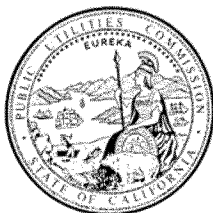


Docket	:	<u>A.10-11-015</u>
Exhibit Number	:	<u>DRA-</u>
Commissioner	:	<u>Simon</u>
ALJ	:	<u>Darling</u>
Witness	:	<u>Waterworth</u>



**DIVISION OF RATEPAYER ADVOCATES  
CALIFORNIA PUBLIC UTILITIES COMMISSION**

**Report on the Results of Operations  
for  
Southern California Edison Company  
General Rate Case  
Test Year 2012**

Update Testimony  
Tax Expenses

San Francisco, California  
September 2, 2011

## TABLE OF CONTENTS

I.	INTRODUCTION.....	1
II.	SUMMARY OF RECOMMENDATIONS.....	1
III.	IMPACT OF THE TAX RELIEF ACT.....	2
	A. SCE's Methodology .....	2
	B. DRA's Position .....	2
	1. SCE's Methodology Fails to Provide Evidence That Consideration of an NOL Is Equitable.....	3
	2. DRA's Proposal is Consistent with D.84-05-036.....	5
	3. SCE's Utilization of an NOL Is Inconsistent with Test Year Ratemaking .....	5

1  
2

## UPDATE TESTIMONY TAX EXPENSES

3 **I. INTRODUCTION**

4 The purpose of this testimony is to provide the Division of Ratepayer  
5 Advocates' (DRA) position relative to the impact of the Tax Relief, Unemployment  
6 Insurance Reauthorization, and Job Creation Act of 2010 (Tax Relief Act). This  
7 testimony addresses the testimony of Southern California Edison (SCE) served on  
8 April 28, 2011, entitled "Update to Reflect Tax Relief Act and Removal of Nuclear  
9 Seismic Study and License Renewal Costs".

10 The Rate Case Plan provides a separate date for the submission of update  
11 testimony to address "[k]nown changes due to governmental action".<sup>1</sup> Pursuant to  
12 the Assigned Commissioner's Scoping Memo and Ruling issued on March 1, 2011 in  
13 this case, parties are to serve Update testimony by October 24, 2011. In order to  
14 provide the Commission and parties with as much advance notice as possible, DRA  
15 is submitting its Update testimony now. DRA does not provide a precise  
16 comparison exhibit figure at this time, but anticipates presenting one as of, if not  
17 before, the due date for the update testimony.

18 **II. SUMMARY OF RECOMMENDATIONS**

19 The following summarizes DRA's recommendations regarding how the  
20 benefits of the Tax Relief Act should flow to ratepayers:

- 21
- 22 • DRA recommends the deferred tax be recognized and flowed  
23 through as a rate base adjustment in the year in which the book  
24 depreciation is recognized and the tax deduction associated with  
bonus depreciation is available.

---

<sup>1</sup> Re: Time Schedules for the Rate Case Plan and Fuel Offset Proceedings (1989) 30 CPUC 2d 577, 609; D.89-01-040

- 1 • DRA recommends that any deductions lost by adhering to SCE's  
2 methodology resulting in a net operating loss (NOL) be applied in  
3 the year available.

### 4 **III. IMPACT OF THE TAX RELIEF ACT**

#### 5 **A. SCE's Methodology**

6 In its Update testimony, SCE models the effects of the Tax Relief Act, for  
7 ratemaking, and also prepares a non-ratemaking (i.e., forecast of actual utility taxes)  
8 calculation as it relates to bonus depreciation. The calculation performed by SCE  
9 related to a forecast of its non-ratemaking taxes which purportedly results in an  
10 estimated net operating loss (NOL). SCE then proposes to delay the allocation of  
11 deferred taxes to ratepayers, apparently presuming that such a deferred tax is not  
12 realized until SCE can claim or utilize the bonus depreciation on its (non-ratemaking)  
13 utility taxes. Therefore, the total impact of the deferred income tax for ratemaking  
14 purposes resulting from the bonus depreciation is delayed by SCE and is not fully  
15 recognized by the test year 2012.

#### 16 **B. DRA's Position**

17 DRA opposes SCE's methodology of delaying the allocation of forecasted  
18 deferred taxes, for ratemaking purposes, to later periods. DRA recommends the  
19 deferred tax be recognized and flowed through as a rate base adjustment in the year  
20 in which the book depreciation is recognized and the tax deduction associated with  
21 bonus depreciation is available. Further, DRA recommends that any deductions lost  
22 by adhering to SCE's methodology resulting in a NOL be applied in the year  
23 available. DRA makes these recommendations based on the following discussion.

24 First, the calculation made by SCE resulting in a NOL for their stand alone  
25 utility operations is not a certainty. It is merely a calculation or forecast that  
26 generates a NOL, creating a purported inability to fully utilize the entirety of the  
27 bonus depreciation under the Tax Relief Act. This forecast results in an inequitable  
28 treatment to ratepayers by delaying benefits based on an uncertain premise. The  
29 effects of bonus depreciation under the Tax Relief Act are a temporary unique  
30 circumstance that should be considered on an individual case basis. In this case,

1 the forecast NOL should be disregarded for ratemaking purposes as it is clearly  
2 detrimental to ratepayers and disregarding the NOL would have no negative effect  
3 on shareholders.

4 Second, SCE's proposal is inconsistent with the guidance of Decision (D.) 84-  
5 05-036 which excludes the effect of NOL carry backs and carry forwards. In this  
6 case, the delayed deferral and its resulting decrease to rate base are carried forward  
7 to future periods. Given this resulting inconsistency, DRA further asserts the NOL  
8 should be disregarded for ratemaking purposes.

9 Third, in the event an NOL is considered at a utility level, one may never exist  
10 at the corporate level. This raises serious doubts regarding the use of an estimate  
11 of a NOL to delay the flow-through of the actual calculation of the deferred tax  
12 generated by bonus depreciation to ratepayers. Given that taxes are prepared at  
13 the corporate level, the forecast of a NOL at the utility level to justify a delay in the  
14 pass through of a deferred tax is unwarranted.

15 If an NOL does not occur at the corporate level, a "phantom NOL" has been  
16 created, based on a modeling effort. The imputed "phantom NOL" calculation  
17 prepared by SCE serves to delay the immediate flow through of the full effect of  
18 bonus depreciation to ratepayers and all applicable deductions. SCE's taxes are not  
19 calculated and paid at the utility level but are paid at the corporate level which  
20 involves numerous other factors (outside the rate case components) resulting in  
21 SCE's true tax burden.

22 **1. SCE's Methodology Fails to Provide Evidence That**  
23 **Consideration of an NOL Is Equitable**

24 SCE's testimony offers no explanation why the deferred tax allocation should  
25 be delayed to ratepayers, and it is based solely on a model of a stand alone subset  
26 of estimated costs. Regardless of the results of SCE's assumptions and modeling,  
27 ratepayers should be treated equitably by the use of appropriate reasonable  
28 assumptions consistent with test year ratemaking. DRA's proposal causes no  
29 adverse impact to shareholders by recognizing the immediate and full allocation of  
30 deferred taxes to ratepayers in the year in which they are available. SCE's modeling

1 effort fails to reflect the fact that real world taxation differs from ratemaking as  
2 recognized in D.84-05-036.

3 The true tax expense or benefit is calculated and paid based on the  
4 consolidated results of the overall operations (corporate level) of Edison  
5 International (EIX). SCE, the utility, is a subset of that consolidation. Furthermore,  
6 SCE's general rate case is a subset of the results of SCE's utility operations; and the  
7 basis for SCE's updated testimony pursuant to the Tax Relief Act. Given these  
8 layers and the varying possibilities of operating results that are removed from the  
9 components of a rate case, the potential existence of an NOL at the corporate level  
10 or utility stand-alone level cannot be forecast with accuracy. The primary issue is  
11 what is fair and reasonable to ratepayers in a ratemaking environment.

12 Ratemaking is a predictive activity that attempts to forecast a subset of costs.  
13 What occurs at the real world taxation level of EIX or the imputed forecast world of  
14 SCE, the utility, is far removed from the ratemaking world in terms of timing the  
15 deferred tax calculation for ratemaking purposes. In modeling the existence of a  
16 NOL for SCE, the utility, the Company has provided no evidence that amounts paid  
17 in taxes at the corporate level have any bearing on the expense predicted via a  
18 modeling effort. There is no evidence presented that an NOL will be generated at  
19 the corporate level for EIX. Nor is there any evidence that if an NOL were to be  
20 generated, it would be as a result of bonus depreciation generated by the utility, in  
21 contrast to a result of factors existing in the other operations of EIX.

22 Lastly, SCE has not shown that a NOL is a certainty or, that in the event one  
23 does, that the reason for the NOL is the result of significant bonus depreciation due  
24 to the Tax Relief Act. Nothing in SCE's Update testimony indicates that immediate  
25 recognition of bonus depreciation, or recognizing applicable deductions, will harm  
26 shareholders. Nor does SCE show that 2012 forecasted taxes at a corporate level,  
27 once dissected and allocated to the utility level, and then to the rate case level would  
28 harm shareholders if an NOL did or did not exist. The NOL is merely a phantom  
29 forecast created from modeling that unreasonably delays the full allocation of  
30 deferred taxes to ratepayers. There is no evidence that shareholders will be harmed

1 by allocating the entire amount of accrued deferred tax as a rate base deduction and  
2 not recognizing a forecast NOL.

3 **2. DRA’s Proposal is Consistent with D.84-05-036**

4 According to D.84-05-036, the effect of NOL carry backs and carry forwards  
5 are to be strictly excluded from the test year calculation. The decision states, “the  
6 practice of excluding carry backs and carry forwards from the test-year calculation of  
7 income taxes is well-founded and should continue.” It also states, “We find that the  
8 practice of excluding carry backs and carry forwards from the test year income tax  
9 calculation reasonably matches benefits and burdens and should be continued”; and  
10 “A tax loss may be the result of timing choices that a utility makes under the tax  
11 laws”. (15 CPUC 2d, pp. 55, 56.)

12 By delaying the impact and not recognizing the full effects of the deferred tax  
13 generated by bonus depreciation by the test year, SCE's proposed delay is  
14 essentially a carry forward of an NOL. Within the context of the Decision whereby  
15 carry forwards are excluded, the resulting carry forward of deferred taxes in this  
16 case due to bonus depreciation is inconsistent with Commission guidance. For  
17 ratemaking purposes, the full effects of bonus depreciation and deferred tax should  
18 be recognized in the year available and calculated regardless of the SCE forecasted  
19 NOL.

20 **3. SCE’s Utilization of an NOL Is Inconsistent with Test**  
21 **Year Ratemaking**

22 Under the “Tax Relief Act” bonus depreciation is immediately available in  
23 calculating corporate income taxes. Pursuant to typical normalization, a deferred tax  
24 is created resulting in an immediate reduction to rate base in the year bonus  
25 depreciation is recorded. By its modeling of an NOL, SCE did not recognize the  
26 immediate and full impact of bonus depreciation as a reduction to rate base. By  
27 SCE’s modeling of an NOL which for utility stand alone income tax purposes is only  
28 imputed and not actual, it serves to delay the effects of bonus depreciation. This  
29 delay is modeled by SCE to be a year or longer. SCE, in its Update testimony,  
30 describes this impact in the following manner:

1 “The revised federal tax depreciation amounts remain subject to the  
2 normalization requirements of Internal Revenue Code Section  
3 168(f)(2). Failure to comply with the normalization requirements would  
4 16 require the use of the book (i.e., straightline) depreciation method  
5 for federal income tax purposes over the regulatory life of the affected  
6 property in lieu of the accelerated ACRS/MACRS depreciation  
7 otherwise permitted under Internal Revenue Code Section 168. A  
8 utility’s deferred income tax liability is deemed consistent with the  
9 normalization requirements if the amount of the deferral is equal to the  
10 difference between income taxes due with ACRS/MACRS and taxes  
11 due without ACRS/MACRS. The deferred income tax liability amount  
12 should not reflect the portion of accelerated tax depreciation  
13 attributable to a net operating loss. The Internal Revenue Service has  
14 ruled that the requisite deferral should be made at the time the utility  
15 realizes an actual tax benefit from the use of the accelerated  
16 depreciation. To the extent SCE is not able to immediately realize the  
17 actual tax benefit (i.e., not able to immediately use the net operating  
18 loss), a deferred tax asset should be created and included in rate base  
19 to offset the corresponding recorded deferred income tax liability. SCE  
20 has made the appropriate adjustments to its deferred tax liability  
21 consistent with Internal Revenue Service’s rulings.”<sup>2</sup>

22 DRA understands the intent of SCE’s approach, and the related Internal  
23 Revenue Service (IRS) guidelines. Despite this, ultimately an NOL may not exist at  
24 either the imputed utility level or at the corporate level where the true tax expense or  
25 benefits, are determined. Given the inherent uncertainties, where tax estimates for  
26 rate cases are just that “estimates”, where EIX has yet to file their 2012 consolidated  
27 corporate tax returns, where EIX has the ability to amend their tax returns in future  
28 periods, then changes to any actual NOL could result. Given that shareholders  
29 derive the lion’s share of the 100% bonus depreciation benefits, DRA recommends  
30 ratepayers should receive the immediate tax deferred benefits associated with  
31 bonus depreciation under the “Tax Relief Act.” By not recognizing the immediate  
32 benefits of bonus depreciation due to a phantom NOL calculation, the resulting rate  
33 base reduction is inappropriately delayed, yet the full benefit is available to  
34 shareholders in the year generated.

---

<sup>2</sup> Update To Reflect Tax Relief Act And Removal of Nuclear Seismic Costs, April 2011, pg. 4.



1 In its review of the Results of Operations (R/O) model results,<sup>3</sup> SCE forecasts  
2 NOL's for both 2011 and 2012. The delay in recognizing the immediate reduction in  
3 rate base, and the corresponding reduction in the revenue requirement could be as  
4 much as two years. DRA has not been able to model the impact. However, it  
5 appears the rate base impact is at least \$250 million in 2012.<sup>4</sup> The immediate  
6 recognition of bonus depreciation will significantly reduce the revenue requirement  
7 for 2012, 2013 and 2014. DRA is continuing to review the deferred tax calculation  
8 and will provide an estimated deferred tax figure under its proposal and revenue  
9 requirement impact in the comparison exhibit or no later than the Fall Update.

10 Additionally in gaining an understanding of the impacts due to bonus  
11 depreciation on the income tax estimate, DRA noted the estimated NOL resulted in a  
12 permanent loss of a roughly \$30 million<sup>5</sup> Section 199 Manufacturer's deduction for  
13 2012.<sup>6</sup> DRA understands that IRS guidelines would prohibit the recognition of this  
14 deduction if no taxable income (i.e., NOL) exists for 2012. But, despite the manner  
15 in which income taxes are estimated, the rationale guiding the estimation, or any IRS  
16 guidelines, ratepayers should receive the benefit. There is no NOL for ratemaking  
17 taxes and this deduction should be recognized. SCE was able to take this deduction  
18 over the past few years although it was not recognized in the last GRC. Absent a  
19 NOL at the Edison International level, then the corporation will be able to utilize this  
20 deduction, and ratepayers will not.

---

<sup>3</sup> Per SCE's response to an e-mail dated July 26, 2011, showing the results of the Tax Relief Impact.

<sup>4</sup> DRA is actively evaluating the calculation to determine the appropriate amount of deferred taxes.

<sup>5</sup> Per SCE's response to an e-mail dated July 21, 2011, the grossed-up revenue requirement impact is \$29,430,576.

<sup>6</sup> Per SCE's response to an e-mail dated July 22, 2011, "as a result of the 2012 net operating loss, the Section 199 deduction was permanently lost for 2012. The tax code does not provide for the ability to recoup this deduction in later years."