

Application of San Diego Gas & Electric Company (U902M) for Authority, Among Other Things, to Increase Rates and Charges for Electric and Gas Service Effective on January 1, 2012.

A.10-12-005  
(Filed December 15, 2010)

Application of Southern California Gas Company (U904G) for authority to update its gas revenue requirement and base rates effective on January 1, 2012.

A.10-12-006  
(Filed December 15, 2010)

Application: A.10-12-005/A.10-12-006  
Exhibit No.: SDG&E-234/SCG-228

**PREPARED REBUTTAL TESTIMONY OF  
RANDALL G. ROSE  
ON BEHALF OF SAN DIEGO GAS & ELECTRIC COMPANY  
AND  
SOUTHERN CALIFORNIA GAS COMPANY**

**BEFORE THE PUBLIC UTILITIES COMMISSION  
OF THE STATE OF CALIFORNIA**

**OCTOBER 2011**



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1                                   **PREPARED REBUTTAL TESTIMONY OF**

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4                                   **AND SOUTHERN CALIFORNIA GAS COMPANY**

5 **I.       INTRODUCTION**

6                   The following rebuttal testimony regarding Taxes addresses the intervenor testimony  
7 dated September 2011 of:

- 8                   • Division of Ratepayer Advocates (“DRA”) in Exhibit DRA-37,
- 9                   • The Utility Reform Network (“TURN”) in the Prepared Testimony of William B.  
10                  Marcus, and
- 11                  • Utility Consumers’ Action Network (“UCAN”), in the Prepared Testimony of William B.  
12                  Marcus.

13                  This rebuttal testimony consolidates all issues and proposals raised by intervenors  
14 regarding taxes for San Diego Gas & Electric Company (“SDG&E”) and Southern California  
15 Gas Company (“SCG”) (jointly, “Applicants”). Section II addresses DRA’s proposed income  
16 tax adjustment for meals and entertainment. Section III addresses DRA’s deferred tax proposals  
17 and its gross-up method for calculating deferred taxes resulting from bonus depreciation.  
18 Section IV addresses the payroll tax adjustments proposed by DRA, TURN, and UCAN. Section  
19 V addresses the franchise fee adjustments proposed by DRA, TURN, and UCAN.

20                  In summary, this rebuttal testimony:

- 21                  • addresses DRA’s partial disallowance of the meals and entertainment addback in the  
22                  income tax calculation;

- 1 • disputes DRA’s proposed methodology to incorporate impacts from the recently-enacted  
2 tax law change for bonus depreciation, and DRA’s proposed exclusion of net operating  
3 losses, both of which improperly adjust deferred taxes;
- 4 • disputes the proposed adjustments to payroll taxes and franchise fees from DRA, TURN,  
5 and UCAN.

## 6 **II. REBUTTAL TO DRA ON INCOME TAXES**

### 7 **A. Overview**

8 Applicants and DRA appear to be in general agreement on the methodology used to  
9 calculate income tax expense and the types of tax adjustments included in the derivation of  
10 income tax expense, therefore, with the exception of the tax adjustment discussed in Section B  
11 below, any differences between Applicants’ and DRA’s estimates of income tax expense will be  
12 attributable to differences in forecasted capital additions, rate base, and long-term debt.

### 13 **B. Meals and Entertainment Deduction**

14 DRA recommends disallowance of a portion of business meals and entertainment  
15 included in the revenue requirement on grounds that such expenses are an unnecessary burden on  
16 ratepayers.<sup>1</sup> DRA recommends allowance of 100% of business travel expenses with no  
17 allowance for meals and entertainment expenses in the revenue requirement. While the required  
18 50% addition to taxable income for meals and entertainment expenses impacts the revenue  
19 requirement for tax expense, DRA’s proposed adjustments to recoverable costs pertain to the  
20 accounting of Applicants’ meals and entertainment expenses, which is outside the scope of  
21 Applicants’ tax showing. Applicants address this expense item in the rebuttal testimonies of  
22 Karen Sedgwick (Exhibits SDG&E-216 and SCG-210). Federal and state tax laws provide a

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<sup>1</sup> Exhibit DRA-37, pp. 7 – 9.

1 deduction for only 50% of business meals and entertainment expenses. Applicants' respective  
2 tax expense calculations will reflect this deduction in accordance with the outcome of this  
3 accounting issue.

4 **III. REBUTTAL TO DRA'S FORECAST OF DEFERRED TAXES AND THE**  
5 **IMPACT OF THE 2010 TAX LAW CHANGE**

6 **A. Tax Legislation Enacted Since the 2008 General Rate Case**

7 Applicants and DRA appear to be in agreement on the methodology and the results in  
8 forecasting deferred taxes resulting from the Economic Stimulus Act of 2008, the American  
9 Recovery and Reinvestment Act of 2009, and the Small Business Jobs Act of 2010.<sup>2</sup> Any  
10 differences between Applicants' and DRA's forecast of deferred taxes as impacted by these  
11 specific legislative acts are attributable to differences between DRA and Applicants' forecasts of  
12 capital additions.

13 **B. Update for 2010 Tax Law Change**

14 1. Summary of New Bonus Depreciation Provisions

15 As discussed in revised direct testimonies (Exhibits SDG&E-34-R and SCG-28-R), the  
16 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("Tax  
17 Relief Act") provided an extension and enhancement of bonus depreciation for 2010, 2011, and  
18 2012.<sup>3</sup> Applicants previously provided a detailed description of the various bonus depreciation  
19 provisions contained in the Tax Relief Act and Applicants' incorporation of their impact on  
20 actual tax return depreciation and the deferred tax reserve that adjusts rate base. In summary,  
21 the 2010 Tax Relief Act allows taxpayers to claim 100% bonus depreciation on qualified capital  
22 additions acquired and placed in service after September 8, 2010 and before January 1, 2012.

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<sup>2</sup> See Exhibit DRA-37 at 12 (Ins. 22-23).

<sup>3</sup> See Exhibits SDG&E-34-R, pp. RGR-16 to RGR-18; and SCG-28-R, pp. RGR-12 to RGR-15.

1 There are specific rules that apply, therefore, even though property might be placed in service  
2 after September 8, 2010, it will not qualify for 100% bonus depreciation unless it was also  
3 acquired or construction began on it after that date as well. For 2012, 50% bonus depreciation is  
4 allowed on qualified capital additions. These bonus depreciation deductions will significantly  
5 reduce current income tax liabilities in 2010, 2011, and 2012 and increase deferred tax liabilities,  
6 but will have no impact on total income tax expense. On July 2011, through submittal of revised  
7 models, testimonies and workpapers, Applicants quantified the impacts of the Tax Relief Act.  
8 SDG&E showed that forecasted deferred taxes increased by \$155 million compared to the  
9 original filing of December 2010 (deferred taxes increased from \$506.9 million to \$661.9  
10 million). SCG showed that forecasted deferred taxes increased by \$92.2 million compared to the  
11 original filing of December 2010 (deferred taxes increased from \$563.7 million to \$655.9  
12 million).

13 As a result of bonus depreciation's impact on current tax liabilities, SDG&E projects it  
14 will be in a tax net operating loss ("NOL") position in 2011 (-\$15.8 million), but will have  
15 taxable income in 2010 and 2012.<sup>4</sup> SCG projects it will be in a tax NOL position in 2010 (-  
16 \$12.4 million), 2011 (-\$57.6 million), and 2012 (-\$7.5 million).<sup>5</sup> The Internal Revenue Code  
17 requires NOLs to first be carried back to offset taxable income in the 2 prior years, and then  
18 carried forward to future years if NOLs remain.<sup>6</sup> The NOLs carried forward represent a deferred  
19 tax asset equal to the future cash tax savings the company may expect.

20 Applicants have properly reflected bonus depreciation and NOLs in its GRC tax expense  
21 and Results of Operation ("RO") modeling of the revenue requirement.

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<sup>4</sup> See Exhibit SDG&E-34-WP-R, pp. 29-32.

<sup>5</sup> See Exhibit SCG-28-WP-R, pp. 23-26.

<sup>6</sup> IRC Section 172(a).

1                   2.       DRA’s Proposed Gross-up Factor Overstates Deferred Taxes

2                   DRA states that due to time constraints, it did not analyze Applicants’ calculations  
3 incorporating the Tax Relief Act.<sup>7</sup> DRA in fact had over a month to review these calculations,  
4 and Applicants were available to answer any questions or walk through any calculations to assist  
5 in that review.<sup>8</sup> Instead, DRA “constructed a factor to gross-up its deferred taxes offset to  
6 ratebase and thereby reflect the impact of the surge in bonus depreciation created by the Tax  
7 Relief Act.”<sup>9</sup> In other words, DRA made no attempt to calculate the true impact of bonus  
8 depreciation through its own working version of Applicants’ RO model. Thus, DRA’s gross-up  
9 factor is inherently inaccurate and lacks regulatory foundation, and should be rejected.

10                  Tax impacts must be properly modeled in order to produce accurate, reliable, and  
11 reasonable results. Because bonus depreciation must be applied specifically to forecasted  
12 qualified capital additions, which have a cumulative effect going forward, one cannot simply  
13 derive a gross-up factor to simulate the true impact. Further complexities exist in the bonus  
14 depreciation rules, which determine whether 50% or 100% bonus depreciation applies, and  
15 which have specific criteria for which asset classes qualify and which do not.<sup>10</sup> Applicants’ RO  
16 model factors all these parameters, and should have been used by DRA to evaluate the tax-  
17 related outputs. Although Applicants contend that on this basis alone DRA’s deferred tax  
18 recommendations should be rejected, Applicants next discuss the specific flaws in DRA’s gross-  
19 up method, and why it would not yield correct or comparable results.

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<sup>7</sup> Exhibit DRA-37, p. 12.

<sup>8</sup> Applicants met with DRA on August 11, 2011 to discuss the Tax Relief Act and review the associated changes in the GRC showing to deferred taxes.

<sup>9</sup> DRA-37, pp. 12 – 13.

<sup>10</sup> See IRS Revenue Procedure 2011-26, issued March 29, 2011.

1 DRA describes its gross-up factor as “the ratio of DRA’s Plant-in-Service over SCG’s (or  
2 SDG&E’s) Plant-in-Service as originally filed in the application multiplied by the quantity of the  
3 Applicant’s Deferred Tax Balance from the update less its Deferred Tax Balance from the  
4 original application.”<sup>11</sup> There are several fundamental flaws in this method. First, the use of a  
5 ratio of DRA’s recommended total plant in service to Applicants’ total Plant-in-Service is  
6 incorrect. If DRA intended to measure the impact of the bonus depreciation provisions in the  
7 Tax Relief Act on deferred taxes, it should have used a ratio of DRA’s recommended capital  
8 additions qualifying for bonus depreciation divided by Applicants’ forecasted capital additions  
9 qualifying for bonus depreciation. Most of Applicants’ Plant-in-Service was added before the  
10 Tax Relief Act was enacted, and did not qualify for bonus depreciation, which nuance DRA’s  
11 ratio does not capture.

12 Second, DRA’s forecast of deferred taxes was improperly adjusted by adding back 100%  
13 of the deferred tax asset (i.e., the NOL) that both SDG&E and SCG forecast as an offset to  
14 deferred taxes. The forecasted NOLs were in part a result of bonus depreciation on capital  
15 additions removed by DRA as part of its review of capital expenditures; therefore, increasing  
16 deferred taxes by the full amount of the deferred tax asset resulting from the forecasted NOL for  
17 SDG&E and SCG overstates the balance of the deferred tax liability. Since DRA recommends a  
18 lower level of capital additions than forecasted by SDG&E and SCG, the logical outcome would  
19 be less bonus depreciation and lower deferred taxes, not more. Yet, DRA’s forecast of deferred  
20 taxes is higher even after adjusting out the deferred tax asset resulting from the NOL. The table  
21 below shows DRA’s forecast of deferred federal income taxes using its gross-up factor

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<sup>11</sup> Exhibit DRA-37 at 13 (lns. 3-6).



1 methodology, compared to Applicants' calculation of deferred taxes using DRA's recommended  
2 forecast of capital additions using the RO Model as updated for the Tax Relief Act.

3 **Calculation of Deferred Federal Income Taxes (DFIT)**  
4 (in millions)

	DRA's Gross-up Factor Calculation	Applicants' Calculation Using DRA's Assump.*	Difference
7 SDG&E	\$660.4	\$604.2	\$56.2
8 SCG	\$747.5	\$696.6	\$50.9

9 Applicants' calculation uses DRA's assumptions regarding capital additions and NOLs to  
10 compute deferred taxes using the RO model (\*). As shown above, use of DRA's gross-up factor  
11 results in a significant overstatement of the deferred taxes created by bonus depreciation  
12 pursuant to the Tax Relief Act -- by \$56.2 million at SDG&E and \$50.9 million at SCG.

13 Therefore, it is abundantly clear that DRA's simplified approach does not reliably approximate  
14 the true impact of bonus depreciation.

15 3. DRA's Method Would Result in a Normalization Violation

16 Applicants must adhere to the tax normalization rules set forth in Internal Revenue Code  
17 Section 168(i)(9),<sup>12</sup> otherwise Applicants will be in violation and will lose the ability to claim  
18 accelerated depreciation (including bonus depreciation), thereby losing the resulting tax benefits  
19 which are then passed to ratepayers. DRA discusses the normalization rules on page 12 of its  
20 testimony and recognizes its appropriate application in ratemaking for income taxes. However,  
21 DRA's gross-up factor would result in a normalization violation that would take away the net tax  
22 benefits ratepayers would otherwise receive. The tax normalization provisions are made up of  
23 laws, regulations, rulings, and regulatory decisions that may be summarized into two rules that

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<sup>12</sup> See also Treasury Regulation Section 1.167(l).

1 prevent utilities from passing the current tax benefits resulting from differences between tax  
2 return depreciation and regulatory depreciation through to ratepayers in either of the following  
3 ways:

- 4 1. By reducing the revenue requirement for income tax expense in the cost of service by any  
5 amount that is attributable to the excess of accelerated federal tax depreciation over  
6 ratemaking tax depreciation computed on a book life and method basis, and/or,
- 7 2. By lowering rate base using a deferred tax reserve that is in excess of the difference  
8 between tax expense recovered in rates and taxes actually paid.

9 Under DRA's gross-up method, the first rule would not be violated, since DRA does not  
10 lower income tax expense by any amount that is attributable to accelerated federal tax  
11 depreciation, including bonus depreciation. However, the second rule would be violated because  
12 of the overstatement of the deferred tax reserve, which reduces rate base by an excessive amount.

13 Applicants, as well as other utilities claiming accelerated tax depreciation, take every  
14 precaution not to violate the normalization rules, for a violation would have drastic negative  
15 consequences for the utilities and their ratepayers. Utilities would become ineligible to utilize  
16 accelerated federal tax depreciation, including bonus depreciation. Instead, utilities would be  
17 required to compute their tax depreciation using the same lives and methods they use to compute  
18 depreciation for ratemaking purposes. Thus, the tax benefits arising from the timing differences,  
19 which DRA references in testimony, would no longer exist. Applicants believe this would  
20 neither be an acceptable result for the utilities nor the Commission, DRA, and ratepayers.

#### 21 4. Error Identified in DRA's Workpapers

22 In examining DRA's workpapers, Applicants identified an error in DRA's computation  
23 of regular depreciation which leads DRA to overstate deferred taxes resulting from bonus

1 depreciation. DRA uses the RO model to compute regular federal tax depreciation and the  
2 resulting deferred income taxes on its adjusted capital expenditures forecasts. However, DRA  
3 then layers on additional deferred taxes to account for the impact of bonus depreciation under the  
4 Tax Relief Act. DRA must first adjust regular depreciation in 2010, 2011, and 2012 so that it  
5 does not calculate the full regular depreciation in addition to bonus depreciation on the same  
6 property. This artificially increases deferred taxes, which leads to an improper decrease to rate  
7 base.

8 For example, if property qualifies for 50% bonus depreciation, the property's tax basis  
9 for computing regular tax depreciation must be cut in half so that regular depreciation is applied  
10 to one half and bonus depreciation is applied to the other half. If property qualifies for 100%  
11 bonus depreciation, then no regular depreciation should be calculated for that property. Since  
12 DRA used the RO model to compute regular depreciation, but not to compute bonus  
13 depreciation, the required basis adjustment before computing regular depreciation did not occur,  
14 and this disconnect leads to an overstated depreciation expense and deferred taxes.

15 **C. DRA's Proposed NOL Treatment Overstates Deferred Taxes and Violates**  
16 **Normalization**

17 DRA objects to the carryback and carryforward of NOLs in the computation of deferred  
18 taxes.<sup>13</sup> In particular, DRA contends the carrying forward of NOLs is unnecessary, harmful to  
19 ratepayers, and not in accord with the 1984 tax decision commonly referred to as OII 24.<sup>14</sup>  
20 DRA's proposed treatment of NOLs (i.e., prevent NOL carryforwards) are neither supported by  
21 OII 24 nor beneficial to ratepayers, as explained below.

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<sup>13</sup> See DRA-37, pg. 13-16.

<sup>14</sup> D.84-05-036, pp. 55-56, Finding of Fact Nos. 15 and 26, and Conclusion of Law No. 8.

1                   1.     NOLs in General

2                   NOLs occur when tax deductions exceed taxable revenue in any year. They create a  
3 deferred tax asset because NOLs do not provide a current benefit to the taxpayer, but may be  
4 carried forward as a reduction to taxable income in future years.<sup>15</sup> In other words, an NOL does  
5 not reduce current taxes paid by the utility and does not provide a current source of cash, but  
6 does create an asset indicative of a future cash tax benefit not yet received.

7                   As explained earlier, both SDG&E and SCG are forecasting NOLs as a result of bonus  
8 depreciation. These NOLs are purely a function of revenues and expenses forecasted in this rate  
9 case, and do not include any impacts on taxable income from sources of income and expense  
10 outside of the rate case. For example, Applicants have not reflected any impact of consolidated  
11 tax adjustments on the utilization of NOLs. Under the tax law, NOLs must first be carried back  
12 to offset taxable income in the prior two years, and if any NOL remains, it can be carried forward  
13 for 20 years. A deferred tax asset is created when NOLs are carried forward.

14                   2.     Applicants' forecasted NOLs

15                   SDG&E forecasts NOLs in 2010 and 2011, but not 2012. Because the 2010 NOL must  
16 be carried back to offset taxable income in 2009, it has no impact on the test year. However, the  
17 2011 NOL of \$11.9 million is carried forward to 2012.

18                   SCG has NOLs in 2010, 2011, and 2012. The 2010 NOL is carried back to 2009, so it  
19 has no impact on TY 2012. The 2011 NOL of \$58.1 million is carried forward to 2012 and the  
20 2012 NOL of \$10.2 million is carried forward as deferred tax asset at the end of 2012. As shown

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<sup>15</sup> IRC Section 172(a) provides a two year carryback and a 20 year carryforward of NOLs. The ordering rules provide that NOLs are first carried back until taxable income has been extinguished in the prior two years, after which, the remaining NOL is to be carried forward to subsequent years until used up.

1 earlier in testimony, SDG&E's NOLs will place SDG&E in a net NOL position in 2011. SCG's  
2 NOLs will place SCG in a net NOL position in 2010, 2011, and 2012.

3 3. DRA's Argument on NOL Carryforwards

4 DRA's reliance on the Commission's decision in OII 24 to argue against the impact of  
5 Applicants' NOLs to deferred taxes is misplaced because the specific decision and findings of  
6 fact pertaining to NOLs in OII 24 solely addresses the calculation of income tax expense, which  
7 is the cost of service component of the revenue requirement, not the deferred tax reserve, which  
8 is a component of rate base. OII 24 is entitled, Income Tax Expense for Ratemaking Purposes,  
9 and states in its preamble:

10 "Investigation into methodologies for determining income tax expenses for  
11 ratemaking purposes, with special consideration of the impact of federally mandated  
12 normalization."<sup>16</sup>

13 This distinction between income tax expense versus deferred income taxes is important  
14 for understanding what the Commission permits for ratemaking purposes. The Commission  
15 concluded that income taxes recovered in the cost of service should be calculated on a stand-  
16 alone annual basis without regard to true-ups that occur after the fact. While this makes perfect  
17 sense in the context of annual income tax expense calculations, by definition, a deferred tax  
18 reserve is the cumulative carryforward of deferred tax liabilities and deferred tax assets from all  
19 prior years. It is the net sum of income tax expense from prior years that remains unpaid.  
20 Denying carryforwards and carrybacks makes no sense in the context of deferred taxes. For  
21 example, using the logic employed by DRA, deferred tax liabilities carried forward from prior  
22 years would be ignored and only the incremental deferred taxes created in the test year would be

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<sup>16</sup> *Ibid.* at 42.

1 used to adjust rate base, rather than the entire accrued balance of deferred taxes carried forward  
2 from all prior years. DRA's NOL position would essentially deprive ratepayers the benefit of  
3 accrued deferred tax balances which offset rate base.

4 DRA is correct in quoting OII 24 by stating, "ratepayers receive the net tax benefit as the  
5 inherent timing difference between 'real world' IRS basis and regulatory basis is recorded as  
6 deferred taxes which reduce ratebase, thereby reducing the current period's revenue  
7 requirement."<sup>17</sup> Netting the "real world" IRS basis and the regulatory basis of tax expense  
8 measures the cumulative tax benefits that utilities collect in rates in excess of the taxes actually  
9 paid. This net deferred tax balance represents an interest free source of cash to the utility and  
10 ratepayers should not be required to pay the utility a return on such balance.

11 However, DRA's recommendation to deny NOL carryforwards does not translate to a net  
12 tax benefit, but rather just one component (i.e., the deferred tax liability alone) representing the  
13 difference between ratemaking tax depreciation and tax return depreciation. This is not an  
14 accurate representation of the net tax benefit. Attachment 1 provides an example of how NOLs  
15 should be treated in accordance with OII 24. That example shows that the difference between  
16 what is collected in rates and what is actually paid in "real world" taxes is the net sum of the  
17 deferred tax liability created by ratemaking and tax return depreciation differences plus the  
18 deferred tax asset created by an NOL.

19 IRS regulations confirm Applicants' treatment of NOLs. The IRS established the  
20 following rule when an NOL is created by using accelerated depreciation instead of ratemaking  
21 depreciation:

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<sup>17</sup> D.84-05-036, pp. 53-54.

1 “The amount of Federal income tax liability deferred as a result of the use of different  
2 methods of depreciation...is the excess...of the amount the tax liability would have  
3 been had a subsection (l) method been used over the amount of the actual tax liability.  
4 If, however, in respect to any taxable year the use of a method of depreciation other  
5 than a subsection (l) method ...results in a net operating loss carryover...which would  
6 not have arisen...had the taxpayer determined his (depreciation) using a subsection (l)  
7 method, then the amount and time of the deferral of tax liability shall be taken into  
8 account in such appropriate time and manner as is satisfactory to the district director  
9 [of the IRS].”<sup>18</sup>

10 The tax normalization rules are designed to prevent public utility commissions from  
11 imputing that unrealized benefit in setting rates. Fairness and equity in ratemaking dictate that if  
12 a utility has not received a tax benefit, it should not be imputed in rates as if it had been received.  
13 In this regard, the ratebase reduction for deferred taxes should measure the actual cash tax  
14 benefit received, not a future benefit waiting to be received. If the Commission disallows  
15 Applicants from carrying forward NOLs, thereby putting them at odds with the normalization  
16 rules, Applicants should be allowed to elect out of bonus depreciation (as they are entitled to do  
17 under the Internal Revenue Code) so that they are no longer in an NOL position. Otherwise, rate  
18 base will improperly reflect a reduction for a cash tax benefit the utility has not received.

#### 19 4. DRA’s Argument on Proration

20 DRA objects to the methodology used by Applicants to build up the deferred tax reserve  
21 that adjusts rate base.<sup>19</sup> Both SDG&E and SCG derive their respective rate base using an

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<sup>18</sup> IRS Regulation Section 1.167(l)(h)(1)(iii). A subsection (l) method of depreciation is depreciation based on book lives and methods.

<sup>19</sup> DRA-37 at 15 (lns. 5-15).

1 average of the beginning-of-year deferred tax balance and a pro rata end of year balance. DRA  
2 argues that deferred income tax balances should be booked mid-year, or the weighted-average at  
3 fifty percent of total cost, as capital additions are for ratemaking purposes.<sup>20</sup> In other words,  
4 DRA recommends computing a simple average of the beginning and end of year balances in the  
5 deferred tax reserve. DRA's recommendation again is specifically prohibited under the  
6 normalization rules. The method used by Applicants is mandated by Treasury Regulation  
7 Section 1.167(l) when rates are set on a future test year, as they are in this GRC. The IRS  
8 specifies the method that must be used to build up the deferred tax reserve as follows:

9 "For the purpose of determining the maximum amount of the reserve to be excluded  
10 from the rate base...if solely a future period is used for such determination, the  
11 amount of the reserve account for the period is the amount of the reserve...at the  
12 beginning of the period and a **pro rata portion** of the amount of any projected  
13 increase to be credited or decrease to be charged to the account during such period."<sup>21</sup>  
14 (emphasis added)

15 In simple terms, the deferred tax reserve that adjusts rate base must be established using  
16 the deferred taxes that existed at the beginning of the test year and a pro-rated end of year  
17 forecasted balance. The beginning of year and pro-rated end of year balances are then averaged  
18 consistent with the other items that make up rate base.

19 In multiple private letter rulings ("PLRs"), the IRS has repeatedly ruled against the  
20 method proposed by DRA as a violation of the normalization regulations.<sup>22</sup> In each case where a  
21 public utility commission rejected the pro rata build up of deferred taxes in favor of a simpler

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<sup>20</sup> *Id.*

<sup>21</sup> IRS Regulation Section 1.167(l)-1(h)(6)(ii).

<sup>22</sup> See Attachment 2, IRS PLR Numbers 9029040, 9202029, and 9224040.



1 method, the IRS ruled that a normalization violation would occur if rates are set based on a  
2 forecasted future period as they are in this GRC. The IRS reasoned:

3 “If a taxpayer chooses to compute its ratemaking tax expense and rate base exclusion  
4 amount using projected data, in whole or in part, then it must use the formula  
5 provided in section 1.167(1)-1(h)(6)(ii) of the regulations to calculate the amount in  
6 the reserve for deferred taxes. This formula prorates the projected accruals to the  
7 reserve so as to account for the actual time these amounts are expected to be in the  
8 reserve. As explained in section 1.167(1) - 1(a)(1), “the formula provides a method to  
9 determine **the period of time during which the taxpayer will be treated as having**  
10 **received amounts credited or charged to the reserve account** so that the  
11 disallowance of earnings with respect to such amounts through rate base exclusion or  
12 treatment as no-cost capital will **take into account the factor of time for which such**  
13 **amounts are held by the taxpayer.**”<sup>23</sup> (emphasis added)

14 In summary, Applicants are in compliance with this requirement and DRA is not.  
15 Further, there are no inconsistencies created among the elements of rate base, as DRA argues.  
16 The beginning deferred tax balance and the end-of-year balance (computed using the specified  
17 pro rata build up) are averaged just like all the other components of ratebase to arrive at the  
18 weighted average ratebase.

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<sup>23</sup> See Attachment 2, IRS PLR No. 9029040.

1 **IV. PAYROLL TAXES**

2 **A. Rebuttal to DRA**

3 For SDG&E, DRA recommends \$32.705 million for payroll taxes (including capitalized  
4 payroll taxes), which is \$542,000 lower than the \$33.247 million proposed by SDG&E.<sup>24</sup> For  
5 SCG, DRA recommends \$44.574 million for payroll taxes (including capitalized payroll taxes),  
6 which is \$201,000 lower than the \$44.775 million proposed by SCG.<sup>25</sup>

7 DRA's proposed reductions are attributable to reductions of the total composite tax rate  
8 (1) to reflect DRA's use of an unadjusted five-year average including 2010 data,<sup>26</sup> and ( 2 )  
9 elimination of Applicants' 2012 adjustment for the Old-Age, Survivors, and Disability Insurance  
10 ("OASDI") taxable wage base growth.<sup>27</sup> In criticizing Applicants' forecast methodology, DRA  
11 claims that Applicants used a five-year average (2005-2009).<sup>28</sup> Applicants did not; they each  
12 calculated a companywide composite tax rate for the 2009 base year by dividing total payroll  
13 taxes paid in 2009 by 2009 Medicare taxable wages (which are not capped by a wage base like  
14 OASDI taxable wages). The most recent data available for 2009 was more accurate for  
15 calculating the forecasted composite tax rate than an averaging of prior period data, because of  
16 forecasted stability in the statutory tax rates and taxable wage bases. Prior periods would have  
17 included outdated rates and taxable wage bases that would improperly impact the composite  
18 payroll tax rate. As Applicants are not making unauthorized updates to earlier forecasts based on  
19 later available data, 2009 represents the correct base year upon which to forecast the test year.  
20 DRA's alternate methodology uses 2010 data in its five-year average. It would be inappropriate

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<sup>24</sup> Exhibit DRA-37, p. 3, Table 37-1.

<sup>25</sup> Exhibit DRA-37, p. 4, Table 37-2.

<sup>26</sup> Exhibit DRA-37, p. 10 (Ins. 16-17).

<sup>27</sup> Exhibit DRA-37, p. 11 (ln. 7).

<sup>28</sup> Exhibit DRA-37, p. 10 (ln. 18).

1 to make isolated and one-sided updates using 2010 data. First, selective updating ignores the  
2 fact that while certain costs may be lower than expected, other costs may be higher than expected  
3 and there is no provision to reflect those instances. Second, the Rate Case Plan is very  
4 prescriptive regarding the types of information that may be updated in a general rate case, and  
5 the proposal by DRA contravenes this intent.

6 Based on recommendations made by interveners in its 2008 GRC, Applicants calculated  
7 payroll taxes more in line with their recommended method. Accordingly, Applicants used  
8 stratified wage schedules to compute payroll tax expense in 2012 instead of an overall  
9 adjustment factor. The details are provided in testimony (Exhibits SDG&E-28-R and SCG-34-  
10 R) and workpapers (Exhibits SDG&E-28-WP-R and SCG-34-WP-R). Therefore, Applicants'  
11 methodology for calculating the composite payroll tax rate does not double count the effect of an  
12 increase in the OASDI taxable wage base. DRA's Table 37-3 does not demonstrate any double  
13 counting in Applicants' computed payroll tax expense. Rather, Applicants forecast a more stable  
14 work force through the test year than DRA. Applicants are not clear on what DRA claims are  
15 improper adjustments (since Applicants didn't use a five-year average as DRA believes), or how  
16 Table 37-3 discredits a payroll tax computation that has been revised in accordance with how  
17 intervenors recommended in the 2008 GRC. Therefore, 2012 projected composite payroll tax  
18 rates of 7.12% for SDG&E and 7.67% for SoCalGas are reasonable and should be adopted.

19 **B. Rebuttal to TURN (SCG)**

20 TURN recommends SCG O&M payroll taxes of \$36.067 million, which is \$713,000  
21 lower than the \$36.781 million proposed by SCG.<sup>29</sup> TURN also recommends a reduction of

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<sup>29</sup> TURN Prepared Testimony of William B. Marcus, p. 52.

1 \$282,000 in capitalized payroll taxes in 2010-2012.<sup>30</sup> Both reductions are attributable to  
2 TURN's recommendations to:

- 3 • reflect changes in payroll tax rates and taxable wage bases released to the public in 2010  
4 and 2011, and
- 5 • reflect TURN's forecast of inflation.

6 With respect to TURN's first recommendation, 2010 and 2011 payroll tax data may differ  
7 from what was originally forecast when the GRC Application was filed in December 2010;  
8 however, it would be inappropriate to make isolated updates to the GRC. As explained earlier,  
9 selective updating ignores the fact that while certain costs may be lower than expected, other  
10 costs are higher than expected and there is no provision to reflect those instances. Second, the  
11 Rate Case Plan is very prescriptive regarding the types of information that may be updated in a  
12 GRC, and TURN's recommendation contravenes this intent.

13 With respect to TURN's second recommendation, SCG disagrees with TURN's  
14 application of inflation into its wage forecast. SCG agrees with TURN in concept that if wages  
15 are inflated, and there are no other factors that impact the rate, the composite tax rate will  
16 decrease. However, TURN has not provided any empirical evidence supporting the validity of  
17 its inflation factor and the increase in the taxable wage base is intended to account for forecasted  
18 wage inflation, therefore, SCG maintains that its 2012 forecasted composite payroll tax of 7.67%  
19 is reasonable and should be adopted.

20 **C. Rebuttal to UCAN (SDG&E)**

21 UCAN recommends O&M payroll taxes of \$12.062 million for electric and \$5.038  
22 million for gas, which in total is \$746,000 lower than the \$12.588 million for electric and \$5.258

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<sup>30</sup> *Ibid.*

1 million for gas forecasted in SDG&E's July 2011 revised testimony (Exhibit SDG&E-34-R).

2 UCAN also recommends a total reduction of \$933,000 in capitalized electric and gas payroll  
3 taxes in 2010-2012.<sup>31</sup> Both reductions are attributable to UCAN's recommendations to:

- 4 • reflect changes in payroll tax rates and taxable wage bases released to the public in 2010  
5 and 2011, and
- 6 • reflect UCAN's forecast of inflation.

7 With respect to UCAN's first recommendation, 2010 and 2011 payroll tax data may  
8 differ from what was originally forecast when the GRC Application was filed in December 2010;  
9 however, it would be inappropriate to make isolated updates to the GRC. The July 2011  
10 revisions were limited to (1) errata and (2) incorporation of the Tax Relief Act. No other updates  
11 were made to the forecasts. As explained earlier, selective updating ignores the fact that while  
12 certain costs may be lower than expected, other costs may be higher than expected and there is  
13 no provision to reflect those instances. Second, the Rate Case Plan is very prescriptive regarding  
14 the types of information that may be updated in a GRC, which UCAN's recommendation  
15 contravenes.

16 With respect to UCAN's second recommendation, SDG&E disagrees with UCAN's  
17 application of inflation into its wage forecast. SDG&E agrees with UCAN in concept that if  
18 wages are inflated, and there are no other factors that impact the rate, the composite tax rate will  
19 decrease. However, UCAN has not provided any empirical evidence supporting the validity of  
20 its inflation factor and the increase in the taxable wage base is intended to account for forecasted  
21 wage inflation. Therefore, SDG&E maintains that its 2012 forecasted composite payroll tax of  
22 7.12% is reasonable and should be adopted.

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<sup>31</sup> Exhibit UCAN-2, Prepared Testimony of William B. Marcus, p. 82.

1 **V. FRANCHISE FEES**

2 **A. Rebuttal to DRA**

3 DRA recommends \$47.830 million for electric franchise fees, which is \$796,000 lower  
4 than the \$48.626 million proposed by SDG&E.<sup>32</sup> The reduction is attributable to DRA updating  
5 of SDG&E's five-year average composite electric franchise fee rate using 2006-2010 data.<sup>33</sup>  
6 DRA made no adjustments to SDG&E's gas franchise fee rate<sup>34</sup> or SCG's franchise fee rate.<sup>35</sup>

7 Because of the volatility in the composite franchise fee rate, as compared to the relative  
8 stability of payroll tax rates, Applicants also used a five-year average to forecast the 2012  
9 composite franchise fee rates, using 2005-2009 data. While Applicants acknowledge that 2010  
10 franchise fee data may differ from what was originally forecast, it would be inappropriate to  
11 make isolated updates to the general rate case for the reasons previously provided.

12 Additionally, DRA's methodology for calculating the annual composite franchise fee  
13 rates is flawed. DRA applied the franchise fee payments recorded in the calendar year to the  
14 same calendar year's gross receipts. In fact, only a portion of the franchise fees based on any  
15 calendar year's gross receipts are paid in the same calendar year. A significant portion of the  
16 franchise fees applicable to the gross receipts from one calendar year are paid in the 1<sup>st</sup> and 2<sup>nd</sup>  
17 quarters of the following calendar year. Applicants' methodology for calculating the annual  
18 composite franchise fee rate properly matched the franchise fees expected to be paid in 2012 to  
19 the gross receipts that generated those franchise fees. Further, DRA's proposed adjustment to  
20 SDG&E's rate but not SCG's rate suggests an inconsistent approach aimed at cost reduction

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<sup>32</sup> Exhibit DRA-37, p.3, Table 37-1.

<sup>33</sup> Exhibit DRA-37, p. 11 (Ins. 20-21).

<sup>34</sup> Exhibit DRA-37, p. 3, Table 37-1 (references electric only).

<sup>35</sup> Exhibit DRA-37, p. 11 (ln. 22).

1 rather than offering a better method. Therefore, the projected 2012 composite electric franchise  
2 fee rate of 3.4345% for SDG&E is reasonable and should be adopted.

3 **B. Rebuttal to TURN (SCG)**

4 TURN recommends a reduction of approximately \$130,000 in franchise fees compared to  
5 the amount SCG forecast.<sup>36</sup> TURN's recommended reduction is attributable to a lower five-year  
6 average franchise fee rate of 1.4551% using 2006-2010 data instead of the proposed 1.4593%.<sup>37</sup>

7 While SCG acknowledges that factoring in 2010 franchise fee and excluding 2005 data  
8 may produce a different result from what was originally forecast by SCG, it would be  
9 inappropriate to make isolated updates to the GRC for the reasons previously provided. Because  
10 SCG prepared its 2012 forecast in accordance with the Rate Case Plan, and since TURN does not  
11 seem to dispute the use of a five-year historical average, SCG's forecasted composite franchise  
12 fee rate of 1.4593% is reasonable and should be adopted.

13 **C. Rebuttal to UCAN (SDG&E)**

14 UCAN recommends a reduction of approximately \$106,000 to SDG&E's 2012  
15 forecasted gas franchise fees compared to the amount SDG&E forecasted in its July 2011 revised  
16 testimony.<sup>38</sup> The gas franchise fee reductions are attributable to a lower two-year average  
17 franchise fee rate of 2.0768% using 2009-2010 data<sup>39</sup> instead of the proposed 2.1104%  
18 developed using a five-year average (2005-2009). UCAN confirmed that SDG&E's forecasted  
19 electric franchise fees are reasonable.<sup>40</sup>

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<sup>36</sup> TURN Prepared Testimony of William B. Marcus, p. 54.

<sup>37</sup> *Ibid.*

<sup>38</sup> UCAN Prepared Testimony of William B. Marcus, p. 84-85.

<sup>39</sup> *Ibid.*

<sup>40</sup> *Ibid.*

1           SDG&E disagrees with UCAN's selective use of 2010 data as well as its inferior  
2 averaging method. While SDG&E acknowledges that 2010 franchise fee data may differ from  
3 what was originally forecast, it would be inappropriate to make isolated updates to the GRC for  
4 reasons previously provided. In addition, SDG&E disputes that a two-year average yields more  
5 reliable results than a five-year average for this particular item. UCAN's analysis of statistical  
6 relevance of 2005-2008 data amounts to no more than carving out data that would yield a lower  
7 rate. SDG&E does not criticize, but simply notes that UCAN provides no contextual reason why  
8 franchise fees are moving in one direction versus another. With the recent attention given to gas  
9 pipeline safety and integrity, one could reasonably expect the activities requiring additional or  
10 expanded presence on county and city property to increase rather than decrease. Assumptions  
11 aside, SDG&E's consistent use of a five-year average for both electric and gas, while UCAN  
12 only proposes a two-year average for gas, indicates that SDG&E's franchise fee rates for both  
13 electricity and gas are reasonable and should be adopted.

#### 14 **VI. SUMMARY AND CONCLUSION**

15           Applicants' forecasts for income taxes, deferred taxes, payroll taxes, and franchise fees  
16 are reasonable and based on properly-applied tax rules, regulations, and precedent, as described  
17 in this testimony. DRA's deferred tax proposals as well as its gross-up method to reflect bonus  
18 depreciation outside of the RO model process are flawed and should not be adopted. Further,  
19 intervenors' selective use of 2010 data in their alternate forecasting methodologies in several  
20 areas should not be allowed.

21           This concludes my prepared rebuttal testimony.



## ATTACHMENT 1

### Treatment of Net Operating Losses (NOLs) in the Calculation of Deferred Federal Income Taxes

The following example illustrates why the deferred taxes that reduce rate base must be the sum of:

- the deferred tax liability created by differences between ratemaking tax depreciation and real world tax return depreciation, and
- the deferred tax asset created when there is an NOL:

Assumptions:

Revenues =	10,000,000
Ratemaking Depreciation =	8,000,000
IRS Tax Depreciation =	11,000,000

#### A. Calculation of Ratemaking Tax Expense Recovered in Rates:

Revenues	10,000,000
Ratemaking Tax Depreciation	<u>-8,000,000</u>
Ratemaking Taxable Income	2,000,000
Tax Rate	x 35%
Ratemaking Tax Expense Recovered in Rates	<u>700,000</u>

#### B. Calculation of “Real World” IRS Tax Liability:

Revenues	10,000,000
IRS Tax Depreciation	<u>-11,000,000</u>
“Real World” IRS Taxable Income	- 1,000,000 (NOL)
Tax Rate	x 35%
Real World IRS Tax Liability*	<u>-0-</u>

Since the “real world” taxable income is less than zero (-\$1,000,000), the actual taxes paid is simply zero. If there is no taxable income in the prior two years, the NOL must be carried forward to a future year until the company once again has taxable income the NOL can offset.

**C. Calculation of Amount That Ratemaking Tax Expense Exceeds “Real World” IRS Tax Liability:**

Ratemaking Tax Expense Recovered in Rates	700,000
Real World IRS Tax Liability	<u>0</u>
Difference	<u>700,000</u>

Ratemaking tax expense exceeds real world taxes paid to the IRS by \$700,000. This represents a cash tax benefit that the company can use to invest in new capital projects. Since it is a no-cost source of capital, it reduces rate base.

**D. Calculation of Deferred Tax Liability Created by Different Depreciation Lives and Methods:**

Ratemaking Tax Depreciation	8,000,000
Tax Return Depreciation	<u>11,000,000</u>
Difference	(3,000,000)
Tax Rate	<u>x 35%</u>
Deferred Tax Liability	<u>(1,050,000)</u>

This calculation shows the difference between ratemaking tax depreciation and tax return depreciation. Ratemaking tax depreciation is based on longer lives and a straight-line method compared to tax return depreciation which is calculated using shorter lives and 150% of straight-line depreciation. This creates a deferred tax liability, but will only produce a cash tax benefit to the extent that the company has enough taxable income to use all the tax depreciation.

**E. Calculation of Deferred Tax Asset Created by NOL:**

“Real World” IRS Taxable Income	-1,000,000
Tax Rate	<u>x 35%</u>
Deferred Tax Asset Created by NOL	<u>350,000</u>

This calculation shows that since the company’s taxable income was negative by - \$1,000,000. This negative taxable income is due to tax depreciation in excess of revenue as shown in calculation “B” above. Since the company did not have taxable income sufficient to use all the tax depreciation it generated, an asset is created.

## SUMMARY

The calculations above demonstrate that in this example, the difference between ratemaking tax expense recovered in rates and the “real world” tax expense actually paid in the test year is \$700,000. Since this represents the amount of cash tax savings benefit received by the utility in the test year, it is the amount that should reduce rate base. Ratebase should not be reduced by the entire deferred tax liability of \$1,050,000 as DRA would argue because the deferred tax liability exceeds the amount of actual cash tax savings by \$350,000, which is the amount of the deferred tax asset created by the NOL.

**ATTACHMENT 2**

IRS Private Letter Ruling Numbers 9029040, 9202029, and 9224040

Checkpoint Contents

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Federal Source Materials

IRS Rulings & Releases

Private Letter Rulings & TAMs, FSAs, SCAs, CCAs, GCMs, AODs & Other FOIA Documents

Private Letter Rulings & Technical Advice Memoranda (1950 to Present)

1990

PLR/TAM 9029068 - 9029001

[PLR 9029040 -- IRC Sec\(s\). 167](#)

**Private Letter Rulings**

## **Private Letter Ruling 9029040, IRC Sec(s). 167**

UIL No. 0167.22-00; 0168.09-00

### **Headnote:**


*Reference(s):* [Code Sec. 167](#);

PROJECTED INCREASE IN DEFERRED TAX RESERVE NEED NOT BE PRORATED.

A regulated public utility computes accelerated depreciation and cost recovery deductions for its property. It uses a normalization method of accounting in determining its utility rates. It makes adjustments to a reserve to account for the deferral of Federal income taxes resulting from (1) the use of accelerated depreciation in calculating its Federal tax liability and (2) the use of straight-line depreciation in calculating its cost of service.

In determining the rates to be charged the utility's customers, a commission used historical and projected data. The historical data included the actual balance of the utility's reserve for deferred taxes on a particular date. The projected data included an estimate of the increase in deferred taxes to be credited to the reserve.

To determine the maximum amount of the deferred tax reserve which could be excluded from the rate base, the regulatory commission added the actual balance of the reserve and a pro rata amount of the projected increase to be credited to the reserve. An oversight counsel objected to the proration as unduly increasing rate base and cost of service, but the utility supported the move.

The Service has held that any projected increase in the deferred tax reserve during the ratemaking test period need not be prorated under regulation  section 1.167(1)-1(h)(6) if, at the time the new rate order takes effect, the period over which this increase was projected has ended. The Service concluded that a failure to use the proration formula in this situation would not violate the normalization requirements of sections 167 and 168.

**Electronic Citation:** 90 TNT 152-37

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**Index Term:** depreciation

**Index Term:** normalization accounting

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### **Full Text:**

Date: April 23, 1990

CC:P&SI:6 TR-31-1525-89

In re: Normalization Ruling Request

Dear \*\*\*

This is in response to your ruling request of April 21, 1989, asking for a determination under [§](#) 1.167(1)-1(h)(6) of the Income Tax Regulations. A conference-of-right was held at the National Office on November 30, 1989, and additional information in connection with the conference was received on December 20, 1989. The facts as represented by the Company follow.

The Company, a regulated public utility, operates in the State, where it is incorporated. For ratemaking purposes, the Company is principally under the jurisdiction of the Commission. The Company files a consolidated federal income tax return for itself and its subsidiaries with the District Director of Internal Revenue in the City.

The Company's property is public utility property within the meaning of [§](#) 167(1)(3)(A) of the Internal Revenue Code. In order to compute accelerated depreciation and cost recovery deductions on this property, the Company uses a normalization method of accounting in determining its utility rates. As part of the method, the Company makes adjustments to a reserve to account for the deferral of federal income taxes resulting from the use of accelerated depreciation in calculating its federal tax liability and the use of straight-line depreciation in calculating its cost of service.

The Commission issued its current rate order for the Company on \*\*\*. In determining the rates to be charged the Company's customers, the Commission used both historical data (actual operating results from \*\*\* as recorded on the Company's regulated books of account) and projected data (expected operating results for \*\*\*). The historical data included the actual balance of the Company's reserve for deferred taxes as of \*\*\*. The projected data included an estimate of the increase in deferred taxes to be credited to the reserve during \*\*\*. Rates went into effect \*\*\*.

In order to determine the maximum amount of the deferred tax reserve that could be excluded from rate base, the Commission added (1) the actual balance of the reserve as recorded on the Company's regulated books of account as of \*\*\*, and (2) the pro rata amount of the projected increase to be credited to the reserve for \*\*\*, as determined under [§](#) 1.167(1)-1(h)(6) of the regulations. The Counsel objected to proration of the projected amounts as unduly increasing rate base and, consequently, cost of service. The Counsel argued that proration was unnecessary, since, at the time the utility rates were to go into effect, the \*\*\* test year would be completely historical. In support of proration, the Company argued that the fact the rates would be in effect after the close of the test period did not change the fact that the data from the test period upon which rates were based were part historical and part projected. The estimated data for \*\*\* were not updated prior to issuance of the rate order to reflect the actual operating results of the Company for these \*\*\* months.



According to [§](#) 168(f)(2) of the Code, cost recovery shall not be available for any public utility property (within the meaning of [§](#) 167(1)(3)(A) of the Code) if the taxpayer does not use a normalization method of accounting. [[§](#) 168(f)(2) corresponds to [§](#) 168(e)(3)(A) under the Accelerated Cost Recovery System (ACRS) (for property placed in service after 1980 but before 1987)].

In order to use a normalization method of accounting, [§](#) 168(i)(9)(A)(i) of the Code provides that the taxpayer must, in computing its tax expense for ratemaking purposes and for reflecting operating results in its regulated books of account, use a method of depreciation with respect to the public utility property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes. Under [§](#) 168(i)(9)(A)(ii), if the amount allowable as a deduction under [§](#) 168 differs from the amount that would be allowable as a deduction under [§](#) 167 (without regard to [§](#) 167(1)) using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under [§](#) 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference. [[§](#) 168(i)(9)(A) corresponds to [§](#) 168(e)(3)(B) under ACRS and [§](#) 167(1)(3)(G), pre-ACRS (for property placed in service before 1981)].

According to [§](#) 168(i)(9)(B)(i) of the Code, one way the requirements of [§](#) 168(i)(9)(A) will not be met is if, for ratemaking purposes, the taxpayer uses a procedure or adjustment that is inconsistent with these requirements. Under [§](#) 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under [§](#) 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base. ([§](#) 168(i)(9)(B) corresponds to [§](#) 168(e)(3)(C) under ACRS).

In general, according to [§](#) 167(1)-1(h)(1)(iii) of the regulations, the amount of federal income tax liability deferred as a result of the use of a different method of depreciation is the excess (computed without regard to credits) of the amount the tax liability would

have been had a subsection (1) method been used over the amount of the actual tax liability.


Under  section 1.167(1)-1(h)(6)(i) of the regulations, a taxpayer does not use a normalization method of accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes excluded from the rate base, or treated as cost-free capital, exceeds the amount of the reserve for the period used in determining the taxpayer's ratemaking tax expense.  Section 1.167(1)-1(h)(6)(ii) goes on to provide the procedure for determining the amount of the reserve for deferred taxes to be excluded from rate base or to be included as no-cost capital. If, in determining depreciation for ratemaking tax expense, a period is used which is part historical and part future, then the amount of the reserve account for this period is the amount of the reserve at the end of the historical portion of the period and a pro rata amount of any projected increase to be credited to the account during the future portion of the period. The pro rata amount of any increase during the future portion of the period is determined by multiplying the increase by a fraction, the numerator of which is the number of days remaining in the period at the time the increase is to accrue, and the denominator of which is the total number of days in the future portion of the period.

Any public utility taking advantage of accelerated depreciation or cost recovery in determining its federal income tax liability must use "normalization" accounting in calculating the rates to be charged to its customers and in maintaining its regulated books of account. Accelerated depreciation was introduced by Congress as a means of encouraging capital formation by industry. In essence, the difference between a company's federal income tax liability calculated using accelerated depreciation and the tax liability it would have were it to use straight-line or a similarly nonaccelerated method of depreciation is an interest-free loan from the Federal Government. The purpose of the normalization requirements is to prevent public utility commissions from subsidizing current utility ratepayers by "flowing through" the taxes deferred by use of accelerated depreciation and to prevent the additional loss of tax revenues resulting from the reduction in utility profits.

In general, a regulatory commission permits a utility to charge its customers rates such that investors can earn a fair rate of return on their investments in the utility (capital costs or return requirements) and the utility can recover its costs of doing business (operating costs, including ratemaking allowances for federal income taxes and for depreciation). In its most common form, flow-through is the process by which a utility regulatory, while calculating depreciation expense for ratemaking purposes on a nonaccelerated -- usually straight-line -- basis, determines ratemaking tax expense by using an accelerated depreciation method. This form of flow-through affects the operating cost elements of the cost of service calculation. By this procedure a reduction in current tax liability resulting from accelerated depreciation is reflected in utility rates as a current reduction in regulatory tax expense. Flow-through accounting, in effect, takes a congressionally mandated subsidy away from a utility and gives it to the utility's customers.

Although the normalization rules prohibit flow-through, ratepayers may benefit from a utility's use of accelerated depreciation in calculating its federal income tax liability. The normalization rules do not limit whatever authority a regulatory agency might have to pass through to ratepayers the benefits of accelerated depreciation, but only require that any such pass-through take place over the period for which the taxes are deferred (any acceleration of this process results in flow-through in its less common form, affecting the capital cost elements of cost of service). In other words, a utility commission may establish rates to be charged a utility's customers which reflect the capital cost savings represented by accelerated depreciation, either by excluding the reserve for deferred taxes from the base upon which a utility's rate-of-return is calculated or by treating the deferred taxes as cost-free capital in determining a fair rate-of-return.

In instituting normalization, Congress made clear its intention not to prevent a regulator from denying a utility a rate of return on what was essentially cost-free capital (the benefits of accelerated depreciation). "The bill [the Tax Reform Act of 1969] does not change the power of the regulatory agencies in the case of normalization to exclude the normalized tax reduction from the base upon which the agency computes the company's maximum permitted profits." S. Rep. No. 552, 91st Cong., 1st Sess. 173 (1969). Unfortunately, this statement was misinterpreted by some regulators as to what specific ratemaking procedures would comply with the new normalization rules. This misinterpretation led to abuses that the Service sought to correct through the issuance of regulations (T.D. 7315, 1974-2 C.B. 67).

 Section 1.167(1)-1(h)(6) was added to the regulations in response to a ratemaking practice by which tax expense for purposes of computing cost of service was determined using historical or actual data, whereas the amount of the reserve for deferred taxes to be excluded from rate base was calculated on the basis of a projection of the amount in the reserve at the end of some future period. This practice presented two problems. First, assuming a financially healthy utility, the amount excluded from rate base was greater than the reserve for deferred taxes at the end of the historical period. Failure to allow an investment return on the excess of this excluded amount over the amount of the reserve for the historical period resulted in flow-through of the benefits of the projected reserve accrual.

Second, even though any projected increase in the reserve for deferred taxes would accrue over time, the entire amount expected to be in the reserve at the end of the future period was excluded from rate base. Excluding the full projected amount, even if ratemaking tax expense was computed using the same projections, resulted in denying a return on a greater amount than the utility was projected to have on hand at any particular time over this future period. [REDACTED] Section 1.167(1)-1(h)(6)(i) deals with the first problem, that of consistency, while 1.167(1)-1(h)(6)(ii) addresses the second problem, that of timing.

[REDACTED] Section 1.167(1)-1(h)(6)(i) of the regulations makes it clear that the reserve excluded from rate base must be determined by reference to the same period as is used in determining ratemaking tax expense. A taxpayer may use either historical data or projected data in calculating these two amounts, but it must be consistent. As explained in [REDACTED] section 1.167(1)-1(a)(l) of the regulations, “the rules provided in [REDACTED] section 1.167(1)-1(h)(6)(i) are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services.”

If a taxpayer chooses to compute its ratemaking tax expense and rate base exclusion amount using projected data, in whole or in part, then it must use the formula provided in section 1.167(1)-1(h)(6)(ii) of the regulations to calculate the amount in the reserve for deferred taxes. This formula prorates the projected accruals to the reserve so as to account for the actual time these amounts are expected to be in the reserve. As explained in section 1.167(1)-1(a)(l), “the formula provides a method to determine THE PERIOD OF TIME DURING WHICH THE TAXPAYER WILL BE TREATED AS HAVING RECEIVED AMOUNTS CREDITED OR CHARGED TO THE RESERVE ACCOUNT so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will TAKE INTO ACCOUNT THE FACTOR OF TIME FOR WHICH SUCH AMOUNTS ARE HELD BY THE TAXPAYER [underlining added].”

The purpose of the proration formula is the same as that of the requirement for consistent periods: to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers. (But unlike the more common form of flow-through, which affects the operating cost elements of cost of service, the flow-through that is the target of [REDACTED] section 1.167(1)-1(h)(6) of the regulations affects the capital cost elements in determining rates.) The proration formula stops flow-through by limiting the deferred tax reserve accruals that may be excluded from rate base, and thus the earnings on rate base that may be disallowed, according to the length of time these accruals are actually in the reserve account.

The effectiveness of [REDACTED] section 1.167(1)-1(h)(6)(ii) of the regulations in resolving the timing issue has been limited by its failure to define some key terms. No where does this provision state what is meant by the terms “historical” and “future” in relation to the period for determining depreciation for ratemaking tax expense (the “test period”). How are these time periods to be measured? Some taxpayers have focused on the type or quality of the data used in the ratemaking process. According to this interpretation, the historical period is that portion of the test period for which actual data is used, while the portion of the period for which estimated is the future period. The second interpretation focuses on when the utility rates become effective. Under this interpretation, the historical period is that portion of the test period before rates go into effect, while the portion of the test period after the effective date of the rate order is the future period.

The first interpretation, which focuses on the quality of the ratemaking data, is an attractive one. It proposes a simple rule, easy to follow and to enforce: any portion of the reserve for deferred taxes based on estimated data must be prorated in determining the amount to be deducted from rate base. The actual passage of time between the date ratemaking data is submitted and the date rates become effective is of no importance. But this interpretation of the regulations achieves simplicity at the expense of precision; in other words, it is overbroad. The proration of all estimated deferred tax data does serve to MAGNIFY the benefits of accelerated depreciation to the utility, but this is not the purpose of normalization. Congress was explicit: normalization “in no way diminishes whatever power the [utility regulatory] agency may have to require that the deferred taxes reserve be excluded from the base upon which the utility’s permitted rate of return is calculated.” H.R. Rep. No. 413, 91st Cong., 1st Sess. 133 (1969)

In contrast, the second interpretation of section 1.167(l)-1(h)(6)(ii) of the regulations is consistent with the purpose of normalization, which is to PRESERVE for regulated utilities the benefits of accelerated depreciation as a source of cost-free capital. The availability of this capital is ensured by prohibiting flow-through. But whether or not flow-through can even be accomplished by means of rate base exclusions depends primarily on whether, at the time rates become effective, the amounts originally projected to accrue to the deferred tax reserve have actually accrued.

If rates go into effect before the end of the test period, and the rate base reduction is not prorated, the utility commission is denying a current return for accelerated depreciation benefits the utility is only projected to have. This procedure is a form of flow-through, for current rates are reduced to reflect the capital cost savings of accelerated depreciation deductions not yet claimed or accrued by the



utility. Yet projected data is often necessary in determining rates, since historical data by itself is rarely an accurate indication of future utility operating results. Thus, the regulations provide that as long as the portion of the deferred tax reserve based on truly projected (future estimated) data is prorated according to the formula in [section 1.167\(1\)-1\(h\)\(6\)\(ii\)](#), a regulator may deduct this reserve from rate base in determining a utility's allowable return. In other words, a utility regulator using projected data in computing ratemaking tax expense and rate base exclusion must account for the passage of time if it is to avoid flow-through.

But if rates go into effect after the end of the test period, the opportunity to flow through the benefits of future accelerated depreciation to current ratepayers is gone, and so too is the need to apply the proration formula. In this situation, the only question that is important for the purpose of rate base exclusion is the amount in the deferred tax reserve, whether actual or estimated. Once the future period, the period over which accruals to the reserve were projected, is no longer future, the question of when the amounts in the reserve accrued is no longer relevant (at the time the new rate order takes effect, the projected increases have accrued, and the amounts to be excluded from rate base are no longer projected but historical, even though based on estimates).

Some taxpayers have pointed to Example (2) in [section 1.167\(1\)-1\(h\)\(iv\)](#) of the regulations as evidence of an interpretation based on the type or quality of the ratemaking data (the question being whether the data is actual or estimated) rather than an interpretation based on the nature of the test period (whether the period is historical or future). This reliance is misplaced, however, since Example (2) sheds no light on how the historical and future portions of the test period are to be measured. Support can be found in this example for both interpretations. The example provides that, in determining ratemaking tax expense, the commission uses historical data for calendar year 1974 and projected data for the 9-month period ending September 30, 1975. In determining rate base exclusion, additions to the deferred tax reserve projected to accrue after 1974 are prorated according to the formula in [section 1.167\(1\)-1\(h\)\(6\)\(ii\)](#). The rate case is filed on January 1, 1975, with rates contemplated to be in effect for the years 1975, 1976, and 1977. So whether the future portion of the test period is that portion for which estimated data is used or that portion after which rates become effective, the future period runs from January 1 to September 30, 1975.

The purpose of the formula in [section 1.167\(1\)-1\(h\)\(6\)\(ii\)](#) of the regulations is to prevent the immediate flow-through of the benefits of accelerated depreciation to utility ratepayers. This purpose is accomplished, as explained above, by limiting the deferred tax reserve accruals that may be excluded from rate base according to the length of time these accruals are expected to be in the reserve account. Therefore, it is both reasonable and proper to conclude that proration of any projected increases to deferred taxes is not required by the regulations if, at the time the new rate order becomes effective, the period for which the reserve accruals were projected has ended. Applying the proration formula in this situation is not required by the regulations. As long as the amount of deferred taxes that is excluded from rate base is no more than the amount in the deferred reserve for the period used in determining cost of service, the requirements of [section 1.167\(1\)-1\(h\)\(6\)](#) of the regulations are satisfied.

Accordingly, based solely on the information provided by the Company above, and viewed in light of the applicable law and regulations, we conclude that any projected increase in the deferred tax reserve during the ratemaking test period need not be prorated under [section 1.167\(1\)-1\(h\)\(6\)](#) of the regulations if, at the time the new rate order takes effect, the period over which this increase was projected has ended. Failure to use the proration formula in this situation will not violate the normalization requirements of sections 167 and 168 of the Code.

A copy of this letter should be filed with the income tax return for the taxable year in which the transaction covered by this ruling occurs.

This ruling applies only to the taxpayer who requested it. According to [section 6110\(j\)\(3\)](#) of the Code, a private letter ruling may not be used or cited as precedent.

Sincerely,

Charles B. Ramsey

Chief, Branch 6

Office of Assistant Chief Counsel

(Passthroughs & Special

Industries)

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Private Letter Rulings & Technical Advice Memoranda (1950 to Present)

1992

PLR/TAM 9202035 - 9202001

[PLR 9202029 -- IRC Sec\(s\). 167, 10/15/1991](#)

**Private Letter Rulings**

**Private Letter Ruling 9202029, 10/15/1991, IRC Sec(s). 167**

UIL No. 0167.22-00; 0168.09-00

**Headnote:**

*Reference(s):* [Code Sec. 167](#);

IRS FINDS CONSISTENCY PROBLEMS IN TREATMENT OF UTILITY'S ESTIMATED DEFERRED TAX RESERVE.

A regulated public utility is subject to the ratemaking jurisdiction of a commission. The utility has submitted to the commission a request for a rate increase. The request is based on a fiscal test year. In determining the maximum amount of the deferred tax reserve that may be excluded from the rate base, the utility applied the proration formula under regulation section 1.167(l)- 1(h)(6) to the estimated accruals to the reserve for certain fiscal years. The company then deducted from the test year average rate base the average of the estimated deferred tax reserves for certain fiscal years, as prorated.

The ratemaking commission objected to the utility's application of the proration formula, asserting that the formula should be applied only to the estimated accruals for the portion of the test year extending beyond the rate order's anticipated effective date. The commission would then deduct the estimated deferred tax reserve, as prorated, from the test year average rate base. Applying the proration formula to the deferred tax accruals, the commission said, is the functional equivalent of taking the weighted average of those accruals.

The company has challenged the commission's proposal, arguing that failure to apply the formula to all the estimated accruals to the deferred tax reserve would violate regulation section 1.167(l)- 1(h)(6). According to the utility, a test year based entirely on estimated financial data and extending beyond the effective date of the rate order is a purely future test period under the regulations. The company also argues that failure to apply the formula to all estimated tax accruals, or at least those for the test year, would violate the [§](#) section 168(i)(9)(B) consistency requirement. The utility further argues that deducting the estimated deferred tax reserve, as prorated by the commission, from the test year average rate base would violate the consistency requirement.

The Service has ruled against the company's position in two out of the three points of contention with the commission. The Service held that the failure to apply the proration formula to all estimated accruals to the deferred tax reserve for the test year, which is based entirely on estimated data and extends beyond the effective date of the rate order, will not violate regulation section 1.167(l)- 1(h)(6). Second, the Service ruled that the failure to apply the proration formula to all the estimated deferred tax accruals for the test year will not violate the consistency requirement of [§](#) section 168(i)(9)(B). And finally, the Service held that the failure to average the deferred tax reserve, as prorated, before excluding the reserve from the average rate base will violate the consistency requirement of [§](#) section 168(i)(9)(B).

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**Full Text:**

Date: October 15, 1991

CC:P&SI:6 TR-31-1152-91

In re: Normalization Ruling Request

Dear \*\*\*

This is in response to your request of June 11, 1991 for rulings under [§](#) section 1.167(l)-1(h)(6) of the Income Tax Regulations and [§](#) section 168(i)(9)(B) of the Internal Revenue Code. A conference-of- right was held at the National Office on September 12, 1991. You represent the facts as follows.

The Company is a regulated public utility operating in northern State. It is a wholly owned subsidiary of the Parent. The Parent files a consolidated federal income tax return on a \*\*\* fiscal yearend basis with the Internal Revenue Service Center in City 1. The Company and the Parent are subject to the examination jurisdiction of the District Director of Internal Revenue in City 2.

The Company is subject to the ratemaking jurisdiction of the Commission. The Company's request for a rate increase is pending before the Commission. This request is based on a fiscal \*\*\* test year (ending \*\*\*). The rate base for the test year is the average of the rate bases for \*\*\*, and \*\*\*. These estimated rate bases were developed using actual financial data for the Company's \*\*\* fiscal year and estimated data for its \*\*\* and \*\*\* fiscal years.

In determining the maximum amount of the deferred tax reserve that may be excluded from rate base, the Company applied the proration formula under [§](#) section 1.167(l)-1(h)(6) of the regulations to the estimated accruals to the reserve for fiscal years \*\*\* and \*\*\* (in conference the Company proposed to prorate only the accruals for \*\*\*). The Company then deducted from the test year average rate base the average of the estimated deferred tax reserves for \*\*\* and \*\*\* as prorated.

The Commission staff objects to the Company's application of the proration formula, arguing that the formula should be applied only to the estimated accruals for the portion of the test year extending beyond the rate order's anticipated effective date of \*\*\*. The staff would then deduct the estimated deferred tax reserve, as prorated, from the test year average rate base. The staff maintains that applying the proration formula to the deferred tax accruals is the functional equivalent of taking the weighted average of these accruals.

The Company objects to the staff's proposal. First, the Company argues, failure to apply the formula to all the estimated accruals to the deferred tax reserve would violate [§](#) section 1.167(l)-1(h)(6) of the regulations. According to the Company, a test year based entirely on estimated financial data and extending beyond the effective date of the rate order is a purely future test period under the regulations.

Second, the Company argues that failure to apply the formula to all estimated deferred tax accruals, at least those for the test year, would violate the consistency requirement of [§](#) section 168(i)(9)(B) of the Code. According to the Company, where cost of service is computed on a month basis, then rate base adjustments, including application of the proration formula, must be computed on the same basis.

Third, the Company argues that deducting the estimated deferred tax reserve, as prorated by the Commission staff, from the test year average rate base also would violate the consistency requirement. according to the Company, if an average rate base is used in determining rates, then the maximum amount of deferred taxes that may be deducted from rate base also must be averaged.

According to [§](#) section 168(f)(2) of the Code, an allowance for depreciation shall not be available for any public utility property (within the meaning of [§](#) section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, [§](#) section 168(i)(9)(A)(i) of the Code provides that the taxpayer must, in computing its tax expense for ratemaking purposes and for reflecting operating results in its regulated books of account, use a method of depreciation with respect to the public utility property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes. Under [§](#) section 168(i)(9)(A)

(ii), if the amount allowable as a deduction under [section 168](#) differs from the amount that would be allowable as a deduction under [section 167](#) using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under [section 168\(i\)\(9\)\(A\)\(i\)](#), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

According to [section 168\(i\)\(9\)\(B\)\(i\)](#) of the Code, one way the requirements of [section 168\(i\)\(9\)\(A\)](#) will not be met is if, for ratemaking purposes, the taxpayer uses a procedure or adjustment that is inconsistent with these requirements. Under [section 168\(i\)\(9\)\(B\)\(ii\)](#), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under [section 168\(i\)\(9\)\(A\)\(ii\)](#), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

In general, according to [section 167\(l\)-1\(h\)\(1\)\(iii\)](#) of the regulations, the amount of federal income tax liability deferred as a result of the use of a different method of depreciation is the excess (computed without regard to credits) of the amount the tax liability would have been had a subsection (l) method been used over the amount of the actual tax liability.

Under [section 1.167\(l\)-1\(h\)\(6\)\(i\)](#) of the regulations, a taxpayer does not use a normalization method of accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes excluded from the rate base, or treated as cost-free capital, exceeds the amount of the reserve for the period used in determining the taxpayer's ratemaking tax expense. [Section 1.167\(l\)-1\(h\)\(6\)\(ii\)](#) goes on to provide the procedure for determining the amount of the reserve for deferred taxes to be excluded from rate base or to be included as no-cost capital. If, in determining depreciation for ratemaking tax expense, a period (the "test period") is used which is part historical and part future, then the amount of the reserve account for this period is the amount of the reserve at the end of the historical portion of the period and a pro rata amount of any projected increase to be credited to the account during the future portion of the period. The pro rata amount of any increase during the future portion of the period is determined by multiplying the increase by a fraction, the numerator of which is the number of days remaining in the period at the time the increase is to accrue, and the denominator of which is the total number of days in the future portion of the period.

Any public utility taking advantage of accelerated depreciation in determining its federal income tax liability must use "normalization" accounting in calculating the rates to be charged its customers and in maintaining its regulated books of account. The purpose of the normalization requirement is to preserve for public utilities the benefit of accelerated depreciation (the measure of this benefit is the difference between a company's federal income tax liability calculated using accelerated depreciation and the tax liability it would have were it to use straightline or a similarly nonaccelerated method of depreciation). This benefit is preserved by proscribing its "flow through" to current utility ratepayers (in its most common form, flow through is the process by which a reduction in current tax liability resulting from accelerated depreciation is reflected in utility rates as a current reduction in regulatory tax expense).

Although the normalization rules prohibit flowthrough, ratepayers are permitted to benefit from a utility's use of accelerated depreciation in calculating its federal income tax liability. The normalization rules do not limit whatever authority a regulatory agency might have to pass through to ratepayers the benefit of accelerated depreciation, but only require that any such passthrough take place over the period for which the taxes are deferred (any acceleration of this process is a form of flowthrough). S. Rep. No. 552, 91st Cong., 1st Sess. 173 (1969). A utility commission may establish rates to be charged a utility's customers that reflect the capital cost savings represented by accelerated depreciation, either by excluding the reserve for deferred taxes from the base upon which a utility's rate-of-return is calculated or by treating the deferred taxes as cost-free capital in determining a fair rate-of-return.

[Section 1.167\(l\)-1\(h\)\(6\)](#) was added to the regulations in response to certain ratemaking practices that resulted in flowthrough. Under [section 1.167\(l\)-1\(h\)\(6\)\(i\)](#), the reserve excluded from rate base must be determined by reference to the same period as is used in determining ratemaking tax expense. A taxpayer may use either historical data or projected data in calculating these two amounts, but it must be consistent. As explained in [section 1.167\(l\)-1\(a\)\(1\)](#) of the regulations, "the rules provided in [[section 1.167\(l\)-1\(h\)\(6\)\(i\)](#)] are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that any be excluded from the rate base or included in no-cost capital in determining such cost of services."

If a taxpayer chooses to compute its ratemaking tax expense and rate base exclusion amount using projected data, in whole or in part, then it must use the formula provided in [section 1.167\(l\)-1\(h\)\(6\)\(ii\)](#) of the regulations to calculate the amount of deferred taxes excludable from rate base. This formula prorates the projected accruals to the reserve so as to account for the actual time these amounts are expected to be in the reserve. As explained in [section 1.167\(l\)-1\(h\)\(1\)](#), "the formula provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer."

The purpose of the proration formula is the same as that of the requirement for consistent periods: to prevent the immediate flowthrough of the benefit of accelerated depreciation to ratepayers. The proration formula stops flowthrough by limiting the deferred tax reserve accruals that may be excluded from rate base according to the length of time these accruals are actually in the reserve account. Thus, the earnings on rate base that may be disallowed are limited so as to prevent flowthrough.

Critical to the interpretation of § 1.167(l)-1(h)(6)(ii) of the regulations is the meaning of the terms “historical” and “future” in relation to the period for determining depreciation for ratemaking tax expense (this test period might not be coextensive with the taxpayer's test year; see, e.g., section 1.157(l)-1(h)(6)(iv) Example (2)). The meaning of these terms does not depend on the type or quality of the data used in the ratemaking process -- whether the data used is actual or estimated -- but on when the utility's rates become effective. The historical period is that portion of the test period before rates go into effect, while the portion of the test period after the effective date of the rate order is the future period.

These date-based definitions of the terms “historical” and “future” are consistent with the purpose of normalization, which is to preserve for regulated utilities the benefit of accelerated depreciation as a source of cost-free capital. This cost-free capital is made available by prohibiting flowthrough. But whether or not flowthrough can be accomplished by means of a rate base exclusion depends primarily on whether, at the time rates become effective, the amounts originally projected to accrue to the deferred tax reserve have actually accrued.

If rates go into effect before the end of the test period, and none of the rate base reduction is prorated, then in regard to the portion of the period after the effective date, the utility is denied a current return for an accelerated depreciation benefit it is only projected to have. This procedure is a form of flowthrough, for current rates are reduced to reflect the capital cost savings of accelerated depreciation deductions not yet claimed or accrued by the utility. Yet projected data is often necessary in determining rates, since historical data by itself is rarely an accurate indication of future utility operating results. Thus, the regulations provide that as long as the estimated accruals to the deferred tax reserve attributable to the future portion of the test period are prorated according to the formula in § 1.167(l)-1(h)(6)(ii), this reserve may be deducted from rate base in determining a utility's allowable return on capital. In other words, if estimated data is used in computing ratemaking tax expense and rate base exclusion, then the passage of time must be accounted for if flowthrough is to be avoided.

In regard to the portion of the test period prior to the effective date, however (where rates go into effect during this period), the opportunity to flow through the benefit of future accelerated depreciation to current ratepayers is gone, and so too is the need to apply the proration formula. In this situation, the only question that is important for the purpose of rate base exclusion is the amount in the deferred tax reserve for this period, whether actual or estimated. Once a portion of a future period, a period over which accruals to the reserve were projected, is no longer future, the question of when the amounts in the reserve accrued over this period is no longer relevant (at the time the new rate order takes effect, at least some of the projected increases have accrued, and so some of the amounts to be excluded from rate base are no longer projected but historical, even though based on estimates).

Beyond the question of accounting for the passage of time is the question of whether the application of the proration formula to less than the entire test period violates the consistency requirement of § 168(i)(9)(B) of the Code (the Company does not argue that the proration formula itself violates the consistency requirement). § 168(i)(9)(B)(i) provides that ratemaking procedures and adjustments must be consistent with the requirements of normalization accounting. This section was enacted to strengthen the prohibition against flowthrough accounting for accelerated depreciation. H.R. Rep. No. S27, 97th Cong., 2d Sess. 3 (1982). Since the opportunity to flowthrough the benefit of future accelerated depreciation to current ratepayers does not exist for the portion of the test period that is prior to a rate order's effective date, then the failure to apply the proration formula to the estimated deferred tax accruals for this period can not violate the consistency requirement.

More specifically, for purposes of properly accounting for any deferred taxes, § 168(i)(9)(B)(ii) of the Code provides that ratemaking estimates or projections of tax expense, depreciation expense, and the reserve for deferred taxes must be consistent with each other and with the estimate or projection of rate base. The Company argues under this provision that all adjustments to rate base, including proration, must be computed over the same period as is cost of service. Yet consistent periods clearly are maintained in the current situation; tax expense, depreciation expense, deferred tax reserve, and rate base are all estimated or projected for the Company's test year (fiscal \*\*\* Proration is an adjustment affecting rate base, but it does not change the fact that the rate base is estimated or projected for the Company's test year.

Proration of the projected accruals to the deferred tax reserve is a discreet adjustment; its purpose is not to properly account for deferred taxes but to account for the passage of time in determining the amount of the reserve that may be excluded from rate base.

Though the proration formula is applied to reserve accruals, this proration is not an adjustment to the reserve. Application of the proration formula does not affect the actual amount of accumulated deferred taxes. The amount of deferred taxes to be amortized when book/tax depreciation differences turn around does not change.

Though the regulations under [§](#) section 167 of the Code were promulgated before the enactment of the consistency provisions of [§](#) section 168(i)(9)(B), they give a good indication that the proration formula does not run afoul of the consistency requirement, or more accurately in this situation, the requirement of consistent periods. [§](#) Section 1.167(l)-1(h)(6)(i) of the regulations provides for consistent periods in determining the amount of the rate base exclusion, followed by [§](#) section 1.167(l)-1(h)(6)(ii), which provides for the proration of deferred tax accruals attributable to any future portion of the test period. Clearly, in regards to determining the maximum amount of deferred taxes excludable from rate base, consistency and timing are two separate, though related, issues.

The final question raised by the Company concerns the deduction of the estimated deferred tax reserve, as prorated under this ruling, from the estimated average rate base. The Company argues that the failure to average the entire prorated reserve in this situation would violate the consistency requirement of [§](#) section 168(i)(9)(B) of the Code. The Commission staff responds that proration is the functional equivalent of averaging; if accruals to the deferred tax reserve are properly prorated, then averaging the prorated reserve would result in an average of an average.

The staff's position confuses function with purpose. Proration is mathematically similar to averaging, but the two techniques serve different purposes. Proration is a crude way of discounting the amount of deferred taxes (cost-free capital) the utility expects to recognize sometime in the future. Averaging, on the other hand, is simply the Commission's chosen method of estimating the test year rate base (it very well could have projected an end-of-period rate base, for example). Both ends are legitimate, but they can not be served by one means.

If an average test year rate base is used in developing rates, all rate base components, including the deferred tax reserve, must be averaged. If the proration of deferred tax accruals substitutes for taking the average of the entire reserve, then the consistency requirement of [§](#) section 168(i)(9)(B) will be violated (the projected deferred tax reserve will not be consistent with the projected rate base). Likewise, if a portion of the test year is a future period, projected accruals to the deferred tax reserve must be prorated. If averaging of the entire reserve substitutes for this proration, then the timing requirement of [§](#) section 1.167(l)-1(h)(6) will be violated (too much will be excluded from rate base, thus denying the utility a return on "capital" it is only projected to have).

Accordingly, based solely on the information provided by the Company above, and viewed in light of the applicable law and regulations, we rule as follows.

- 1) Failure to apply the proration formula to all estimated accruals to the deferred tax reserve for the test year, which is based entirely on estimated data and extends beyond the effective date of the rate order, WILL NOT violate [§](#) section 1.167(l)-1(h)(6) of the regulations. The estimated deferred tax accruals for the portion of the test year prior to the rate order's effective date need not be prorated.
- 2) Failure to apply the proration formula to all the estimated deferred tax accruals for the test year WILL NOT violate the consistency requirement of [§](#) section 168(i)(9)(B) of the Code.
- 3) Failure to average the deferred tax reserve, as prorated, before excluding the reserve from the average rate base WILL violate the consistency requirement of [§](#) section 168(i)(9)(B).

In accordance with the power of attorney on file at this office, we are sending a copy of this letter to your authorized representative.

This ruling is directed only to the taxpayer who requested it. [§](#) Section 6110(j)(3) of the Code provides that a private letter ruling may not be used or cited as precedent.

Sincerely,

Charles B. Ramsey

Chief, Branch 6

Office of Assistant Chief Counsel

(Passthroughs & Special

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**Private Letter Rulings**

## **Private Letter Ruling 9224040, 3/16/1992, IRC Sec(s). 167**

UIL No. 0167.22-01; 0168.24-01

### **Headnote:**

*Reference(s):* [Code Sec. 167](#);

IRS RULES ON EFFECT OF NORMALIZATION REQUIREMENTS ON DETERMINING UTILITY'S DEFERRED TAX RESERVE.

A public utility is regulated by a public utility commission. In a pending request for rate increases filed with the commission, the utility based its revenue requirements on a test year and used an average rate base for that test year, consisting of an average of the estimated rate bases at specified times. The estimated rate bases were developed using the utility's actual financial data through a certain period and estimated data for a future period.

The utility and the commission's staff disagreed over the application of regulation [§](#) section 1.167(l)-1(h)(6) in determining the maximum amount of the deferred tax reserve that may be deducted from the average rate base for the test year. The disagreement concerned two areas. The first was the period to which the proration formula under regulation [§](#) section 1.167(l)-1(h)(6)(ii) is applied. The second area of disagreement is the methodology to use to determine the maximum amount of the deferred tax reserve to be deducted from the rate base, when an average rate base is used for the test year and when some or all of the test year is a future period for purposes of regulation [§](#) section 1.167(l)-1(h)(6)(ii).

The Service has ruled that when a test year is based entirely on estimated data and the effective date of the rate order occurs within the test year, the portion of the test year occurring after the effective date of the rate order represents the future portion of the period for purposes of regulation [§](#) section 1.167(l)-1(h)(6)(ii). Thus, the proration formula provided in the regulation applies only to the estimated changes in the deferred tax reserve accruing after the effective date of the rate order.

The Service also ruled that when an average rate base is used and when the test period is part historical and part future for purposes of regulation [§](#) section 1.167(l)-1(h)(6)(ii), failure to reduce the average rate base by the average of (1) the estimated deferred taxes at the beginning of the test period and (2) the estimated deferred taxes at the end of the test period as prorated under [§](#) section 1.167(l)-1(h)(6)(ii) will violate the consistency rules of [§](#) section 168(i)(9)(B).

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In re: Private Letter Ruling Request Regarding Normalization

Dear \*\*\*

This letter responds to your representative's letter of December 23, 1991, requesting rulings under the normalization requirements of [section 1.167\(l\)-1\(h\)\(6\)](#) of the Income Tax Regulations and [section 168\(i\)\(9\)\(B\)](#) of the Internal Revenue Code.

Taxpayer represents that the facts are as follows:

Taxpayer is a public utility engaged in the production, purchase, distribution, and sale of electricity and natural gas in State X. Taxpayer is a wholly owned subsidiary of Parent, which files a consolidated federal income tax return on a calendar year basis.

Taxpayer is regulated by the Commission. In its pending request for rate increases in Docket Y, Taxpayer based its revenue requirements on a \*\*\* test year and used an average rate base for that test year, consisting of an average of the estimated rate bases at \*\*\* and \*\*\*. These estimated rate bases were developed using Taxpayer's actual financial data through \*\*\* and estimated data for the period \*\*\* through \*\*\*. The Commission is expected to authorize a rate increase effective in \*\*\*.

In Docket Y, Taxpayer and the Commission's staff disagree over the application of [section 1.167\(l\)-1\(h\)\(6\)](#) of the regulations in determining the maximum amount of the deferred tax reserve that may be deducted from the average rate base for the test year. The disagreement concerns two areas.

The first area of disagreement is the period to which the proration formula under [section 1.167\(l\)-1\(h\)\(6\)\(ii\)](#) of the regulations is applied. Because Taxpayer believes that its test year is solely a future period for purposes of this regulation, Taxpayer applied the proration formula to the estimated changes in the deferred tax reserve from \*\*\* through \*\*\*. The Commission's staff disagrees, contending that the portion of the test year that occurs after a rate order's effective date is the future period and thus, the proration formula should be applied only to the estimated changes in the deferred tax reserve accruing during that period.

The second area of disagreement is the methodology to use to determine the maximum amount of the deferred tax reserve to be deducted from the rate base, where an average rate base is used for the test year and where some or all of the test year is a future period for the purposes of [section 1.167\(l\)-1\(h\)\(6\)\(ii\)](#) of the regulations. Taxpayer, after applying the proration formula to the estimated changes in the deferred tax reserve from \*\*\* through \*\*\* then deducted from the average rate base for the test year, the average of the prorated estimated deferred taxes at \*\*\* , and \*\*\* . The Commission's staff, however, believes that the average of the estimated (not prorated) deferred tax balances at \*\*\* and \*\*\* may be deducted from the average rate base for the test year if that average is less than the prorated estimated deferred taxes at \*\*\* .

Taxpayer is concerned that an incorrect determination of the maximum amount of the deferred tax reserve that may be deducted from the rate base in Docket Y may violate the normalization requirements of [section 168\(i\)\(9\)](#) of the Code. Accordingly, Taxpayer seeks the following rulings:

1. Where a test year is based entirely on estimated data and the effective date of the rate order occurs within the test year, whether the normalization rules of [section 1.167\(l\)-1\(h\)\(6\)](#) of the regulations require the proration formula provided in this regulation to be applied only to the estimated changes in the deferred tax reserve accruing after the effective date of the rate order?
2. Where an average rate base is used and where the test period is part historical and part future under [section 1.167\(l\)-1\(h\)\(6\)\(ii\)](#) of the regulations, whether the consistency rules of [section 168\(i\)\(9\)\(B\)](#) of the Code require the average rate base to be reduced by the average of (i) the estimated deferred taxes at the beginning of the test period and (ii) the prorated estimated deferred taxes at the end of the test period?

[Section 168\(f\)\(2\)](#) of the Code provides that the depreciation deduction determined under [section 168](#) shall not apply to any public utility property (within the meaning of [section 168\(i\)\(10\)](#)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, [section 168\(i\)\(9\)\(A\)\(i\)](#) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account,



to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes. Under [§](#) 168(i)(9)(A)(ii), if the amount allowable as a deduction under [§](#) 168 differs from the amount that would be allowable as a deduction under [§](#) 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under [§](#) 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

According to [§](#) 168(i)(9)(B)(i) of the Code, one way in which the requirements of [§](#) 168(i)(9)(A) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment that is inconsistent with these requirements. Under [§](#) 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under [§](#) 168(i)(9)(A)(ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to all 3 items and with respect to the rate base.

[§](#) 1.167(l)-1(h)(6) of the regulations provides another way in which the normalization requirements for public utility property are not satisfied.

Under [§](#) 1.167(l)-1(h)(6)(i) of the regulations, a taxpayer does not use a normalization method of accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes that is excluded from the rate base, or that is treated as cost-free capital, exceeds the amount of the reserve for deferred taxes for the period used in determining the taxpayer's tax expense for ratemaking purposes.

[§](#) 1.167(l)-1(h)(6)(ii) of the regulations describes the procedure for determining the maximum amount of the reserve for deferred taxes to be excluded from the rate base or to be included as cost-free capital. If, a period ("test period") is used that is part historical and part future, then the amount of the reserve account for this period is the amount of the reserve at the end of the historical portion of the period and a pro rata amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period. The pro rata amount of any increase or decrease during the future portion of the period shall be determined by multiplying the increase or decrease by a fraction, the numerator of which is the number of days remaining in the period at the time the increase or decrease is to be accrued, and the denominator of which is the total number of days in the future portion of the period.

Any public utility that uses accelerated depreciation in determining its federal income tax liability must use "normalization" accounting in calculating the rates to be charged its customers and in maintaining its regulated books of account. The purpose of the normalization requirement is to preserve for public utilities the benefit of accelerated depreciation as a source of cost-free capital. This benefit is preserved by prohibiting its "flowthrough" to current utility ratepayers (in its most common form, flowthrough is the process by which a reduction in current tax liability resulting from accelerated depreciation is reflected in utility rates as a current reduction in regulatory tax expense).

Although the normalization rules prohibit flowthrough, ratepayers are permitted to benefit from a utility's use of accelerated depreciation in calculating its federal income tax liability. The normalization rules do not limit whatever authority a regulatory agency might have to passthrough to ratepayers the benefit of accelerated depreciation, but only require that any such passthrough take place over the period for which the taxes are deferred (any acceleration of this process is a form of flowthrough). S. Rep. No. 552, 91st Cong., 1st Sess. 173 (1969). A utility commission may establish rates to be charged a utility's customers that reflect the capital cost savings represented by accelerated depreciation either by excluding the deferred tax reserve from the base upon which a utility's rate-of-return is calculated or by treating the reserve as cost-free capital in determining a fair rate-of-return.

[§](#) 1.167(l)-1(h)(6) of the regulations provides guidance as to the amount of the deferred tax reserve that may be excluded from the rate base or treated as cost-free capital, without resulting in flowthrough.

If a public utility computes its ratemaking tax expense and rate base exclusion amount using projected data, in whole or in part, then the utility must use the formula provided in [§](#) 1.167(l)-1(h)(6)(ii) of the regulations to calculate the amount of the deferred tax reserve excludable from the rate base. This formula prorates the projected accruals to the reserve so as to account for the actual time these amounts are expected to be in the reserve. Consequently, the proration formula stops flowthrough by limiting the accruals to the deferred tax reserve that may be excluded from the rate base according to the length of time these accruals are actually in the reserve account. Thus, the earnings on rate base that may be disallowed are limited so as to prevent flowthrough.

Taxpayer's first ruling request relates to the meaning of the terms "historical" or "future" in [§](#) 1.167(l)-1(h)(6)(ii) of the regulations. The meaning of these terms does not depend upon the type or quality of the data used in the ratemaking process -- whether the data used is actual or estimated -- but on when the utility's rates become effective. Thus, the historical period is that

portion of the test period before the effective date of the rate order, while the future period is that portion of the test period after the effective date of the rate order.

These date-based definitions of the terms "historical" and "future" are consistent with the purpose of normalization, which is to preserve for public utilities the benefit of accelerated depreciation as a source of cost-free capital. This cost-free capital is made available by prohibiting flowthrough. However, whether or not flowthrough can be accomplished by means of a rate base exclusion depends primarily upon whether, at the time rates become effective, the amounts originally projected to accrue to the deferred tax reserve have actually accrued.

If the rates become effective before the end of the test period, then in regard to the portion of the test period that is prior to the rate order's effective date, at least some of the projected increases or decreases in the deferred tax reserve have actually accrued even though based on estimated data. As a result, these increases or decreases are no longer projected but are historical. Thus, the opportunity to flowthrough the benefit of future accelerated depreciation to current ratepayers does not exist for the portion of the test period that is prior to the effective date of a rate order and consequently, the application of the proration formula under [§](#) section 1.167(l)-1(h)(6)(ii) of the regulations to the estimated deferred tax accruals for this period is not required.

Taxpayer's second ruling request concerns the determination of the maximum amount of the deferred tax reserve that may be deducted from the rate base under [§](#) section 1.167(l)-1(h)(6) of the regulations.

In this regard, Taxpayer and the Commission's staff disagree over the application of the consistency requirements of section 168(i)(9)(B) of the Code in determining the maximum amount of the deferred tax reserve that may be excluded from an average rate base. The consistency rules of section 168(i)(9)(B) require that ratemaking estimates or projections of tax expense, depreciation expense, and the reserve for deferred taxes must be consistent with each other and with the estimate or projection of the rate base. As a result, if an average rate base for the test year is used in developing rates, all rate base components, including the deferred tax reserve, must be averaged. Thus, in determining the amount of the deferred tax reserve that may be deducted from an average rate base, the failure to exclude the average of Taxpayer's reserve at the beginning and end of the test year will violate the consistency requirements of section 168(i)(9)(B).

Besides the question of whether the consistency rules of [§](#) section 168(i)(9)(B) of the Code require the averaging of the deferred tax reserve accounts, there is the question of whether section 1.167(l)-1(h)(6) of the regulations requires proration of the deferred tax reserve where a portion of the test year is a future period as determined under this ruling.

Under [§](#) section 1.167(l)-1(h)(6)(i) of the regulations, the maximum amount of the deferred tax reserve that may be excluded from the rate base is the amount of the deferred tax reserve for the test year used in determining the tax expense for ratemaking purposes. If a portion of the test year is a future period as determined under this ruling, [§](#) section 1.167(l)-1(h)(6)(ii) provides that the estimated changes in the deferred tax reserve for this period must be prorated.

The Commission's staff argues that in determining the amount of the deferred tax reserve that may be excluded from rate base, proration is not necessary under [§](#) section 1.167(l)-1(h)(6) of the regulations when an average rate base is used for a future test year because the deferred tax expense is matched with the change in the accumulated deferred income taxes associated with the accelerated depreciation of public utility property. This position, however, ignores the purpose of the proration formula. As explained in [§](#) section 1.167(l)-1(h)(1)(a)(1), "[t]he formula provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer."

If averaging of the deferred reserve account at the end of the historical portion of the test year and at the end of the future portion of the test period substitutes for proration, the regulatory agency is only focusing on the average amount of the reserve during the test period instead of accounting for the actual time that the accruals to the deferred tax reserve are expected to be in the reserve during the test period. Consequently, too much of the changes in the deferred tax reserve may be excluded from rate base and thus, the utility is denied a current return for an accelerated depreciation benefit it is only projected to have. This procedure is a form of flowthrough because current rates are reduced to reflect the capital cost savings of accelerated depreciation deductions not yet claimed or accrued by the utility. Thus, the simple average of the deferred tax reserve account at the beginning and end of the test period will violate the normalization requirements of [§](#) section 1.167(l)-1(h)(6) of the regulations.

While the purpose of both the consistency requirements of [§](#) section 168(i)(9)(B) of the Code and the timing requirements of [§](#) section 1.167(l)-1(h)(6) of the regulations is to prevent the flowthrough of the benefit of accelerated depreciation to ratepayers, these

requirements are two separate normalization requirements that must be satisfied. If an average rate base is used, the failure to average the deferred tax reserve at the beginning and end of the test year will violate the consistency requirements of [§](#) section 168 (i)(9)(B). If a portion of the test year is a future period for purposes of [§](#) section 1.167(l)-1(h)(6), the failure to use the prorated deferred tax reserve will violate the timing requirements of [§](#) section 1.167(l)-1(h)(6). Thus, here, the average of Taxpayer's (i) estimated deferred tax reserve at \*\*\* and (ii) prorated estimated deferred tax reserve at \*\*\* must be used in determining the maximum amount of the deferred tax reserve that may be excluded from the rate base under [§](#) section 1.167(l)-1(h)(6).

Based on Taxpayer's representations and the analysis as set forth above, we conclude as follows:

1. Where a test year is based entirely on estimated data and the effective date of the rate order occurs within the test year, the portion of the test year occurring after the effective date of the rate order represents the future portion of the period for purposes of [§](#) section 1.167(l)-1(h)(6)(ii) of the regulations. Thus, the proration formula provided in this regulation applies only to the estimated changes in the deferred tax reserve accruing after the effective date of the rate order.
2. Where an average rate base is used and where the test period is part historical and part future for purposes of [§](#) section 1.167(l)-1(h)(6)(ii) of the regulations, failure to reduce the average rate base by the average of (i) the estimated deferred taxes at the beginning of the test period and (ii) the estimated deferred taxes at the end of the test period as prorated under [§](#) section 1.167(l)-1(h)(6)(ii), will violate the consistency rules of [§](#) section 168(i)(9)(B) of the Code.

This ruling is directed only to the taxpayer who requested it. [§](#) Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney, a copy of this letter is being sent to your authorized representatives.

Sincerely yours,

Charles B. Ramsey

Chief, Branch 6

Office of Assistant Chief

Counsel

(Passthroughs and Special

Industries)

Enclosures (2):

Copy of this letter

Copy for [§](#) section 6110 purposes