

**CTC TAX WORKSHOP
APPENDIX TO
JOINT PROPOSAL AND EXHIBIT**

1 Definitions

The participants have agreed upon the following definitions:

1.1 DEFERRED TAX LIABILITY (DTL)

Taxes owed by the utilities to taxing authorities. The liability is based on the difference between book and tax basis, after accounting for accumulated book depreciation and accumulated tax depreciation to date. The difference times the applicable tax rate establishes the nominal amount of the liability. The liability generally will not come due immediately, but will be paid over time.

1.2 DEFERRED TAX ASSET (DTA)

Income taxes due from taxing authorities to the utilities. A DTA will usually come about because book treatment is more favorable than the corresponding tax treatment. For example, PG&E's treatment of vacation pay gives rise to a DTA because PG&E funds the taxes due. When a DTA is created, the utilities have paid more in tax today, but will receive future tax deductions that yield a tax benefit later.

1.3 FLOW-THROUGH TAX ACCOUNTING

Under this method of ratemaking, tax expense is included in the test year revenue requirement based on actual cash taxes paid to taxing

authorities. Thus, the benefit of accelerated tax depreciation is passed through to ratepayers in the early years of an asset's life, but is repaid in the form of higher rates in the later years of the asset's life. The Commission has adopted flow-through tax accounting for pre-1981 additions to plant, post-1980 differences between book and tax basis, and state taxes.

1.4 NORMALIZED TAX ACCOUNTING¹

This method of ratemaking sets rates based on tax expense computed as if book depreciation (which is not accelerated) were deductible on tax returns. In effect, ratepayers reimburse utilities for total tax expense, including current and deferred taxes. This increases ratemaking tax expense initially, and gives utilities cash for deferred tax expense in excess of amounts actually paid to tax authorities in the early years of the asset's life. However, in the later years of an asset's life, ratepayers benefit from lower rates because the total tax expense is lower, and the Deferred Tax Reserve is used to pay current taxes due to taxing authorities in excess of the total tax expense recovered in rates.

1.5 DEFERRED TAX RESERVE

For assets subject to normalized tax accounting, ratepayers will pay for a level of tax expense in rates, in the early years of the asset's life, that is higher than the tax expense paid by the utilities to taxing authorities. This extra amount funds a Deferred Tax Reserve that reverses in later years to pay tax expense to taxing authorities that is higher than that collected in

¹ Applies predominantly to life and method timing differences on plant placed-in-service after 1980.

rates. During the existence of the reserve, it is used to lower rate base, thus providing a benefit to ratepayers by lowering the return component of rates.

1.6 REGULATORY ASSET OR RECEIVABLE

Amounts owed by the ratepayers to utilities. As defined above, a DTL can be computed for any asset based on the relative amounts of book and tax depreciation taken to date. If the asset was subject to flow-through tax accounting, the utilities have a regulatory receivable that recognizes that ratepayers have benefited from lower rates in the early years of the asset's life, with the expectation of paying higher rates in the future in order to pay the DTL. If the asset was subject to normalization tax accounting, the ratepayers have funded the DTL; thus, there will not generally be a regulatory asset in conjunction with normalized assets.

1.7 REGULATORY LIABILITY OR PAYABLE

Amounts owed by the utilities to ratepayers.

2 The Ratemaking Tax Algorithm

This complex issue of fixed asset taxation can be clarified through understanding the following principles:

- 2.1 Depreciation is beneficial to ratepayers and utilities because it is deductible, and therefore lowers tax expense.
- 2.2 Book and tax depreciation at the end of life for any given asset will be exactly the same.

- 2.3 If book and tax depreciation during the life of the asset is the same, taxes do not present an issue because there is conformity between the book and tax expense levels. The ratemaking revenue requirement would be based solely on recovery of the plant investment.
- 2.4 However, tax depreciation is generally accelerated compared to book depreciation, creating a “gap” between book and tax during the life of the asset.
- 2.5 As this gap is closed (via reimbursement in rates for book depreciation that is treated as income for tax purposes because accelerated tax depreciation has already reduced taxable income in prior periods), taxes will be due to the taxing authorities.
- 2.6 If ratepayers reimbursed utilities for tax expense based on actual tax depreciation (“flow-through”), then ratepayers will benefit from lower rates as the gap builds up, but must pay higher rates to close the gap in the later years of the asset’s life, because utilities will pay taxes on the gap.
- 2.7 If ratepayers reimbursed utilities for tax expense as if book depreciation were deductible, then they have funded (“normalized”) the taxes due on the gap. Ratepayer funding will be used on behalf of ratepayers to pay taxes due to taxing authorities as the gap is closed.

3 Complications Raised by the CTC

- 3.1 As noted above, either the flow-through or normalized methods of tax accounting will generally yield the same revenue requirement over the life of the asset. (The normalization method will produce a somewhat lower

revenue requirement in nominal dollars, since the Deferred Tax Reserve lowers rate base, and thus the return component of rates).

- 3.2 Under CTC, the regulated status of the assets will come to a close at the end of the transition period; this is generally before the assets will have fully depreciated. This book depreciation is now being accelerated; thus there is a need to fund taxes on the “gap” under CTC that would normally unwind in due course under cost-of-service regulation, but which will now be accelerated.
- 3.3 In effect, the Preferred Policy Decision and AB 1890 require utilities to credit ratepayers for the reversal of the Deferred Tax Reserve in computing the CTC revenue requirement. In addition, ratepayers must now make a “catch up” payment over the transition period to repay the benefits previously received by ratepayers on the flow-through assets and to fund the Deferred Tax Reserve. Once funded, the Deferred Tax Reserve will be used to pay taxes due to taxing authorities.