~~Pacific Gas a~~utilities~~nd Electric Company any covered utility that wishes~~ to use savings from th<u>is</u>~~ese~~ new tax law~~s~~ to invest in additional, needed utility infrastructure, not otherwise <u>funded in</u> rates, within a time frame shorter than would be practicable through the formal application [or advice letter] process. ~~to file an advice letter requesting establishment of a separate memorandum account into which to record the revenue requirement associated with such additional capital investment.~~ The establishment of a memorandum account does not change rates, nor guarantee that rates will be changed in the future. This mechanism simply allows the Commission to determine at a future date whether rates should be changed, without having to be concerned with issues of retroactive ratemaking.

BACKGROUND

On December 17, 2010, President Obama signed the ~~Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("~~Tax Relief Act~~")~~. It has come to the attention of the Commission that this law may provide tax relief to the utilities regulated by this Commission. Provisions in the Tax Relief Act may reduce the utilities' costs of providing service. Many of the utilities regulated by this Commission have their rates set on a cost-of-service basis. These utilities include, without limitation: water and sewer system corporations, small local exchange carrier telephone corporations (small LECs), gas and electrical corporations, pipeline corporations, and heat corporations.

Among, other provisions, the Tax Relief Act provides for 100% bonus depreciation on certain business property put into service after September 8, 2010 and before January 1, 2012. The Tax Relief Act also provides for 50% bonus depreciation for property placed into service thereafter and before January 1, 2013 and for property placed into service in 2013 where construction begins prior to January 1, 2013.

Consistent with the Internal Revenue Code, the Commission's ratemaking procedures do not reflect in rates the full reduction in tax expense in the year in which accelerated depreciation is taken for tax purposes. Rather, rates are set as if depreciation for tax purposes were being calculated on the straight line method over the projected life of the asset (the same depreciation method used for setting rates). Thus, the utility collects in rates taxes that will not need to be paid until a later time, if at all.[1] Nevertheless, ratepayers do get a benefit from the accelerated depreciation. This is accomplished through "normalization" and the use of a "deferred tax reserve". The deferred tax reserve for any particular asset reflects the amount of depreciation taken for tax purposes that exceeds the amount used in setting rates. This difference is then multiplied by a tax rate to yield the amount of deferred tax reserve. Thus, for example, assume a utility puts into

[1] See *City of Los Angeles v. Public Utilities Commission*, 15 Cal. 3d 680, 686 (1975) (for an enterprise that is either expanding or stable, accelerated depreciation does not merely defer taxes, but eliminates them entirely).

The approach the Commission should adopt to achieve this purpose:

The Original Draft Resolution[3] proposed to accomplish the above purpose by making the rates of all cost-of-service rate regulated utilities subject to refund for the limited purpose of allowing ratepayers to benefit, to the extent, if any, the Commission finds reasonable, from tax benefits resulting from the Tax Relief Act.

In their comments and discussions with Commission staff, the utilities pointed out several disadvantages of this approach, primarily the uncertainty created by the "subject to refund" language. The utilities noted that the purpose of the bonus depreciation provisions of the New Tax ~~Laws~~Law is to encourage additional capital investment, thereby stimulating employment and the economy. The utilities could use tax savings realized under the New Tax ~~Laws~~Law to fund additional, needed utility infrastructure investment not otherwise funded by rates. This may be an opportune time to increase capital investment, given decreases in construction costs and the availability of bonus depreciation for plant put into service before 2013. At least some of the utilities intend to use tax savings from the New Tax ~~Laws~~Law to fund additional, needed utility infrastructure investment. However, the utilities informed staff that they would be reluctant to do so if some unknown amount of the tax savings were instead needed to fund rate reductions.

In light of these factors, this resolution has been revised to eliminate the subject to refund language. Instead, this resolution uses a memorandum account to track the various benefits and costs of the New Tax ~~Laws~~Law. This approach still permits the Commission to determine at a later date whether some of the impacts of the New Tax ~~Laws~~Law should be reflected in rates, without having to be concerned about retroactive ratemaking issues. However, this approach replaces the uncertainty of "subject to refund" language with specific calculations that will be contained in a memorandum account. As a result, this resolution should not impede the capital investment that the New Tax ~~Laws~~Law are intended to encourage.

The second and third drafts of this resolution ~~attempted to~~ accommodated the desire of some utilities to use the tax savings realized under the New Tax ~~Laws~~Law to fund additional, needed utility infrastructure investment not otherwise funded in rates, by allowing the revenue requirement impacts of such additional investment enabled by the bonus depreciation provisions of the New Tax ~~Laws~~Law to be tracked as an offset to the memorandum account. This resolution ~~no longer~~ authorizes such an offset. ~~Instead, it provides a different mechanism to allow utilities to make timely, additional, needed utility infrastructure investments with the tax savings realized from the New Tax LawsLaw.~~ Therefore, this resolution also establishes that this memorandum account will be a one-way memorandum account.

[3] See immediately preceding footnote.

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~~There are several reasons why we are no longer allowing an offset to the memorandum account created by this resolution for needed utility infrastructure investment not otherwise funded in rates. First, provision of such an offset unduly complicated the creation and terms of the memorandum account. Second, provision of such an offset would allow utilities to recover costs for infrastructure investment without any preliminary Commission review of the scope and kind of investments that might be made. Other changes we are making to the resolution would exacerbate this problem.~~

Southern California Edison (SCE) has demonstrated that it may well have a revenue requirement increase due to the New Tax ~~Laws~~Law during 2011, while the revenue requirement decreases will be fully reflected in rates for their 2012 GRC test year and the years thereafter.[4] ~~In response to this showing, we believe that fairness requires that we allow the memorandum account to be a two-way memorandum account to reflect both revenue requirement decreases and revenue requirement increases flowing directly from the New Tax LawsLaw. However, allowing Allowing a two-way memorandum account in which utilities could book~~ the revenue requirement associated with additional, needed utility infrastructure enabled by the bonus depreciation provisions of the New Tax ~~Laws~~Law, could allow even larger, unidentified, and unreviewed additional capital investments to be made, and their costs recovered from ratepayers (subject only to after-the-fact reasonableness review).[5]

For the foregoing reasons we are ~~eliminating any offset to~~ establishing that the memorandum account ~~to track the revenue requirement associated with additional utility infrastructure investment~~ shall be a one-way memorandum account. And instead~~,~~ of requiring a pre-spending application or advice letter for all projects funded by the tax benefits, we are establishing guidelines for the utilities to follow. To the extent a utility stay 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 leter seeking Commission approval in order to go forward with the investment.

~~there will be two ways in which utilities that wish to invest the tax savings from the New Tax LawsLaw in additional, needed utility infrastructure investment can proceed. In general, we prefer that large utility infrastructure investment programs be presented to the Commission by means of an application, which allows a full, advance review by the Commission of such a program. However, there are several factors relating to the New Tax LawsLaw that may make the use of an application a less than optimum approach.~~

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[4] In this regard, we note that an explanation of the circumstances under which the memorandum account might contain a revenue requirement increase was much more persuasive than abstract arguments for a two-way account.

[5] Under a two-way memorandum account, the amount of additional investment revenue requirement that could thus be recovered would no longer be limited to the amount of revenue requirement savings during the period covered by the memorandum account.

This memorandum account will be a one~~two~~-way memorandum account~~, i.e., it will be available for the Commission to consider whether utility rates should be reduced or increased to reflect the tax impacts of the New Tax Laws~~Law ~~during the Memo Account Period~~

_The following paragraphs describe in further detail some of the wording we have used above in describing the memorandum account.

Amounts in the memorandum account will be recorded on a "revenue requirement basis." This means that each utility will be tracking the revenue requirement impact of each change resulting from the New Tax ~~Laws~~Law. This is important, because, consistent with the Internal Revenue Code, the tax savings from accelerated depreciation are not passed through directly to ratepayers, but instead, as explained above, ratepayers benefit through the process of normalization and the creation of a deferred tax reserve that is deducted from rate base. We also ensure that all amounts recorded in the memorandum account will be recorded on a consistent basis by requiring that they all be recorded on a revenue requirement basis.

We refer to amounts not otherwise reflected (or recovered) in rates. We use this terminology to exclude costs and expenses recovered through previously authorized rates, e.g., rates set in a prior GRC. We also use it to exclude costs or expenses recovered through rates set after the date of this resolution, e.g., through a balancing account or another memorandum account, or a formal proceeding prior to the utility's next GRC.

Insert * language from Res #2 →

In their comments on the Original Draft Resolution, the energy utilities pointed out that the bonus depreciation afforded by the New Tax ~~Laws~~Law will decrease their taxable income, and therefore may decrease, or eliminate, the Internal Revenue Code Section 199 Manufacturer's tax deduction that they are entitled to, which is already reflected in their revenue requirements. The utilities also pointed out that the New Tax ~~Laws~~Law will have impacts on their working cash, an item that is a component of their rate base and therefore also reflected in their revenue requirements. We agree that each of these items can properly be reflected in the memorandum account. The energy utilities also argued that the New Tax ~~Laws~~Law will impact their CIAC (contributions-in-aid-of-construction) revenues. Energy utilities are taxed on plant contributed by others, such as real estate developers. Accordingly, when such entities contribute plant to the utility they must also contribute an amount to cover the tax impacts (the tax component of CIAC). We agree that the New Tax ~~Laws~~Law are likely to have a revenue requirement impact relating to energy utility CIAC. The energy utilities are authorized to include these CIAC impacts in their memorandum accounts on a revenue requirement basis and consistent with any requirements of the Internal Revenue Code.

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memorandum account reflects a net revenue requirement increase, the memorandum account will be terminated without any impact on rates.

The following paragraphs describe in further detail some of the wording we have used above in describing the memorandum account.

Amounts in the memorandum account will be recorded on a "revenue requirement basis." This means that each utility will be tracking the revenue requirement impact of each change resulting from the New Tax Law and of the additional, needed infrastructure investment enabled by the tax savings resulting from the bonus depreciation provisions of the New Tax Law. This is important, because, consistent with the Internal Revenue Code, the tax savings from accelerated depreciation are not passed through directly to ratepayers, but instead, as explained above, ratepayers benefit through the process of normalization and the creation of a deferred tax reserve that is deducted from rate base. We also ensure that all amounts recorded in the memorandum account will be recorded on a consistent basis by requiring that they all be recorded on a revenue requirement basis.

In several places, we refer to amounts not otherwise reflected or recovered in rates. We use this terminology to exclude costs and expenses recovered through previously authorized rates, e.g., rates set in a prior GRC. We also use it to exclude costs or expenses recovered through rates set after the date of this resolution, e.g., through a balancing account or another memorandum account, or a formal proceeding prior to the utility's next GRC.

Insert into page 11

Another key, related concept is "additional utility infrastructure investment." By additional utility infrastructure investment we mean investment made possible by the tax savings from the New Tax Law that is in addition to investment otherwise included in rates. For utilities that have an adopted figure for additions to plant in service during the year(s) included within the Memo Account Period, the additional utility infrastructure investment will ordinarily be the amount by which additions to plant in service for that Period exceed the adopted figure for that same Period.[3] For some utilities, the Memo Account Period will include Attrition Year(s) for which there is no specific adopted figure for additions to plant in service. Those utilities may calculate the amount of investment that is included in rates by inflating the Test Year figure for additions to plant in service by the same percentage by which the Attrition Year's revenue requirement exceeds the Test Year's revenue requirement. If a utility without an adopted figure for additions to plant in service during any portion of the Memo Account Period contends

[3] The Memo Account Period will begin in the middle of Test Years or Attrition Years for Covered Utilities. This will at least require some proration of the adopted figure. Furthermore, infrastructure investment may occur in large lumps. Therefore, it may be necessary to look at plant additions during the period(s) immediately preceding the Memo Account Period for a Covered Utility to see how much of the plant additions during the Memo Account Period were actually "additional" to the adopted amount.

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