparent that Conclusion of Law 12 should be recast. We modify D.87-09-026 by rescinding present Conclusion of Law 12 and replacing it with new Conclusion of Law 12, which reads as follows:

"Conclusion of Law 12:

"For utilities which elect Method 2, if the utility collects a gross up using an incremental tax rate that is more than its incremental tax rate as determined on a taxable year basis without consideration of a tax credit or tax loss carry forwards, the difference between what was and what should have been collected should be refunded to the contributor.

"The same reasoning applies to a contributor who was required to pay gross up on AIAC."

The parties have raised the question of the discoverability of Toro's and CUS' income tax returns. Because the pertinent question before us is the correct interpretation of our decision on the calculation of tax gross ups (D.87-09-026), we decline to decide, in this investigation, whether the tax returns of Toro and CUS are discoverable. In California income tax returns are privileged (Schnabel v. Superior Court (1993) 5 Cal 4th 704), but the privilege is not absolute (5 Cal 4th at 721). We have no record in this investigation upon which to base a determination of privilege. That issue should be resolved in C.92-04-034, a proceeding brought by Castlerock against Toro and CUS, where the issue has been raised and where a complete record can be fashioned. We will, however, assure compliance with our order by requiring a report from water utilities who have received contributions and

advances, and we will require that the results of this decision be added to the utilities' Rules.

Comments

This decision was distributed for comments as a Proposed Decision. Both Toro and CUS agreed with the Proposed Decision. Suburban Water Company and Valencia Water Company proposed that refunds of the tax gross-up should never be made. Castlerock asserts that Conclusion of Law 12 should not be limited to Method 2 utilities. The other commentors, PG&E, Southern California Gas Company, San Diego Gas & Electric Company, and San Gabriel Water Company, argued that the modification in the Proposed Decision be limited to small water and telephone companies. PG&E's argument is representative and persuasive.

Findings of Fact

PG&E points out that D.87-09-026 provided two practical methods to determine the amount of a gross-up: Method 1, which computes the gross-up using a factor for future tax depreciation and Method 2, which computes the gross-up without considering tax depreciation. Method 2 was made ineligible to the state's larger utilities. It was developed to address special problems of small water and telephone utilities.

In our discussion of Method 2 in D.87-09-026, we recognized the special problems of small water and telephone utilities that are not always in a taxable situation and addressed not only gross-up collection but also gross-up refunding. Conclusion of Law 12 was directly connected to implementing Method 2. It addressed the special and unique problems posed by those utilities eligible for Method 2--solely small water and telephone utilities that are not always in a taxable position. PG&E believes that Conclusion of Law 12 was not intended to impact large electric and gas utilities.

PG&E submits that the present controversy could be narrowed by limiting the application of Conclusion of Law 12 to those utilities eligible to elect Method 2, which was the apparent intent of the original CIAC decision. Such a narrowing of the

scope of Conclusion of Law 12 is further supported by recently enacted federal tax legislation, which repeals the CIAC tax on water and sewer utilities. Section 1613 of the Small Business Jobs Protection Act of 1996 exempts from federal taxation CIAC received by all water and sewer utilities after June 12, 1996. This federal legislation eliminates the matters in dispute on a prospective basis for the very entities and their contributors (i.e., the small water and sewer utilities) which triggered the present controversy.

As explained by PG&E, Conclusion of Law 12 was directed at Method 2 utilities. We will adopt PG&E's clarification and specifically limit the application of Conclusion of Law 12 to Method 2 utilities.

Findings of Fact

D.87-09-026 was intended to set forth rules which, when applied, would cause the tax consequences of CIAC and AIAC to be revenue neutral. Conclusion of Law 12 was one of those rules.

2. The diverse interpretation of Conclusion of Law 12 by the parties to this petition for modification requires a clarification which can best be met by rescinding Conclusion of Law 12 and replacing it with a new Conclusion of Law 12.

3. The new Conclusion of Law 12 reads as follows:

> "12. For utilities which elect Method 2, if the utility collects a gross-up using an incremental tax rate that is more than its incremental tax rate as determined on a taxable year basis without consideration of a tax credit or tax loss carry forwards, the difference between what was and what should have been collected should be refunded to the contributor."

Conclusions of Law

1. Conclusion of Law 12 in D.87-09-026 should be rescinded and replaced with Conclusion of Law 12 set forth in Finding of Fact 3.

2. In all other respects, D.87-09-026 is affirmed.

ORDER

IT IS ORDERED that:

1. Conclusion of Law 12 in Decision 87-09-026 is rescinded and replaced by Conclusion of Law 12 set forth in Finding of Fact 3 of this decision.

2. Within 60 days after filing its annual Federal and State income tax returns, each regulated water and sewer company which has collected tax gross-ups for Contributions-in-Aid of Construction and Advances-in-Aid of Construction in the prior year shall file a statement with the Commission stating whether gross-ups were overcollected and, if so, whether the overcollected gross-ups have been refunded to the contributors. Such filing shall also include detailed computations showing development of such refunds.

3. Within 60 days from the effective date of this order, all regulated water and sewer utilities shall amend their filed Main Extension, Rule 15 forms to include standard language provided by the Water Division informing all prospective contributors of their rights to obtain refunds authorized by this order, and that tax gross-ups are not required for contributions and advances received after June 12, 1996.

4. The Executive Director is directed to serve a copy of this order to each regulated water and sewer utility.

This order is effective today.

Dated October 9, 1996, at San Francisco, California.

P. GREGORY CONLON
President
DANIEL Wm. FESSLER
JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
JOSIAH L. NEEPER
Commissioners