



State of New Jersey
DIVISION OF RATE COUNSEL
140 EAST FRONT STREET, 4TH FL
TRENTON, NEW JERSEY 08625

CHRIS CHRISTIE
Governor

KIM GUADAGNO
Lt. Governor

STEFANIE A. BRAND
Director

May 3, 2013

Via Hand Delivery And Electronic Mail

Kristi Izzo, Secretary
New Jersey Board of Public Utilities
44 South Clinton Avenue, 9th Floor
Post Office Box 350
Trenton NJ 08625-0350

Re: I/M/O of the Board's Review of the Applicability
And Calculation of a Consolidated Tax Adjustment
BPU Dkt. No. EO12121072

Dear Secretary Izzo:

Enclosed for filing please find an original and ten copies of the Division of Rate Counsel's comments in the above matter. A copy of these comments is being electronically sent to rule.comments@bpu.state.nj.us pursuant to the Board of Public Utilities' March 6, 2013 Notice of Opportunity to Comment issued in this matter.

We are enclosing one additional copy of the materials transmitted. Please stamp and date the copy as "filed," and return to our courier. Thank you for your consideration and assistance.

Respectfully submitted,

STEFANIE A. BRAND
DIRECTOR, DIVISION OF RATE COUNSEL

By: s/ Diane Schulze
Diane Schulze
Assistant Deputy Rate Counsel

**I/M/O THE BOARD'S REVIEW OF THE APPLICABILITY
AND CALCULATION OF A CONSOLIDATED TAX ADJUSTMENT
BPU Dkt. No. EO12121072**

**Division of Rate Counsel Comments
May 3, 2013**

Introduction

On January 23, 2013, the New Jersey Board of Public Utilities (“BPU” or “Board”) issued an Order establishing a proceeding to address the issue of Consolidated Income Tax Adjustments (“CTAs”).¹ CTAs result from the filing of a consolidated income tax return by a utility, its parent, and other members of a consolidated income tax group. The filing of a consolidated income tax return allows members of the consolidated group with taxable income to take advantage of tax losses incurred by other group members. It is the long standing law in New Jersey that benefits associated with the filing of a consolidated income tax return should be shared with the regulated utility’s customers.² The mechanism for effectuating such sharing is the CTA, which is applied in a utility’s base rate case.

The BPU noted in its CTA Order establishing this generic proceeding that the methodology currently utilized by the BPU to calculate CTAs has been utilized for approximately 20 years. Given the changes in tax laws and corporate structures over this period, the BPU has determined that it would be appropriate to review its consolidated income tax policy. In addition, a recent base rate case stipulation, adopted by the Board,

¹ I/M/O the Board’s Review of the Applicability and Calculation of a Consolidated Tax Adjustment, BPU Docket No. EO12121072, January 23, 2013 (hereinafter the “CTA Order”).

² I/M/O the Revision in Rates Filed by New Jersey Power & Light Company, Increasing Its Rates For Electric Service, 9 N.J. 498,528 (1952).

contained a provision whereby the parties requested that the Board institute a generic proceeding to review the issues related to CTAs.³

In the CTA Order, the BPU stated that it was interested in soliciting input from stakeholders, including the utilities, customers, and Rate Counsel on the issue of CTAs, in order to determine: a) the use by the Board of the consolidated tax savings adjustment policy; 2) how to calculate the amount of savings that arise from filing a consolidated return; 3) how these savings should be equitably shared between the regulated company and the ratepayers; and 4) if a rulemaking proceeding should be undertaken to establish utility-wide or statewide standards with respect to the implementation of a consolidated tax adjustment policy. Accordingly, the BPU directed Staff to convene all interested parties to participate in a generic proceeding to review issues related to CTAs. The BPU noted that “until such time as the Board makes a final determination on the consolidated tax adjustment issues, the current consolidated tax savings policy shall apply.” CTA Order, p.2.

On March 6, 2013, Staff issued a Notice of Opportunity to Comment (“Notice”) requesting that interested parties provide information on the following:

- Please explain your company or organization’s position on whether the Board should utilize CTA.
- If the Board continues the use of CTA, please describe and detail what changes to the CTA methodology, if any, should be adopted by the Board.

³ I/M/O 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. 48:2-12 and N.J.S.A. 48:2-21.1 and for Other Appropriate Relief, BPU Docket No. ER11080469, Order Approving Stipulation, p.8 (Oct. 23, 2012).

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

The Division of Rate Counsel ("Rate Counsel") hereby submits these comments in response to Items 1 and 2 contained in the Notice. Rate Counsel will not comment on Items 3 and 4 as these were directed to the utilities and do not apply to Rate Counsel.

Discussion

1. It Is Settled Law In New Jersey That Utility Consumers Are Entitled To Have Reflected In The Calculation Of Utility Rates – Through The Use Of a CTA - The Savings That Result From The Utility's Participation In a Consolidated Tax Group.

The Board should continue to reflect a CTA in setting utility rates as current law in New Jersey requires that the savings associated with the utility's participation in a consolidated tax group should be shared with the utility's customers. The New Jersey Supreme Court, in reviewing a utility's claim that the Board had improperly imposed an adjustment to reflect federal income tax savings resulting from the filing of a consolidated return, held that New Jersey utilities are allowed:

. . . a deduction from gross income for actual operating expenses only (or actual normalized operating expenses), and not for hypothetical expenses which did not and foreseeably will not occur. Thus it is entitled to an allowance for actual taxes and not for higher taxes that it would pay if it filed on a different basis.⁴

This holding was relied upon by the Appellate Division in rejecting the claim of a water utility that the Board should allow in utility rates the full tax rate of 48% against net income because that was the amount paid to the parent company. The Appellate Division found that the claimed tax payment did not accurately represent the amount of tax payable to the IRS and determined:

If Lambertville is part of a conglomerate of regulated and unregulated companies which profits by consequential tax benefits from Lambertville's contributions, the utility consumers are entitled to have the computation of those benefits reflected in their utility rates.

It is only the real tax figure which should control rather than that which is purely hypothetical.⁵

This language has long been relied upon by the Board in establishing CTAs for the State's utilities. For example, in discussing a CTA in an Atlantic City Electric base rate proceeding, the Board reasoned that:

[T]he courts have on a number of occasions upheld such adjustments by the Board, indicating generally that a utility is not entitled to collect a certain amount of tax expense from ratepayers merely because that amount may have been paid to the holding company based upon the statutory income tax rate applied to utility income. To the extent that the utility is part of a larger conglomerate of regulated and unregulated companies which derives net tax benefits as a consequence of utility net income, the utility ratepayers are entitled to have rates reflect a computation of those benefits.⁶

⁴ I/M/O the Revision in Rates Filed by New Jersey Power & Light Company, Increasing Its Rates For Electric Service, 9 N.J. 498,528 (1952) (citations omitted) .

⁵ In re Lambertville, 153 N.J. Super. 24, 28 (App. Div. 1977) rev'd in part on other grounds, 79 N.J. 449 (1979) (citing In re New Jersey Power & Light Company, 9 N.J. 498, 528 (1952))

⁶ 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 and Charges for Electric Service, Phase II, ER90091090J, (Oct. 20, 1992).

Similarly, in a Jersey Central Power and Light Company base rate case the Board noted that the “Appellate Division has repeatedly affirmed the Board’s policy of requiring utility rates to reflect a consolidated tax savings” and found that “ratepayers who produce the income that provides the tax benefits should share in those benefits.”⁷ Again, in the Rockland base rate case the Board recognized that “It is well-settled law and Board policy that consolidated tax savings are to be shared with customers.”⁸ Thus, as a matter of law, the Board must continue to require that utilities that file a federal income tax return as part of a consolidated income tax group must share the tax benefits associated with the consolidated tax return with ratepayers through a CTA.

2. It Is Sound Ratemaking Policy That Savings Realized Through The Filing Of A Consolidated Tax Return Are Shared With The Utility’s Customers.

The Board should also continue to impose a CTA on utilities that file their federal income tax returns as part of a consolidated income tax group because it is sound ratemaking policy. Establishing a revenue requirement based on a stand-alone federal income tax methodology overstates the Company’s expense, results in a windfall to shareholders, and results in rates that are higher than necessary. It is fundamentally unfair for customers to pay fictitious expenses that the holding company then retains as excess profits.

⁷ I/M/O the Petition of Jersey Central Power & Light Company for Approval of Increased Base Tariff Rates and Charges for Electric Service and Other Tariff Revisions, BPU Docket No. ER91121820J, (June 15, 1993).

⁸ I/M/O the Verified Petition of Rockland Electric Company for the Approval of Changes in Electric Rates, its Tariff for Electric Service, its Depreciation Rates, and for Other Relief, BPU Docket No. ER021000724 (April 20, 2004).

While there have been changes in federal tax policy and corporate structures as noted by the BPU in its Order in this case, the fundamental rationale for imposing a CTA remains unchanged. The tax sharing arrangements of consolidated group members is generally governed by a Tax Sharing Agreement (“Agreements”) among the members of the consolidated group. Pursuant to these Agreements, subsidiaries with positive taxable income pay the amount of their stand-alone tax liability to the parent company. The parent company then pays the amount of taxes due by the consolidated group to the IRS. Any excess funds are then allocated by the parent company to the members of the consolidated income tax group with tax losses, resulting in a contractual means to have the regulated and profitable subsidiaries subsidize unregulated and unprofitable ventures.

Because utilities are virtually assured of positive income, these procedures transfer the excess amounts collected from ratepayers for income tax expense from the utility to the affiliates that generated the income tax losses, effectively resulting in a subsidization of the unregulated affiliates by New Jersey ratepayers. The CTA adopted by the BPU provides some compensation to ratepayers for this subsidization. The CTA should be continued by the BPU, not only because it is the law, but because it is good ratemaking policy and it results in just and reasonable rates that reflect at least a portion of the federal income tax benefits associated with filing a consolidated income tax return.

Net operating losses have value only because they can be used to offset positive taxable income of other group members. Thus, it is the positive taxable income of utilities, and other consolidated group members, that give the net operating losses their value and result in the consolidated income tax savings. The consolidated income tax adjustment does not attempt to transfer to ratepayers the tax benefit of any unregulated

entity; it simply recognizes that the filing of a consolidated tax return results in a collective benefit to all members of the consolidated income tax group, and that a portion of that benefit should be allocated to the utilities and their ratepayers.

A utility's parent company has the right to organize any way that it chooses. However, once a parent company decides that a consolidated income tax return should be filed, all members of the consolidated group become individually responsible for the entire annual tax liability. Therefore, it is entirely reasonable for the Board to share the benefits of a consolidated income tax filing with New Jersey ratepayers. Moreover, by requiring a CTA, the Board is not attempting to reach out and import non-regulated transactions into the regulated entity. As previously noted, the consolidated income tax adjustment simply recognizes the impact on utilities of filing a consolidated income tax return.

3. The Appropriate Method for the BPU to Utilize in the Future Will Depend Upon Information Provided in this Proceeding

There are two principal methods of calculating CTAs, the operating income method and the rate base method. With the rate base method, a utility's rate base is reduced by the accumulated tax benefits allocated to each entity that has positive taxable income. This method does not directly reduce the income tax expense included in a utility's revenue requirement, but rather provides for the treatment of these accumulated benefits as cost-free capital. This is the method adopted by the BPU. The second method, the operating income or actual taxes paid method, provides for a direct reduction

to pro forma income taxes to reflect the utility's allocable share of tax benefits resulting from tax losses of affiliates.

The methodology currently utilized by the BPU was established by Board Order dated April 20, 2004, in the Rockland Electric Company base rate case.⁹ That methodology aggregates the taxable income or tax loss for each company in the consolidated income tax group from 1991 to the most recent data available. The annual tax losses for those companies that had aggregated net losses are then aggregated from 1991 to the present. For each year, the aggregated tax loss for all of those individual companies that had an aggregated (1991-present) taxable loss is then multiplied by that year's annual federal income tax rate, in order to determine the annual tax loss benefit for the year. The resulting aggregated tax benefit, adjusted for Alternative Minimum Taxes, is then allocated among all the companies that had cumulative positive taxable income for the period from 1991-present, based on each entity's share of the aggregated positive taxable income.

Since this methodology utilizes cumulative data since 1991, in some cases the resulting CTAs have become quite significant. In addition, there have been changes in the tax laws since the BPU adopted the RECO Methodology. As a result, some companies have argued in recent rate cases that this methodology is no longer appropriate.

Rate Counsel believes that this proceeding should include an examination of various CTA methodologies to determine which approach is most reasonable going forward. In making this determination, the BPU should consider a number of factors

⁹ 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 No. ER02100724, (April 20, 2004) (hereinafter the "RECO Methodology").

including, but not limited to, the history of the consolidated income tax groups with regard to the payment of federal income taxes, the current tax laws, the impacts on both ratepayers and the Company of various CTAs, and the overall reasonableness of various CTA methodologies. Rate Counsel does not believe that there is sufficient evidence at this time to recommend a change to the RECO Methodology, however, Rate Counsel is receptive to further evaluation of various CTA methodologies. Rate Counsel believes that the information requested from the utilities in the Notice will facilitate this evaluation. In addition, as discussed below, Rate Counsel believes that additional information is required in order to develop a full and complete record in this case. Such a record is important to ensure that an appropriate methodology is ultimately implemented by the BPU, whether it be a continuation of the RECO Methodology or adoption of a different CTA methodology. Rate Counsel looks forward to participating with the other parties in this proceeding to ensure that the Board selects a CTA methodology that is appropriate, fair, and reasonable.

4. The BPU Should Require Additional Information From the Utilities.

In addition to the policy issues discussed in the Notice, the Notice also requests that the utilities in New Jersey provide certain data with regard to CTAs. Specifically, the Notice requests that the utilities a) calculate a CTA pursuant to the RECO methodology and b) provide the actual amount of the CTA, if any, included in each company's last base rate case.

While this information will be very helpful in evaluating the methods that may be used to impose a CTA, there is additional data that Rate Counsel believes would also be

helpful to the Board as it evaluates the CTA issue. Therefore, Rate Counsel recommends that the Board require the utilities to also provide the following:

- A copy of any tax sharing agreement relating to the filing of a consolidated income tax return;
- The year in which the utility was first included in a consolidated income tax return;
- The total amount paid by the utility to its parent company for federal income taxes in each year since 1991;
- The total amount paid by all members of the consolidated income tax group to the parent company relating to federal income taxes, in each year since 1991;
- The amount paid to each loss company by the parent, in each year since 1991;
- The total amount paid by the consolidated entity to the IRS for federal income taxes in each year since 1991;
- The amount of bonus depreciation taken by each member of the consolidated income tax group in each year since 1991;
- The amount of Alternative Minimum Taxes paid by the consolidated income tax group in each year since 1991;
- The amount of any tax loss carryforward available to the consolidated group and the period(s) over which these tax loss carryforwards are available to be used by the consolidated group;
- A brief description of each company included in the consolidated income tax group since 1991, along with an indication of whether each company is regulated or non-regulated;

- The reason why a company that was previously included in the consolidated income tax group is no longer included in the group;
- All workpapers and calculations relating to the calculation of the CTA as requested in the Notice;
- The federal income taxes (both current and deferred) reported by the consolidated income tax group on the parent company's Annual Report, by year since 1991;
- The federal income taxes (both current and deferred) booked by the utility, by year since 1991;

This information will assist the BPU in determining the impact of various CTA methodologies on the utilities in New Jersey. In addition, it will provide information to the BPU that will be helpful in evaluating the reasons for the tax losses of various group members and the source of the tax benefits that result from the filing of a consolidated income tax return. This information will be especially helpful in evaluating the impact of different methodologies on different utilities, since it is likely that different companies will be impacted by different methodologies to various degrees.

5. The Parties Should Have the Opportunity to Provide Further Comments In this Case

The information requested in the Notice, as well as the additional information discussed above, will assist the BPU to make informed decisions regarding the CTA. In order to develop a full record in this case, the BPU should provide the parties with an opportunity for further comment once the utilities have submitted the information

requested in the Notice as well as the additional information recommended by Rate Counsel.

Without examining the information requested in the Notice and the additional information recommended by Rate Counsel, the parties do not have sufficient information to evaluate the impact of various CTA methodologies on each New Jersey utility. Once this information is provided, the parties will be in a better position to provide recommendations to the BPU on whether a change should be made to the methodology used to calculate the CTA and the likely impact of a CTA on utility rates in future cases.

Given the complex nature of the issues to be discussed, Rate Counsel recommends that the BPU establish a formal stakeholder proceeding once all of the recommended information is provided by the utilities. Based on the results of that stakeholder proceeding, a formal rulemaking should be employed to establish the CTA methodology going forward. Rulemaking procedures are preferred when the action is intended to have a “widespread, continuing, and prospective effect, deals with policy issues, materially changes existing laws, or when the action will benefit from rulemaking's flexible fact-finding procedures.”¹⁰ The rulemaking procedures of the New Jersey Administrative Procedure Act give all parties affected by the proposed rule “an opportunity to participate in the process, both to ensure fairness and also to inform regulators of consequences which they may not have anticipated.”¹¹ Once decided, the CTA should be uniformly applied to all the State’s utilities. Accordingly, the

¹⁰ I/M/O the Provision of Basic Generation Service for the Period Beginning June 1, 2008, 205 N.J. 339, 349 (2011) (citing N.J.S.A. § 52:14B-2(e)).

¹¹ Id.

determination of the proper CTA calculation should be determined through a formal rulemaking process.

Conclusion

The Board should continue to reflect a CTA in setting utility rates as current law in New Jersey requires that the savings associated with the utility's participation in a consolidated tax group should be shared with the utility's customers. This proceeding should include an examination of various CTA methodologies to determine which approach is most reasonable. That approach should be reflected in regulations going forward.