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PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

I.D.#2945

ENERGY DIVISION **RESOLUTION G-3354**

December 4, 2003

R E S O L U T I O N

Resolution G-3354. Pacific Gas and Electric (PG&E), Southern California Edison (Edison), San Diego Gas & Electric Company (SDG&E), Southern California Gas Company (SoCalGas), and Southwest Gas Corporation (SWG) request tariff revisions to reflect a decrease in the Income Tax Component of Contribution (ITCC) associated with Contributions in Aid of Construction.

By PG&E Advice Letter (AL) 2466-G/2386-E filed on June 6, 2003.
By Edison AL 1715-E filed on June 19, 2003.
By Edison AL 120-G filed on June 19, 2003.
By SDG&E AL 1505-E/1382-G filed on June 11, 2003.
By SoCalGas AL 3267 filed on June 12, 2003.
By SWG AL 692 filed on July 14, 2003.

SUMMARY

This resolution approves PG&E Advice Letter (AL) 2466-G/2386-E, Edison ALs 1715-E and 120-G (Catalina), SDG&E AL 1505-E/1382-G, SoCalGas AL 3267, and SWG AL 692. Those ALs implement a revised bonus depreciation rate to be applied to the ITCC for contributions in aid of construction (CIAC) made from August 1, 2003 to January 1, 2005.

This resolution also denies the request of the California Building Industry Association for retroactive tax treatment for CIAC taxes already paid with respect to contributed property eligible for the lower ITCC rate of 22% between the dates of May 5, 2003 and August 1, 2003.

BACKGROUND

In 1986 President Reagan signed into law the Tax Reform Act of 1986 that made contributions in aid of construction taxable under the Internal Revenue Code (IRC). In Decision (D.)87-09-026, the Commission noted that I.R.C. Sec. 118 set forth three examples of contributions in aid of construction:

1. A developer constructs utility facilities (e.g., water lines and a water tower) and turns over these facilities to a utility;

2. A developer furnishes the necessary funds to the utility to construct the facilities; and

3. A municipality pays a utility to relocate facilities that are being destroyed in connection with road construction.[1]

When a utility receives such a contribution the developer pays the income tax on that contribution, called the ITCC.

Finding No. 4 of D. 87-09-026 explains how the ITCC is calculated:

> "Method 5 places the tax burden on the contributor but mitigates the burden by requiring, in addition to the plant contribution, only the present value of the future tax burden. The gross-up is calculated by using the utility's incremental federal tax rate. As the payment by the contributor, by definition, does not completely pay the tax, the utility pays the difference, rate bases the tax on the CIAC net of gross-up, and recovers the difference over time in rate of return, thus causing the ratepayers to share the burden of the tax. Because the gross-up amount paid by the contributor is estimated to offset the future revenue requirements attributable to the tax actually paid, the

[1] Decision No. 87-09-026 25 or CPUC 2d 305

> ratepayers are, to the extent the estimate turns out to be accurate, indifferent."

The advice letters under consideration in this resolution request a revision to the ITCC similar to one that was approved by the Commission over a year ago. The issues and the tax law are the same, but the amount of bonus depreciation is different.

On May 28, 2003, President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 107-27; the "Act"). Section 201(a) of the Act modifies a depreciation provision—Section 168(k) to the Internal Revenue Code—now entitled, "Special Allowance for certain property acquired after September 10, 2001, and before January 1, 2005." The Act raised the Special depreciation Allowance from 30% to 50%, and extended the termination date to January 1, 2005. Section 201 of that law states:

> "The amendments made by this section shall apply to taxable years ending after May 5, 2003."

The utilities' current tariffs show contributions to consist of 1) Income Tax Component of Contribution (ITCC); and 2) the balance of the contribution, excluding income taxes.

The additional depreciation allowed under this Act temporarily reduces the utilities' ITCC factor. The revised ITCC factor has been calculated by each utility, except SDG&E, by using Method 5 as described in D.87-09-026 and D.87-12-028. SDG&E used the Maryland method.[2] Under the utilities' AL filings the ITCC tax factor would temporarily decline from 27% to 22% on all property contributed to the utilities on or after August 1, 2003 and before January 1, 2005. Property contributed to the utilities after December 31, 2004, will be subject to the previously authorized ITCC tax factor of 34% for Edison, 37% for SDG&E and 35% for SoCalGas, PG&E and SWG.

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[2] "Method 5 places the lion's share of the tax burden on the person causing the tax; to the extent the discount rate is not perfectly adjusted, the ratepayer would have to share some of the burden;…" Under the Maryland Method "The current tax shortfall would be funded by the utility shareholder." Ref. 25 CPUC 330 331.

PG&E, Edison, SDG&E and SoCalGas request an effective date of August 1, 2003. SWG requests an effective date of August 20, 2003.

NOTICE

Notice of PG&E AL 2466-G/2386-E, Edison ALs 1715-E and 120-G (Catalina), SDG&E AL 1505-E/1382-G, SoCalGas AL 3267, and SWG AL 692 was made by publication in the Commission's Daily Calendar. PG&E, Edison, SDG&E, SoCalGas and SWG stated that a copy of the Advice Letter was mailed and distributed in accordance with Section III-G of General Order 96-A.

PROTESTS

The California Building Industry Association (CBIA) filed a protest on June 25, 2003 to PG&E AL 2466-G/2386-E, Edison AL 1715-E, SDG&E AL 1505-E/1382-G and SoCalGas AL 3267. CBIA claims 5600 members and asserts that its members probably represent the largest group of CIAC taxpayers in California. CBIA said the proposed dates in the ALs would allow the Utilities to impose the current CIAC tax (27%) - rather than the lower 22% tax – on projects for which the utilities will be provided the special bonus depreciation allowance made available by the Act.

CBIA protests the effective dates of August 1, 2003 proposed by PG&E, Edison, SDG&E, and SoCalGas. Under the various utility proposals, CBIA observes that an applicant will be eligible for the lower 22% CIAC tax factor only on contributions made after August 1, 2003. CBIA contends that the lower 22% CIAC tax factor should apply to all property contributed by an applicant to the utility that qualifies for the special bonus depreciation allowance provided by the Act, irrespective of whether the applicant contribution is made before or after August 1, 2003. CBIA said the utilities artificially premise the applicability of the lower CIAC tax factor on the timing of approval of their respective advice letters and ignore any effort to assess applicants the 22% CIAC tax on projects commenced after May 5, 2003 and before August 1, 2003 that nevertheless qualify for the favorable tax treatment contemplated by the Act. CBIA said that the utilities have frustrated the intention of past Commission precedent as well as the Act itself by proposing effective dates that would allow them to charge

applicants for higher CIAC taxes on projects for which the utility themselves will be eligible for lower tax treatment.

CBIA says its proposed effective date for the utility advice letters is based on the tax code and the date the utility will receive the tax benefits. CBIA emphasizes its position with the following examples. If the utility's tax year runs from July 1, 2002 to June 30, 2003, property acquired by the utility after May 5, 2003 will be eligible for the 50% bonus depreciation. If the utility's tax year runs from January 1, 2003 to December 31, 2003 property acquired after May 5, 2003 will also be eligible for the 50% bonus depreciation. CBIA contends that the Commission should require the utilities to apply the reduced CIAC tax factor of 22% to qualifying property contributed by applicants after May 5, 2003 pursuant to a contract between applicant and utility in effect on or after May 6, 2003.

CBIA requests retroactive treatment for CIAC taxes already paid with respect to contributed property that is subject to the bonus depreciation. Without retroactive treatment, CBIA said, Utilities will be collecting more taxes than required by the IRS. CBIA quotes D.87-09-026, Conclusion of Law 12, as a basis for refunds for bonus depreciation:

> "If a utility is not in a taxable position in the year that it receives a contribution or refundable advance, there is no tax liability. The tax gross-up received from the contributor under Method 2 or Method 5 should then be refunded to the contributor. If a utility collects a gross-up calculated using an incremental tax rate that is more than its incremental rate, as determined on a ratemaking basis, the difference between what was and what should have been collected should be refunded to the contributor."

Response of PG&E, Edison, SoCalGas and SDG&E

On July 3, 2003 PG&E, Edison, SoCalGas, and SDG&E (the "Responding Utilities") jointly responded to CBIA's protest. The Responding Utilities make the following four points:

1) The CIAC gross-ups received by the Responding Utilities are passed through to ratepayers and the benefits/burdens of excessive/inadequate gross up rate is realized/borne by ratepayers. The Responding Utilities will receive no windfall.

2) SDG&E is not seeking to create a windfall from contributors or ratepayers from the implementations of the Act under the Maryland method.
3) Determination of eligibility for bonus depreciation under CBIA's proposal would be neither straightforward nor non-controversial.
4) The Responding Utilities' proposal to apply a reduced gross-up rate to *all* contributions received between August 1, 2003 and January 1, 2005, is reasonable and consistent with Commission guidance.

The Responding Utilities explain that under Method 5 they treat the taxes they incur as an addition to rate base and the gross-up revenue received from contributors offsets the cost to ratepayers of this rate base inclusion. All gross-up revenues the utilities receive from applicants are tracked and returned to ratepayers as deferred revenue.

The Responding Utilities quoted D.87-09-026, Finding of Fact No. 4:

> "Because the gross-up amount paid by the contributor is estimated to offset the future revenue requirements attributable to the tax actually paid, the ratepayers are, to the extent the estimate turns out to be accurate, indifferent."

The Responding Utilities explained: "…if the gross-up rate is too high, ratepayers benefit through lower retail rates; if the gross-up is too low, ratepayers subsidize other customers [contributors] through retail rates." Because PG&E, Edison and SoCalGas will treat only the taxes they pay as rate base additions and because all gross-ups received are reflected as deferred revenues (resulting in reduced rates), there is no windfall (or shortfall) to the utility from a gross-up rate that turns out to be either too high or too low.

The Responding Utilities' response indicates that SDG&E uses the Maryland method. The Responding Utilities refer to D.87-09-026, mimeo p.4[3]: "The Maryland method gives a utility the option to absorb part of the tax…". Under the Maryland method the calculation is the same as under Method 5, but the shortfall between the tax liability in year one and the tax gross-up collected from

[3] 25 CPUC 2d 304.

the contributor is borne by the utility shareholder rather than the ratepayer. The response said adoption of the Maryland Method puts SDG&E's shareholders at risk for any shortfall in the calculation of the tax burden resulting from undercharges. The response said SDG&E seeks no windfall from contributors or ratepayers resulting from implementation of the Act. The response said SDG&E's request to reduce the ITCC rate from 27% to 22% effective August 1, 2003, rather than May 6, 2003, is solely to avoid the unreasonable burden of retroactive implementation and to allow SDG&E a reasonable amount of time to put into place the procedures necessary to implement the change in law.

To qualify for the 50% bonus depreciation, property must constitute "50% bonus depreciation property". The Responding Utilities provide an example of property acquired after May 5, 2003, pursuant to a binding contract entered into before May 5, 2003, that will not qualify a 50% bonus depreciation property under Internal Revenue Code (IRC) section 168(k). The Responding Utilities said that it is likely that not all property acquired after CBIA's recommended implementation date will be viewed as 50% bonus depreciation property under section 168(k). The Responding Utilities conclude that even after a case-by-case review of thousands of transactions entered into after May 5, 2003, not all such property will qualify as bonus depreciation property.

The Responding Utilities introduced more interpretive issues that may become disputes between the utility and contributors, if contributions were reviewed on a case-by-case basis for a lower ITCC eligibility. For example when does a contract become binding? What contract date applies for purposes of determining the May 5, 2003, rule (i.e. is it the date of the master contract, or the individual contract)? Is property (e.g. poles, lines, transformers) that PG&E acquired pursuant to a contract *prior* to May 5, 2003, eligible for bonus depreciation merely because it was installed after May 5, 2003, pursuant to a contract signed after May 5, 2003? Do the self-constructed[4] property rules apply to IRC Sec 168(k)(D)(i)[5]? Can a project be segmented or is the relevant date the

[4] Under Title I 101.(k)(C)(i) Self-Constructed Property is property manufactured, constructed or produced by a taxpayer for that taxpayer's own use.

[5] Under this section the taxpayer must have begun manufacturing, constructing, or producing the property after September 10, 2001, and before January 1, 2005.

commencement of construction of an overall project (e.g. BART to the airport)? What if some of the contributed property (or reconstructed[6] property) in a project has been recycled and does not qualify as "original use" property within the meaning of Section 168(k)(2)(A)(ii)[7]

The Responding Utilities said the Internal Revenue Service (IRS) has given no answer to these and numerous other questions and contend that it may be years before the IRS (or the courts) issue guidance on these matters. In the interim, the utilities, the contributors and the Commission will become needlessly ensnared in disputes over bonus depreciation of relatively small dollar amounts.

The Responding Utilities state that, under their proposal, all contributions received on or after August 1, 2003, and before January 1, 2005, would be eligible for the reduced gross-up rate. The Responding Utilities assert that their approach, unlikely to burden either the ratepayers, the utilities or Commission, reasonably balances the competing interests of ratepayers and contributors and makes the best of a complex situation. The Responding Utilities said the contributors in some cases will actually benefit from the utilities' approach of lowering the gross-up rate for all post-August 1, 2003 contributions because, if a case-by-case approach were required, some post-August 1, 2003, contributions would be determined ineligible for the lower gross-up rate. The Responding Utilities cite as an example post-August 1, 2003 contributions ineligible for bonus depreciation under IRC Sec 168(k), such as contributions received pursuant to contracts executed prior to May 5, 2003.

The Responding Utilities state that they filed for reductions in the gross-up rate within 25 days of enactment of the Act and ask for an effective date based on Commission policy and a workable system.

the Responding Utilities pointed to D.87-09-026, 2d CPUC 25 329 that states:

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[6] Examples of reconstructed property are refurbished transformer, capacitor or other equipment that is installed in a new work order.

[7] This section sets forth criteria for sale-leasebacks that were placed in service after September 10, 2001, and sold and leased back by such person within 3 months.

> "We are not seeking a perfect system; we are seeking a workable system. We understand that the Method 5 gross-up is only an approximation. We would expect that Method 5 would require one computation in regard to the contributor: the present value of the revenue requirement over time. Once that is determined the contributor makes the contribution gross-up for taxes by an amount equivalent to the net present value of the revenue requirement for the tax. The contributor has no further interest in the transaction. Should any part of the equation prove erroneous, the ratepayer will bear the burden or reap the benefit absent any imprudence on the part of the utility. Should there be imprudence, then routine Commission practice would correct the imprudence"

The Responding Utilities assert that Method 5 is only an approximation and they should not be required to retroactively review literally thousands of past transactions for bonus depreciation eligibility and undertake refunds that may often be less than the utility's administrative cost to review the transaction and process the refund.

DISCUSSION

In its protest CBIA requests an effective date of May 5, 2003 as a basis of eligibility for the lower 22% tax rate to be applied to all contributions that are subject to bonus depreciation made on or after that date, through December 31, 2004.

To CBIA's protest, the Responding Utilities responded:

a) the gross-ups received are passed through to ratepayers and the benefits/burdens of excessive/inadequate gross up rate is realized/borne by ratepayers;

b) the shortfall between the tax liability in year one and the tax gross-up collected from the contributor is borne by SDG&E's[8] shareholders rather than its ratepayers;

[8] SDG&E is the only energy utility that uses the Maryland method.

c) determination of eligibility for bonus depreciation will be neither straightforward nor non-controversial;

d) there is no utility windfall since all gross-ups received are treated as deferred revenues;

e) not all properties contributed between May 5, 2003 and August 1, 2003 will be eligible for the bonus depreciation, and not even all properties contributed after August 1, 2003 may be eligible for bonus depreciation;

f) utilities, contributors and the Commission will become needlessly ensnared in disputes over small dollar amounts;

g) some contributors will benefit from the utilities' proposal since some post-August 1, 2003 contributions would not be eligible for the lower 22% rate;

h) D.87-09-026 sought a workable, not a perfect system.

The utilities' proposal is reasonable. The utilities responded to the tax law change (that actually was not signed until May 28, 2003) within three weeks with advice letter proposals. President Bush did not sign the Act until May 28, 2003. Allowing for time to analyze the Act, file the advice letters by the middle of June and seek Commission approval, August 1, 2003 is a reasonable effective date without retroactivity.

Their proposal is essentially a simple, workable, cost-effective approach that will not unduly burden the utilities, ratepayers, the Commission, or applicants. While some applicants who may be technically eligible for the reduced ITCC may not receive the benefit of that reduction, other applicants may very well receive undeserved benefits. To determine every applicant that is eligible for the bonus depreciation, the utilities would need to do a costly case-by-case review of thousands of applications. Such a review would likely cost more than the benefits that would be received by applicants, and may lead to unnecessary controversy. The utilities will receive no windfall from their proposal.

Informal CBIA Proposals

In an attempt to resolve its protest the CBIA also informally offered to the Energy Division three alternative proposals to resolve the issue of compensation for the builders for the interval May 5, 2003 to August 1, 2003, or 87 days. The proposals are: 1) extend the expiration date of the 22% ITCC from January 1, 2005 to March 28, 2005; 2) reduce the ITCC rate below 22% to compensate for the 87 days of bonus depreciation missed, or 3) require the Utilities to refuse checks in an amount below an established floor, or refund a portion of the ITCC payment from developers. Checks written for amounts below the established floor, or amounts refunded, would compensate builders for bonus depreciation benefits missed during the 87 days at issue.

Although CBIA's proposals were made outside their protest, the Energy Division elicited responses to these proposals from the utilities, including SWG. The utilities presented arguments of administrative burden, undue enrichment of contributors that did not pay between May 5, 2003 and August 1, 2003, inequity between contributors that would not be eligible before January 1, 2005 and those that would benefit after January 1, 2005, and inconsistency with D.87-09-026 and with the Internal Revenue Code.

Of CBIA's three alternative proposals both 2) and 3) require an estimate of bonus depreciation benefits lost during the 87 days before August 1, 2003 and require the utilities to review the many applications that were submitted during that interval. Proposals 2) and 3) also may require retroactive refunds of part of the builder's payments. Also, to the extent the second proposal to reduce the ITCC rate to compensate for the 87 days of bonus depreciation eligibility applies to any person making a contribution or advance, it would result in a windfall to those that did not actually pay any ITCC between May 5, 2003 to August 1, 2003. Both of these proposals would be unreasonable administrative burdens and would be inequitable.

The Energy Division further explored CBIA's proposal to extend the date for the lower ITCC rate.

The Energy Division obtained from the four larger utilities estimates of the costs of reviewing applications received for contributions in aid of construction for the months of May, June and July of 2003 and total contributions recorded during those same months. The utilities also provided a calculation of the benefits to builders and developers, due to the ITCC rate difference of 5% (27% less 22%).

Actual benefits are probably less since not all contributions are eligible for the lower bonus depreciation rate of 22%. Results are as follows:

Utility Estimates of Case-by-Case
Review Costs vs. Benefits to Applicants,
May through July 2003

Utility	Cost Estimates ranging From	To	Contributions	Benefits
PG&E	$800,000	$1,000,000	$4,049,920	$202,496
SoCalGas	775,000	775,000	556,000	27,800
SDG&E	375,000	375,000	4,080,000	204,000
Edison	140,000	600,000	3,790,915	189,546
Totals	2,090,000	2,750,000	12,476,835	623,842

Based on the estimates above, the utilities contend that applicant benefits are far outweighed by the costs of reviewing the 3 additional months of applications for eligibility for the lower depreciation rate.

CBIA suggested extending the eligibility date beyond January 1, 2005 to compensate for the 87 days omitted by the utilities from May 5, 2003 to August 1, 2003. We expect that the costs and benefits comparison of the 87 day period ending March 28, 2005 would be comparable to that above, that is the costs would outweigh the benefits.

Moreover, CBIA's proposal is inequitable since the costs of reviewing the additional applications could ultimately burden the utility's ratepayers[9], while

[9] Additional expenses incurred by utilities might be included in their next general rate case showing. In addition, the additional expenses would reduce the utilities' rate of return or return on equity, thereby potentially impacting the amount of ratepayer revenue sharing for utilities operating under performance-based ratemakingmechanisms.

the benefits of CBIA's proposal would accrue to the contributors of the ITCC. Also, the proposal to extend the expiration of the 22% ITCC tax factor for an 87-day period into 2005 would not necessarily compensate those that actually paid the ITCC tax factor of 27% between May 5, 2003 and August 1, 2003. Therefore we do not agree that we should consider CBIA's request to extend the eligibility period beyond January 1, 2005 to compensate builders and developers for the applications not considered for the bonus depreciation rate of 22% in the interval May 5, 2003 to August 1, 2003.

SWG's AL 692 requested an effective date of August 20, 2003. SWG indicated to our Energy Division that an effective date of August 1, 2003 could be readily accomplished. We will also make SWG's AL 692 effective August 1, 2003.

COMMENTS

Public Utilities Code section 311(g)(1) provides that this resolution must be served on all parties and subject to at least 30 days public review and comment prior to a vote of the Commission. Section 311(g)(2) provides that this 30-day period may be reduced or waived upon the stipulation of all parties in the proceeding.

The 30-day comment period for the draft of this resolution was neither waived nor reduced. Accordingly, this draft resolution was mailed to parties for comments, and will be placed on the Commission's agenda no earlier than 30 days from today.

FINDINGS

1. On May 28, 2003 President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 raising the Special Depreciation Allowance from 30% to 50%, and extending the termination date to January 1, 2005.

2. The increase in the depreciation benefit lowers the ITCC rate from 27% to 22%.

3. The effective date of the Special Depreciation Allowance under the Act is May 5, 2003.

4. PG&E, Edison, SoCalGas and SDG&E filed Advice Letters requesting a tariff revision that would lower the ITCC, effective August 1, 2003. SWG's Advice Letter requested an effective date of August 20, 2003.

5. The California Building Industry Association filed a protest requesting that the utilities' Advice Letters be made effective May 5, 2003.

6. The Responding Utilities argued that: 1) the utilities will receive no windfall - the gross-ups received are passed through to ratepayers and the benefits/burdens of excessive/inadequate gross-up rate is realized/borne by ratepayers; 2) SDG&E is not seeking to create a windfall from contributors or ratepayers from the implementations of the Act under the Maryland method; 3) determination of eligibility for bonus depreciation will be neither straightforward nor non-controversial; and 4) the Responding Utilities' proposal to apply a reduced gross-up rate to *all* contributions received between August 1, 2003 and January 1, 2005, is reasonable and consistent with Commission guidance.

7. The cost of utility review of the applications received during the 87-day period from May 5, 2003 to August 1, 2003 exceeds the benefits to applicants of the lower ITCC rate.

8. We expect that the costs and benefits of utility review will be comparable for the first 87 days of 2005 as for the interval May 5, 2003 through August 1, 2003.

9. The benefits of utility review of the applications during the 87-day period from May 5, 2003 to August 1, 2003 accrue to builders and developers, while the costs of such review are borne by utility and potentially ratepayers.

10. CBIA's proposals do not necessarily compensate those eligible parties who made contributions between May 5, 2003 and August 1, 2003.

11. The utilities' AL requests should be approved with an effective date of August 1, 2003.

12. CBIA's protest should be denied.

THEREFORE IT IS ORDERED THAT:

1. PG&E Advice Letter (AL) 2466-G/2386-E, Edison Advice Letters 1715-E and 120-G, SDG&E AL 1505-E/1382-G, and SoCalGas AL 3267 are approved as filed.

2. SWG AL 692 is approved with an effective date of August 1, 2003.

3. The protest of the California Building Industry Association is denied.

This Resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed and adopted at a conference of the Public Utilities Commission of the State of California held on December 4, 2003; the following Commissioners voting favorably thereon:

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WILLIAM AHERN
Executive Director