atlantic city electric

A PHI Company

Philip J. Passanante
Associate General Counsel

92DC42
500 N. Wakefield Drive
Newark, DE 19702

P.O. Box 6066
Newark, DE 19714-6066

302.429.3105 – Telephone
302.429.3801 – Facsimile
philip.passanante@pepcoholdings.com

May 3, 2013

VIA FIRST CLASS MAIL and
ELECTRONIC MAIL
kristi.izzo@bpu.state.nj.us
rule.comments@bpu.state.nj.us

Kristi Izzo
Secretary of the Board
State of New Jersey
Board of Public Utilities
44 South Clinton Avenue, 9th Floor
P.O. Box 350
Trenton, New Jersey 08625-0350

RE: In the Matter of the Board's Review of the Applicability and Calculation of a Consolidated Tax Adjustment
BPU Docket No. EO12121072

Dear Secretary Izzo:

Pursuant to the Notice of Opportunity to Comment issued on March 6, 2013, following are Atlantic City Electric Company's Comments in connection with the above captioned matter

Please return a "filed" and time-stamped copy of these Comments in the self-addressed, postage-prepaid envelope provided.

Feel free to contact the undersigned with any questions. We look forward to working with the Board on finalizing this important proceeding in a thorough and expeditious fashion

Respectfully submitted,

Passanante /jpr
Philip J. Passanante
An Attorney at Law of the
State of New Jersey

Enclosure

cc: Tricia Caliguire, Esquire (electronic and First Class Mail)
Jerome May (electronic and First Class Mail)
Mark Beyer (electronic and First Class Mail)
Jake Gertsman, Esquire (electronic and First Class Mail)
Babette Tenzer, Esquire (electronic and First Class Mail)
Wendy E. Stark, Esquire (electronic)
Mindy L. Herman (electronic)
Roger E. Pedersen (electronic)
Colleen A. Foley, Esquire (electronic)

Atlantic City Electric Company
Responses to BPU Staff's 3/6/2013 Notice of Opportunity to Comment
BPU Docket No. EO12121072

1. **Please explain your company or organization's position on whether the Board should utilize CTA.**

RESPONSE:

A consolidated tax adjustment ("CTA") should not be used to determine a utility's tax expense for ratemaking purposes. As discussed in greater detail below, Atlantic City Electric Company ("ACE" or the "Company") has demonstrated that a CTA is inequitable, outdated and contrary to the positions of the vast majority of state regulators and FERC. The Board's current policy as defined by a strict interpretation of its decision in Rockland Electric Company, BPU Docket No. ER02100724 ("Rockland decision") can result in the most punitive of CTAs in the few states that still impose a CTA. Evidence of the flawed policy and its arbitrary impact is the range of results that can vary from the 1% of rate base adjustment in the Rockland decision in 1992 to the 43% of rate base adjustment that would result from the imposition of that same methodology to ACE in its base rate case that was filed on August 5, 2011.[1] With this significant and egregious reduction in rate base, ACE is at risk of being denied an opportunity to earn a reasonable return on its investment in violation of the basic tenets of setting just and reasonable rates.

From a policy perspective, the CTA takes New Jersey in the wrong direction. By automatically and arbitrarily reducing a utility's rate base, the CTA creates a significant disincentive to investment in New Jersey. This disincentive to invest is particularly problematic at a time when utilities across the state are rebuilding and making their systems more resilient following Hurricane Sandy and other major storm events in recent years. Aging infrastructure issues also need to be addressed by the industry, requiring large capital investments. While the Board has recognized these issues and the importance of investment[2], continued use of the CTA runs directly counter to those important initiatives by discouraging investment in the State. Investors

---

[1] *I/M/O The Petition of the Atlantic City Electric Company for Approval of Amendments to Its Tariff to Provide for an Increase in Rates an Charges for Electric Service Pursuant to N.J.S.A. 48:2-21 and N.J.S.A. 48:2-21.1 and for Other Appropriate Relief*, BPU Docket No. ER11080469.

[2] I/M/O the Board's Review of the Utilities' Response to Hurricane Irene, BPU Docket No. EO11090543, Order dated January 23, 2013; *I/M/O the Board's Establishment of a Generic Proceeding to Review Costs, Benefits, and Reliability Impacts of Major Storm Event Mitigation Efforts*, BPU Docket No. AX13030197, Order dated March 20, 2013.

who provide the necessary capital for these infrastructure investments are concerned about the implications of the CTA and have questioned why ACE would continue to invest in a service territory that eliminates 43% of the rate base.

The CTA further violates longstanding regulatory principles of ring-fencing that are otherwise well-established in New Jersey. While the BPU has insulated the utilities from the risk of unregulated affiliates in other contexts[3], the CTA imputes to the utilities the phantom benefits from those same unregulated affiliates, all while the ring-fencing measures remain in place. This violates the principle that the benefits should follow the burdens since in the context of the CTA, the customers are given the full benefit but carry none of the risk or burden of the activities that created the benefit. Meanwhile, the entities that did bear the risk of the loss (the loss affiliate and its parent company and investors) are deprived of the full benefit arising from the losses they financed and the risks they bore alone. Such a result is not only inconsistent on its face, but is also inconsistent with good regulatory practice.

Moreover, New Jersey applies the CTA in a manner that provides the largest adjustment for ACE both now and into the future. With its disregard of tax law, of changed circumstances in corporate structures and activities and of the interests of shareholders and other affiliates, the CTA as applied in New Jersey is the most punitive of even the small number of jurisdictions that still apply a CTA. And these adjustments result in arbitrary reductions to the utilities' rate base that bear no relationship to the utilities' investments or to the actual cost of serving customers. The fact that the amount of CTAs can widely vary depending on the activities and legal structure of consolidated groups should indicate that CTAs are not on solid economic footing. Why should similar utilities have different rates merely because one utility files a consolidated return? Filing a consolidated income tax return has nothing to do with providing utility service, or the cost of providing that service.

ACE is owned by Pepco Holdings, Inc. ("PHI" or "Parent"). For federal income tax purposes, PHI is the common parent of an affiliated group that has included approximately 100 affiliates including ACE and two other regulated utilities—Delmarva Power & Light Company ("DPL")

---

[3] *See N.J.A.C.* 14:4-4.1 *et seq.* (Public Utility Holding Company Standards).

and Potomac Electric Power Company ("Pepco"). DPL's retail operation is subject to regulation in Delaware and Maryland, and Pepco's retail operation is subject to regulation in Maryland and the District of Columbia.

The New Jersey Board of Public Utilities ("Board") is required by statute to ensure the provision of safe, adequate and proper service at just and reasonable rates. N.J.S.A. 48:2-21; N.J.S.A. 48:2-23. For rates to be just and reasonable for the utility, they must "permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding, risks and uncertainties..."[4] Importantly, the setting of rates is based on the utility's expenses and property used in the provision of public service – not the expenses or property of any affiliate. One of the objectives of ratemaking is to allow utilities to collect revenues that equal the sum of a reasonable rate of return on the property they are using in providing service plus their operating expenses.[5] Income tax expense is an operating expense that is recoverable and considered a component of cost of service.[6] The determination by the regulator of what amount of income tax expense is allowable should be based on the *utility's* revenues less its expenses.

Any adjustment to accrued income tax expense by the regulator to reflect some perceived ancillary benefit of the utility participating with other affiliated entities in filing a consolidated return erroneously lowers the utility's revenues for reasons that are wholly unrelated to the actual cost of service and prevents the utility from earning a reasonable rate of return on its investment. For these and the reasons more fully set forth below, ACE respectfully requests that the Board

[4] *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 679, 692 (1923); see also *Federal Power Com. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

[5] See e.g., *In re New Jersey Power & Light Co.*, 9 N.J. 498, 508 (1952) (noting that the Board's statutory ratemaking authority requires "justice" to both the utility and ratepayers, and that the utility's rates are to reflect the company's "rate base, its expenses and the rate of return developed by relating its income to its rate base.")

[6] *In re Intrastate Industrial Sand Rates,* 66 N.J. 12, 21-21 (1974) ("The justness and reasonableness of a particular rate of fare can only be determined after an examination of a company's property valuation which constitutes its rate base; its expenses, including income taxes and an allowance for depreciation; and the rate of return developed by relating its income to the rate base.")

reconsider its prior position of imposing CTAs and issue an order stating that CTAs will no longer be applied in future proceedings.

CTAs Violate a Fundamental Regulatory Principle

It is a basic principle in ratemaking that ratepayers should not be responsible for costs that do not benefit them and therefore they should not receive any inherent tax benefit associated with disallowed costs. Stated differently, this principle dictates that the party that incurs a cost is entitled to the associated tax benefit that results from the cost being incurred. The tax benefit cannot be separated from the underlying cost. This is sometimes referred to as the "benefits follows burdens" principle.

Our federal tax system imposes a tax on "taxable income." "Taxable income" is a net amount. It is "accrued income" (income that the taxpayer has earned) reduced by "accrued expenses" (expenses that the taxpayer has incurred) that are deductible. For a corporation engaged in a business activity, most expenses related to or connected with that business activity are deductible for tax purposes and as such, reduce taxable income. In fact, the ability to reduce taxable income is an inherent characteristic of a deductible expense. If the deductible expense is incurred, the taxable income is reduced. Deducting an expense that is incurred against taxable income results in a decrease in taxable income, and it is that decrease in income which is often referred to as the "tax benefit" of the expenditure. If the taxpayer does not make the deductible expenditure, there is no reduction in taxable income. The tax benefit is, thus, inextricably linked to and cannot be separated from the underlying deductible expenditure.

When the Board applies a CTA, that process runs contrary to both basic ratemaking and tax law in that it reflects a reduction in an incurred operating expense (income tax expense) by some portion of the tax benefit connected to a deductible expenditure that ACE's customers did not fund or bear any risk of loss. For example, assume that one of ACE's affiliates makes a deductible expenditure of $1,000 and it has no income to offset that deduction. Under this scenario, the question is who should realize the tax benefit associated with that deductible expense? Because the parent company and shareholders funded that deduction, they should receive the tax benefit. Therefore, the deduction reduces the consolidated group's federal taxable income by $1,000. The tax effect of that reduction is $350 ($1,000

X 35% – he current corporate federal income tax rate). The affiliate had deductions that exceeded its income. Utility customers have no responsibility whatsoever for the affiliated expenses and do not bear any of the risk of the non-profitable entity because the expenditures had no nexus or connection whatsoever to the utility providing service.

Imposing a CTA reflects a reduction of the utility's tax expense by some portion of the tax effect of the $1,000 deductible expenditure. Reducing a recoverable expense by the tax benefit associated with an expenditure which was not allowed in determining cost of service runs counter to basic ratemaking principles.

In fact, the Board's policy is the exact opposite for tax benefits associated with disallowed costs. A disallowed cost is a cost that a regulatory commission determines should not be recovered from utility customers or one that the utility is precluded from recovering by statute or regulation. Costs that are found to be imprudent are clearly costs that are not recoverable from utility customers. Costs that are determined not to be necessary to the provision of service or that do not benefit customers are other types. Certain advertising costs, trade association dues and charitable contributions are examples of expenditures that are, in some jurisdictions, considered non-recoverable. In addition to some of the costs mentioned above, it has been the Board's practice to disallow one half of utility rate case expenses.

The disallowance of certain expenses does not impact the tax deduction. Costs that are ordinary and necessary in conducting the utility business are deductible for tax purposes even though the regulatory commission may disallow all or a portion of the cost in setting rates. Under the Board policy, the associated tax benefits of disallowed costs do not reduce regulatory income tax expense. Since customers are not paying the costs, they do not receive the associated tax benefit. The benefit associated with the disallowed costs is not shared between shareholders and customers; instead it is allocated to the party who paid the cost—shareholders. The result should be no different here in the case of filing consolidated income tax returns.

The regulatory premise that the tax benefit of a cost that is not allowed by the Board cannot be factored into rates was established and approved by the New Jersey Supreme Court in

Hackensack Water Company v. BPU.[7] In that case, the Court determined that only the tax benefits of allowed costs could be used in determining income tax expense for purposes of setting rates and, as a consequence, the party responsible for the cost receives the inherent tax benefit.

The Board's policy of using CTAs is entirely inconsistent with the treatment afforded disallowed costs. From a cost responsibility viewpoint, they are clearly the same. In each situation, the tax benefit results from a deductible cost. In the consolidated return situation, the tax benefit results from a related affiliate whose expenses exceed its income. In both situations, customers have no responsibility for paying the disallowed costs or the affiliate's excess deductible expenses. Yet, a portion of the tax benefit associated the affiliate's loss is allocated to the utility under a CTA regime. Imposing a CTA cannot be supported under any reasonable regulatory policy if the regulatory goal is to establish rates based on the expenses of the utility.

The CTA Violates Ring-Fencing Principles

"Ring-fencing" is the term applied to legal measures to isolate certain assets or liabilities within a corporation.[8] In the utility context, ring-fencing measures are generally intended to insulate the regulated utility from the "failed diversification investments" of unregulated affiliates within the same holding company structure.[9] Typical ring-fencing measures include: capital structure requirements, dividend restrictions, unregulated investment restrictions, prohibitions on utility asset sales, collateralization requirements, working capital restrictions, prohibitions on inter-company loans, maintenance of stand-alone bonds, and independence of corporate board members.[10]

---

[7] 172 A2d 651, 35 N.J. 239 (1961).

[8] Fetter, Steve. *Don't Fence Me Out*, Public Utilities Fortnightly, October 2004, pages 20-22, at 20.

[9] Grygiel, Dr. Fred and Garvey, John. *Fencing in the Regulated Utilities*, Public Utilities Fortnightly, August 2004, at page 32.

[10] *"Ring-Fencing" A State-By-State Summary*, Regulatory Focus Special Report, October 15, 2003.

In 2006 and 2007, the Board began implementing various regulations to address ring-fencing issues.[11] Among those initial restrictions were regulations limiting the amount of investment a utility holding company can make in businesses unrelated to the utility industry. Specifically, N.J.A.C. 14:4-4.3 requires that a utility holding company "ensure its aggregate investment in all nonutility associates in the public utility holding company system [do] not exceed 25 percent of the aggregate assets of all public utilities and utility associates in the public utility holding company system."

In 2009, the Board adopted a number of restrictions regarding the participation of electric and gas utilities in money pool arrangements. Pursuant to N.J.A.C. 14:4-4.7(f), after April 6, 2009, an electric utility may not participate in a money pool unless it was previously approved by the Board, or unless the money pool is structured in such a manner that only public utilities may borrow from the money pool. The money pool regulations expressly prohibit any loans to non-utilities, and are geared toward segregating utility assets (here, revenues) from the rest of the holding company. Yet, through the CTA, the Board is effectively treating the utility as if it were making loans which it is otherwise not permitted to do. Moreover, money pool loans are limited to short-term loans only. Thus, the CTA rate base adjustment methodology over-compensates customers since a higher rate of return is used in making this adjustment, rather than a lower short-term debt rate. While it is true that money is fungible, the Board's regulations do not view utility revenues in that manner.

The Board has made, and continues to make, concerted efforts to protect public utilities from the activities of unregulated subsidiaries. Indeed, it is a matter of Board regulation that holding company investments in nonutility entities and activities must be significantly restricted in order to protect utility companies from losses that might be generated by those entities. This view, however, is turned on its head in the context of the CTA. There, the Board's policy allocates the benefits of tax losses generated by nonutility subsidiaries without any apparent limitation on the amount of the losses or the size of the resulting rate base adjustment. While the Board generally seeks to protect and insulate the utility from its non-regulated affiliates, the present CTA

[11] See N.J.A.C. 14:4-4.1 *et seq.* Public Utility Holding Company (PUHC) Standards.

methodology appropriates the benefits of tax losses for New Jersey customers while New Jersey's regulations ensure that the utility and its customers bear little or no risk from those activities. Thus, the CTA allocates to ratepayers a benefit for which the holding company has assumed all of the risk. This is not an equitable sharing as between shareholders (who fund the investments and assume their risks) and ratepayers (who have been insulated from adverse consequences by the Board's regulations).

Legal Precedent

It is a matter of well-settled law in New Jersey that the Board "is vested with broad discretion in the exercise" of its ratemaking authority, and the exercise of that discretion will be respected by the courts provided the Board's actions are reasonable and supported by evidence.[12] The Company is aware that the courts have held that utility customers can receive some portion of the benefit of filing consolidated returns and that the Board's current policy is to adjust the utility's rate base by CTAs.[13] The Company contends that the Board's policy and the decades-old court decisions supporting CTAs are inconsistent with important, current and widely recognized regulatory principles including ring-fencing and the cost principle (i.e., the party responsible for the cost should be entitled to any associated tax benefit from incurring the cost), and also run afoul of federal tax law.

As a preliminary matter, ACE strongly disagrees with the assertion that a CTA must be imposed as a matter of law. The courts[14] have clearly established that while the Board has the authority to impose a CTA, it is not required to do so. Moreover when the Board determines that a CTA is appropriate, it has the obligation to design an adjustment that is reasonable and more importantly withstands scrutiny and should be reflective of the actual tax benefit, if any. The current rate base template created in the Rockland decision cannot be supported under any reasonable analysis.

---

[12] *Public Service Coordinated Transport v. State*, 5 N.J.196, 214-15 (1950).

[13] For example, *Lambertville*, 153 N.J. Super. 24 (App. Div. 1977), rev'd in part on other grounds, 79 N.J. 449 (1979).

[14] *New Jersey Power & Light Company*, 9 N.J., 498, 89 A.2d 26 (1952); *Lambertville Water Company*, 153 N.J. 24, 378 A.2d 1158 (1977); *Toms River Water Company*, 158 N.J. 57, 385 A.2d 862 (1978) and *New Jersey Bell Telephone Company*, 162 N.J. Super. 60, 392 A.2D 216 (1978).

The current New Jersey theory and method of calculating CTA that have been applied by the Staff and Rate Counsel result from Board proceedings including the Rockland decision and Jersey Central Power and Light Company, Final Decision and Order, June 15, 1993 ("JCPL"). The Board at page 8 of the JCPL Order stated "[T]he rate base approach properly compensates ratepayers for the time value of money that is essentially lent cost-free to the holding companies." In effect, the Board equated a consolidated tax savings as a loan, although there is actually no loan from the utility to its parent. The theory goes on to argue that the amount of the fictional loan is a portion of the income tax payments the utility makes to its parent that is used by the parent to theoretically offset tax losses generated by other non-regulated affiliates.

If you assume hypothetically that the utility has loaned monies to its parent, the hypothetical loan creates a hypothetical loan receivable from the parent. Yet, the loan receivable has been ignored in setting rates. The difficulty of relying on the process of trying to measure a fiction is that it results in a fiction. The fiction is created by trying to capture a benefit that has no connection with the cost of providing utility service. Filing consolidated income tax returns should not impact utility rates because utility rates should be based on costs associated with providing utility services. And the use of such a fiction is not a supportable or sustainable foundation on which to set rates.

Negative Impact of the CTA

The Board endorsed a template that was used in the Rockland decision to calculate Rockland's hypothetical loan. In the case of Rockland, the template resulted in a 1% reduction in rate base. In case of the most recent rate proceeding for ACE, the same calculation would result in a 43% reduction in rate base. The fact that the range of the adjustment can vary so widely is evidence that applying the template blindly can yield results that are unreasonable. Moreover, it seems hard to imagine that the Board contemplated rate base adjustments of this magnitude when it adopted the current CTA methodology.

ACE contends that the methodology and template used to calculate a CTA have little or no relationship to the actual current and future tax situation of the utility and its affiliate, and most importantly grossly overstates any real or perceived consolidated tax savings. The methodology has many flaws, including its use of over 20 years of historical data without adjusting for structural change in the utility's consolidated group that grossly distorts the amount of any fictional loan.

Indeed, in ACE's 2011 base rate case, parties argued that the use of the Rockland CTA methodology resulted in a CTA that was not reasonable.[15] Among the concerns cited in that case are the following adverse impacts:

- CTAs produce financial results inconsistent with sound financial management policy and could ultimately produce higher costs to ratepayers, as a result of investors' reluctance to supply capital to New Jersey-based utilities on reasonable terms.
- CTAs could result in a reduction in earnings so large as to possibly be considered a 'taking' by investors.
- CTAs could result in lower stock prices, lower credit ratings, higher capital costs and damage to investors' view of the Board. This could result in ratepayers ultimately paying higher rates for utility service.
- The investment community would be shocked given the magnitude of the proposed ACE Consolidated Tax Adjustment.

ACE fully agrees that these are significant concerns, and notes that Board Staff recognized that the CTA posed real risks to the utilities in New Jersey.

By imposing an automatic, and in the case of ACE, material reduction to rate base, the CTA imposes a significant disincentive to investing capital in the electric system in New Jersey. The automatic reduction that, by design, is unrelated to the actual investments being made in the system, inappropriately and negatively skews the financial results for the utility, resulting in an artificially low return on investment that can prevent a utility from having an opportunity to earn its authorized rate of return. Such a reduction in the return, and the opportunity to earn a fair return, could lead to a result where investors have suffered a "taking" inflicted by a regulatory policy. In addition, it can also be expected to factor into investors' decisions and to impact the utility's ability to access capital on reasonable terms and conditions. Ultimately, that will be

---

[15] *See Staff Initial Brief* in BPU Docket No. ER11080469.

expected to lead to an increase in the cost of capital, and then an increase in the rates paid by customers.

The Company also contends that the Board's policy is not reflective of current regulatory practice. In the Staff's Initial Brief in BPU Docket No. ER11080469, Staff discusses its position that ratepayers should not pay PHI a "phantom tax" which never goes to the Internal Revenue Service. In supporting its position, Staff cites the *Lambertville* decision. The Staff stated:

> The court found that if the utility is part of a conglomerate which profits by consequential tax benefits from the utility's contributions, the utility customers are entitled to have computation of those benefits reflected in their utility rates. The court noted that the BPU commissioners have "the power and the function to take into consideration the tax savings flowing from the filing of a consolidated return and determining what proportion of the consolidated tax is reasonably attributable to (the utility)."[16]

ACE believes the court used an exaggerated description implying that the act of filing a consolidated income tax return results in "profits" and that the utility, by submitting its tax liability to the parent, is making contributions to the parent. Certainly there are benefits associated with a group filing consolidated tax returns—for example, income from certain members offset losses from other members—but offsetting consolidated income against consolidated deductions does not result in the consolidated group having generated more "profits" had the group filed separate returns. Just as important, there is no contribution by the utility to the parent company for its income taxes. Payments made to the parent are based on the utility's stand-alone income tax liability.

The Company contends that the exaggerated description likely results from the court confusing actual cash payments with tax expense. In the late sixties and during the next decade, it was a common debate with respect to whether utility income tax expense should be based on current income tax expense (current income payable; i.e., cash payments) rather than accrued income tax expense, which also includes deferred income tax expense. In general deferred income tax expense is equal to the future expected income tax liability or benefit associated with timing differences (for example, accelerated tax depreciation). Under Generally Accepted Accounting

[16] *See Staff Initial Brief* in BPU Docket No. ER11080469, at 35.

Principles ("GAAP"), income tax expense includes both components of income tax expense, current and deferred income tax expense. The point is that *Lambertville* was decided over 30 years ago and therefore does not reflect current regulatory practice. By offsetting income against losses, the consolidated group receives the tax benefit only associated with expenditures that are deductible and there cannot be any "profit" that results from realizing the associated tax benefits of making deductible expenditures.

Taking into account CTAs in setting rates cannot be supported under the cost principle. Utility customers should not receive the cash tax benefit, if any, which results from the utility's affiliates incurring deductible expenditures. Shareholders provide the funds to pay the costs of those expenses, so they should receive 100% of any inherent tax benefit. Using CTAs clearly violates the cost principle and results in arbitrary subsidies to utility customers. Lastly, whether a utility files a consolidated return should have no impact on the utility's rates. Income tax expense for the utility should be determined based on the utility's income less its expenses. To do otherwise, factors into the rates costs that customers do not pay and for which they bear no risk.

CTAs Do Not Reflect GAAP

Statement of Financial Accounting Standard ("SFAS") 109[17] is the Standard for "accounting for income taxes." Specifically paragraph 40 of SFAS 109 provides, in part, that:

> The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. This statement does not require a single allocation method. The method adopted, however, shall be systematic, rational and consistent with the broad principles established in this Statement. A method that allocates current and deferred taxes to members of the group by applying this Statement to each member as if it were a separate taxpayer meets those criteria.

[17] The Financial Accounting Board has codified its accounting standards and guidelines and SFAS 109 is designated as ACS 740.

As discussed further below, CTAs do not meet the principles established in SFAS 109. Allocating income tax benefits from loss members to income members reduces income tax expense below the amount that would be determined under SFAS 109 or GAAP. Reducing rate base by some quantitative amount that attempts to capture the tax benefit of member losses is an indirect reduction to income tax expense.

SFAS 109 provides several specific methods that meet its principles. The separate income tax return method is acceptable. The separate income tax method allocates current and deferred income tax expense to each member of a consolidated group as if each member were a separate taxpayer. Also acceptable is the "benefits for loss." The "benefits for loss method" modifies the separate income tax return method so that net operating losses or other tax attributes are treated as realized by the member who generated them when those tax attributes are realized by the consolidated group. When the tax attributes are realized in the consolidated tax return, the loss member would reflect an intercompany receivable from the parent which represents the realization of the member's tax attribute. The "benefits for loss method" is the most common method used by taxpayers and it is used by PHI. Note that under the "benefits for loss method," SFAS 109 requires that the member whose loss is realized in the consolidated return, records a receivable from the parent representing the tax effect of the realized loss. In contrast, the Board's policy recognizes a hypothetical loan receivable from the member generating the income and not the member generating the loss.

CTAs do not comply with either the separate return or "benefit for loss" method and do not comply with the principles of SFAS 109. The reason is fairly obvious. CTAs allocate a portion of the tax benefits of a subsidiary that has losses to a brother/sister subsidiary that has income. SFAS 109 principles dictate that the subsidiary with income calculates its current tax liability as if it were a separate taxpayer. The principles of SFAS 109 prevent the income member from recognizing a tax benefit from an affiliate as a reduction in its tax expense or recording a receivable from its parent if the parent ultimately paid a smaller amount to the US Treasury due to its losses or the losses of another member of the consolidated group. The goal of separate financial statements is to present the separate entity's financial results based on its activity.

CTAs do not comply with that goal because they distort the separate financial results of the utility's separate activity.

CTAs also violate basic accrual accounting. Regulatory income tax expense should be based on the amount of income tax expense that accrues on taxable income resulting from utility activity. Accrued income tax expense should equal the income rate multiplied by utility income less utility expenses. CTAs attempt to factor into rates some perceived cash benefit of the utility being a member of a group that files a consolidated return. Attempting to quantify a cash benefit runs afoul of basic accrual accounting.

New Jersey Is in the Small and Shrinking Minority of CTA Jurisdictions

New Jersey is part of a small and shrinking minority of states that apply the CTA. Of the 52 regulatory jurisdictions (50 states, the District of Columbia, and FERC), only four jurisdictions recognize a CTA. Thus New Jersey and only 3 others are in the very small minority of jurisdictions that impose this adjustment. In recent years, jurisdictions such as Washington[18], Oregon[19] and Kentucky[20] have rejected or eliminated the CTA, which has brought the number of jurisdictions that do not recognize a CTA to 48.

The recent rejection of CTA has come with thoughtful regulatory analysis, recognizing that a CTA is not based on sound regulatory and economic principles. For instance, in a recent decision declining to impose a CTA, the Washington Utility Commission explained:

> The CTA violates the principle, if not the letter, of our recent decisions establishing "ringfences" that protect ratepayers from non-regulated activities by declining to pull benefits or burdens from activities "outside the ring-fence" into the regulated business. Not only are we provided no reason to act contrary to our recent precedent in this regard, doing so here could jeopardize the

[18] *WUTC vs. Puget Sound Energy, Inc.*, Docket No.UE-111048.

[19] Senate Bill 967.

[20] Kentucky Utilities Company Case No. 2009-00548.

> integrity of our rationale for "ring-fencing" and undermine its defensibility if it were attacked.[21]

In 2006, the Minnesota Public Utilities Commission explained its rationale as follows:

> As the Commission found when it adopted its current allocation procedures, it is impossible to establish principled, self-executing, *one-sided*, allocation mechanisms. Any sharing of benefits is inevitably accompanied by the sharing of risks, which is why the Commission adopted and continues to enforce strict "stand-alone" allocation principles. It is far more important to protect ratepayers from loss than to give them opportunities for windfalls. While ratepayers will not be harmed by missing a chance for a tax break they had nothing to do with creating, they would be harmed by paying higher rates to cover losses from unregulated investments they had nothing to do with making. It would be imprudent to throw off the protections that have shielded ratepayers from the adverse impacts of twelve turbulent years of unregulated utility investments, in order to claim a tax refund that might not exist, had those protections not spared ratepayers the consequences of a catastrophic unregulated investment. And any reevaluation those protections might merit should take place only in another lengthy, carefully considered, industry-wide proceeding.[22]

Similarly, two commissions in jurisdictions in which PHI has utilities have recently addressed CTAs. In Maryland, the Maryland Public Service Commission ("MD Commission") rejected the MD Commission Staff proposal to apply a CTA in an application by DPL. The MD Commission discussion[23] of CTA included the following:

> The Commission previously addressed the issue of a consolidated tax adjustment in a proceeding involving Washington Gas Light Company ("WGL"). The Commission noted that the basic theory for filing a consolidated tax return is that a corporate system pays taxes on their consolidated taxable income which permits the net operating income of some members to be used to offset the net

---

[21] *WUTC v. Avista Corp.*, Docket Nos. UE-080416, *et al.* Order 08 ¶151 (December 9, 2008; cited with approval in *WUTC v. Puget Sound Energy, Inc.*, Docket Nos. UE-111048, *et al.*, Order 08 ¶194 (May 7, 2012).

[22] (Emphasis in original) *I/M/O the Application of Northern States Power Company d/b/a/ Xcel Energy for Authority to Increase Rates for Electric Service*, Docket No. E-002/GR-05-1428, p. 25 (Order dated September 1, 2006).

[23] Delmarva Power & Light, Public Service Commission Order No. 83085, December 30, 2009, at Page 21.

> operating losses of other companies. Consequently, without taxable income, the tax losses cannot be translated into system-wide tax savings.
>
> The Commission stated that it "is a rule of general application that the rates charged for a regulated utility should only reflect the costs associated with providing the utility service and should not reflect costs associated with other businesses …

The MD Commission concluded its discussion of a CTA on Page 23 of the Order by stating;

> [w]e find that Delmarva is treated fairly for tax purposes in the overall taxation structure of the corporate family, and that Delmarva's ratepayers are not subsidizing the parent or its unregulated affiliates. Accordingly, we find that the Staff's proposed consolidated tax adjustment is not necessary to ensure fairness, and we decline to apply it.

The MD Commission rejected applying a CTA because it recognized that to do so would violate the basic rule that rates should solely be based on costs incurred in providing utility services and should not reflect costs associated with other businesses.

In an application filed by Pepco, the Public Service Commission of the District of Columbia ("DC Commission") recently issued Order No. 15710[24] in which it rejected the application of a CTA. In its decision, starting at Paragraph 275, the DC Commission stated:

> Given the record before us, the Commission has decided to adhere to our traditional stand-alone approach regarding federal and district tax expense, which is widely followed by the majority of Commissions throughout the country. OPC's CTA proposal has several flaws which, in our opinion, reinforce our adherence to this long-standing policy.
>
> OPC's CTA proposal undercuts common tax practice for affiliate companies, violates the "cost responsibility principle," and threatens to create inequities for other PHI affiliate companies (such as those engaged in equipment leasing) that have "earned" the tax benefits and relied on their availability to them….

[24] Formal Case No. 1076, In the Matter of the Application of Potomac Electric Power Company for Authority to increase Electric Retail Rates and Charges for Electric Distribution Service, Dated March 2010.

Like the MD Commission, the DC Commission recognized that the application of a CTA is not consistent with the stand-alone approach and does not represent sound regulatory policy.

The vast majority of other regulatory jurisdictions agree with the Commissions of Maryland and the District of Columbia.

Conclusion

The Board's policy of applying CTAs should be reversed. No CTA should be applied when setting rates. Rates should be based on the costs associated with providing utility service. Applying a CTA violates the cost responsibility principle because rates are adjusted downward based on the tax benefit of costs that utility customers did not pay.

If the Board continues to apply a CTA, the Company is convinced that the future application will seriously impact its ability to provide reliable service to its customers in New Jersey without a significant increase in the cost of capital. It will be a challenge for ACE to entice shareholders to continue to invest in new and upgraded facilities when a mechanical implementation of a policy established many decades ago results in a rate base reduction of up to 43%. Such a punitive approach is likely to make capital increasingly difficult to obtain on reasonable terms and conditions. As the cost of the Company's capital increases, so too will customer rates.

ACE is proud of its record of reinvesting 100% of its income for the past five years in new and upgraded facilities and it is committed to providing reliable and affordable service. However, ACE's reinvestment policy and commitment to upgrade facilities would be seriously jeopardized by the future application of a CTA.

The Company urges the Board to fully evaluate the economic theory for applying CTAs. A reasonable and fair evaluation of such should result in the Board changing its policy. Clearly, the Board has the authority and flexibility to stop applying a CTA to New Jersey utilities.

2. If the Board continues the use of CTA, please describe and detail what changes to CTA methodology, if any, should be adopted by the Board.

RESPONSE:

As discussed in the response to Question 1, the Company's position is that the imposition of a CTA is inappropriate for ratemaking purposes. However, if the Board were to continue the use of a CTA despite the numerous and compelling reasons cited above, ACE does not waive its objections to its continued use. Nevertheless, in order to respond to the Board's request, there are numerous changes which must be made to the current CTA methodology to correct errors, to comply with current tax law, and to ensure that the results are less punitive and arbitrary.

Without waiving or conceding the Company's objections to a CTA, there are several fundamental principles that any CTA calculation should meet. The Company discusses these principles in more detail hereinafter. Fundamental principles include:

- Any CTA calculation must be based on tax law and regulations, both as they exist now and with the flexibility to take into account future changes. The mechanics of filing a consolidated tax return are controlled by the income tax statute and regulations. Any process of trying to quantify the benefit of filing a consolidated tax return must adhere to the tax rules.

- Any CTA methodology must be flexible enough to consider changes in circumstances of the industry, the utility and corporate structures, not only changes that have occurred since the current CTA methodology was adopted, but also changes that may occur in the future. For instance, when the current CTA methodology was originally implemented, the Board had jurisdiction over utilities' generation assets. While the scope of the utilities' operations changed significantly as did the Board's jurisdiction, the current methodology was not changed to reflect this important change in circumstance. Because future changes by their nature cannot be predicted with certainty now, flexibility to take these changes into account must be put in place.

- Any CTA methodology should fairly balance the interests of shareholders and other affiliates of the utility as well as interests of the utility's customers—any perceived tax benefit should be fairly allocated between all affiliates and then shared with shareholders.

Just as the Company has certain modifications it would propose, Staff previously proposed modifications in the context of a recent base rate case for ACE. The Company believes that these also must be considered and, as modified below, incorporated into any CTA that would be imposed in the future. Among the suggestions made to modify the current CTA methodology are the following:

- Limit the CTA calculation period to 15 years.

  ACE agrees that one of the significant problems with the current methodology is that it reaches back to 1991 to start the calculation, and as some parties argue, will always go back to 1991, no matter how many years in the future the calculation is made. Such an open-ended and ever increasing period of time adds to the egregious and punitive nature of the calculation. Hence, a modification of the period of time over which the calculation is made must be implemented. ACE believes the period should be much shorter than the 15 years suggested by Staff. ACE proposes the period should be limited to period of 3-5 years. The 3-5 year period would assume that the hypothetical loan is repaid after 3-5 years.

- Modify the adjustment to include a 50/50 sharing of tax benefits between customers and investors.

  As described more fully elsewhere in this response, ACE's view is there are no benefits to share; however, if there were perceived benefits, ACE believes that it only makes sense that at a minimum the benefit be shared with the party that incurred the cost—the shareholders.

Below is a discussion of the specific flaws that should be corrected if the Board continues to apply CTAs.

If a CTA Is Adopted, It Should Be Based on a "Pour Over" Approach

Should the Board decide to continue to apply a CTA in some form or manner, the first step in attempting to quantify whether there is any actual cash savings to the consolidated group from the utility participating in a consolidated income tax return should be calculated under the "pour over" approach. For example, if all of ACE's other affiliates have net taxable income sufficient to utilize the loss of any other affiliate; there should be no consolidated tax benefit to ACE. All of the other affiliates should be grouped together to determine if there is positive or negative taxable income without ACE. If the other members as a group have sufficient positive taxable income to absorb the loss, there is no consolidated tax savings. Using the "pour over" approach, Rockland would not have had any CTA because the other members of its consolidated group had sufficient positive taxable income to offset the losses without using the income of Rockland.

The "pour over" approach is the only approach that has theoretical footing. The legal and structural relationship is between the utility and its parent and not between its brother/sister affiliates owned by the parent. Tax payments flow to the parent and do not flow across to brother/sister corporations. Therefore, it makes little sense to assert that ACE should benefit from a brother/sister corporation's loss when another brother/sister in the same group has net income. For example, assume that Sub X is owned by Sub Y, and that Sub Y is owned by the parent. Sub X has a loss of $100 and Sub Y has income of $150. It makes no sense for ACE to be allocated any portion of Sub X's loss because its owner/shareholder in the same subgroup has income. Under the tax rules, the amount of income that tiers up from Sub Y to the parent is $50 of income—the net of the loss and the income. The approach from the Rockland decision combines all of the loss affiliates to calculate the CTA and makes little sense. It does, however, result in the largest possible adjustment which is clearly punitive.

Tax Law and Regulations Must Apply in Calculating CTAs

Nor does the CTA template take into account the mechanics of the consolidated income tax regulations and laws that impact the allocation and use of tax attributes. If the assumptions were that a CTA measures some perceived benefit of filing a consolidated income tax return, any such measurement must be based on the income tax rules and regulations of filing a consolidated income tax return. To not consider the rules and regulations creates a real and substantial disconnect between the calculation and creation of the hypothetical benefit compared to the actual calculation of benefits to the parent company and results in an unjust and unreasonable adjustment to the utility's expenses.

Mr. Warren presented an example of the template in his Rebuttal Testimony in Docket ER11080469 beginning on page 30 that demonstrates how consolidated income tax regulations would prevent a consolidated group from offsetting a member's income that was generated in a taxable year in which the member was not a member of the consolidated group—a separate return year. Below is the example.

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Total**
ACE	$300	$300	$300	$300	$300	$0	**$1,500**
Corp X						$500	**$500**
Corp Y						($400)	**($400)**

The example assumes that ACE has income of $300 in years 1-5 and no income in year 6. In year 6 ACE was acquired by Corp X—the parent corporation. Corp X also owns Corp Y. In year 6 Corp X has $500 of income and Corp Y has a $400 loss. Under the mechanics of the current methodology, the companies with income are grouped to together and the loss companies are grouped together. In the example, ACE and Corp X have $2,000 of income for years 1-6 and Corp Y has a $400 loss in year 6. The current methodology would say that the CTA for ACE is $105[25] and the hypothetical loan and rate base reduction is $105.

Under the consolidated return rules[26], there can be no possible reduction in the tax payments to the federal government that results from the $1,500 income that ACE had in years 1-5. There are at least three tax problems with assuming that the Corp Y's loss in year 6 somehow benefits ACE.

[25] (($1,500/$2,000 X $400) X 35% federal tax rate).

[26] In general, see income tax regulation section 1.1502-21 for rules with respect to the limitation of losses to separate return years although in year 6 of the example, there is no consolidated net operation loss as defined by income tax regulation section 1.1502-21(e) to offset losses—the group has consolidated taxable income of $100 in year 6.

First, ACE was not a member of the consolidated group in years 1-5 and did not become a member of the Corp X group until year 6. Losses incurred in years in which ACE is a member of the consolidated group (year 6) cannot be carried back to years in which ACE filed a separate return unless a portion of the consolidated net operating loss was attributable to ACE. In the example, none of the loss in year 6 is attributable to ACE; the consolidated income tax regulations prevent any of the losses incurred by Corp Y from being carried-back to offset ACE's income in years 1-5.

Second, in year 6, under the consolidated income tax regulations, there is no consolidated net operating loss to carryback. In year 6, the group's positive taxable income is $100. It has no losses to carryback to offset ACE's income in years 1-5.

Last, the current carryback period for losses is only two years. So even if ACE had been a member of the group for the full six years, Corp Y's loss in year 6 can only be carried back to years 4 and 5.

In reality, in the case of ACE, affiliates that were owned by Conectiv and PHI prior to ACE being acquired by them are included in the calculation. Therefore, this preceding example directly applies, and demonstrates the adverse effect on ACE. Not adhering to the consolidated return rules is a major flaw that significantly distorts the results. The consolidated income tax return rules are complicated and applying them to a group with significant structural changes—new members coming into the group and old members departing the group—requires a thorough knowledge and understanding of the tax rules.

An additional example of the issue that results from not complying with tax law is the treatment of consolidated net operating losses ("CNOLs"). CNOLs are defined as the combined consolidated group's excess of deductions over gross income.[27] Stated differently, CNOLs result when the members of the consolidated group's deductions exceed their income. In Docket ER 11804089, no adjustments were made to reflect PHI's CNOLs. The simple rule is that a consolidated group that has a CNOL has not realized the cash tax benefit of those losses. The

[27] See Income tax regulations section 1.1502-21(e).

nature of CNOLs means that the group has to have income in future periods to offset CNOLs, i.e., the CNOLs can only result in cash reductions when they offset taxable income in the future.

In short, if a CTA continues in any form, which it should not, it must reflect tax laws and regulations that impact consolidated income tax returns. Just as important, the methodology should be flexible so that future tax law and regulation changes can be reflected. While the rules are complex, any method that shortcuts the process can significantly distort the result.

CTAs Should Consider Current Legal Structure

The current methodology does not recognize changes in organizational structure. Merged, sold or liquidated entities should be eliminated from the CTA calculation as of the date the merger, sale or liquidation occurs. If the Board considers the tax benefit to be a hypothetical loan from the utility to its parent, the entity that generated the loss can never repay that loan once the entity leaves the consolidated group. If the Board continues the myth of the hypothetical loan, that loan should be deemed repaid when an entity is merged, sold or liquidated. In most commercial situations, when an entity goes out of existence, its liabilities are settled or its creditors have a loss associated with unpaid loans. ACE contends that the hypothetical loan should be afforded the same treatment that occurs in commercial situations. As soon as the consolidated group member is merged or liquidated, the hypothetical loan should be deemed satisfied.

For example, when ACE was acquired by Conectiv in 1998, Conectiv had an existing subsidiary, Conectiv Communications ("Communications"). Communications was a start-up business that made a significant investment in the newly deregulated telecommunication business. In 2002 Conectiv disposed of that business. In the template used by DRC and Staff, over $300 million of losses incurred by a business that was disposed of in 2002 are still reflected in the CTA calculations. ACE's customers had no risk associated with the losses incurred by Communications and they did not pay $1 of any costs that Communications spent. Yet, the template endorsed by the Board includes losses incurred by Communications in years 1998-2002. The continued inclusion of losses from entities that are no longer in the consolidated group yields an unfair and unreasonable result.

Without an adjustment for merged, sold or liquidated members, the adjustment never reverses. Stated differently, the hypothetical loan can never be repaid by the parent. It is not reasonable that losses that will not reverse due to the entity no longer being a member of the consolidated group, and for which its shareholders paid every dollar of those losses, should continue to subsidize ACE's customers. Any hypothetical loan associated with such losses should be deemed paid. The original intent of the Board could not have been that the hypothetical loan be permanent.

CTAs Should Consider Changes to the Utility's Business

The current methodology also fails to consider changes to the utility's business and to the Board's jurisdiction. When the Board started to impose a CTA on ACE, ACE was a vertically integrated utility that included regulated generation assets. Today ACE's retail operation only includes distribution facilities. The generation assets were divested and the transmission activities are fully regulated by FERC, not the Board. Any computation of a CTA should adjust for such changes in the business. On a jurisdictional basis, taxable income for ACE was larger in the years in which ACE owned generation assets and the Board's jurisdiction included transmission activities. And despite the fact that ACE no longer has any generation business and transmission is no longer subject to the Board's jurisdiction, the current CTA computation uses 100% of ACE's income in years in which generation and transmission were subject to the Board's jurisdiction. For the years in which ACE's generation and transmission assets were not regulated by the Board, taxable income associated with those assets should be removed from ACE's taxable income in calculating any perceived CTA. Otherwise any allocation of losses to ACE is overstated.

CTAs Should Not Include Entities Designed to Produce Tax Losses

CTAs should recognize that certain tax provisions were enacted to encourage and incent taxpayers to invest in certain activities. For example, PHI has affiliates that invest in leveraged leases. These affiliates were formed prior to PHI acquiring ACE. The economics associated with the leveraged leases are based on realizing the tax benefits. It is punitive to PHI's shareholders if the New Jersey CTA captures a portion of the tax benefits associated with leases that were executed prior to ACE joining PHI's consolidated return.

Any CTA methodology should also exclude losses generated by the parent holding company. The reason for the exclusion is that the business activity of the parent holding company is likely to produce tax losses due to provisions in the tax law. In general, holding companies incur deductible expenses, including interest on debt, officer compensation and shareholder expenses. However, the income that parent companies use to pay their expenses and to pay dividends to shareholders is derived from dividends that their subsidiaries pay. Intercompany dividends from members of the consolidated group are excluded from taxable income as a "100% dividend received deduction." So by the nature of their business, holding companies are likely to generate losses forever. They have deductible expenses, but their income, for the most part, is not taxable. An alternative to excluding the parent company from the CTA calculation is to treat the portion of the hypothetical loan to the parent as being repaid after a short period--perhaps 2-3 years.

Rate Base Reduction Should Be Treated as if It Is Debt

The current CTA methodology calculates the impact to ACE's revenue requirement using the Company's overall cost of capital. If the Board's theory of CTAs is that the utility has loaned the adjustment to its parent, then the hypothetical loan should be treated as debt. Any debt—hypothetical or real—should impact rates at ACE's weighted cost of debt. Treating the adjustment at the overall cost of capital is not supportable if the adjustment is considered a hypothetical loan and treating it at the overall cost of capital is punitive.

Methods Other Than the Rate Base Method Used in New Jersey

While the above-mentioned adjustments are to the current methodology, there are alternatives to the CTA rate base method that can be less punitive. There are two other methods have been either used or debated that do not use the rate base approach. These methods include:

- The cost of service CTA method and
- The parent company interest adjustment.

Cost of Service Method

The cost of service method looks at the utility's tax rate for a short period of time (i.e., 3 – 5 years) and applies that rate to its taxable income for purposes of a base rate case. The time period used is representative of the effective period (the period for which rates in a base rate case are being established). By using a short period to compute the impact of adjusting effective income tax rates by current income tax paid by the consolidated group, this method does not have the cumulative impact which arises in the rate base method. It is our understanding that Pennsylvania and West Virginia use some version of the cost of service method.

The Board has used the cost of service method in the past. It is the Company's position that there is no consolidated tax benefit if the Board is committed to setting rates on a stand-alone approach. If, however, the Board decides to continue to apply a CTA, then it should consider all factors and all methods when imposing a CTA to a utility. The CTA methodology employed by the Board should consider the utility's unique tax posture and attributes. In deciding whether to continue to impose a CTA, the Board should attempt to balance the long-term interest of ratepayers and shareholders and the Board should recognize that any CTA methodology that unfairly subsidizes customers would cause long-term negative impacts to shareholders and that ultimately would cause negative impacts to utility service.

Parent Company Interest Adjustment Method

While not a traditional CTA calculation, this adjustment is used if a parent company receives a tax benefit for its interest tax expense in a consolidated group with a utility subsidiary. The parent interest adjustment takes into account some portion of the interest deduction taken by a parent company on its outstanding debt and reduces the utility's income tax expense by the tax effect of such portion. The rationale for this adjustment is that the equity of the utility is partially funded by parent company debt for which it takes a tax deduction. The adjustment accounts for the parent company tax deduction by lowering the utility's income tax expense. It is our understanding that Florida and Indiana use some version of the interest adjustment method.

Conclusion

The current New Jersey CTA denies ACE the opportunity to earn just and reasonable rates. The regulatory compact contemplates that a utility is entitled to an opportunity to earn a reasonable rate of return on its investment if it provides the infrastructure necessary to provide reliable service to customers. As proposed by Rate Counsel in ACE's Docket No. ER 11080469, its CTA adjustment of $386 million would have reduced ACE's unadjusted rate base by approximately 43%. That amount of adjustment is not supportable for the reasons expressed above.

Most importantly, the sheer size of the proposed adjustment proves that the methodology does not remotely measure the perceived benefit. For example, in the 20 years since the Board first initiated a CTA there have been four litigated rate cases[28] in which CTA was a contested issue. The rate base adjustments in those four cases range from .01% to 3%. The most recent adjustment proposed by Rate Counsel in ACE's last base rate proceeding is more than 14 times the largest adjustment determined in the litigated cases. Adjustments of the size proposed in ACE's base rate case will dictate that ACE and its shareholder take drastic action to mitigate the damage.

Even Staff acknowledged that the amount of the CTA proposed in the last base rate case produces results that may not be considered fair and suggested that certain modifications be applied. Assuming the Board continues to impose CTAs, ACE does not believe that "one size fits all." As stated, companies are different, tax attributes vary and the legal structures can create significant complexities. Tax law and regulations are constantly changing and those changes add complexities to measure any real or perceive benefits from a utility filing a consolidated return. Using a static template that was accepted over 20 years ago has little chance to capture a reasonable amount.

[28] Rockland Electric Company, BPU Docket No. ER02100724 (April 20, 2004); *Atlantic City Electric Company*, supra; *Jersey Central Power and Light Company*, BPU Docket No. ER02080506 (July 25, 2003) and Jersey Central Power and Light Company, BPU Docket No. ER91121820J (Feb. 25, 1993).

The point is that computing CTAs is not a simple exercise. Care must be exercised and all factors affecting the computation must be considered. The Board has the flexibility to cease using a CTA, which ACE urges the Board to accept. If the Board continues the policy, it has the obligation to adopt alternative methodologies that consider each company's unique tax characteristics and to reevaluate the impact of imposing a CTA.

3. Please calculate a CTA for your company utilizing the current Board methodology set forth in the Board's April 20, 2004 order, *I/M/O the Verified Petition of Rockland Electric Company for the Recovery of its Deferred Balances and the establishment of Non-Delivery Rates Effective August 1, 2003 and I/M/O the Verified Petition of Rockland Electric Company for Approval of Changes in Electric Rate, its Tariff for Electric Service, its Depreciation Rates, and for Other Relief, BPU Docket Nos. ER02080614 and ER02100724.*

RESPONSE:

Using the template created in the Rockland decision and using tax data for the period of 1991 - 2010, the proposed CTA rate base reduction in BPU Docket No. ER11080469 was $386 million. Given that ACE's unadjusted total rate base in that docket was $896 million; the proposed CTA represented a 43% decrease in rate base.

It is ACE's position that at the minimum the amounts must be adjusted to reflect tax provisions that govern consolidated income tax returns-carrybacks, carryforwards and CNOLs. As Mr. Warren detailed in his rebuttal testimony in BPU Docket No. ER11080469, applying the consolidated income tax return rules would reduce the proposed adjustment to $73 million. Next, the adjustment should only reflect distribution assets subject to the Board's jurisdiction—that reduces the $73 million by approximately a third—to approximately $49 million. Last, any perceived benefit should be shared with the shareholders who funded the losses. A 50%/50% sharing allocation would reduce the $49 million to a much less punitive adjustment of $24.5 million, which would have been approximately 3% of rate base. In addition, the use of the Company's long-term cost of debt, as opposed to its authorized rate of return, would better reflect the hypothetical loan that a CTA attempts to portray.

4. **If applicable, please provide the actual amount of the CTA included in your company's last base rate case.**

RESPONSE:

ACE's last distribution base rate case (BPU Docket No. ER11080469) ended in a settlement that did not quantify a consolidated tax adjustment although it did specify that the settlement includes consideration of a consolidated tax adjustment.