Application	:	A.05-12-002
Exhibit Number	:	DRA-12
Commissioner	:	Bohn
Admin. Law Judges	:	Kenney, Econome
Witness	:	Waterworth

DIVISION OF RATEPAYER ADVOCATES
CALIFORNIA PUBLIC UTILITIES COMMISSION

Report on the Results of Operations Electric and Gas Distribution Electric Generation for Pacific Gas and Electric Company

General Rate Case
Test Year 2007

Income, Payroll and Property Taxes

San Francisco, California
April 14, 2006

INCOME, PAYROLL, AND PROPERTY TAXES

I. INTRODUCTION

This exhibit presents DRA's analysis and recommendations regarding PG&E's income, payroll, and property tax expenses and responds to PG&E's request for tax related revenue requirements contained in Exhibit PG&E-2, Distribution Results of Operations, Chapter 7 - Payroll Taxes, and Chapter 11 - Income and Property Taxes, and Exhibit PG&E-3, Generation Results of Operations, Chapter 10 - Income and Property Taxes. PG&E is requesting cost recovery for test year estimated income and other taxes.

Regulated tax expense is comprised of the following items: (1) Federal Income Taxes (FIT), 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.

II. SUMMARY OF RECOMMENDATIONS

DRA's recommendations, resulting in differences or issues relative to PG&E's estimates, are as follows:

1. DRA recommends that any changes in federal and state tax law made before the close of the record in this proceeding be incorporated into the tax estimates for the test year, after review of the new law by DRA.

1 **III. DISCUSSION**

2 The following section provides a brief background of regulated tax expense
3 and a discussion of certain specific tax deductions, credits and other tax policy issues
4 applied in determining taxable income for ratemaking purposes, as well as other
5 issues affecting revenue requirements for taxes other than income. Unless otherwise
6 noted, all discussions apply equally to both federal and state income tax expense.

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

8 While the mathematical model used to calculate tax expense is seemingly
9 unequivocal, the underlying accounting conventions, applicable tax rates, and the
10 determination of what constitutes allowable deductions is a function of current federal
11 and state tax law, including new laws expected to affect the test year, regulatory tax
12 policy as determined by numerous Commission decisions, and DRA recommended
13 tax and adopted tax policy. Much of existing Commission tax policy was established
14 in Order Instituting Investigation 24 (OII 24), D.84-05-036, 15 CPUC 2d 42 (1984).
15 Numerous subsequent decisions adopted a variety of changes in ratemaking tax policy
16 in order to comply with changes in federal and state tax laws. Consequently, although
17 a mathematical model may be used, there are a number of estimated factors driving
18 income tax expense requiring a review to attempt to assess the reasonableness of the
19 utilities request.

20 DRA also attempts to ensure that the test year's income tax expense estimate
21 should reflect, to the extent possible, the current deduction of expenses in which there
22 is a book/tax timing difference. In D.84-05-036, the Commission stated, "[f]or the
23 present, we will continue our current policy regarding flow-through treatment of
24 timing differences consistent with applicable tax law."[1] DRA assumes the

[1] 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.

1 Commission will continue to adopt policies, which result in the test year tax estimate
2 reflecting, to the extent possible,[2] the flow-through of forecasted expenditures.
3 Another important factor is the ratemaking concept of normalization. Its aim is
4 to adjust a utility's operating expenses in the test year by eliminating abnormal, non-
5 annual events that are known and certain to change in a regularly recurring manner.
6 For example, accelerated depreciation is a tax expense, which is normalized over the
7 life of an asset when computing ratemaking tax expense. It is known and certain that
8 toward the end of the life of an asset, straight-line (book) depreciation will exceed
9 accelerated tax depreciation. However, at the conclusion of the asset's life, the total
10 depreciation charges under both book and tax methods will be equivalent.
11 Income tax normalization permits a utility to include as its current ratemaking
12 expense an amount of income tax expense that is higher than what the utility will
13 actually pay. This is based on the theory that the taxes saved by the accelerated
14 depreciation (taken on the real world tax returns) are merely deferred. Utilities
15 generally use accelerated methods of depreciation on their real world tax returns,
16 while using the straight-line method for book purposes. IRS rules require that utilities
17 use book depreciation rates on all plant purchased or constructed after 1980 when
18 computing regulated tax expense. To mitigate the effect of normalization, the tax
19 effect of the differences between accelerated and straight-line depreciation is booked
20 to a deferred tax reserve. The deferred taxes are used to reduce ratebase.
21 Because of current tax law, utilities are required to adopt normalization for
22 depreciation on assets placed in service after 1980. However there is no federal tax
23 requirement that normalization be used for other tax timing differences. In fact, it is
24 the policy of this Commission to flow through non-plant tax timing differences.
25 Consequently, all federal and state tax timing differences should be flowed through to

[2] 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.

the ratepayer to the extent allowed by Commission policy, and federal and state tax law.

Lastly, the regulated utility's *parent corporation* actually pays the income taxes of the regulated utility as part of a consolidated or combined income tax return. Therefore, it is DRA's position that the regulatory goal of estimating tax expense is to mirror, to the extent permissible by tax law, the actual tax liability of the regulated unit payable to the parent corporation. In order to assess the predictive accuracy of the methodology utilized by PG&E, DRA requested PG&E to provide a reconciliation from the 2003 GRC income tax request to actual income taxes. Based on the results of PG&E's response, DRA considered the current methodology (as set forth in PG&E's application) a reasonable predictor of income tax expense.

B. Recent Tax Law Changes

1. Energy Policy Act of 2005

The Energy Policy Act of 2005 was signed into law on August 8, 2005. The Act was intended to establish a comprehensive, long-range energy policy. It provides incentives for traditional energy production as well as newer, more efficient energy technologies, and conservation. Title XIII of the Act provides incentives applicable to electricity infrastructure, domestic fossil fuel security, conservation and energy efficiency provisions, alternative motor vehicles and fuels incentives, additional energy tax incentives, and revenue raising provisions. The portion of the Act, which applies to the income tax components of this ratecase, relates to a decrease in the tax depreciable life of natural gas lines from 20 years to 15 years for property placed in service after April 11, 2005 and before January 1, 2011.

2. American Jobs Creation Act of 2004

The American Jobs Creation Act of 2004 was signed into law on October 22, 2004. The Act repeals the exclusion for a portion of income earned by exporters (so-called extraterritorial income), allows a deduction for income attributable to production in the United States, alters numerous other tax laws for both domestic and

1 foreign corporations, and provides individuals with an optional deduction for state and
2 local sales taxes (in place of state and local income taxes.) In addition to making
3 many other changes to tax law, the Act also makes several changes to the federal
4 tobacco production quota program and extends both Internal Revenue Service (IRS)
5 and customs user fees through September 30, 2014. The provisions of the Act have
6 various effective and sunset dates. The portion of the Act, which applies to the
7 income tax components of this ratecase, relates to a domestic manufacturing
8 deduction. PG&E states that while production of electricity qualifies for the
9 deduction, transmission and distribution of electricity do not. Therefore, there is no
10 effect on the manufacturer's tax deduction.

11 **3. Jobs and Growth Tax Relief Reconciliation Act of 2003**

12 The Jobs and Growth Tax Relief Reconciliation Act of 2003 was signed into
13 law on May 28, 2003. The key provisions of the Act were to aaccelerate a 10%
14 bracket expansion, accelerate reduction in income tax rates, accelerate reduction of
15 marriage penalties, accelerate an increase in the child tax credit, reduce taxes on
16 dividends and capital gains, increase small business expensing for new investment,
17 increase first-year bonus depreciation, and alternative minimum tax (AMT) hold-
18 harmless relief. The portion of the Act, which applies to the income tax components
19 of this ratecase, relates to the increased first-year bonus depreciation. The additional
20 first-year bonus depreciation deduction is increased from 30 percent to 50 percent for
21 investments acquired and placed in service after May 5, 2003 and before January 1,
22 2005. Taxpayers may also continue to use 30 percent bonus depreciation for property
23 acquired and placed in service before January 1, 2005. PG&E has stated for 2007
24 there should be no impact on federal tax depreciation for the electric or gas
25 distribution function related to the special depreciation allowance on additions made
26 in 2007. There should be no affect on state tax depreciation because as of the date of
27 filing state law has neither conformed to the 30% rate, nor conformed to the 50% rate.
28

C. Federal and State Tax Rates

For federal income tax purposes, PG&E utilized the corporate tax rate of 35% to compute FIT. For state income tax purposes, PG&E utilized the corporate tax rate of 8.84% to compute CCFT.

D. Major Adjustments to Federal and State Income Taxes

1. Interest Expense Deduction

For FIT purposes, applying the weighted average cost of long-term debt to estimated rate base derived interest expense. In its application, PG&E used a weighted long-term debt cost factor of 2.78% to estimate its interest expense deduction. D.05-12-043 adopted an 11.35% ROE and 8.79% ROR for PG&E in 2006, but no cost of capital has been adopted for 2007 yet. Any other differences in the total amount of interest expense deductible for regulated income tax purposes are, therefore, the result of differing rate base estimates between PG&E and DRA.

Under current federal tax law, Investment Tax Credits (ITC) must be amortized over the life of the underlying plant when estimating regulated federal income tax expense. Generally, this method of normalizing ITC applies to plant placed in service after 1980. Public utility corporations have two normalization methods to choose from when electing a method to amortize ITC for regulated tax purposes. Under option one, the tax benefits of ITC are flowed through to ratepayers by deducting deferred ITC from rate base; as each year passes, the deferred ITC balance decreases, thereby ratably restoring rate base over the book life of the plant which generated it. Under option two, the tax benefits of ITC are ratably flowed through as a direct reduction of estimated FIT. PG&E uses option one. This is an important distinction because it affects how PG&E and DRA computed the interest expense deduction for FIT purposes.

The unamortized deferred investment tax credit balance was deducted from rate base for this calculation because PG&E is an option one company (see discussion for ITC above). "Interest synchronization" which normally results in a higher interest

1 deduction, and therefore, a lower regulated FIT expense, is not applicable because of
2 how PG&E treats unamortized ITC (option one). PG&E also used this approach in its
3 results of operations. For CCFT purposes, the unamortized ITC was deducted from
4 rate base by DRA and PG&E before applying the same debt cost factor. For CCFT
5 purposes, it does not matter whether PG&E is an option one or two company because
6 there is no ITC available for CCFT purposes.

7 **2. Federal and State Tax Depreciation Deductions – Fixed Assets**

8 For FIT purposes, tax depreciation for all post-1980 plant has been normalized
9 using book lives and rates. For 1980 and prior years' plant, the appropriate
10 accelerated depreciation has been flowed through. For CCFT purposes, tax
11 depreciation has been flowed-through in estimating CCFT taxable income. Tax
12 depreciation for ratemaking purposes does not include depreciation on plant costs
13 disallowed in previous rate cases. DRA reviewed PG&E's methodology and from a
14 top-level perspective found PG&E's estimate appeared reasonable. However, time
15 did not permit an audit of pre-2005 vintages to better assess the reasonableness of
16 PG&E's estimate. Any differences or recommendations are the result of either
17 DRA's capital witnesses, or depreciation witness.

18 **3. Federal and State Operating Expense Adjustments**

19 PG&E included certain negative adjustments in the tax deduction tables for
20 each of gas, electric and URG segments. The negative adjustments have the effect of
21 increasing taxable income, thereby increasing income tax expense. Negative
22 operating expense adjustments totaling $22.02 million for electric distribution and
23 $14.37 million for gas distribution are primarily related to depreciation timing
24 differences, book-to-tax for business meals, and book based capitalized A&G
25 expenditures. PG&E's capital witness handled a significant proportion of this
26 adjustment and conversely any changes will be the result of changes recommended by
27 DRA's capital witnesses.
28
29

4. Federal and State Cost of Removal Deductions

The cost of removal deduction is estimated on the basis of forecasted plant retirements for the test year. Removal costs are incurred when plant is physically removed from service. Removal costs are deductible for tax purposes when incurred. Under the normalization requirements of the tax code, estimated removal costs associated with plant vintage years after 1980 are not currently deductible. However, a cost of removal deduction is still available for 1980 and prior property for FIT purposes, and for all vintage years for purposes of calculating CCFT taxable income. For this reason, the deductible CCFT estimate is larger than the FIT deduction. Current deductions for cost of removal are reflected in the FIT and CCFT tables. DRA noted removal costs were consistent with prior years with a slight uptrend. Given that DRA noted no unusual or infrequent events that would impact the removal costs estimates, DRA found PG&E's estimates reasonable.

5. Federal and State Repair Allowance Deductions

The cost of plant construction is capitalized for book purposes. However, a percentage of these capitalized costs are deductible for income tax purposes as repairs (repair allowance). A repair allowance deduction is generally available for 1980 and prior years' vintage assets for FIT purposes, and on all vintages for CCFT purposes. DRA utilized a 5-year average (2000-2004) to test the reasonableness of PG&E's estimate. Using this estimating methodology, DRA noted that PG&E's estimate, although lower, was still within the limits of reasonableness given their methodology was based on federal tax guidelines for deductions. Therefore, DRA does not take issue with PG&E's estimate.

6. FIT Deduction for Prior Year's CCFT

The amount of CCFT allowed as a deduction for FIT purposes by the IRS is not the current year's CCFT. The amount allowed on the FIT return is the prior year's CCFT liability. This creates a timing difference between when the CCFT 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 cases,
2 A.85-12-050 (I.86-11-019). D.89-11-058, issued on November 22, 1989, requires
3 that for ratemaking purposes, the prior year Commission *adopted* CCFT number be
4 used as the deduction for CCFT taxes in arriving at FIT taxable income.

5 PG&E's estimate of 2006 CCFT (used as prior year CCFT for the 2007
6 estimate) was calculated utilizing the same methodologies used to calculate 2007
7 income tax expense. As a reasonableness check, DRA used known Commission-
8 approved amounts and rates to estimate prior year CCFT. In developing this estimate
9 DRA increased the Commission-approved 2005 Adjusted Revenue Requirement
10 (RRQ) by the Commission-approved 2005 CPI floor to determine an estimated 2006
11 revenue requirement. This result was then used to determine a cumulative income
12 increase from 2003 to 2006 by dividing the 2006 estimated RRQ by the Commission-
13 approved 2003 RRQ. This cumulative increase was then multiplied by the 2003
14 CCFT to determine DRA's estimated 2006 CCFT. DRA's estimates, in utilizing this
15 reasonableness check, resulted in relatively small differences in both directions when
16 compared to PG&E's estimates. DRA had no issue with PG&E's current estimate as
17 both methodologies resulted in similar numbers.

18 **7. Potential Charitable Contribution Deductions**

19 As a result of PG&E's emergence from bankruptcy PG&E agreed to donate
20 lands. DRA considered the question as to whether these land donations could be
21 considered a charitable contribution as a conservation easement. In response to DRA
22 DR ORA-035, PG&E states the following:

23 "Based on PG&E's interpretation of the tax law in this area, PG&E will not
24 claim a charitable deduction for the conservation easements on its tax return."

25 DRA followed with Data Request ORA-087 asking the following:

26 a. In relation to PG&E's above statement, please provide a detailed
27 explanation (inclusive of citing specific IRS or other applicable codes) as to how
28 PG&E derived its conclusion (relative to the tax law interpretation) resulting in PG&E
29 not claiming a charitable deduction. For example, if PG&E's interpretation of the tax

law is based on IRS code(s) that speak to the inabilty to claim donated lands as they were part of a settlement agreement, then cite the specific IRS code(s) and include the specific language from that code that clearly demonstrates that PG&E can not claim a deduction. This is just an example, and PG&E may have derived its interpretation/ conclusion based on other sources and assumptions. DRA is attempting to understand how PG&E arrived at its conclusion.

b. In relation to PG&E's above statement, is PG&E stating that under no circumstances, (barring any definitive tax law changes that clearly allow for the deduction), will it claim a deduction (in any capacity) for the donated lands on its tax return? Please disregard this question if the response to a. above clearly demonstrates that PG&E can not claim a deduction for the donated lands.

PG&E's response:

"a. Section 170 of the Internal Revenue Code allows a deduction for charitable contributions. The section defines a charitable contribution as a "contribution or gift" to a governmental entity or charitable organization. The question here is whether PG&E's transfer of the conservation easements as part of the Settlement/Rate Agreement was a "contribution or gift."

In Rev. Rul. 67-246, 1967-2 C.B. 104, the Service addressed "donations" for which the donor received some benefit in return. The ruling held that when a donor receives something in exchange for their contribution, there is a presumption that there was not a gift.

The authorities that most closely parallel PG&E's situation for determining whether PG&E is considered to have received a *quid pro quo* for the transfer, thereby disqualifying the transfer as a charitable contribution, are the various rulings and cases dealing with transfers by developers to government entities. In Rev. Rul. 57-488, 1957-2 C.B. 157, a developer transferred land to a county to allow the county to widen a road leading to lots the developer wished to develop. The ruling concluded that the transfer of title to the land was not a charitable contribution because the

transfer was required to secure the consent of the county planning commission for the development. The developer received a benefit, the approval of the development, in exchange for the land and the transfer was therefore not charitable.

Case authority addressing transfers by developers include *Stubbs v. United States*, 428 F.2d 885, (9th Cir. 1970). In *Stubbs*, the taxpayer had also donated land for a public road, in this case for access to land that the taxpayer wanted to develop as a trailer park and shopping center. The court found that the motive of the taxpayer was to provide access to the taxpayer's property and to assist in obtaining the necessary rezoning. The court held that the taxpayer's motive was not charitable but to obtain a benefit that otherwise might not be forthcoming. *See also* G.C.M. 38055 (August 22, 1979)("If a payment proceeds primarily from the incentive of anticipated benefit to the payor beyond the satisfaction that flows from the performance of a generous act, it is not a true charitable contribution or gift"- citing *Stubbs*); *See also Perlmutter v. Commissioner*, 45 T.C. 311 (1974)(land given for school and recreation use not a charitable contribution as given in exchange for approval of subdivision).

If PG&E claimed a charitable contribution for the transfer of the conservation easements, there is substantial risk that PG&E would lose this position and would be subject to penalties. The IRS would argue that PG&E agreed to the transfer only to induce the CPUC and the State to enter into the Settlement/Rate Agreement and the transfer would not qualify as a charitable contribution. And as evidenced by the hard line that the IRS took against donations of conversation easements in Notice 2004-41, 2004-28 IRB 31 (June 30, 2004), it is very possible that the IRS would seek to assert penalties against PG&E if it sought a charitable deduction. Based on the above, PG&E will not claim a charitable deduction for the conservation easement on its tax return or in any other capacity.

b. See above. Regardless, PG&E is required to file an 851 Application to obtain pre-approval for the transfer of the conservation easement and thus DRA will have an opportunity to address the actual treatment of the transfer. Even without actual changes in the underlying law, there may be some evolution in legal

interpretation of the applicable law (*e.g*., additional rulings and case authority addressing donations of easements). As part of this Application process, PG&E plans on updating its position and fully affording DRA an opportunity to address the tax treatment at the time of the transfer (including the possibility of arguing the appropriate ratemaking treatment of any possible tax benefits accruing to PG&E)."

As a result of PG&E's response, DRA is including this DR response noting PG&E's assurance that DRA will have the opportunity to review the 851 application for any beneficial tax implications.

E. Payroll Taxes

Payroll taxes and their respective rates and wage bases are: Federal Insurance Contribution Act (FICA) 6.20%, $89,700 wage base, Medicare 1.45%, no wage cap, Federal Unemployment Insurance (FUI) 0.80%, $7,000 wage base, and State Unemployment Insurance (SUI) 2.100%, $7,000 wage base.

Pursuant to the 2007 GRC, PG&E provided DRA with an analysis indicating the predictive accuracy of their approach. Based on PG&E's response, DRA found the results of the PG&E's methodology (as set forth in PG&E's application) as reasonable. Any differences between DRA and PG&E are due to differences in the test year estimate for labor expense.

F. Property Taxes

DRA's recommended tax deduction for property taxes is based upon the test year estimated full accrual of ad valorem taxes due on property held as of the lien date. This amount is higher than the property taxes estimated for book purposes because for book purposes, only the estimated actual calendar year payments are considered. The difference between the full year accrual and the book amount is the lien date adjustment, which has been flowed through as a current tax deduction for estimating test year taxable income. This is consistent with PG&E's ability to deduct for actual FIT and CCFT purposes the full year lien date accrual amount.

1 Pursuant to the 2007 GRC, PG&E provided DRA with an analysis indicating
2 the predictive accuracy of their approach. Based on PG&E's response, DRA found
3 the results of the PG&E's methodology (as set forth in PG&E's application) as
4 reasonable. The differences between DRA's property tax estimate and PG&E's are
5 solely due to differences in plant estimates.