BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

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In the Matter of the Application of SAN JOSE WATER COMPANY (U168W) for an Order authorizing it to increase rates charged for water service by $34,928,000 or 12.22% in 2016, by $9,954,000 or 3.11% in 2017, and by $17,567,000 or 5.36% in 2018.	Application 15-01-002 (Filed January 5, 2015)

COMMENTS OF THE OFFICE OF RATEPAYER ADVOCATES ON THE PROPOSED DECISION OF ALJ TSEN.

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I. INTRODUCTION

Pursuant to Rule 14.3 of the Rules of Practice and Procedure of the California Public Utilities Commission ("Commission" or "CPUC"), the Office of Ratepayer Advocates ("ORA") submits these Comments on the Proposed Decision ("PD") of Administrative Law Judge Pat Tsen relating to the General Rate Case ("GRC") Application of San Jose Water Company ("SJWC") for Test Year ("TY") 2016.

After having settled on about 50% of SJWC's requests, ORA supports the PD except on two issues: 1) prior tax credits resulting from the Tangible Property Regulation (TPR) and Enterprise Zone Sales and Use Credits (EZ credit;) and 2) labor expenses for overtime. ORA's Comments address only the areas in the PD where there are legal, factual, or technical errors. The Commission should not construe ORA's silence on a particular subject as assent on that issue. ORA recommends that the final decision the Commission adopts in this proceeding include the changes described in these Comments.

II. DISCUSSION

A. The PD commits error by sanctioning the utility's windfall tax credits without providing any commensurate ratepayer benefits.

Section 3.7 of the PD addresses issues raised by ORA regarding SJWC's prior years' tax credits. ORA is of the opinion that the PD commits error here and that the Commission's decision should instead give this issue the full and thorough analysis that it deserves. The PD allows SJWC to retain significant TPR and EZ tax credits without affording its ratepayers any of the benefits. This does not amount to just and reasonable ratemaking.

The impact of the TPR on rates is that SJWC will receive $7.2 million in refunds instead of using those credits for depreciation for future ratepayer savings. In addition, as the PD acknowledges, SJWC filed refund claims for years 2008-2012 to claim the EZ tax credit and received $880,000 in credit in 2014, resulting in a total tax windfall of approximately $8.08 million, (excluding the impact of those deductions on future rates.) This rate application is the first time SJWC brought the TPR impact on the rates before the Commission in a GRC application. The Commission did not consider the TPR repair allowance in setting the rates in the last GRC.

In this GRC, SJWC wants to retain the state income tax savings resulting from the implementation of the TPR repair allowance for 2013 and prior years, 2014 and 2015 and the revenue requirement associated with normalizing the federal income tax savings, instead of flowing these savings through to the ratepayers. It claims that the memorandum accounts to track refunds requested by ORA amount to retroactive ratemaking and should be rejected by the Commission. The PD unfortunately agrees with the utility.

The PD in this area contains errors in at least three respects: 1) although it purports to place an obligation on a utility to notify the Commission of significant tax law changes between the filing of GRCs, in this instance it ignores its own recommendation and instead grants SJWC a tax windfall despite its failure to satisfy this obligation; 2) the PD fails to consider the fact that these tax law changes will affect future rates, and therefore establishing memorandum accounts or some other mechanism to avoid continuing tax windfalls would be appropriate; and 3) having restricted its analysis of the issue to ORA's recommendation to establish memorandum accounts to track SJWC's significant tax credit windfall, the PD fails to consider any of the alternative mechanisms suggested by ORA, or those taken by the Commission in the past in similar circumstances, to reach an equitable distribution of the tax credits between the utility and its ratepayers. ORA will address these failings below.

1. The PD does not follow through on its own recommendations regarding the "appropriate regulatory treatment" for a utility that has experienced or anticipates a large reduction in its revenue requirements due to tax law changes between its GRCs.

The PD acknowledges the problem that changes in tax law occurring between a utility's General Rate Cases ("GRC") could lead to significant inequities between the utility and its ratepayers unless those changes receive appropriate regulatory treatment. It states that "[w]hen utilities experience or anticipate large and unexpected increases in costs, they will typically request authority from the Commission to establish a memorandum account or raise rates. *Utilities should be under the same obligation to notify the Commission when it experiences or anticipate[s] a large reduction in its revenue requirements due to tax changes*." (PD, p. 33, *emphasis added*.) As the record shows however, SJWC failed to notify the Commission, and the PD, despite its admonitions to the contrary, takes no steps to put its recommendations into practice.

In this proceeding, SJWC chose to ignore this obligation, even though it knew the tax changes went into effect 17 months before it filed this GRC application. It cannot be reasonably disputed that SJWC anticipated that these tax changes would lead to a large reduction in its revenue requirements, or that it had more than enough time to notify the Commission thereof, so that these changes could be considered and dealt with appropriately in this GRC, or through the establishment of some other mechanism, like a memorandum account. SJWC however, did no such thing, and the PD in effect rewards it for its inaction. In ORA's opinion, admonishing a utility to do something and then rewarding its non-compliance does not constitute appropriate regulatory treatment.

On this issue, ORA recommends that the Commission review and follow its rationale in its most recent Southern California Edison Company (SCE) GRC decision, D.15-11-021, at pp. 430-455, issued only seven months ago. In that Decision, the Commission considered similar tax law change circumstances. There, although SCE appears to have adopted a slightly more nefarious strategy than SJWC, (it knowingly used different methodologies for its tax filings as opposed to regulatory filings) ORA respectfully submits that the same regulatory principles regarding treatment of significant tax law changes should apply in this proceeding. In that decision, the Commission took into consideration the utility's conduct regarding non-notification of the tax law changes, what the utility's obligations are under these circumstances, and what alternative methodologies were available to address the apparent tax savings windfall besides just memorandum accounts. The Commission would be wise to adopt a similar outcome, analysis and the regulatory principles outlined in D.15-11-021.

For example, in that decision, the Commission stated that "[a]lthough we do not adopt specific criteria for when SCE must bring accounting changes to our attention directly (beyond simply recording them in the Tax Accounting Memorandum Account) we wish to send a clear signal to SCE in favor of prompt disclosure. We expect SCE to bring to our attention any major changes in tax accounting at least as soon as it notifies the SEC, investors, or other public agencies. SCE need not have precise calculations of the revenue requirement impacts in order to alert this Commission of such changes. *Failure to disclose such changes in a timely fashion undermines the integrity of the regulatory process and may be found to be a violation of Rule 1."* (D.15-11-021, p. 461. *Emphasis added*.) The PD however, although it appears to be making the same point, does not follow through on the consequences for a utility not complying with these admonitions, as was done in the SCE decision. As a result, the PD unwittingly undermines the integrity of the regulatory process by permitting SJWC to get away with keeping silent on the tax credits.

2. The PD shirks the Commission's duty to use all means legally at its disposal to ensure federal tax credits are passed onto ratepayers.

In D.15-11-021, the Commission stated that "the California Supreme Court has made clear that it is the duty of the Commission 'to use any means legally at its disposal, including adjustment of rate of return, to insure that the savings [arising from a federal tax credit] were passed to the customers.' Moreover, the Court has unanimously annulled a Commission decision that failed to consider an alternative method to flow through the benefits of a change in tax law to ratepayers. In light of the substantial and consistent case law, it is clear that the Commission would fail to regularly pursue its authority and abuse its discretion if it did not endeavor to mitigate the harm to ratepayers." (D.15-11-021, p.433.) The PD, on the other hand, has taken no steps to mitigate the harm to SJWC's ratepayers, and appears to have considered ORA's memorandum account solution as the only potential alternative to giving SJWC a tax windfall. ORA alleges this amounts to an abuse of discretion.

Further, specifically with regard to significant changes in tax law, in D.15-11-021, the Commission stated: "[i]n *So. Cal. Edison Co. v. Pub. Util. Comm'n* (*SCE II*),[1] the California Supreme Court explained that California law has recognized that because 'taxes are treated as part of a utility's cost of service, any tax savings should not be retained by the utility but should be immediately passed on to the utility's customers.' Thus, '[a]ny savings acquired through the use of accelerated depreciation . . . is to be immediately flowed through to the ratepayers.' Finally, quoting its decision a year earlier in *SCE I*, the Court emphasized that it is 'elementary' that 'the 'return' – i.e., the profit – of the utility is calculated solely on the rate base – i.e., the capital contributed by its investors; the utility is not entitled to earn an additional profit on its expenses." (D.15-11-021, pp. 441-442.)

3. The PD's memorandum account analysis fails to consider their value with regard to future tax expenses related to the change in accounting for TPR and EZ tax credits.

The PD fails to consider how or whether future rates may be affected by granting SJWC's tax windfall, notwithstanding its acknowledgement that ORA asserts in its testimony that the TPR adjustments for future years affect not only present income taxes, but also the future income taxes that ratepayers must pay. (PD, p .31.) Expensing the repair allowance in the current year would reduce the

[1] *So. Cal. Edison Co. v. Pub. Util. Comm'n*, 23 Cal. 3d 470 (1979) (*SCE II*).

current year taxes but the taxes in the future years would increase because SJWC's tax depreciation basis would be lowered by the same amount, resulting in lower tax depreciation deductions in future years. In other words, by taking the repair allowance, SJWC's income tax would be lower now but would be higher in the future. This would result in a higher revenue requirement and higher rates in the future.[2] SJWC would keep the tax reduction associated with TPR for 2013 and prior, 2014, and 2015 (approximately $7.2 million), but the ratepayers would have to pay higher taxes in the future by a similar amount. That is because the maintenance expenditures that SJWC expensed for those years would not be available to deduct in the future, due to the PD's reduction in SJWC's tax depreciation basis by the same amount.

The PD however, errs by not considering or discussing these recommendations. It fails to follow the Commission's prior findings quoted above that because taxes are treated as part of a utility's cost of service, any tax savings should not be retained by the utility but should be immediately passed on to the utility's customers.

Thus, the PD's conclusion that establishing memorandum accounts to address this issue would be a retroactive ratemaking does not make sense because TPR affects that future income tax obligation that the ratepayers must pay. When tax law changes affect future tax obligation, it could not be claimed as retroactive ratemaking since the tax law changes affect not only the present taxes but also the future tax obligation. Therefore, the PD's claim of retroactive ratemaking is not reasonable, specifically with regard to its failure to address the future consequences to ratepayers, and should be rejected.

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[2] `Tr. At 300:22-26.

4. Limiting its analysis to memorandum account treatment is insufficient.

The PD limits its analysis to ORA's recommendation to establish memorandum accounts to track the revenues and expenses affected by the new tax law. Without any analysis of why SJWC took no steps to notify the Commission of the tax law changes between the introduction of the TPR in August 2013 and its filing of its 2014 taxes in September 2015, the PD appears to conclude that the only way ratepayers could benefit from these refunds would be if these memorandum accounts were established before SJWC filed its 2014 taxes and received refunds. If this portion of the PD were to be adopted by the Commission, it would send a clear and wrong message to any utility that no matter the size of the refunds it may receive as a result of a tax law change, or when the utility found out about it, that doing nothing in terms of notifying the Commission of the changes is permissible, because it can always rely on a retroactive ratemaking defense later to avoid passing those refunds onto ratepayers. That clearly conflicts with the Commission's decision in D.15-11-021. Accordingly, the Commission should correct the PD so that the final decision does not violate the principles clearly set out in D.15-11-021.

SJWC proposes to normalize the federal income savings and flow through state income tax savings. Under normalization of tax savings, the tax savings would be used to reduce rate base. However, SJWC wants to keep the savings ($7.2 million) attributable to state income taxes. The amount of money involved with the state income tax is substantial. If the Commission is concerned about the possibility of retroactive ratemaking regarding ORA's recommendation to refund the state tax savings through a memorandum account, the Commission could consider another alternative and have SJWC normalize its state income tax savings. By normalizing both the federal and state tax savings, the state income tax savings as well as the federal savings would be passed onto the ratepayers through reduction in the future revenue requirements through a rate base reduction.

ORA submits that the Commission should follow its rationale in D.15-11-021, so as to conclude that even though memorandum accounts are one possible solution to this issue, adopting a simple rate base offset to offset the future tax expense related to tax law changes is another. (D.15-11-021, p. 431.) In that decision, the Commission determined that this outcome is a prospective change, and not prohibited by retroactive ratemaking principles. (Id.)

ORA believes that SJWC should, like most of other large water utilities, including California Water Service Company, Golden State Water Company and California American Water Company, choose to normalize both federal and state income tax savings. Having SJWC normalize both federal and state income tax savings would make the ratemaking uniform throughout the water industry, and offer ratepayers better protection against utility greed.[3]

B. Labor Expenses - Overtime

In Section 3.3.5 of the PD regarding overtime expenses, it adopts SJWC's proposal of a non-inflation adjusted 3-year average using years 2012-2014. ORA opposes using just 3 years of data to determine overtime expenses, and recommends using a non-inflation adjusted 5-year average that will reduce the abnormally high overtime years such as 2013, which is consistent with Rate Case Plan recommendation to use 5 years of data.

Without any legal or factual support or analysis, the PD concludes that the three year average provides a sufficiently normalizing effect on the high overtime in 2013. This insufficiency in providing support for this conclusion is also highlighted by the PD's

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[3] California Water Service GRC D.14-08-011, Attachment A Settlement, p. 97-98.

Golden State Water Company GRC D.14-04-021, p. 26-28.

California American Water Company D. 15-04-007, Attachment A Amended Settlement, p. 77-78.

internally inconsistent use of yearly averages. The PD does not explain why its decision to adopt a 3-year average is reasonable, why it prefers the 3-year average to any other average, or why its averaging is inconsistent with its treatment of normalizing corporate expenses, (using a 5-year average, or Regulatory Expenses using a 6 year average). ORA submits that its recommendation to use 5 years of data is preferable, given that the data is available and that it more fairly comports with the General Rate Case Plan.

III. CONCLUSION

In light of the above, ORA recommends that the PD be changed so that the Commission does not grant SJWC the tax windfalls granted by the PD.

The PD should be amended as follows:

> Finding of Fact NO. 21. Overtime expenses should be normalized by using a five-year average.
>
> Finding of Fact No. 27. Establishing memorandum accounts to track future refunds of taxes paid between a utility's GRC filings is not retroactive ratemaking.
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> Conclusion of Law No. 12. Overtime expense should be calculated using a five-year average to normalize high overtime years.

Respectfully submitted,

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