CPUC Docket: A.25-05-009
Exhibit Number: TURN Ex-23

UPDATE PHASE

EXCERPT FROM A.21-06-021, PG&E-10, CHAPTER 14 (WORKING CASH)

Submitted on Behalf of

THE UTILITY REFORM NETWORK

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September 18, 2026

Application: 21-06-021
(U 39 M)
Exhibit No.: (PG&E-10)
Date: February 28, 2022
Witness(es): Various

PACIFIC GAS AND ELECTRIC COMPANY

2023 GENERAL RATE CASE

EXHIBIT (PG&E-10)

RESULTS OF OPERATIONS

[INCLUDES ERRATA THROUGH FEBRUARY 28, 2022 AND FEBRUARY 28, 2022 SUPPLEMENTAL TESTIMONY]

(PUBLIC VERSION)

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CHAPTER 14

WORKING CASH

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methodology for computing expense lags generally remains the same as that used in the prior two GRCs.

a. Income Tax Expense Lags

The following sections discuss the calculation of expense lags for federal and state income tax expense.[9] For both federal and state income taxes, the expense lag should be equal to the revenue lag, that under the current analysis is 48.66 days.[10]

1) Background

As discussed above, in general, the expense lag for a particular category of expenditure is the length of time between the midpoint of the period in which PG&E incurs the expense and the date that the expense is paid. In previous GRCs, PG&E has computed the expense lag for current federal and state income taxes based on a projection of when estimated taxes will be paid during the test year.

However, there are years in which PG&E's consolidated tax group will pay no income taxes, for various reasons. For example, as a result of the claims paid by PG&E to wildfire victims in 2020, PG&E does not expect to pay federal or state income taxes for a number of years. This occurs because the amount of claims that PG&E can deduct on its consolidated tax return exceeds its taxable income, and in accordance with the Internal Revenue Code, PG&E is required to carry forward to future years deductions exceeding taxable income. Those deductions that are carried forward are called Net Operating Losses (NOLs). In the case of the NOLs from the recent payment of wildfire claims, as those NOLs are applied to taxable income in future years, the tax benefits of using those NOLs to reduce income taxes accrue to shareholders, since they paid the claims.[11]

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9 These revisions correct errors in the original testimony.

10 The revenue lag formula can be found in Section D.1. Also refer to workpapers supporting Exhibit (PG&E-10), Ch. 14, WP 14-134.

11 Per D.21-04-030 and D.21-05-011, certain tax benefits accruing to shareholders will be used by shareholders to fund a trust to credit customers for charges on recovery bonds related to the rate-neutral financing of some of the wildfire claim payments.

For many years, the federal government, in efforts to stimulate the economy, allowed taxpayers to greatly accelerate the depreciation of their annual capital investments through the use of "bonus" and accelerated depreciation, which offset all or a portion of the federal taxable income. These bonus and accelerated tax depreciation benefits exceeding regulatory depreciation are tracked over time as deferred taxes, and the tax benefits are provided to ratepayers as a reduction to rate base.[12] When NOLs arise from federal tax depreciation deduction of rate base assets, the federal tax benefits of using those NOLs to reduce income taxes in future years accrue to ratepayers.

As discussed below, the CPUC has provided guidance on the expense lag for deferred taxes. However, CPUC SP U-16, which is the basis for the working cash analysis, does not address the situation in which a utility is not paying any current taxes because of NOL carryforwards. To correctly calculate the tax expense lag, an understanding is needed of guidance the CPUC has provided that is applicable to the tax expense lag, as well as how and when the cash from income tax expense collected in rates is actually deployed.

2) Guidance Provided By The CPUC

The CPUC has provided guidance on how to treat NOLs due to depreciation, as well as how to treat NOLs due to losses, temporary or otherwise, borne by shareholders. With respect to federal deferred taxes for accelerated depreciation of rate base assets, CPUC SP U-16 establishes that the expense lag is zero days. That happens because there is a reduction to rate base at the time the expense is accrued:[13]

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12 The accelerated depreciation for federal taxes has typically resulted in the utility paying less in federal income taxes in the earlier years of the assets, but the utility will pay those taxes in later years. These taxes not yet paid are essentially interest-free loans from the government to encourage investments in plant and equipment used to provide service to customers, and hence reduce rate base.

13 Rate base is reduced as expenses are accrued, because the accrual represents an explicit assumption that the cash is paid when the expense is accrued. The lead-lag study corrects for the timing mismatch of accrual accounting and actual cash flows.

> 45. For utilities which have used accelerated amortization to reduce income taxes, the Commission, in fixing rates, has permitted normalization of the income tax expense, thereby offsetting the reduction in the tax, but has deducted from the rate base the average accumulated deferred taxes due to accelerated amortization. Therefore, for those utilities where rates have been set on this procedure, the lag days for the offsetting amount due to accelerated amortization should be zero. The reason for this is that the adjustment is already included in the rate base, and to assign the same lag days as for the actual income taxes would in effect be doubling the deduction from working cash.[14,15]

With respect to NOLs due to losses, temporary or otherwise, borne by shareholders, as stipulated in Order Instituting Investigation 24 (OII 24),[16] and under the construct of California utility ratemaking, such NOLs and the tax benefits do not increase or decrease a utility's cost of service or rate base. OII 24 established the principle that any reduction in tax obligations resulting from expenses that are not allowed for ratemaking accrue to shareholders. This kind of NOL is created when the utility has incurred expenses that it cannot recover in rates and are in excess of its taxable income. In that case, shareholders bear the costs of the unrecovered expenses, and therefore, the tax benefits of those deductions taken accrue to shareholders. The unused shareholder deductions can be applied against taxable income in future years for the benefit of shareholders. However, they do not yield a cash benefit to shareholders until the time they are applied to offset income tax owed.

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14 SP U-16, p. 3-13.

15 This is similar to how SP U-16 calculates the expense lag for depreciation expense: the reduction to rate base at the time the depreciation expense is incurred results in an expense lag of zero. SP U-16, p. 3-12.

16 Beginning in 1978, the Commission instituted the OII 24 as a comprehensive investigation into the methods to be used by the Commission to establish income tax expense for ratemaking purposes by public utilities and other regulated entities. The proceeding spanned nearly 6 years, involved 22 days of public hearing, and included evidence submitted by CPUC Staff, utilities, and other parties. D.84-05-036, mimeo, p. 3. OII 24 was an exhaustive proceeding, covering 14 major tax issues. It has continued to guide the Commission's approach to income tax issues for more than 37 years.

3) Deployment of Cash Related to NOLs Outside of Rate Base

Because NOLs that arose from costs borne by shareholders are not compensated as part of the cost of service ratemaking, these NOLs are not included in rate base. As a corollary, there is no impact on rate base when these NOLs are used to offset a cash tax liability for PG&E's consolidated tax return group according to the IRS rules and guidance. The use of the NOLs provides a tax benefit to shareholders that is created by tax law. If the tax benefit did not accrue to shareholders, ratepayers would effectively avoid the tax liability included in the cost of service. As a result, the concepts embodied in OII 24 require that the working cash calculation should not provide a secondary benefit to ratepayers that belongs to shareholders. Applying that concept to the lead-lag study, the cash is "paid" to shareholders as it is received in revenue from customers, and hence the expense lag is set to be equal to the revenue lag, resulting in no benefit to ratepayers in working cash. This methodology applies to both federal and state income taxes.

Of note, under CPUC D.21-04-030 and D.21-05-015, which authorized PG&E to issue rate-neutral securitized debt to be paid with non-bypassable charges to customers, as the tax benefits of certain NOLs and deductions for expense borne by shareholders related to wildfires are realized, PG&E will contribute the cash to a Customer Credit Trust to provide a credit to customers. The NOLs and deductions are estimated at about $24 billion for federal income taxes and $28 billion for state income taxes, subject to a cap of $7.59 billion in contributions.[17]

4) Deployment of NOLs Included in Rate Base

For federal taxes, NOLs from accelerated depreciation increase rate base because they are incurred when PG&E does not actually

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[17] *See* D.21-04-030 at 91 ¶ 4 (OP 4) ("Pacific Gas & Electric Company shareholders shall contribute $7.59 billion of additional contributions (the Additional Shareholder Contributions) funded by certain shareholder-owned tax deductions or net operating losses (the Shareholder Tax Benefits) to the Customer Credit Trust consistent with the discussion in this decision.").

realize the cash tax benefits that are passed through to ratepayers as deferred tax reductions to rate base.[18] In effect, they offset, or decrease, federal deferred taxes that are a reduction to rate base. As PG&E applies the federal NOLs related to accelerated depreciation of rate base against future taxable income, PG&E realizes the tax benefits that were deferred from previous years, and those cash tax benefits are assumed to be invested in rate base and the benefit is provided to ratepayers as a reduction to rate base in the years the NOLs are applied to reduce federal tax liability. When the federal NOL is decreasing and there is a corresponding decrease in the deferred tax asset and rate base, the expense lag should be zero because the working cash benefit is offset by the rate base reduction, consistent with SP U-16.

5) Federal Income Tax Expense Lag

In 2023 and subsequent years, consolidated federal tax liability is zero because tax deductions are estimated to exceed taxable income. In addition, in 2023, the federal NOL related to accelerated depreciation is expected to increase under the normalization rules required by the IRS but is expected to be utilized and decrease in subsequent years. While the NOLs related to accelerated depreciation that are being used would have a zero lag per SP U-16 principles outlined above, those related to costs borne by shareholders and those related to increases in deferred taxes due to normalization rules for accelerated depreciation have an expense lag for 2023 that should be equal to the revenue lag of 48.66 days.[19]

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[18] The federal tax normalization rules require that when PG&E cannot realize the cash tax benefits immediately, rate base is increased until the benefits can be realized in a later year. IRS Private Letter Rulings 201519021, 201438003.

[19] In years in which the federal NOL related to depreciation is increasing, the implication is that deductions are reducing the taxable income to zero, meaning generally that costs currently deductible are exceeding billed revenue. Those costs are being funded by shareholders, and the tax benefit is paid to them as the cash is received from customers, hence the expense lag is equal to the revenue lag.

In all cases, the expense lag is no more than equal to the revenue lag. PG&E proposes to set the federal tax expense lag equal to the revenue lag of 48.66 days.

6) State Income Tax Expense Lag

For the same reasons that NOLs related to wildfire payments borne by shareholders have an expense lag equal to the revenue lag for federal tax expense, the use of such NOLs to offset state tax expense result in a state tax expense lag equal to the revenue lag of 48.66 days. During the GRC period, NOLs for shareholder borne wildfire expenses are projected to offset state tax liability starting in 2024. As with the federal NOLs, the tax benefit from using the state NOLs will be contributed to a trust to fund credits to customers. For test year 2023 and part of 2024, state tax liability is projected to be offset with existing NOLs from 2019 that pre-dated the 2020 resolution of wildfire claims paid by shareholders under PG&E's plan of reorganization. Nearly all of these state NOLs arose from wildfire mitigation costs that were incurred in 2019 and recorded in various balancing and memorandum accounts. Such expenses remain in balancing accounts until there is a determination by the Commission on their recovery from customers. According to OII 24, amounts recorded in balancing accounts (whether over or under collections) should not be included when considering either state income tax expense or related impacts on working cash. To implement that requirement, tax expense that is offset by NOLs resulting from costs recorded in balancing accounts should have an expense lag equal to the revenue lag of 48.66 days. Setting the expense lag equal to the revenue lag effectively removes any impact on working cash from state income tax expense. Thus, PG&E proposes to set the state tax expense lag equal to the revenue lag of 48.66 days.

b. Other Expense Lags

Other expense lags are calculated using the data sources shown in Table 14-1.