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May 3, 2013

Via E-mail and Regular Mail

Kristi Izzo, Secretary
Board of Public Utilities
44 South Clinton Avenue, 9th Floor
Trenton, NJ 08625-0350

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

Dear Secretary Izzo:

Please accept this submission on behalf of Jersey Central Power & Light Company ("JCP&L") in response to the Board of Public Utilities' ("Board" or "BPU") March 6, 2013 "Notice of Opportunity to Comment" ("March 6 Notice") in the above-referenced matter.

JCP&L is pleased to provide responses to the four questions posed in the March 6 Notice. In addition to these comments, JCP&L has also joined in comments that the New Jersey Utilities Association ("NJUA") is filing on behalf of a number of its member companies.

Response to the Board's Questions

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

JCP&L's position is, unequivocally, that the Board should not implement a consolidated tax adjustment ("CTA") in rate setting proceedings. JCP&L is providing this response as additional support of the NJUA's response to Question 1 opposing the utilization of a CTA. JCP&L notes that the NJUA has already provided, in the White Paper that accompanies its submission, a survey of the regulatory policies across the United States concerning CTAs, noting that the Federal Energy Regulatory Commission ("FERC") abandoned the implementation of CTAs in 1983 in favor of a "stand-alone" approach, and that New Jersey is currently one of only four states that routinely employs a CTA in rate setting proceedings. As noted in the NJUA White Paper, a CTA has been rejected by FERC and in the overwhelming number of states based on a number of factors, including the near universal agreement of regulatory commissions as to the inappropriateness of its use, concerns about subsidization of ratepayers by non-regulated operations, application of appropriate cost/benefit and risk allocation principles so as to, among other things, protect utility customers from the risks associated with unregulated activities, and to maintain consistency with fundamental ratemaking principles of cost causation and proper allocation of benefits and burdens.

JCP&L will not repeat the full details of the NJUA White Paper here. Instead, JCP&L provides a brief overview of the history of CTAs in New Jersey, along with an overview of the evolution of Internal Revenue Service ("IRS") policies with respect to

CTAs, which indicates that application of a CTA along the lines advocated in recent New Jersey rate cases could produce a violation of IRS tax normalization rules. JCP&L also explains why the application of a CTA is unjust because it violates a fundamental ratemaking principle by comingling expenses and, therefore, earnings of regulated and non-regulated entities for purposes of ratemaking. Moreover, the application in perpetuity of what has been characterized as the current New Jersey CTA methodology, as advocated in recent New Jersey base rate proceedings, produces wholly unreasonable and potentially confiscatory results.

History of the Application of CTAs in New Jersey

At the outset it must be emphasized that there is no statute or regulation in New Jersey that mandates either that a CTA be applied or the use of any particular CTA methodology. There are several court decisions that appear to give the Board discretion with respect to approving CTAs, albeit without imposing any particular CTA requirement or methodology. However, those cases were decided many years ago under a tax regime that is different from that to which utility companies are subject today. Indeed, the most recent of those cases in which a CTA was upheld was decided 35 years ago.[1]

While the New Jersey cases cited herein have upheld the Board's authority to provide for the reflection in the ratemaking context of a utility's tax savings resulting from a consolidated tax filing, given the broad discretion the courts grant to the Board in this

[1]*See New Jersey Power & Light Company*, 9 N.J. 498 (1952); *Lambertville Water Company*, 153 N.J. Super. 24 (App. Div. 1977); *Toms River Water Company*, 158 N.J. Super. 57 (App. Div. 1978); *New Jersey Bell Telephone Company*, 162 N.J. Super. 60 (App. Div. 1978).

area, this case law does not impose a mandate regarding the application of a CTA under any and all circumstances, nor does it require the use of any particular CTA methodology.

In the *New Jersey Power* decision, the New Jersey Supreme Court, although critical of what it considered to be an inappropriate CTA adjustment, nonetheless accepted it in light of: (1) rising tax levels; (2) the apparent satisfaction of the public with existing rates; and (3) the fairness of the rate of return under the existing rates.[2] The court thus addressed the CTA within its discussion of the entirety of the rate setting process. Notably, in this context, the Court chose not to prescribe a CTA mandate.

In *Toms River Water*, the court referenced a number of different CTA calculation methodologies and concluded that "[t]he Board has the power and discretion to choose any of the foregoing general approaches or <u>any other</u> approach which rationally determines [a utility's] effective tax rate."[3] The court thus recognized the Board's power to consider consolidated tax savings, or any other "rational" approach, but, as in *New Jersey Power*, did not mandate a CTA as such.

Similarly, in *Lambertville Water*, the court did not direct the application of a CTA but merely acknowledged the Board's power to take it into consideration. The court stated that "the P.U.C. Commissioners therefore have the power and function to take into consideration the tax savings flowing from the filing of the consolidated return ..."[4], provided that it results in a "reasonable" attribution of the tax benefits. While the court stated that "[i]t is only the real tax figure which should control rather than that which is purely hypothetical", it did not offer any explanation of how the Board should determine

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[2] *New Jersey Power*, *supra*, 9 N.J. at 528-529.
[3] *Toms River Water*, *supra*, 158 N.J. Super. at 59 (emphasis added).
[4] *Lambertville Water*, *supra*, 153 N.J. Super. at 28.

what the "real tax figure" is.[5] It is not surprising that the Appellate Division did not explain what it meant by the "real tax figure" – as the federal Court of Appeals for the D.C. Circuit has held, given the complexity of the federal tax code and utility rate making, a simplistic reliance on the concept of "actual taxes paid" is clearly inappropriate.[6] Here again, the court's acknowledgement of the Board's discretion in this area, combined with its focus on the need for a reasonable result, does not constitute a mandate for the imposition of a CTA.

In both *Toms River Water* and *Lambertville Water*, the Board's initial CTA formula was rejected and the cases were remanded back to the Board for reconsideration so that the Board might come, respectively, to "meaningful" and "precise" findings.[7] While these cases do not mandate the application of a CTA, they do point to the Board's duty to take a rational approach where it is applied. The relevant case law has certainly not established a particular structure of the CTA that can be universally and rationally applied to all rate cases.

Relevant IRS History with Respect to CTA Methodology

CTAs received much attention at the federal level during the 1980s, during which the IRS issued several rulings consistently concluding that flowing-through consolidated tax savings to customers violates the normalization rules.

In November 1990, the U.S. Treasury issued a Notice of Proposed Rulemaking in an attempt to more comprehensively address the application of the normalization rules to

[5] *Id.*, 153 N.J. Super. at 28.
[6] *City of Charlottesville v. FERC*, 774 F. 2d 1205, 1215 (D.C. Cir. 1985)(explaining that the concept "actual taxes paid" is meaningless – "... the imprecision of the 'actual taxes paid' formulation is exceeded only by the name of the Holy Roman Empire: two out of the three words are wrong.")

consolidated return tax benefits (55 F.R. ¶49294, 1990-2 C.B. 869 (Nov 27, 1990)). The IRS proposed that allocating consolidated tax benefits to utilities for the purpose of reducing tax expense would violate the normalization requirements; however, the IRS noted that it would be permissible to allocate the tax benefits to utilities for the purpose of reducing rate base. According to the IRS proposal, "a utility must compute its ratemaking tax expense as if it filed a separate [tax] return...[I]t is inconsistent with normalization for ratemaking tax expense to be reduced on account of the losses of another corporation with which the utility files a consolidated return." The proposal further went on to say, however, that it would "permit the exclusion from a utility's rate base (or, alternatively, the treatment as no-cost capital) of an amount not in excess of the utility's share of the consolidated tax benefits." In other words, the IRS suggested that consolidated tax benefits could be allocated to a utility participating in a consolidated tax group provided that the adjustment is applied to reduce the rate base on which the utility earns a return, not the utility's ratemaking tax expense.

This IRS proposal acknowledged that consolidated tax benefits arise not from the mere fact that members of the consolidated tax group produce tax losses, but from the fact that the tax losses of certain of these members are able to reduce the consolidated tax liability even though the individual members, alone, generally would not be able to realize the cash benefit of those losses until a subsequent tax year. Thus, any consolidated tax benefit allocated to those consolidated tax group members with a positive tax liability is limited to the time value of money between the time that the tax losses actually reduced

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[7] *Toms River Water*, 158 N.J. Super. at 61; *Lambertville Water*, 153 N.J. Super. at 29.

the consolidated tax liability and the time the associated cash benefits would otherwise be realized by the loss members.

The proposed regulations elicited strong criticism from all sides. In April of 1991, the proposed regulations were withdrawn pending congressional guidance. Later that year, a Congressional hearing was held to address the reasons underlying the withdrawal. At that hearing, the Deputy Assistant Secretary of the Treasury for Tax Policy testified that the IRS had changed its position in this regard, based on a memorandum authored by the IRS Chief Counsel. The memorandum generally concluded that CTAs do not implicate tax normalization rules, subject, however, to two limitations: The relevant portion of his memorandum is as follows:

> These arguments do raise a concern that a consolidated tax adjustment might be used to offset a utility's deferred tax reserve from normalization or might be used to flow through the accelerated depreciation benefit of another regulated utility in the same consolidated group. These concerns are worthy of further study. Until they are resolved we can only say with confidence that consolidated tax adjustments do not violate normalization, provided that the adjustments are applied only to the extent of current ratemaking tax expense and not to the deferred tax reserve applicable to accelerated depreciation on public utility property, and provided that the taxable income of any other regulated utilities used in the calculation of the adjustments is computed on a normalized basis.[8]

<u>New Jersey CTA Methodology May Produce Results that Violate IRS Normalization Rules</u>

Generally, the Internal Revenue Code requires that a utility's book depreciation method be used in computing the tax expense element of cost of service. Further, to comply with the normalization rules, for ratemaking purposes, the utility may not apply any methodology that uses an estimate or projection of utility tax expense, depreciation expense or deferred tax reserve, unless such estimate is also used for computing the other two and for rate base. Utility tax expense is comprised of two components: current taxes and deferred taxes, which are identifiable on the utility's income statements. With respect to normalization, the relevant Internal Revenue Code sections only apply to the deferred taxes, and not the current taxes, paid by the utility. Said another way, only current taxes (not deferred taxes) can be affected by the CTA to avoid a violation of normalization rules, a point that was acknowledged in the 1991 memorandum from the IRS Chief Counsel discussed above.

One way in which the application of the CTA in New Jersey, even in the form of a rate base adjustment, may be inconsistent with the IRS normalization rules is that it does not limit the application of the CTA to the amount of the current taxes in the test year. In this regard, it is clear that the application of the CTA to the deferred component of tax expense is not permitted under the tax normalization rules. Therefore, simply applying the adjustment to rate base is not, in and of itself, sufficient to avoid conflict with the normalization rules. Clearly, the rate base adjustment cannot produce a reduction to pre-tax income that exceeds the amount of current taxes in rates (test year). Otherwise, the deferred component of tax expense *is* affected.

Recently, there has been a greater proliferation of tax losses due to, among other things, incremental depreciation timing differences occasioned by the enactment of the American Recovery and Reinvestment Act of 2009 and the Tax Relief Act of 2010, which

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[8] Memorandum from IRS Chief Counsel, Abraham Shashy, distributed at the September 11, 1991 hearing before the Ways and Means Subcommittee on Select Revenue Measures, sponsored by and in conjunction with the testimony of Michael Graetz, Deputy Assistant Secretary of Tax Policy.

include investment incentives in the form of additional "bonus" depreciation. Computing utility tax expense for ratemaking purposes by reference to consolidated results frustrates federal tax policy by shifting to ratepayers the benefits of congressionally-endorsed tax incentives to encourage investment, the prevention of which is, in fact, the underlying premise of the tax normalization rules. Further, to the extent that the CTA is computed using tax losses produced by a regulated utility in the consolidated tax group, such CTAs are not within the "normalization safe harbor" described by the IRS memorandum and, consequently, carry with them the material risk of violating the normalization rules.

CTAs Violate the Ratemaking Principle of Separation

Both the Generally Accepted Accounting Principles ("GAAP") and FERC Uniform System of Accounts financial statements are designed to fairly reflect the underlying financial results of the businesses they describe. The basis of a presentation of a utility's revenue requirements are the financial statements, or "books", of the regulated entity that provides electric service to its customers in the relevant jurisdiction, in this case New Jersey. In connection with the preparation of these financial statements, multi-utility holding companies are required to track and allocate shared costs to assure that rates charged to customers only include costs associated with providing service to each utility's respective customer base. State regulatory commissions, including the BPU, have routinely observed this fundamental principle of separation in ratemaking, with the intention that, for example, retail and wholesale related revenues, costs, and property are properly allocated to the appropriate jurisdiction (*i.e.*, state or federal).

Contrary to this fundamental premise, the application of a CTA causes non-jurisdictional operations to have a direct effect on jurisdictional rates. If the tax positions of non-regulated affiliates change from year to year, so will the applicable CTA. As such, the tax efficiency and tax consequences of the actions and decisions made by non-regulated entities will directly impact rates for regulated customers, with the result that the affiliate actions become embedded elements of each dollar of revenue collected by the utility and expended in the provision of electric service. The effect on the rates of regulated utility customers arising from this dependency on unregulated operations undoubtedly blurs the historical distinctions between the businesses and violates separation principles.

In the wake of deregulation of the electric utility industry, state regulatory agencies have taken steps to *prevent* comingling of regulated utility assets and liabilities with those of affiliated competitive ventures. These legislative and regulatory actions are referred to as "ring fencing" and are for the purpose of protecting ratepayers from the risk of and losses from competitive (unregulated) activities. The New Jersey CTA methodology, on its face, conflicts with the basic principles of ring-fencing between regulated and competitive affiliates. A CTA that includes taxable income or losses from competitive, affiliated members of a consolidated tax pool calls into question the "arms-length" business relationship, potentially enabling piercing of the corporate veil and risking consolidation of assets in the event of bankruptcy. A CTA is inconsistent with "arm's length" treatment since a tax sharing agreement in which a loss member does not get paid for its losses even if it reduces the consolidated tax liability is neither the norm nor commercially reasonable.

Accumulation of Consolidated Tax Benefits in Perpetuity Produces Unreasonable and Potentially Confiscatory Results

The application of the current New Jersey CTA methodology to consolidated tax group members that have been involved in merger, acquisition or other corporate restructuring activities highlights another shortcoming of this methodology. When this methodology is applied to a utility in a very large consolidated tax pool: 1) where certain members produce significant tax losses in every year; and 2) where, through re-organization or for other business reasons, certain members may no longer be a going concern, the consolidated tax benefits are accumulated in perpetuity and the CTA can eventually become so large that it can completely eclipse rate base. This problem is exacerbated when certain members were not even affiliated with the utility at the time the losses were incurred. Clearly, a CTA that reduces a utility's rate base by a substantial amount (and, therefore, the utility's income and ability to achieve a reasonable return on equity) would be unreasonable and confiscatory.[9]

From a financial perspective, the application of a CTA is completely transparent on the income statement and balance sheet, except for the fact that it lowers utility revenues, thereby inhibiting the ability of the utility to earn a fair return. Aside from the fact that a CTA would lower a utility's revenues, the utility's reported tax expense will be exactly the same with or without a CTA. The utility will pay its computed tax liability pursuant to the consolidated group tax sharing agreement regardless of the imposition of a CTA. However, since utility revenues will decrease while all other items on the income

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[9] *See, e.g., Bluefield Waterworks & Imp. Co. v. Public Service Commission of W. Va.*, 262 U.S. 679, 43 S.Ct. 675 (1923); *In Re Public Service Coordinated Transport*, 5 N.J. 196, 216 (1950).

statement, including (and in particular) the reported tax expense, remain the same, the utility's ability to earn a fair return on equity is handicapped. The imposition of a substantial CTA clearly impairs the utility's opportunity to earn its allowed return.

Thus, the imposition of CTAs could result in unintended consequences. To the extent that the revenue reductions resulting from the application of a CTA impaired the utility's ability to earn a fair return, certainly there would be consideration given to altering the corporate structure; for example, consideration would have to be given to removing the utilities from the consolidated group, forming another consolidated group with just the utilities, etc. There is potential, however, for such avoidance measures, which in any event result in a needless diversion of resources, to diminish the effectiveness of organizational structure, reduce tax efficiency and introduce redundancy; all of which can negatively impact the overall cost structure of the consolidated tax group of which the utility is a member.

The significance of these concerns is highlighted by the evolution of the CTA impacts in New Jersey just since 2004. The impact initially involved in the *Rockland* order[10], which set forth what is characterized as the Board's current methodology for calculating a CTA, involved a $147,000 adjustment to rate base, approximately 1 percent of Rockland Electric's rate base at the time.[11] In contrast, the "*Rockland*" adjustment proposed by the Division of Rate Counsel ("Rate Counsel") witness in the recently

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[10] *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*
[11] Initial Decision, OAL Docket Nos. 07892-02, 09366-02, *I/M/O Rockland Electric (June 10, 2003), at 55.*

concluded Atlantic City Electric Company ("ACE") base rate case involved an approximate $386 million adjustment, more than 43 percent of ACE's rate base.[12] Even Board Staff's proposal to reduce this clearly unacceptable impact still would have resulted in an approximate $137 million adjustment, still nearly 15 percent of ACE's rate base.[13] Such extreme adjustments, and the stark variations from case to case, which apparently depend on factors that have no fundamental relationship to legitimate ratemaking principles, create an environment of uncertainty for the utilities, their shareholders, and prospective investors and lenders, which would, as stated by Board Staff, ultimately result in higher rates for ratepayers.[14]

In sum, for all the reasons set forth above and in the NJUA's response, JCP&L urges the Board to follow the precedent of 46 other states and the FERC and discontinue the application of a CTA in utility base rate cases.

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.*

Please refer to JCP&L's response to Question 1 above, as well as the NJUA's response to this question in its separate filing. In short, while the Board's current CTA methodology contains many flawed elements and can produce illogical results and confiscatory rates, JCP&L recommends that the best change the Board can make to its current methodology is to completely discontinue the implementation of CTAs.

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[12] BPU Docket No. ER11080469.
[13] Board Staff Initial Brief, p. 41, BPU Docket No. ER11080469.
[14] Board Staff Initial Brief, p. 36, BPU Docket No. ER11080469.

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 Rates, its Tariff for Electric Service, its Depreciation Rates, and for Other Relief, BPU Docket Nos. ER02080614 and ER02100724.*

In JCP&L's pending base rate case, in response to a discovery request from Rate Counsel, JCP&L explained why it is not possible for it to calculate a CTA using the Board's "*Rockland*" methodology:

> The Company is unable to apply the methodology adopted by the BPU in Docket No. ER02100724 to its situation. There are a number of aspects of theCompany's current tax situation that were not present in that case and the order issued by the BPU does not specify the treatment of these particular aspects. Among the items unaddressed in the RECO Case are the following: the Company's consolidated income tax group has a consolidated net operating loss carry forward, the net operating losses produced by group members in a number of the earlier tax years considered in the RECO Case will have expired by now, the Company's generation operations were deregulated during the computation period, the Company's transmission operation became non-jurisdictional during the computation period and the Company flowed through certain of the net operating losses of one or more of its affiliates in prior rate cases.[15]

However, in an effort to provide the Board with a quantification of the likely result of the application of a methodology based on the *Rockland* decision, JCP&L has performed a calculation modeled on the adjustment proposed by Rate Counsel's witness in the recently concluded 2011-2012 ACE base rate case (see footnote 12 above). The result of that calculation would be a downward adjustment to JCP&L's rate base of $493 million. This would result in an annual earnings reduction of $38.4 million and a

[15] Response to RCR-CIT-36 in Docket No. ER12111052.

reduction in ROE of 350 basis points – a result of confiscatory magnitude. It is also noteworthy that an annual earnings reduction of this order of magnitude would exceed JCP&L's entire current tax expense for the test year in its pending rate case. If this were to occur, then the indirect impact on the Company's deferred taxes would clearly produce the potential for the normalization violation described on pages 7 to 8 above.

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

In JCP&L's last completed base rate case, the Board ordered a $36.9 million CTA to rate base. *See I/M/O The Verified Petition of Jersey Central Power & Light Company for Review and Approval of an Increase in and Adjustments to its Unbundled Rates and Charges for Electric Service, and for Approval of Other Proposed Tariff Revisions in Connection Therewith, et al.* Docket No. ER02080506, *et al.*, (Order dated May 17, 2004, p. 47).

Respectfully submitted,

/s/Gregory Eisenstark
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