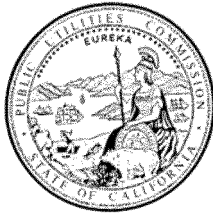


Docket:	:	<u>A.12-11-009</u>
Exhibit Number	:	<u>DRA-20</u>
Commissioner	:	<u>Florio</u>
ALJ	:	<u>Pulsifer</u>
Witness	:	<u>Wuehler</u>



DIVISION OF RATEPAYER ADVOCATES
CALIFORNIA PUBLIC UTILITIES COMMISSION

**Report on the Results of Operations
for
Pacific Gas and Electric Company
General Rate Case
Test Year 2014**

Tax Expenses and Other Financial Matters

San Francisco, California
May 3, 2013

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TAX EXPENSES AND OTHER FINANCIAL MATTERS

I. INTRODUCTION

This exhibit presents the analyses and recommendations of the Division of Ratepayer Advocates (DRA) regarding Pacific Gas and Electric Company's (PG&E) forecasts of tax expenses for Test Year (TY) 2014, as well as other financial matters.

Regulated tax expense comprises the following items: (1) Federal Income Taxes (FIT) and State Income Taxes (California Corporate Franchise Taxes (CCFT)); (2) payroll taxes; and (3) property, or *ad valorem* taxes. These tax expense categories are the composite of projected taxable income streams, book expenses, special tax deductions, and tax credits, calculated within the combined contexts of "real world" tax law, and "regulatory world" tax policy. Tax expense also includes taxes, which are not a function of income streams, but of the payment of employee compensation, and the ownership of property.

DRA's forecasted tax expenses are computed in the Results of Operations (RO) model, since they are dependent upon DRA's forecasts of income, expenses, and plant balances.

II. SUMMARY OF RECOMMENDATIONS

The following summarizes DRA's recommendations:

- That the tax deductions for entertainment expenses be eliminated and the associated TY 2014 revenue requirements be removed.
- That the meals-related expenses be decreased by \$359,321 for the revenue requirement and that the associated income tax deductions be reduced by \$179,661.
- That the 50% bonus depreciation rate be included for the year 2013 when calculating deferred taxes.
- That the 50% bonus depreciation rate be used in the Test Year (TY) 2014 and post-test year 2015 and 2016 deferred tax calculations.
- Alternately, the 2014 rate for bonus depreciation should be 12.5% to allow for certain qualifying property placed in service after December 31, 2012 and before January 1, 2014.

- 1 • If and when the bonus depreciation rule is extended to 2014, PG&E
2 should be directed to update the bonus depreciation rate to 50%.
- 3 • That the AFUDC rate be set calculated with short-term debt of 30%
4 of the total capital structure.
- 5 • That the Return on Equity rate in the AFUDC calculation be set the
6 same rate as the long-term debt rate for PG&E.
- 7 • That the AFUDC rate be set at 3.91%.

8 **III. DISCUSSION / ANALYSIS OF INCOME TAXES**

9 The following section provides a brief background of regulated tax expense
10 and a discussion of certain specific tax deductions, credits and other tax policy
11 issues related to determining taxable income for ratemaking purposes, as well as
12 other issues affecting revenue requirements for taxes other than income. Unless
13 otherwise noted, all discussions apply equally to both federal and state income tax
14 expense.

15 **A. Basis for Regulated Income Tax Expense**

16 While the mathematical model used to calculate tax expense is seemingly
17 unequivocal, the underlying accounting conventions, applicable tax rates, and the
18 determination of what constitutes allowable deductions is a function of current
19 federal and state tax law, including new laws expected to affect the test year,
20 regulatory tax policy as determined by numerous Commission decisions, and DRA
21 recommended tax and adopted tax policy. Much of existing Commission tax policy
22 was established in Order Instituting Investigation 24 (OII 24), Decision (D.) 84-05-
23 036.¹ Numerous subsequent decisions adopted a variety of changes in ratemaking
24 tax policy in order to comply with changes in federal and state tax laws.
25 Consequently, although a mathematical model may be used, there are a number of
26 estimated factors driving income tax expense requiring a review to attempt to assess
27 the reasonableness of the utilities' request.

¹ 15 CPUC 2d 42 (1984).

1 DRA also attempts to ensure that the test year's income tax expense estimate
2 should reflect, to the extent possible, the current deduction of expenses in which
3 there is a book/tax timing difference. In D.84-05-036, the Commission stated, "[f]or
4 the present, we will continue our current policy regarding flow-through treatment of
5 timing differences consistent with applicable tax law."² DRA assumes the
6 Commission will continue to adopt policies which result in the test year tax estimate
7 reflecting, to the extent possible,³ the flow-through of forecasted expenditures.

8 Another important factor is the ratemaking concept of normalization. Its aim
9 is to adjust a utility's operating expenses in the test year by eliminating abnormal,
10 non-annual events that are known and certain to change in a regularly recurring
11 manner. For example, accelerated depreciation is a tax expense, which is
12 normalized over the life of an asset when computing ratemaking tax expense. It is
13 known and certain that toward the end of the life of an asset, straight-line (book)
14 depreciation will exceed accelerated tax depreciation. However, at the conclusion of
15 the asset's life, the total depreciation charges under both book and tax methods will
16 be equivalent.

17 Income tax normalization permits a utility to include as its current ratemaking
18 expense an amount of income tax expense that is higher than what the utility will
19 actually pay. This is based on the theory that the taxes saved by the accelerated
20 depreciation (taken on the real world tax returns) are merely deferred. Utilities (or
21 the holding company of a utility) generally use accelerated methods of depreciation
22 for their actual, real world tax returns, while using the straight-line method for book
23 purposes. Internal Revenue Service (IRS) rules require that utilities use book
24 depreciation rates on all plant purchased or constructed after 1980 when computing
25 regulated tax expense. To mitigate the effect of normalization, the tax effect of the

² See D.84-05-036, discussion at Section I, pp. 32-33a. The Commission did not adopt additional normalization requirements beyond those required for depreciation.

³ DRA's recommended treatment for certain tax deductions and benefits is limited by Income Tax Normalization requirements of the Internal Revenue Code, as well as tax policy established in D.84-05-036. For example, currently, disallowed expenses cannot be used as tax deductions.

1 differences between accelerated and straight-line depreciation is booked to a
2 deferred tax reserve, which reduces the rate base on which return is calculated.

3 Because of current tax law, utilities are required to adopt normalization for
4 depreciation on assets placed in service after 1980. There is no federal tax
5 requirement that normalization be used for other tax timing differences. It is the
6 policy of this Commission to flow through non-plant tax timing differences.
7 Consequently, all federal and state tax timing differences should be flowed through
8 to the ratepayer to the extent allowed by Commission policy, and federal and state
9 tax law.

10 **B. Overview of PG&E's Request**

11 For federal income tax purposes, PG&E used the corporate tax rate of 35%.
12 For state income tax purposes, PG&E used the corporate tax rate of 8.84% to
13 compute CCFT. Payroll taxes and their respective rates and wage bases used in the
14 results of operations are: Federal Insurance Contribution Act (FICA) 6.20%,
15 \$117,900 salary cap; and Medicare 1.45%, no salary cap.

16 **C. Significant Tax Changes since the Last General Rate Case**

17 Since the 2011 General Rate Case (GRC) was filed, Congress passed three
18 laws with material tax implications.

19 First, on September 27, 2010, President Obama signed into law the "Small
20 Business Jobs Act."⁴ The Act extended a provision enacted in 2008 that created for
21 most depreciable personal property acquired in 2010 a special allowance or bonus
22 depreciation of 50 percent of the asset's basis in the year of acquisition. Property
23 eligible for bonus depreciation is most property with a recovery period of 20 years or
24 less. PG&E has included the effect of the depreciation allowance in its forecast of
25 federal deferred taxes in this filing. As of the date of this filing, California has not
26 conformed to this change.

⁴ *Small Business Jobs Act of 2010*, Pub. L. No. 111-240.

1 Second, on December 17, 2010, President Obama signed into law, the “Tax
2 Relief, Unemployment Insurance Reauthorization, and Job Creation Act.”⁵ This Act
3 included a provision that created bonus depreciation of 100 percent of the asset’s
4 basis for qualifying property placed in service after September 8, 2010, and before
5 January 1, 2012. The Act also provides for 50 percent bonus depreciation for
6 qualifying property placed in service during 2012. Property eligible for the bonus
7 depreciation is property with a recovery period of 20 years or less. PG&E has
8 included the effect of the depreciation allowance in its forecast of federal deferred
9 taxes in this filing. As of the date of this filing, California has not conformed to this
10 change.

11 Finally, on December 31, 2011, President Obama signed into law, the
12 “National Defense Authorization Act.”⁶ This Act included a provision that excluded
13 Section 1603 Treasury Cash Grants from the Internal Revenue Code (IRC)
14 normalization rules applicable to the Investment Tax Credit (ITC). In years where
15 PG&E is not able to utilize ITC due to a net operating loss, PG&E may have elected
16 to receive Section 1603 grants instead. PG&E has normalized the grants following
17 the rules for ITC in its filing.

18 The provision for 50 percent bonus depreciation for certain qualified property
19 acquired after December 31, 2007 has been extended several times and was
20 recently extended to certain qualified property placed in service before January 1,
21 2014 (before January 1, 2015, for certain property with a long production period).
22 DRA believes that it is reasonable to expect that it will be extended again to apply to
23 the same qualified property placed in service prior to January 1, 2015.

24 Other than the changes described above, federal and state taxing authorities
25 have made only minor changes to income tax law since PG&E filed its 2011 GRC,
26 most of which do not affect PG&E.

⁵ *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*, Pub. L. No. 111-312.

⁶ *National Defense Authorization Act for Fiscal Year 2012*, Pub. L. No. 112-81.

1 **IV. ADJUSTMENTS TO FEDERAL AND STATE INCOME TAX**

2 **A. Interest Expense Deduction**

3 For FIT purposes, rate base derived interest expense is computed by
4 applying the weighted average cost of long-term debt cost factor to estimate its rate
5 base interest expense deduction. DRA does not take issue with PG&E's estimates
6 for the total amount of rate base interest expense deductible for regulated income
7 tax purposes.

8 Under current federal tax law, Investment Tax Credits (ITC) must be
9 amortized over the life of the underlying plant when estimating regulated federal
10 income tax expense. Generally, this method of normalizing ITC applies to plant
11 placed in service after 1980. Public utility corporations have two normalization
12 methods to choose from when electing a method to amortize ITC for regulated tax
13 purposes. Under option one, the tax benefits of ITC are flowed through to ratepayers
14 by deducting deferred ITC from rate base; as each year passes, the deferred ITC
15 balance decreases, thereby ratably restoring rate base over the book life of the plant
16 which generated it. Under option two, the tax benefits of ITC are ratably flowed
17 through as a direct reduction of estimated FIT. PG&E uses option one.

18 The unamortized deferred investment tax credit balance was deducted from
19 rate base for this calculation because PG&E is an option one company (see
20 discussion for ITC above). "Interest synchronization" which normally results in a
21 higher interest deduction, and therefore, a lower regulated FIT expense, is not
22 applicable because of how PG&E treats unamortized ITC (option one). PG&E also
23 used this approach in its results of operations. For CCFT purposes, it does not
24 matter whether PG&E is an option one or two company because there is no ITC
25 available for CCFT purposes. DRA does not take issue with PG&E's ITC rate base
26 deduction.

27 **B. Federal and State Tax Depreciation Deductions**

28 For FIT purposes, tax depreciation for all post-1980 plant has been
29 normalized using book lives and rates. For 1980 and prior years' plant, the

1 appropriate accelerated depreciation has been flowed through. For CCFT purposes,
2 tax depreciation has been flowed-through in estimating CCFT taxable income. Tax
3 depreciation for ratemaking purposes does not include depreciation on plant costs
4 disallowed in previous rate cases. DRA does not take issue with PG&E's federal
5 and state tax depreciation deductions.

6 **C. Federal and State Cost of Removal Deductions**

7 The cost of removal deduction is estimated on the basis of forecasted plant
8 retirements for the test year. Removal costs are incurred when plant is physically
9 removed from service. Removal costs are deductible for tax purposes when
10 incurred. Under the normalization requirements of the tax code, estimated removal
11 costs associated with plant vintage years after 1980 are not currently deductible.
12 However, for FIT purposes, a cost of removal deduction is still available for 1980 and
13 prior property, and for all vintage years for purposes of calculating CCFT taxable
14 income. For this reason, the deductible CCFT estimate is larger than the FIT
15 deduction. Current deductions for cost of removal are reflected in the FIT and CCFT
16 tables. DRA does not take issue with PG&E's methodology for estimating the cost
17 of removal deductions.

18 **D. Federal and State Repair Allowance Deductions**

19 The cost of plant construction is capitalized for book purposes. However, a
20 percentage of these capitalized costs are deductible for income tax purposes as
21 repairs (repair allowance). A repair allowance deduction is generally available for
22 1980 and prior years' vintage assets for FIT purposes, and on all vintages for CCFT
23 purposes. DRA does not take issue with PG&E's estimate.

24 **E. FIT Deduction for Prior Year's CCFT**

25 The amount of CCFT allowed as a deduction for FIT purposes by the IRS is
26 not the current year's CCFT. The amount allowed on the FIT return is the prior
27 year's CCFT liability. This creates a timing difference between when the CCFT
28 payment is made and when it is allowed as a tax deduction.

1 This issue was addressed in Phase II of one of PG&E's prior general rate
2 cases, A.85-12-050 (I.86-11-019). D.89-11-058, issued on November 22, 1989,
3 requires that for ratemaking purposes, the prior year Commission adopted CCFT
4 number be used as the deduction for CCFT taxes in arriving at FIT taxable income.

5 DRA had no issue with PG&E's current estimate of the amount of CCFT used
6 as a deduction for FIT.

7 **F. Payroll Taxes**

8 Payroll taxes and their respective rates and wage bases are: Federal
9 Insurance Contribution Act (FICA) 6.20%, \$117,900 salary cap; Medicare 1.45%, no
10 wage cap; Federal Unemployment Insurance (FUI) 0.60%, \$7,000 wage base; State
11 Unemployment Insurance (SUI) 6.200%, \$7,000 wage base; and San Francisco
12 Payroll Tax at 1.5% of payroll expenses for employees working in San Francisco.
13 DRA does not take issue with PG&E's payroll tax estimates.

14 **G. Property Taxes**

15 The California Constitution requires the State Board of Equalization (SBE) to
16 annually assess public utilities at Fair Market Value. Taxes are levied and collected
17 in the same manner as county assessed properties.

18 Estimated property taxes were developed using SBE valuation methods
19 appropriate for closely regulated public utilities. The SBE uses the Cost and the
20 Capitalized Earnings Ability value indicators to determine PG&E's system-wide
21 assessment. Generally, this valuation method should not result in a valuation
22 significantly different from rate base.

23 For the 2014 test year, property tax forecasts are determined by multiplying
24 the taxable Historical Cost Less Depreciation (HCLD) by the property tax factor. The
25 property tax factor is comprised of the base year market-to-cost ratio (relationship
26 between the most current assessment (fiscal year 2011/2012) and the taxable
27 HCLD) multiplied by the composite tax rate. The composite tax rate is computed
28 based on assessment and tax data from the latest known fiscal tax period (fiscal
29 year 2011/2012). The property tax factor was escalated and applied to each

1 forecasted period to reflect annual increases in the tax rate. The tax rate for test-
2 year 2014 was computed based on a 5-year average and applied consistently to tax
3 year 2012/2013 through 2014/2015 reflecting the continuing increase in special
4 assessments and local tax rate increases.

5 The final expense amount is determined using two fiscal period assessment
6 estimates. For example, test-year 2014 property tax expense is comprised of one-
7 half of fiscal year 2013/2014 and one-half of fiscal year 2014/2015. DRA does not
8 oppose PG&E's property taxes estimates.

9 **H. Capitalized Software Adjustment**

10 Section 167(f)⁷ of the IRC requires taxpayers to capitalize and depreciate
11 certain software acquired in the open market. Section 174 of the IRC provides that
12 some portion of the cost of certain self-developed software may be deducted
13 currently. As in the 2011 GRC, PG&E has used normalized tax accounting
14 treatment for amounts that are capitalized under Section 167(f) and flow-through tax
15 accounting treatment for the amounts that are deductible under Section 174.

16 The normalized tax accounting used in this case for the Section 167(f) portion
17 of the adjustment is the tax accounting used in Decision 88-01-061 for depreciable
18 tax basis placed in service since 1986. Since this tax effect is normalized, deferred
19 tax expense is calculated for this item. PG&E has also followed past practice in
20 using flow through accounting for the amounts deductible under Section 174.

21 DRA does not oppose PG&E's capitalized software adjustment.

22 **I. Meals and Entertainment Deduction**

23 Federal tax laws place a limit of 50% on the deduction for meals and
24 entertainment expenditures. To incorporate this statutory limit into its revenue
25 requirements, PG&E includes a negative adjustment equal to 50% of its estimates of

⁷ The Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103-66) added Section 167(f) to the IRC, effective for capitalized software purchased after August 10, 1993.

1 the total amount of expense for meals and entertainment.⁸ For ratemaking
2 purposes a tax deduction is calculated on the remaining half of the total amount of
3 expense for meals and entertainment and the tax effect of this deduction is
4 subtracted from the original estimates of the amount of expense for meals and
5 entertainment in revenue requirements.

6 DRA does not agree with the deductions and associated TY 2014 revenue
7 requirements for entertainment-related expenses, be they travel, meals, or tickets.
8 DRA removes these entertainment-related expenses from all revenue requirements
9 because these social and cultural activities are of a dubious benefit to ratepayers
10 and PG&E has not produced any testimony showing any such benefit. DRA's
11 adjustment is supported by prior Commission decisions, which have twice rejected
12 entertainment-related expenses (e.g., Disneyland tickets, luncheons, retiree dinners)
13 from rate setting because they are an unfair economic burden⁹ and ratepayers
14 should not be required to pay for them.¹⁰ Furthermore, the Commission has
15 rejected entertainment expenditures because they give the appearance of a "free
16 lunch" at ratepayers' expense.¹¹ The Commission upheld the exclusion of
17 entertainment expenses and entertainment related meals in the most recent
18 Southern California Edison GRC.¹² PG&E's entertainment expenses clearly fall
19 under the same category of expenses that the Commission has rejected in the past,
20 and therefore DRA rightfully removes them.

21 DRA recommends that the tax deductions for entertainment expenses be
22 eliminated and associated TY 2014 revenue requirements be removed from the

⁸ Ex. PG&E-2 WP 12-396.

⁹ D.82-12-054; 10 CPUC 2d at 140-141.

¹⁰ D.93-12-043; 52 CPUC 2d at 513-514.

¹¹ D.90-01-016; 35 CPUC 2d 80 at 135-136.

¹² D.12-11-051, pages 620-621.

1 appropriate FERC accounts. The amount of these entertainment-related expenses
2 for TY 2014 is \$54,265.¹³

3 DRA also does not agree with the tax deductions and associated TY 2014
4 revenue requirements of \$15,245,115¹⁴ for meals expense. DRA sent a data
5 request¹⁵ for records of meals in 2011 asking for records of meal charges greater
6 than or equal to \$1,000, asking for sufficient information to determine whether the
7 meals were not primarily for entertainment purposes. DRA determined from the
8 information supplied by PG&E that \$359,321 related to employee recognition and
9 other items that DRA believes are not appropriate to be charged to ratepayers. DRA
10 recommends that the meals-related expenditures be decreased by \$359,321 in the
11 appropriate FERC accounts for revenue requirement, and that the associated
12 income tax deductions be reduced by an adjustment of \$179,661 (half of \$359,321).

13 **V. DISCUSSION / ANALYSIS OF DEFERRED TAXES**

14 As discussed in section III A, above, sometimes there are differences
15 between when deductions are recognized for rate making versus when they are
16 recognized for income tax purposes. The majority of these differences occur when
17 depreciation expense is allowed for income tax purposes but, due to tax law¹⁶, they
18 are not recognized for rate making until the year in which they are recognized for
19 accounting.

20 The following simplified example illustrates how this works. For a piece of
21 equipment costing \$100,000 with a depreciable life of 10 years and using the
22 straight-line depreciation method, the yearly depreciation expense would be 10% per
23 year, or \$10,000. For income tax purposes, this equipment also qualifies for 50%

¹³ Using the 2011 Base Year amount at Exhibit PG&E-2 WP 12-97 as a proxy.

¹⁴ Ibid.

¹⁵ DRA-PG&E-228-JRW.

¹⁶ When tax normalization is required.

1 bonus depreciation in the first year. So the first year depreciation for income tax
2 purposes would be \$55,000 (\$50,000 bonus plus \$5,000 which is 10% of the
3 remaining depreciable balance). The \$45,000 difference in first year depreciation
4 will result in deferred taxes. The deferred taxes will then reverse over the remaining
5 9 years of the depreciable.

6 The 50% bonus depreciation provision became effective on January 1, 2008
7 and was originally scheduled to expire after December 31, 2009. For 2010, the 50%
8 bonus depreciation provision applied to a more restricted set of depreciable assets
9 up through September 8, 2010. Then for assets placed in service from September
10 9, 2010 up to and including December 31, 2012 the bonus depreciation provision
11 was increased to 100%. The 50% bonus depreciation provision has also been
12 extended for assets placed in service before January 1, 2014 and for certain
13 qualifying property placed in service before January 1, 2015.

14 PG&E only included 12.5% for bonus depreciation for 2013 with the
15 expectation that the bonus depreciation would not be available in 2013. The 12.5%
16 rate is to cover certain qualifying property that is to be placed in service after
17 December 31, 2012 and before January 1, 2014. DRA recommends that the rate for
18 2013 should be 50% because the tax law was changed to allow for 50% bonus
19 depreciation for the entire year of 2013.

20 PG&E has not included the 50% bonus depreciation for 2014, 2015, and
21 2016. DRA believes that due to the recent history of extensions for bonus
22 depreciation rules, there is a reasonable likelihood that it will be extended beyond
23 2013. So DRA recommends that the 50% bonus depreciation be included for 2014,
24 2015, and 2016.

25 At a minimum, the 2014 rate for bonus depreciation should be 12.5% to allow
26 for certain qualifying property placed in service after December 31, 2012 and before
27 January 1, 2014. Then if the bonus depreciation rule is extended beyond 2013,
28 PG&E should be directed to update the bonus depreciation rate to 50% or whatever
29 rate the government sets.

1 **VI. DISCUSSION OF BALANCING ACCOUNTS**

2 PG&E has proposed to eliminate six tracking accounts and add four new
3 tracking accounts.¹⁷ These proposals are found in Exhibit PG&E-10, chapter 9.

4 **A. PG&E's Request and DRA Recommendations**

5 PG&E included a number of proposed changes to tracking accounts.¹⁸

6 **1. Elimination of Tracking Accounts**

7 PG&E proposes the elimination of six tracking accounts:

- 8 · SmartMeter Balancing Account
- 9 · Meter Reading Costs Balancing Accounts (electric and gas)
- 10 · Distribution Integrity Management Expense Balancing Account
- 11 · Market Redesign Technology and Upgrade Memorandum Account
- 12 · Service Disconnection Memorandum Accounts (electric and gas)
- 13 · Tax Act Memorandum Account

14 Each of these accounts was set up to address specific issues that covered a
15 finite period of time. If there is no longer a purpose to continue these tracking
16 accounts then DRA does not oppose their elimination.

17 **2. New Tracking Accounts**

18 PG&E proposes the addition of four new balancing accounts.¹⁹

- 19 · Electric Emergency Recovery
- 20 · Hydro Licensing and License Conditions Costs
- 21 · Nuclear Regulatory Commission Rulemaking Implementation Costs
22 Balancing Account
- 23 · Gas Leak Survey and Repair Balancing Account

¹⁷ Tracking accounts include balancing accounts and memorandum accounts and track costs for specific purposes.

¹⁸ Ex. PG&E-10, Chapter 9.

¹⁹ Ibid.

1 DRA's recommendations for these balancing accounts are addressed in the
2 cost section relating to each account.

3 In general, DRA believes that balancing accounts are most useful when they
4 have a specific purpose and a defined shelf life. Balancing accounts should not be
5 used to cover on-going costs of operations. The Commission should review the
6 facts and circumstances related to the underlying issues and reject balancing
7 accounts for which there is not a defined sunset. The fact that costs fluctuate from
8 year to year should not be a reason for the establishment of a balancing account.

9 **VII. DISCUSSION OF ALLOWANCE FOR FUNDS USED DURING** 10 **CONSTRUCTION**

11 Allowance for Funds Used During Construction (AFUDC) is a mechanism that
12 allows a utility (PG&E) to be compensated for the costs incurred during construction
13 of an asset that will eventually, after appropriate reasonableness reviews, become a
14 part of its rate base. These costs are classified as Construction Work In Progress
15 (CWIP). AFUDC is included to actual construction costs to determine the final cost
16 that is added to rate base. After the final amount is added to rate base, the utility
17 (PG&E) can then earn a return based on the rate of return (ROR) that is authorized.

18 The CWIP is not included in rate base from the date of inception of the project
19 because 1) has not yet been deemed a reasonable expenditure and 2) it is not yet
20 used and useful in providing benefits to the utility ratepayers. Only after the cost has
21 been determined to be reasonable as well as the asset being used and useful to
22 ratepayers is the utility allowed to add the asset to rate base and to begin earning a
23 return on the asset.

24 **A. Overview of PG&E's Request**

25 PG&E has requested that the AFUDC rate to finance CWIP be set using the
26 cost of its "long-term debt and equity financing in compliance with PG&E's CPUC-

1 authorized capital structure.”²⁰ In other words, PG&E requests that CWIP earn the
2 full authorized ROR from the date costs are first incurred.

3 **B. Analysis of PG&E’s Request**

4 PG&E’s request that CWIP earn the full authorized ROR from the date that
5 costs are first incurred is virtually the same as requesting that CWIP be included in
6 rate base from the inception of each project. The only difference is that the AFUDC
7 recorded during the construction period is capitalized into rate base for future
8 recovery instead of being recovered in the current year.

9 Prior to completion of construction, the project provides no service or benefit
10 to ratepayers. It is neither used nor is it useful. For energy utilities there has
11 historically been the presumption that until the asset is used and useful to the
12 ratepayers, it should not be included in rate base. When it becomes used and
13 useful, it is added to rate base and ratepayers pay for that use by paying a return on
14 the net book value of the asset. After it is no longer used and useful, the asset is
15 removed from rate base so that ratepayers do not continue to pay for something that
16 provides them with no benefit.

17 **1. Justification for and Analysis of AFUDC**

18 When an entity, whether regulated or non-regulated, constructs an asset,
19 there are carrying costs used to finance the construction of that asset. Those
20 carrying costs add to the total cost of construction. In ratemaking for regulated
21 utilities, those carrying costs are referred to as Allowance for Funds Used During
22 Construction. It is appropriate to recognize AFUDC as a part of the construction
23 costs. The question then is what rate is appropriate for AFUDC?

24 For a non-regulated entity, AFUDC is a cost that it will seek to keep as low as
25 possible. A non-regulated entity cannot set its future earnings based on the total
26 cost of the asset. Its future revenues related to a constructed asset are determined

²⁰ Ex. PG&E-10, Chapter 11, page 11-1, lines 17-19.

1 by competitive market forces rather than on the mechanisms that exist in a regulated
2 environment. A higher AFUDC amount will result in a higher asset cost and a lower
3 return earned on that asset in the future. So that entity will have a clear incentive to
4 1) keep the AFUDC rate as low as possible which will keep the final asset cost as
5 low as possible, 2) keep the construction period as short as reasonably possible. A
6 well-run non-regulated entity will actively seek to keep its AFUDC rate as low as
7 possible by utilizing short-term debt and long-term debt to the maximum extent
8 possible.

9 In contrast, a regulated utility does not have the same motivation to minimize
10 AFUDC costs. The costs for AFUDC included in the asset eventually are included in
11 rate base, which is the basis for a regulated utility's earnings. So there is a potential
12 motivation for a regulated utility to make the AFUDC rate as high as possible in
13 order to maximize its earnings. The higher the AFUDC rate, the more the regulated
14 utility will earn in the future.

15 Due to the monopoly nature of the regulated utility business, there is a need
16 for regulatory policy to provide a reasonable restraint on costs as a substitute for
17 market forces that do not exist in a monopoly setting. Allowing a utility to use its full
18 ROR as the rate for its AFUDC is bad policy which gives the utility little incentive to
19 control costs. It also removes an incentive to minimize the time to complete
20 construction projects.

21 Regulatory policy does not make utility decisions. It merely provides a
22 reasonable framework as a proxy for a competitive marketplace from which a utility's
23 management can make decisions. Regulatory policy thus provides restraints that
24 can lead to more efficient and ratepayer friendly decisions by the utility.

25 **C. DRA Recommendation for AFUDC**

26 The Federal Energy Regulatory Commission's (FERC) formula for AFUDC
27 includes short-term debt along with the components of a utilities capital structure
28 used to determine its ROR, which includes long-term debt, preferred stock and
29 common stock. Utility management has discretion over how much of each
30 component is used. PG&E has included zero short-term debt in its requested

1 AFUDC rate. This has the effect of maximizing the possible AFUDC rate. It also
2 has the effect of treating CWIP the same as other rate base items that are used and
3 useful in providing service to ratepayers. So even if PG&E uses short-term debt to
4 finance CWIP, the rate PG&E would record for AFUDC is its full authorized ROR.

5 **1. Short-Term Debt in AFUDC Rate Calculation**

6 PG&E says that it currently “has a revolving line of credit of \$3 billion.”²¹
7 Exhibit A of PG&E’s application shows that its short-term borrowings were \$1.647
8 billion at December 31, 2011 and \$0.397 billion at September 30, 2012. PG&E’s
9 application also shows CWIP as \$1.770 billion at December 31, 2011 and \$2.095
10 billion at September 30, 2012. DRA requested that PG&E provide actual short-term
11 debt amounts by month for the five years 2008 to 2012.²² PG&E provided the
12 average funds outstanding by month. The short-term debt amount during that five
13 year period ranged from a low of \$0.60 billion to a high of \$1.602 billion. The
14 average monthly amount for the five years was \$0.775 billion. Based on these
15 numbers, there is sufficient room and ability for PG&E to use short-term debt to
16 finance a portion of its CWIP. The issue is what is an appropriate amount. In
17 practice, that question is a management decision. But for ratemaking, the
18 Commission must set that rate to provide incentive for PG&E to be efficient in its use
19 of capital and to also provide fair and equitable treatment for ratepayers.

20 DRA proposes that it is reasonable to use short-term debt to fund 30 percent
21 of CWIP. That amounts to \$0.531 billion at December 31, 2011 and \$0.629 billion at
22 September 30, 2012. It is not clear whether any of PG&E’s current short-term
23 borrowings can be attributed to CWIP. If it were assumed that the current amount is
24 zero, adding these amounts to the existing short-term debt would result in \$2.178
25 billion at December 31, 2011 and \$1.028 billion at September 30, 2012. Adding
26 short-term debt equal to 30 percent of CWIP at September 30, 2012 (\$0.629 billion)

²¹ Ex. PG&E-10, Chapter 11, page 11-13, lines 16.

²² Response to data request DRA_AudOra001-Q01-FWF, April 30, 2013.

1 to the average short-term borrowings for 2008 to 2012 (\$0.775 billion), gives a total
2 average short-term debt of \$1.404 billion. Each of these numbers is well below
3 PG&E's current revolving line of credit of \$3 billion. PG&E clearly has room to
4 finance 30 percent of its CWIP with short-term debt. At times, PG&E has sufficient
5 short-term debt capacity to finance 100 percent of CWIP. The actual percentage of
6 short-term debt used is a management decision.

7 Including 30 percent short-term debt in the calculation of PG&E's CWIP will
8 provide a regulatory restraint on costs that a complete market place does not
9 provide due to PG&E's monopoly status. DRA recommends that the AFUDC rate
10 calculation include short-term debt at 30% of the total capital used to finance CWIP.

11 The rate for short-term debt would be equal to PG&E's actual average short-
12 term debt rate. As a proxy, DRA uses the 2014 projected rate for 3-month
13 commercial paper, or 0.16 percent.²³

14 **2. Return on Equity in AFUDC Rate Calculation**

15 CWIP is treated differently from rate base in part because it is not yet
16 providing service to ratepayers. It is not yet used nor is it useful. Providing a full
17 rate of return on an asset that is not yet used and useful does not provide any
18 incentive for PG&E to control its costs similar to the control provided via competitive
19 markets for non-regulated entities.

20 In D.11-05-018, PG&E's last GRC, the Commission addressed a situation
21 where an asset was not used and useful, but for which the Commission determined
22 that a return was appropriate.²⁴ In that decision it was determined that the return on
23 equity should be set at the same rate as the long-term debt rate. In so doing, a
24 return was allowed but it was not equal to that authorized for a used and useful
25 asset that provides benefits to ratepayers.

²³ IHS Global Insight, US Economic Outlook, April, 2013.

²⁴ D.11-05-018, Rate of Return on abandoned meters.

1 Using that approach to CWIP, DRA recommends that the return on equity
 2 rate for the AFUDC calculation be set at the long-term debt rate. Using PG&E's
 3 latest authorized cost of capital, that rate would be 5.52 percent as opposed to the
 4 authorized equity rate of 10.4 percent. This rate would change as PG&E's cost of
 5 debt rate changes in its authorized cost of capital updates.

6 **3. DRA Recommended AFUDC Rate**

7 Using the approach to AFUDC described above, DRA recommends an
 8 AFUDC rate of 3.91 percent as shown in Table 20-1.

Table 20-1
 DRA's Recommended AFUDC Rate

	Capital	Cost	Weighted Cost
Short Term Debt	30.00%	0.16%	0.05%
Long Term Debt	32.90%	5.52%	1.82%
Preferred Stock	0.70%	5.60%	0.04%
Common Equity	36.40%	5.52%	2.01%
AFUDC Rate	100.00%		3.91%

9

10 PG&E used its 2011 authorized rate of return as the AFUDC rate in its
 11 application, as shown in Table 20-2.

Table 20-2
 PG&E's Requested AFUDC Rate

	Capital Structure	Cost	Weighted Cost
Short Term Debt	0.00%	0.00%	0.00%
Long Term Debt	47.00%	6.05%	2.84%
Preferred Stock	1.00%	5.68%	0.06%
Common Equity	52.00%	11.35%	5.90%
AFUDC Rate	100.00%		8.79%

12

13

1 PG&E's authorized rate of return for 2013 is shown in Table 20-3.

Table 20-3
PG&E's Authorized Cost of Capital for 2013

	Capital Structure	Cost	Weighted Cost
Short Term Debt	0.00%	0.00%	0.00%
Long Term Debt	47.00%	5.52%	2.59%
Preferred Stock	1.00%	5.60%	0.06%
Common Equity	52.00%	10.40%	5.72%
Rate of Return	100.00%		8.37%

2