

May 3, 2013

**VIA HAND DELIVERY AND E-MAIL**

Board of Public Utilities  
Kristi Izzo, Secretary  
44 South Clinton Avenue  
9<sup>th</sup> 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, Docket No. EO12121072***

Dear Ms. Izzo,

The natural gas, electric, water and wastewater utilities listed in footnote 1 that are members ("Companies") of the New Jersey Utilities Association ("NJUA")<sup>1</sup> jointly provide this response to the questions in the "Notice of Opportunity to Comment" dated March 6, 2013 in the above referenced docket. An additional ten copies of this letter are enclosed. An electronic copy of these comments has also been provided to [rule.comments@bpu.state.nj.us](mailto:rule.comments@bpu.state.nj.us).

The Companies appreciate the New Jersey Board of Public Utilities' ("Board") examination of this issue and this initial opportunity to comment. We look forward to working with the Board and its Staff on this matter.

**1. Please explain your company or organization's position on whether the Board should utilize Consolidated Tax Adjustment (CTA).**

**RESPONSE:** The Companies do not support the utilization of a CTA in rate setting proceedings. In fact, the Companies have attached a White Paper that compiles the use of the

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<sup>1</sup> The NJUA members participating in this submission are: Aqua New Jersey, Inc., Atlantic City Electric Company, Pivotal Utility Holdings, Inc. d/b/a Elizabethtown Gas, Jersey Central Power & Light Company, Public Service Electric & Gas Company, South Jersey Gas Company, Atlantic City Sewerage Company, Middlesex Water Company, New Jersey American Water, Gordon's Corner Water Company, Shorelands Water Company, and United Water. Some of these Companies also are providing individual responses to these questions. The Companies reserve the right to assert arguments separately in this proceeding; by joining in this filing such Companies do not waive their rights to file additional material and participate individually in this proceeding. NJUA is the New Jersey statewide trade association for investor-owned utilities that provide essential water, wastewater, electric, natural gas and telecommunications services 24 hours a day, 7 days a week, 365 days a year.

CTA nationwide and shows, among other things, that New Jersey is part of a very small and shrinking minority of states that apply the CTA in the rate setting process. Additionally, the current approach in New Jersey can result in very large adjustments that appear to have little or no relationship to the actual current and future tax situation of the utility, may result in unintended consequences and negative impacts on utility credit quality and cost of capital, and may impact the attractiveness of New Jersey utilities to investors.

**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:** NJUA believes that a CTA should not be used by the BPU and that its policy should be to develop a reasonable tax expense in a rate case. In its initial brief, dated July 27, 2012, filed before the Office of Administrative Law in a recent Atlantic City Electric Company base rate case (“ACE Case”),<sup>2</sup> Board Staff noted the significant concerns set forth below in response to a position advanced by the Division of Rate Counsel (“Rate Counsel”) based on Rate Counsel’s interpretation of what has been characterized as the Board’s current CTA methodology. While Staff’s brief in that case still argued for a CTA, albeit significantly smaller than that proposed by Rate Counsel, Staff’s concerns, in fact, are implicated by the imposition of any CTA and demonstrate why New Jersey should adopt the position of almost all U.S. jurisdictions in rejecting a CTA.

- Board Staff’s brief pointed out the following concerns with Rate Counsel’s position:
  - “However, Staff believes that the application of the consolidated Tax Savings Adjustment proposed by Rate Counsel would 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.” (Board Staff Brief, pages 35-36).
  - “Rate Counsel’s proposed adjustment” (as applied in the ACE case) could result in a “reduction in earnings ...so large as to possibly be considered a ‘taking’ by investors.” (Board Staff Brief, page 36).
  - “The end result of Rate Counsel’s Consolidated Tax Savings Adjustment in this case could be 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.” (Board Staff Brief, page 36).
  - “The investment community would be shocked given the magnitude of the proposed ACE Consolidated Tax Adjustment...” (Board Staff Brief, page 37).

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<sup>2</sup>*In the Matter of the Petition of Atlantic City Electric Company for Approval of Amendments to Its Tariff to Provide for an Increase in Rates and 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.

- “In addition to the deleterious impact on shareholder value, bond investors and ratepayers would be impacted as a result of the likely credit rating downgrade.” (Board Staff Brief, page 37).
- “In addition, because of the magnitude of the adjustment for Consolidated Income Taxes, the investment community could downgrade New Jersey’s investment climate as it pertains to utilities as well as their perception of the quality of regulation in New Jersey.” (Board Staff Brief, pages 37-38).

**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:** For some member companies, a calculation of the impact of a CTA, reflecting either the Staff or Rate Counsel interpretation of the methodology from the above-mentioned Rockland proceeding, has been provided in prior base rate cases through confidential discovery responses, or by parties to those cases in testimony.<sup>3</sup>

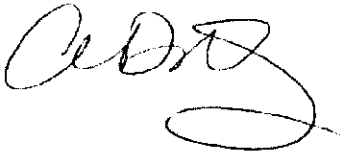
**4. If applicable, please provide the actual amount of the CTA included in your company’s last base rate case.**

**RESPONSE:** Many recent base rate cases were resolved through settlement and, as such, did not provide information about a specific value for a consolidated tax adjustment, although there may have been language noting consideration of a consolidated tax adjustment.

**CONCLUSION**

In closing, the Companies are united in their appreciation for the Board’s willingness to examine the policy for setting a reasonable income tax expense in the rate setting process. We look forward to the next steps in this proceeding.

Sincerely,



Andrew D. Hendry  
President and Chief Executive Officer

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<sup>3</sup> Certain member companies joining in this submission, specifically Middlesex Water Company, Gordon’s Corner Water Company, and Shorelands Water Company, under their current corporate structures, respectively, are not subject to a CTA and, therefore, do not have a response to questions 3 and 4.

**Consolidated Tax Adjustments  
Background Paper  
New Jersey Utilities Association**

**Introduction**

The New Jersey Board of Public Utilities (the Board or BPU) has instituted a generic proceeding to review whether consolidated tax adjustments (CTAs) are appropriate for setting utility rates. Existing Board policy concerning application of a CTA was first implemented in 1992.<sup>1</sup> Although the New Jersey Utilities Association opposes the use of a CTA in setting utility rates, this paper provides information on the application of a CTA in other jurisdictions across the United States. As demonstrated, the CTA is not utilized in the vast majority of jurisdictions and, in recent years, has been explicitly rejected in a number of jurisdictions in which it has been considered.

As a general rule, every corporation subject to the federal income tax must report their tax liability on a separate return. However, Section 1501 of the Internal Revenue Code permits an affiliated group of corporations to elect to report its tax liability on a single, consolidated return. Utilities are no different from other businesses in this respect. By filing a consolidated tax return, a utility's parent company may offset the income of some members of the consolidation group with the losses of other members. However, filing a consolidated tax return requires compliance with a complex set of regulations, and election to file such a return is somewhat permanent in nature (i.e., absent IRS consent to discontinue filing consolidated returns, the group must continue to file a consolidated return even if doing so turns out to be disadvantageous relative to filing separate returns).

**CTA Defined**

The CTA is a regulatory concept in which the federal income tax expense of a regulated utility that is set during a base rate case is reduced by a portion of the tax benefits generated by a non-regulated affiliate's tax losses. A CTA seizes a portion of the tax benefits generated by non-regulated affiliate companies and appropriates those benefits to the ratepayers of the regulated utility. There are also situations where the use of a consolidated tax return results in higher federal income taxes paid than if the filing had been done on a "stand-alone" basis. However, NJUA is unaware of any regulatory commission symmetrically applying the CTA for ratemaking when the result is a higher tax expense, and therefore, higher rates, for the regulated utility.

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<sup>1</sup> *In re the 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 No. ER02100724 (Order dated April 20, 2004), *In re the Petition of Atlantic City Electric Company for Approval of Amendments to its Tariff to Provide for an Increase in Rates and Charges for Electric Service, Phase II*, Docket No. ER90091090J, (Order dated October 20, 1992).

### Where else are CTAs utilized?

The Board's policy with regard to CTAs is not reflective of the vast majority of regulatory agencies in this country. We are aware of only four states where comprehensive CTAs<sup>2</sup> are applied on a systematic basis: New Jersey, Pennsylvania, West Virginia, and Texas<sup>3</sup> (excluding gas utilities). Under Texas' "Gas Utility Regulatory Act," or "GURA", gas utilities are regulated by the Texas Railroad Commission (TRC), not the Texas Public Utility Commission.<sup>4</sup> Under Section 104.055 of GURA, the TRC is precluded from imposing a CTA on the gas utilities under its jurisdiction. In addition, there is pending legislation in the Texas Legislature which would preclude CTAs for all Texas utilities. The legislation, SB1364/HB711, passed in the Senate and is awaiting consideration in the House.

Thus, 49 regulatory jurisdictions (including the Federal Energy Regulatory Commission (FERC), the District of Columbia, and the New Orleans City Council) do not subscribe to the imposition of comprehensive CTAs.

NJUA is aware of two states where a more limited adjustment for consolidated taxes, the "parent interest adjustment," is utilized – Indiana and Florida.<sup>5</sup> This methodology will be described in greater detail later in this paper.

Oregon previously imposed comprehensive CTAs systematically pursuant to a 2005 statute, but on May 24, 2011, the Oregon Legislature enacted legislation that repealed the 2005 statutory requirement.<sup>6</sup> Since the repeal, it is our understanding that CTAs have not been employed in Oregon.

### Recent CTA Activity

In the 30 months prior to the filing of Rebuttal Testimony in the Atlantic City Electric Company base rate case proceeding in May 2012 (BPU Docket No. ER11080469), at least four final orders were issued by state regulators specifically *rejecting* the use of CTAs. These include orders issued by the Public Service Commission of Maryland,<sup>7</sup> the District of Columbia Public Service Commission,<sup>8</sup> the Kentucky Public Service Commission (KPSC),<sup>9</sup> and the Nebraska Public Service Commission.<sup>10</sup> In addition, in May of 2012, the Washington Utilities &

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<sup>2</sup> A comprehensive CTA is one that considers the tax benefits produced by all members of the consolidated group rather than those produced by only selected members.

<sup>3</sup> Tex. Pub. Util. Comm'n, *Application of Central Power and Light Company for Authority to Change Rates*, Docket 14965 (Second Order on Rehearing) (October 16, 1997); *Barasch v. Pennsylvania Public Utility Commission*, 507 Pa. 561, 493 A.2d 653 (1985); *Monongahela Power*, Case No. 06-0960-E-42T (December 5, 2008).

<sup>4</sup> See Tex. Utilities Code Ann. Sec. 101.001 et seq.

<sup>5</sup> See Florida Commission rule 25-14.004; See *Re Muncie Water Works Company*, Cause No. 34571, Indiana Public Service Commission, 44 PUR 4<sup>th</sup> 331 (1981).

<sup>6</sup> ORS 727.210.

<sup>7</sup> *Delmarva Power and Light Company*, Order No. 83085 (December 30, 2009).

<sup>8</sup> *Potomac Electric Power Company*, Formal Case No. 1076 (March 2, 2010).

<sup>9</sup> *Kentucky-American Water Company*, Case No. 2010-00036 (December 14, 2010). Note that in a 2005 order, the KPSC had imposed a CTA on Kentucky-American Water in Case No. 2004-00103. However, in two subsequent cases, Kentucky Utilities – Case No. 2009-00548, and Louisville Gas & Electric – Case No. 2009-00549, the KPSC affirmatively rejected CTAs and the KPSC rejected the imposition of a CTA on Kentucky-American Water in the more recent (2010) case cited

Transportation Commission expressly rejected a proposed CTA.<sup>11</sup> In Docket No. E-002/GR-05-1428 (Northern States Power), issued on September 1, 2006, the Minnesota Public Utilities Commission rejected the use of CTAs. The New Mexico Public Regulation Commission rejected the use of CTAs in Case #07-00077-UT (Public Service of New Mexico), issued on April 25, 2008. In fact, the last time a CTA was affirmatively adopted was in early 2007 by West Virginia.<sup>12</sup>

Three of the Commissions referenced above that have recently rejected the use of CTAs cite the rarity of its application in regulatory jurisdictions as a primary rationale for their rejection of CTAs. In a December 2009 order, the Public Service Commission of Maryland stated that, in order to adopt the CTA recommended within that proceeding by Commission staff, the Commission would have to “depart substantially from prior Commission decisions and join a *very small minority* of commissions.”<sup>13</sup> In a later case, the Public Service Commission of the District of Columbia based its rationale for rejecting the CTA upon, among other factors, “well settled ratemaking practices, practices and reasoning of the FERC ... [in addition to] the *overwhelming majority of other state commissions*.”<sup>14</sup> In a December 2010 rate case where the KPSC denied utilization of a CTA, it was asserted that the KPSC’s policy is to “consistently” reject proposals to apply a CTA and instead to treat utilities on a stand-alone basis. The KPSC’s adoption of this policy is based on the KPSC’s finding that use of a CTA “would result in the subsidization of ratepayers by non-regulated utility operations” and “[m]oreover” because “*many*” jurisdictions “disfavor” its application.<sup>15</sup>

Other regulators that have considered and rejected the CTA have pointed to its incompatibility with standard rate making practices, familiar principles of utility law, and ratepayer interests. In 2006, the Minnesota Public Utilities Commission (MPUC) rejected the CTA on multiple grounds and held that its rejection was consistent with cost- and benefit-allocation principles applied in previous orders in which it consistently rejected the CTA. Those principles, asserted the MPUC, were adopted, not only in recognition of utility burdens, but also to protect ratepayers from the risks associated with utility diversification into unregulated enterprises.<sup>16</sup> In 2008, in a New Mexico Public Regulation Commission (NMPRC) order rejecting a CTA, the NMPRC cited the treatise, Accounting for Public Utilities, by Robert L. Hahne and Gregory E. Aliff (a widely accepted and authoritative source on utility accounting), which explains that the stand-alone approach is “[t]he only approach that is

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above.

<sup>10</sup> *Source Gas Distribution*, Application No. NG-0060 (March 9, 2010).

<sup>11</sup> *Puget Sound Energy, Inc.*, Docket UE-111048/UG-111049 (May 7, 2012).

<sup>12</sup> *Rebuttal Testimony of James I. Warren, IMO Petition of Atlantic City Electric Company for Approval of Amendments to its Tariff to Provide for an Increase in Rates and Charges for Electric Service Pursuant to NJSA 48:2-21 and NJSA 48:2-21.1 and for Other Appropriate Relief* (May 23, 2012).

<sup>13</sup> *Delmarva Power and Light Company*, Order No. 83085 (pg. 10) (December 30, 2009) (emphasis added).

<sup>14</sup> *Potomac Electric Power Company*, Formal Case No. 1076 (order on reconsideration, p. 16) (June 23, 2010) (emphasis added).

<sup>15</sup> *Kentucky-American Water Company*, Case No. 2010-00036 (December 14, 2010). The KPSC noted that a prior approval of the CTA in 2005 was an exception to its policy of consistently rejecting a CTA and that application in that case had involved “unique circumstances” concerning approvals and specific benefits associated with a merger. See *Id.* at 56 (emphasis added).

<sup>16</sup> *In the Matter of the Application of Northern States Power Company d/b/a Xcel Energy for Authority to Increase Rates for Electric Service in Minnesota*, Docket No. E-002/GR-05-1428 (pps. 25-26) (September 1, 2006).

consistent with *standard ratemaking principles*.”<sup>17</sup> The NMPRC determined that the stand-alone method is proper because it “serves the public interest by being consistent with and promoting the accounting and regulatory principles of cost causation, the benefits/burden equation, and prevention of cross subsidization.”<sup>18</sup> Notably, NMPRC also cited the apparent “weight of state authority” in its determination to reject a CTA.<sup>19</sup> In its rejection of a CTA as part of a 2010 order, the Nebraska Public Service Commission found that, for any future rate cases, estimating the taxable income “the Company would report if it filed federal income taxes on its own ... is the most reasonable way of determining the appropriate federal tax expense.”<sup>20</sup>

More recently, in a May 2012 order rejecting a CTA, the Washington Utilities and Transportation Commission (WUTC), which has repeatedly rejected proposed consolidated adjustments, cited a prior order in which it held that utilization of a CTA would violate the “*familiar principle in utility law*” that financial benefits should only follow the burden of risks.<sup>21</sup> The WUTC referenced its adoption of ring-fencing provisions in its rejection of a CTA, noting the protection offered by the ring fence for utility customers: “...after having insulated PacifiCorp and its customers from the risks of leveraged financing at the parent, Staff and Public Counsel seek to secure for customers the cost and tax benefits of that financing ... If the *risks and costs* of activities at the parent-level are borne *exclusively* by shareholders – *because customers are insulated from them by the ring fence* – then it is fair and appropriate for the shareholders, and not the customers, to receive the benefits that result from those activities.”<sup>22</sup>

It is also worth noting that, after having employed CTAs for a number of years, in 1983, FERC switched to a “benefits follow burdens” (*i.e.*, a non-CTA) approach (Opinion No. 173).<sup>23</sup> Like the state jurisdictions referenced above, FERC rejected the CTA, abandoning its application for the stand-alone approach. In its opinion rejecting the CTA, *Re Columbia Gulf Transmission Co.*, 23 FERC 61,396, Opinion 173 (1983), FERC based its stand-alone approach primarily upon a “benefits follow burdens” analysis which was repeatedly referenced in that opinion.<sup>24</sup>

### **What CTA methodologies are used?**

Of the four states that systematically impose comprehensive CTAs, only New Jersey and Texas utilize a cumulative “time value”-based methodology. In each case, the theoretical tax benefit is the same: the cumulative amount of taxes saved by using tax losses in consolidation that would not have been able to be used absent consolidation. In New Jersey, the CTA is applied in such a way that the CTA rate “penalty” equals the portion of the theoretical tax benefit allocable to the utility multiplied by its weighted overall pre-tax cost of capital. In Texas, the “penalty” equals the portion of the theoretical tax benefit allocable to the utility multiplied

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<sup>17</sup> *Public Service of New Mexico*, Case No. 07-00077-UT (Recommended Decision of the Hearing Examiner, p. 129) (March 6, 2008) (Final Order issued April 25, 2008).

<sup>18</sup> *Id.* at 131.

<sup>19</sup> *Id.* at 128.

<sup>20</sup> *Source Gas Distribution*, Application No. NG-0060, at p. 15.

<sup>21</sup> *Puget Sound Energy*, Docket 111048/UG-111049, Order 08 at 69 (May 7, 2012) (emphasis added).

<sup>22</sup> *Id.* citing *WUTC v. PacifiCorp*, Docket UE-050684, Order 04 ¶ 285 (April 17, 2006) (emphasis added).

<sup>23</sup> *Re Columbia Gulf Transmission Co.*, 23 FERC 61,396, Opinion 173 (1983).

<sup>24</sup> *See, e.g.*, 23 FERC at 61,851, 61, 861-62.

by the utility's weighted long term debt rate.<sup>25</sup> Given that a utility's weighted overall pre-tax cost of capital is higher than its weighted long term debt rate, New Jersey's methodology results in a distinctly more punitive CTA than does Texas' methodology. In addition, Texas caps its "look back" at fifteen years based upon the fact that, under federal tax law, pre-1998 net operating losses can only be carried forward fifteen years.<sup>26</sup>

The remaining two states that systematically impose comprehensive CTAs, West Virginia and Pennsylvania,<sup>27</sup> utilize a "cost of service" methodology. During the rate making process, instead of computing the current portion of tax expense based on the tax liability the utility would owe as a stand-alone entity, regulators reduce that expense based on the tax losses produced by other members of the consolidated tax group. A rolling historical average over a number of years (such as 3 or 5) is utilized to derive the benefit by which tax expense for the test period is reduced. Unlike the New Jersey and Texas methodologies, the cost of service CTA is not cumulative so that it is only the tax results during the averaging period that impact rates.

As noted above, Indiana and Florida use a "parent interest adjustment". Under this methodology, if the parent company of a utility receives a tax benefit for deducting interest on debt and the parent and the utility file as part of a consolidated tax return group, then an allocable portion of the tax benefit of the parent's interest deduction is applied to reduce the utility's tax expense for ratemaking purposes.

### **History of the CTA in New Jersey**

Since the inception of the CTA in New Jersey in 1952, the Board has applied several different methodologies for calculating a CTA, including, *inter alia*, the "imputed interest" methodology,<sup>28</sup> and the "chronic loss" approach,<sup>29</sup> both of which utilize a "cost of service" adjustment applicable to a utility's income statement. As noted in the introduction of this paper, existing Board policy in the calculation of a CTA, which is to utilize a "rate base" approach, was first implemented in 1992.

During the years 1986 through 1991, due to significant uncertainty with respect to the IRS's policy toward CTAs, the Board did not utilize a CTA in utility rate cases.

### **Summary**

New Jersey is one of a very limited number of regulatory jurisdictions (4 of 53) that currently utilizes a comprehensive CTA. Of the few jurisdictions utilizing a comprehensive CTA, the Board's approach is one of the most onerous.

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<sup>25</sup> *Central Light and Power* (Second Order on Rehearing) (pps. 107-08 and 111-13 and Conclusion of Law 38).

<sup>26</sup> *CPL v. Public Utility Com'n of Texas*, 36 S.W.3d 547, 555 (Tex. App. Austin-2000).

<sup>27</sup> See *Monongahela Power*, Case No. 06-0960-E-42T (pps. 7-8) (December 5, 2008); See generally *Barasch*, 507 Pa. 561, 493 A.2d 653.

<sup>28</sup> See *I/M/O The Revision of Rates Filed by New Jersey Water Company Increasing Rates For Water and Sewer Service*, BPU Docket No. 7412-915 (Decision and Order January 8, 1976) and *In re Monmouth Consolidated Water Co.*, P.U.R.4<sup>th</sup> 464, BPU Docket No. 776-481 (April 27, 1978).

<sup>29</sup> See *In re Lambertville Water Co.*, Docket Nos. 746-481, 754-244 (September 11, 1981).