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PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

COMMISSION ADVISORY
AND COMPLIANCE DIVISION
Energy Branch

RESOLUTION E-3396
November 22, 1994

R E S O L U T I O N

RESOLUTION E-3396. SOUTHERN CALIFORNIA EDISON COMPANY REQUESTS AUTHORITY TO CLASSIFY CERTAIN DEMAND-SIDE MANAGEMENT PROGRAMS AS EXPENSE PROGRAMS AND NOTICE OF INTENT TO SUSPEND SHARED SAVINGS EXPENDITURES.

BY ADVICE LETTER 1071-E, FILED ON SEPTEMBER 9, 1994.

SUMMARY

1. In this advice letter, Southern California Edison Company (Edison) requests authority to classify, as of January 1, 1995, certain demand-side management (DSM) activities as Expense programs for earnings purposes. In addition, Edison provides formal notice of its intent to suspend activities and expenditures under the Shared Savings earnings category effective January 1, 1995. Edison does not specify the duration of its requests.
2. Toward Utility Rate Normalization (TURN) protested this advice letter on procedural grounds and claimed there was insufficient information to assess its impact. We have incorporated TURN's procedural concerns into our consideration and disposition of Edison's requests. TURN's protest is otherwise denied.
3. This Resolution authorizes Edison to shift its Performance Adder funds to the Expense category for a six month period, beginning January 1, 1995. Should Edison seek a re-categorization of these programs on a more extended basis, an application will be necessary.
4. Edison has not requested our authorization to suspend its shared savings programs. Nonetheless, we clarify that its DSM Bidding Pilot Programs must continue to receive shared savings treatment, consistent with Decision (D.) 94-09-041. In addition, Edison is directed to accrue unspent ratepayer funds in its DSM one-way balancing account and must file an advice letter at the conclusion of the six-month period to discuss the disposition of these funds.

BACKGROUND

1. In an Internal Revenue Service (IRS) audit of Edison's 1983 through 1985 tax returns, the IRS examining agent determined that Edison's DSM program expenditures must be capitalized for tax purposes, rather than expensed as Edison and other utilities have treated such costs. The determination was based on a United States Supreme Court decision, Indopco, Inc. v. Commissioner, (503 Us.S. _____, 117 L.Ed. 2n 226, 112 S.Ct. 1039 (1992)) which found that if a current cost to a company creates a substantial future benefit for the company, then that cost should be capitalized and not expensed for tax purposes.

3. By Advice Letter 1030-E, filed on November 23, 1993, Edison requested authority to establish a DSM Tax Change Memorandum Account. By Resolution E-3374, Edison received authorization to establish a DSM Tax Change Memorandum Account to record potential future costs associated with changes in tax treatment of prospective DSM expenditures, and the associated interest, to the extent interest accrues after the establishment of the memorandum account. While the memorandum account allows Edison to track these costs on a prospective basis, there is no guarantee of future recovery of these costs.

4. Edison has been active in assuming the leadership role in seeking resolution of the tax uncertainty because of the immediate risk it faces from the disallowance of its deductions from DSM. To this end, it is seeking federal legislation to resolve uncertainty regarding the appropriate federal tax treatment for DSM expenditures. The IRS determination was based on DSM expenditures which occurred during years prior to the implementation of shareholder incentive mechanisms. Edison believes that the tax risk is increased now that shareholder incentives are in place, particularly due to the impact of ex post measurement. Measurement and evaluation verifies the future benefit of DSM programs. By D.93-05-063, we adopted ex post measurement and evaluation protocols for DSM programs, which would be applied beginning with program year 1994. Under the protocols, shareholder incentives are contingent upon the results of measurement studies over a ten-year period.

5. By filing this advice letter, Edison requests relief that it believes will allow it to prospectively mitigate the tax risk, while it continues to pursue resolution of the federal tax uncertainty. Edison states that the relief requested in the advice letter is narrowly-tailored to allow the preservation of the infrastructure developed for delivering DSM programs. Edison asserts that in the absence of this relief, it will dismantle this infrastructure and, in effect, curtail delivery of any type of ratepayer-funded DSM program.

6. Edison specifically requests that the Commission issue a Resolution which:

- a) authorizes Edison to classify, as of January 1, 1995, its Performance Adder DSM activities and its expenditures for Southern California Gas Company's

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Residential DSM Bidding Pilot Program as Expense programs; and

- b) affirms that DSM activities classified as Expense programs are not eligible for shareholder incentives.

7. In addition, Edison has used this advice letter to formally notify the Commission of its intent to:

- a) suspend, as of January 1, 1995, its DSM expenditures and activities authorized for certain Shared Savings programs. The programs impacted will be:

Residential Appliance Efficiency Incentives
Nonresidential Incentives
Residential New Construction
Nonresidential New Construction

- b) implement audit and information activities as Expense programs, which will provide Edison's customers with energy advice.

8. Edison and the Division of Ratepayer Advocates (DRA) entered into a Memorandum of Understanding (MOU) on September 2, 1994, concerning the funding level of Edison's 1995 General Rate Case (GRC). The MOU proposes a reduced level of DSM funding, but does not address the classification of programs and suspension of activities that Edison believes is necessary to mitigate the DSM tax uncertainty.

7. Edison filed Advice Letter 1071-E on September 9, 1994.

Notice

The Advice Letter was noticed in accordance with section III of General Order 96-A, by publication in the Commission Calendar, distribution to Edison's advice filing service list, and its DSM Policy Advisory Group (PAG).

PROTESTS

1. The Commission Advisory and Compliance Division (CACD) received a protest from Toward Utility Rate Normalization (TURN) on September 29, 1994.

2. TURN protests the advice letter on procedural grounds, stating that an advice letter filing is inappropriate, since all of the programs and activities affected by Edison's request await Commission action in the Test Year 1995 GRC, Application (A.) 93-12-025. TURN notes that the anticipated settlement between Edison and DRA makes it unlikely that the Commission will have made its determination before January 1, 1995, as to which programs should be funded, and to what extent. In addition, TURN states that Edison's proposed actions are policy-setting, and therefore should not be considered via an advice

letter. TURN suggests that a generic investigation be opened into the tax issue so that its impact on DSM programs can be thoroughly assessed.

3. Finally, TURN protests Advice Letter 1071-E, because insufficient information is provided to adequately assess the potential tax impact, the impact on the GRC, and the disposition of the unspent funds. TURN suggests that those funds be returned immediately to ratepayers in the form of a reduced revenue requirement, and not carried over to later program years.

4. Edison, in its response, states that an advice letter is appropriate in this case, citing General Order 96-A, Section V. Edison also cites Advice Letter 908-E and Resolution E-3288, which allowed Edison to allocate to various incentive-based DSM programs pre-Collaborative carry-over funds. These carry-over funds were classified as expense rather than contributing toward the incentive mechanism. Edison also states that TURN's call for a single forum to address the tax issue is only appropriate after the tax issue has been resolved, and then only if the ultimate resolution of this issue will necessitate generic changes to utility DSM programs. Edison believes that approval of its request will not result in any changes to Commission DSM policy, nor will it result in any permanent program changes. Edison also states that an advice letter is appropriate, since it received general approval for the request from its PAG, other than TURN.

5. Edison states that it has provided sufficient information in this advice letter filing. Edison believes that TURN's confusion is due to mistakenly thinking that Advice Letter 1071-E is intended to modify its GRC request. Edison provides no additional information, but states that its only intention in this request is to request interim relief to preserve its DSM infrastructure, regardless of what is adopted in the 1995 GRC.

DISCUSSION

1. DSM programs focus on the customer side of the meter and include energy efficiency and conservation, load management, load retention and load building, fuel substitution, measurement and evaluation, and other DSM. Our major focus has been to encourage programs which provide energy efficiency. This Commission has encouraged conservation programs since the mid-1970's. More recently, we have adopted shareholder incentive mechanisms, as opposed to command-and-control regulation, to carry out the legislative mandates codified in Public Utilities Code Sections 701.1 and 746.

2. Energy efficiency and conservation programs are classified into shared savings programs, performance adder programs, and expensed programs. These categories relate to the type of shareholder incentive for which the program may be eligible. For those DSM programs which provide resource benefits; i.e., those that avoid or defer more costly supply-side alternatives, we have adopted various shared savings performance-based

incentives. While DSM programs are generally funded by ratepayers, the benefits resulting from these programs are shared in some fashion between ratepayers and shareholders. For programs that serve equity concerns or provide benefits which are difficult to measure, we have adopted performance adder mechanisms. Other programs, such as information, are expensed and not eligible for incentives. The role of shareholder incentives is to offset the regulatory and financial biases against DSM (or in favor of supply-side resources) that utility might have in procuring least-cost resources.

3. The Commission adopted shareholder incentive mechanisms on a more permanent basis in D.93-09-078. With D.94-10-059, we adopted specific guidelines on implementing both shared savings and performance adder programs. It is these incentive mechanisms that would apply to Edison's 1995 programs. We note that Edison not only supported the more permanent adoption of shareholder incentives, but was active in sponsoring the proposed incentive that was adopted, with some modifications, by D.94-10-059. That decision addresses the tax issue on a prospective basis, stating that:

The ramifications of this potential tax consequence have not been fully evaluated, and the outcome of the tax issue will not be resolved in the time frame of this phase of the proceeding. While parties generally agree that this change in tax treatment would impact tax levels and associated revenue requirements, they do not agree on whether or how it would affect the utilities' evaluation of the cost-effectiveness of DSM programs, for either funding or earnings claim purposes. . .

In the event that current tax practices change, Panel 1 recommends that any effects these changes may have on earnings calculations be applied to prospective program years, and not programs that have already been implemented. We believe that this is a reasonable approach in light of the uncertainty regarding the tax treatment of DSM expenditures. However, should the IRS ruling remain in effect, we will need to clarify how it should apply to the earnings claim for future programs. We will do so in the first AEAP [Annual Earnings Assessment Proceeding] following the IRS' final determination on this issue. (D.94-10-059, mimeo, p. 114).

TURN's concern as to a generic investigation into the tax issue will therefore be addressed in the relevant AEAP.

4. There are two fundamental issues that must be discussed in considering Edison's request. Is an advice letter the proper procedural vehicle for implementing a broad policy change? If so, does Edison's request have merit?

5. Advice letters are generally used to implement policy and make changes to tariff schedules. Edison has indicated that General Order (G.O.) 96-A, Section V provides that an advice

letter may be used to implement changes in service which do not result in increased rates or charges. However, Section VI of G.O. 96-A states:

the tariff schedules of a utility may not be changed whereby any rate or charge is increased, or any condition or classification changed so as to result in an increase, or any change made which will result in a lesser service or more restrictive conditions at the same rate or charge until a showing has been made before the Commission and a finding by the Commission that such increase is justified.

A formal application to increase rates shall be made in accordance with the Commission's Rules of Procedures, except where the increases are minor in nature (G.O. 96-A, amended September 28, 1988, p. 11, emphasis added).

While Advice Letter 1071-E does not impact rates, it may certainly have the impact of lessening service or placing more restrictive conditions upon that service.

6. Furthermore, D.94-10-059 has expanded the DSM fund-shifting rules to Edison, which have been applicable to other respondents in our DSM Rulemaking.¹ These policies allow for unlimited movement of funds between programs given the same shareholder incentive treatment, as discussed more fully in D.94-10-059. The decision clarifies that, aside from certain exceptions, any movement in or out of these various categories must be requested via an application.

7. We therefore view Edison's request as a fundamental change in our fund-shifting policy. Although there have been some fund-shifting precedents, these related to very different circumstances - not a suspension of programs, nor a re-classification of an entire category of programs. We are, however, somewhat sympathetic to Edison's position. Edison is trying to protect its shareholders from a potential tax liability, but has no clear-cut regulatory avenue down which to proceed. Pacific Gas & Electric Company (PG&E) has requested a reduction in its 1995 DSM budget (for different reasons), but has petitioned to modify its Test Year 1993 GRC to do so. Edison does not have that option. Its 1992 GRC decision covers DSM programs for the period ending December 31, 1994. Beginning January 1, 1995, its DSM programs and services will be governed by the 1995 GRC decision, a decision which has not yet been issued, nor is likely to be by year-end, as TURN points out.

8. As TURN made clear in its protest, Edison's procedural grounds for this advice letter are tenuous. However, given the

¹ The respondents to R.91-08-003/I.91-08-002 are Pacific Gas & Electric Company, Edison, San Diego Gas & Electric Company, and Southern California Gas Company.

regulatory timing issues and the immediacy of its DSM tax dilemma, CACD recommends that we allow the advice letter to stand for the very limited duration we discuss below.

9. It is unclear at this time exactly what the potential tax liability will be in absolute terms. In discussions with CACD, Edison has confirmed that its potential tax liability over the 10-year earnings period is 23% of expenditures on a net present value basis. First year cost would be 40% of expenditures. While the dollar impact of the affected programs must be clarified, it is more important to ensure continuation of the DSM infrastructure, which the Commission has so carefully nurtured.

10. Shareholder incentives were established because the private value of DSM has diverged significantly from the societal benefits that can be accrued from these programs. We are very hesitant to sacrifice the long-term benefits of DSM to a tax liability threat which may or may not materialize, particularly given the time and effort that has been spent in developing DSM policy guidelines. However, given the specific IRS situation in which Edison finds itself and to avoid completely dismantling Edison's DSM delivery system, CACD recommends that we authorize a limited shift in the performance adder program funds to the expensed, non-earnings category.

11. CACD recommends that the Commission authorize the re-categorization of funds for a six-month period, beginning January 1, 1995. Should Edison decide that it is necessary to re-categorize these programs for a more extended time period, an application should be filed. At that time, a showing should be made which will allow the Commission to determine if such a policy shift is in order. The application should outline Edison's analysis of the tax liability, discuss the merits of converting the tax memorandum account into a balancing account, and an explanation of the future of DSM programs at Edison.

12. In addition, the ramifications of Edison's future suspension of its shared-savings DSM programs should be fully explored. Although Edison has not asked the Commission for authorization to suspend these programs, this is clearly a fundamental policy change that should be assessed by all interested parties. Although Edison has suggested that certain filings and measurement activities may be curtailed as a result of its action, we caution Edison that this, too, should be assessed as part of its application.

13. Edison has characterized this advice letter as receiving the support of its DSM Policy Advisory Group. However, TURN, the Department of General Services, California Large Energy Consumers Association and California Manufacturers Association have recently resigned from this committee, stating that "no useful purpose exists for customers to participate in Edison's Advisory Committee absent significant changes by Edison in its approach to DSM program decision-making." Rather than acting as a strong partnership, as provided for in D.92-02-075, the Policy Committee members assert that they have not received

sufficient information so that there is a meaningful opportunity to participate. CACD believes such input is essential and contributes to the collaborative process. The resignation, then, of key members of its PAG provides additional strength to the merits of Edison filing an application addressing the fundamental policy issues, should continued re-categorization and suspension be sought.

14. Edison has stated that it is formally notifying the Commission that all shared savings programs will be suspended for 1995. However, in D.94-09-041, the Commission rejected aspects of Edison's amended application related to its request that the Commission suspend the DSM Bidding Pilot contracts until the tax issue is favorably resolved. Edison also requested that if the DSM Bidding Pilot Programs were not suspended, the Commission should classify the DSM Bidding Pilot Program as an expense program. Instead, the Commission ruled that Edison was aware of the potential tax liability well in advance of filing A.94-05-016. Edison's request was denied (See D.94-09-041, mimeo, p. 14-17). Consistent with D.94-09-041, CACD recommends that Edison be precluded from suspending shared savings treatment for its DSM Bidding Pilot programs in 1995.

15. As TURN points out, the suspension of shared-savings programs will create a pool of ratepayer money that will not be used for its intended purpose; i.e., to accrue long-term benefits associated with resource programs. Resource programs represent significant long-term benefits and the infrastructure related to the delivery of these programs should not be abandoned, as we have discussed above. CACD recommends that during the interim period of suspension, the funds authorized in the 1995 Test Year GRC decision should be accrued in Edison's one-way balancing account. At the end of the six-month period discussed above, CACD recommends that Edison be directed to file an advice letter discussing the disposition of these funds.

FINDINGS

1. Edison filed Advice Letter 1071-E on September 9, 1994.
2. Edison requests authority to classify its Performance Adder DSM programs as Expense programs for earnings purposes beginning January 1, 1995. In addition, Edison provides formal notice of its intent to suspend activities and expenditures under the Shared Savings category effective January 1, 1995.
3. Resolution E-3374 authorized Edison to establish a DSM Tax Change Memorandum Account. This account does not guarantee recovery of such expenditures.
4. Edison seeks to mitigate its potential tax liability and at the same time preserve its DSM delivery infrastructure, to the extent possible.
5. With the exception of the DSM Bidding Pilot Programs, Edison's requests are reasonable for a limited duration, due to

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regulatory timing issues and the immediacy of its specific IRS situation. Edison's requests represent a fundamental shift in Commission DSM policy, which should be considered in an application should Edison seek to implement them on a long-term basis.

6. TURN protested Advice Letter 1071-E on procedural grounds, which have been considered in this Resolution.

7. D.94-09-041 precludes Edison from suspending shared savings treatment of DSM Bidding Pilot Programs. It is reasonable to require that Edison file a supplemental advice letter, which clarifies that its pilot bidding programs will continue to receive shared savings treatment during 1995.

8. It is reasonable to require Edison to accrue its unspent ratepayer funds in its DSM one-way balancing account, consistent with current policy. It is reasonable to have Edison file an advice letter on June 30, 1995, which discusses the disposition of these funds.

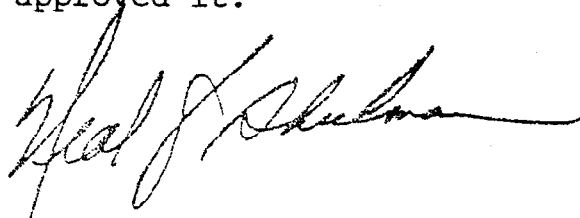
9. Nothing in this Resolution shall be considered to set a precedent in A.93-12-025 or any other proceeding related to DSM.

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THEREFORE, IT IS ORDERED that:

1. Southern California Edison Company is authorized to shift its Demand-Side Management Performance Adder Programs to the Expense category for a six-month period, beginning January 1, 1995.
2. Southern California Edison Company shall file an advice letter at the end of the six-month period, which discusses the disposition of ratepayer funds maintained in its one-way balancing account.
3. The protest of Towards Utility Rate Normalization has been considered in the disposition of this Resolution. Except as otherwise noted, it is denied.
4. Should Southern California Edison Company choose to implement the fund-shifting as conditioned in this resolution and exclusive of the Bidding Pilot Programs, it shall file a supplemental advice letter to Advice Letter 1071-E on or before December 22, 1994, which clarifies that its Demand-Side Management Bidding Pilot Programs will receive Shared Savings treatment, consistent with Decision 94-09-041. The supplemental advice letter shall also incorporate the six-month timing limitations to Southern California Edison Company's request, as discussed herein.
5. To the extent Southern California Edison Company seeks an extension of the six-month time period authorized today, an application must be filed. This application should provide a showing before the Commission which will allow us to fully assess such a policy shift, as discussed in this Resolution.
6. This Resolution is effective today.

I hereby certify that this Resolution was adopted by the Public Utilities Commission at its regular meeting on November 22, 1994. The following Commissioners approved it:



NEAL J. SHULMAN
Executive Director

DANIEL Wm. FESSLER
President
PATRICIA M. ECKERT
NORMAN D. SHUMWAY
P. GREGORY CONLON
JESSIE J. KNIGHT, Jr.
Commissioners