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April 5, 2011

Commission President Michael Peevey
Commissioner Timothy Alan Simon
Commissioner Michel P. Florio
Commissioner Katherine J.K. Sandoval
Commissioner Mark Ferron
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

Re: Draft Resolution L-411 Establishing a Memorandum Account for all Cost-of-Service Rate-Regulated Utilities To Reflect The Benefits Of Recent Federal Tax Legislation

Dear Commissioners:

Last week Commissioners Sandoval and Ferron convened an all-party meeting regarding Draft Resolution L-411 and the appropriate ratemaking treatment of the benefits from the New Tax Laws. At the conclusion of the meeting Commissioner Sandoval invited the parties to consider alternatives that might prove to be acceptable approaches to capturing the benefits. TURN wishes to put one such alternative approach on the table. Rather than requiring an application or advice letter for any proposed capital expenditure using the tax benefits, the Commission could adopt a two-track approach. To the extent a utility's additional expenditures associated with the tax benefits go to infrastructure replacement (based on criteria the Commission would set forth in the Resolution), there would be no need for a before-the-fact application or advice letter. Only if a utility seeks to use the tax benefits to support capital expenditures in areas not tied to infrastructure replacement would it need to first seek approval through the application or advice letter process. The approach is described in further detail below.

This alternative approach is premised on the Commission retaining several key elements of the latest circulated version of the Draft Resolution. First, it is essential that the Commission retain the central feature set forth in the most recent version of the Draft Resolution: The benefits of the New Tax Laws must either fund necessary capital expenditures for utility plant, or flow to benefit ratepayers. TURN submits that, all else equal, if the choice facing utility management is to make capital expenditures or have unspent funds go to ratepayers, there is a greater likelihood that the utility will make the capital additions than if the choice is to either make the capital expenditures or keep unspent funds. While the most recent utility positions seem geared toward using the benefits to fund further necessary capital expenditures for utility plant, on their own such statements of good intentions do not provide sufficient ratepayer protection.

Second, the fact that a utility can spend more money does not necessarily mean that it should, or that the incremental expenditure would be reasonable.[1] It is therefore important for the Commission to address up front whether the proposed additional spending through use of the tax benefits would serve not only the near-term goal of increasing capital expenditures in California, but also the longer-term interests of utility ratepayers.

The alternative TURN puts forward seeks to relieve the tension between the utilities' stated desire to expeditiously invest the tax benefits in utility plant and the need for Commission review of such spending proposals to ensure that they are a reasonable and appropriate use of funds that, if not so invested, should flow to ratepayers. The Draft Resolution would require an application as the preferred means of review or, where that approach is not feasible, an advice letter that addresses the need for the new spending. The utilities have complained that such an approach would impede their ability to make capital investments to the betterment of California's economy.[2]

TURN offers the following alternative approach. Instead of requiring a pre-spending application or advice letter for all projects funded by the tax benefits, the final version of Resolution L-411 could establish clear guidelines of the types of capital expenditures the Commission seeks to encourage with this source of funds. To the extent a utility stays within these guidelines, it would not need to seek pre-approval of the spending (although reasonableness would still be subject to review in a subsequent GRC). Should a utility determine that the tax benefits would be best invested in some area outside of the Resolution's guidelines, it would need to file an application or advice letter seeking Commission approval in order to go forward with the investment.

The guidelines should steer the capital spending into infrastructure replacement. The Commission often hears that service reliability will deteriorate unless a utility increases its capital expenditures in order to address system deficiencies and aging infrastructure. To the extent the tax benefits get spent on such projects, the Commission would accelerate the pace of infrastructure replacement.

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[1] As a recent example, consider PG&E's Distribution Reliability Improvement Program. The utility was prepared to spend nearly $2 billion to achieve certain distribution reliability improvements. Upon review, the Commission scaled the proposed spending back to $357 million, and noted that spending 16% of the utility's proposed amount would achieve 68% of the quantifiable reliability improvement benefits. (D.10-06-048, p. 2.) PG&E now contends that it could spend $400 to $600 million per year over the next two years on projects enabled by the tax benefits, without any specificity regarding what that spending would achieve.

[2] In TURN's view, these complaints are overwrought. The Commission has adopted and operated under expedited processes when circumstances warranted, achieving timely outcomes without sacrificing its oversight role or opportunities for public input in the process. However, TURN also recognizes that this is an area in which perception may matter as much as substance, and the utilities could successfully create a perception that requiring even a pre-spending advice letter would scale back the additional capital investment and job creation benefits that might ensue.

TURN submits the following criteria the Commission should adopt to guide the spending into the appropriate areas:

- The Commission should identify the types of infrastructure replacement projects that it most wants to encourage, which would typically be the types of projects included in GRC applications. For example, for the electric utilities, projects would include proactive replacement of poles and underground cables, replacement of existing substation transformers that are over 50 years old, and work to improve the reliability of the worst-performing distribution circuits on their system.[3] For gas utilities, projects would include accelerating existing programs of distribution pipeline replacement, replacement of the riskiest gas transmission lines, and installing "smart pigs" in gas transmission lines.

- The property that the investment is made in must be CPUC-jurisdictional (i.e., no electric utility can spend the money on FERC jurisdictional transmission).

- For dual-fuel utilities, the investment amount must not exceed the tax benefits associated with the specific electric or gas functions (i.e., SDG&E and PG&E cannot spend electric system tax benefits to invest in their gas systems).

- The property that the investment is made in must itself be eligible for bonus depreciation.[4]

- The property that the investment is made in must have a tax depreciable life of at least 15 years (to ensure the spending is on assets where accelerated depreciation has the most value to ratepayers).

- The spending must not provide generation capacity at a new plant.[5]

TURN does not suggest that these represent the entire universe of appropriate criteria. And while the examples are described in terms that are clearly energy-centric, nearly all the regulated cost-of-service utilities have raised concerns about their ability to achieve necessary levels of infrastructure replacement in the near term. TURN submits that such criteria seeking to direct the tax benefits to infrastructure replacement will provide the Commission some assurance that the benefits are being put to good purpose if used for capital expenditures rather than rate reductions.

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[3] Costs associated with hooking up new customers or serving increasing customer demand in the normal course of business would not be within this category. Such spending is not "infrastructure replacement" but rather "infrastructure additions."

[4] This criterion is intended to prevent the tax benefits from being spent on real estate or software.

[5] PG&E has a number of small hydroelectric generation projects that are controversial and, in TURN's view, should not be funded with the tax benefits. Both this provision and the 15-year minimum would also prevent additions to utility photovoltaic programs previously approved in separate applications.

Finally, several utilities have stated concerns regarding the potential adverse effect that any sort of "subject to refund" provision might have on their ability to use the tax benefits to fund additional capital expenditures, and the difficulty of determining what level of expenditures would be "incremental" to GRC-authorized funding levels. To the extent such concerns are valid, TURN submits that the Reliability Investment Incentive Mechanism (RIIM) currently in place for SCE provides a structure that would sufficiently mitigate both these concerns.[6]

Subject to Refund: In SCE's current GRC cycle (covering 2009-2011), the utility has approximately $3.378 billion of authorized RIIM capital expenditures. If SCE spends a total RIIM amount over the three-year period that is less than the authorized amount, then SCE will return the difference to ratepayers as a one-time event.[7] The language in SCE's tariffs implementing this potential return to ratepayers is very straightforward: "If an overcollection in revenue requirement is determined from (1) the authorized reliability-related capital additions being greater than recorded adjusted capital additions . . . these amounts shall be refunded to customers."[8] This potential refund to customers has not appeared to hinder SCE's RIIM capital expenditures, as the utility seems to be on course to spend the full amount authorized over the three-year period. Thus the Commission should reject claims that a "subject to refund" element here would be counter-productive, and instead direct that any tax benefits not spent on approved capital projects will be returned to ratepayers.

Incremental: The SCE GRC decision (D.09-03-025) adopted capital expenditure forecasts for 2009, but not for 2010 or 2011. In Resolution E-4313, the Commission adopted SCE's proposed approach for calculating RIIM capital expenditures in 2010 and 2011, by escalating the level adopted for 2009 by the escalation factors adopted for attrition purposes (4.25% for 2010, and 4.35% for 2011). Again, the Commission could use a similar approach here to determine a proxy for the authorized capital expenditure level in 2010, 2011 or 2012, even where there is no specific authorized capital expenditure level for that year. Applying the adopted attrition increase on a percentage basis to the capital expenditures authorized for the most recent test year would provide the proxy, and the Commission could deem amounts spent above that level to be "incremental" to the capital expenditures already provided for in the most recently approved GRC revenue requirement.

TURN concludes with a reminder that time is of the essence here. As the latest version of the Draft Resolution correctly explains, "there could be substantial amounts in deferred tax reserves that do not get reflected in rates unless the Commission takes

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[6] The RIIM example is particularly of interest in that the mechanism seeks to encourage capital expenditures in areas that "preserve long -term electric service reliability" and specifically includes items such as distribution a nd substation infrastructure replacement. Res. E -4313, p. 2.

[7] Res. E-4313, p. 8 (http://docs.cpuc.ca.gov/word_pdf/FINAL_RESOLUTION/119977.pdf).

[8] The language appears in Section LL of SCE's preliminary statement. http://www.sce.com/NR/sc3/tm2/pdf/ce291.pdf

action." (Draft Resolution, p. 3.) And for so long as the Commission defers taking action, the utilities continue to have the option of flowing these "substantial amounts" to their shareholders. To the extent the Commission seeks to limit the available options to investment in necessary capital expenditures or decreases in the authorized revenue requirement (and, all else equal, lower rates), it needs to issue the Resolution and thereby create the memorandum account. Now that we are three months into 2011, the "substantial amounts" from 25% of this year are already unlikely to be subject to the memorandum account. You need to act before that figure grows any larger.

As always, we thank you for your consideration of these matters. Please let me know if you have any questions regarding this proposal or TURN's position on the New Tax Laws.

Yours truly,

/s/

Robert Finkelstein
Legal Director

cc: Marzia Zafar, CPUC
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