ITEM NO. CA9

PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: November 17, 2020

REGULAR ____ **CONSENT** __X__ **EFFECTIVE DATE** ______________________

DATE: November 6, 2020

TO: Public Utility Commission

FROM: Russ Beitzel

THROUGH: Bryan Conway, Michael Dougherty, and Bruce Hellebuyck **SIGNED**

SUBJECT: AVION WATER COMPANY, INC:
(Docket No. UM 1936)
Requests approval of Deferred Accounting Associated with H.R. 1 – Tax Cuts and Jobs Act.

STAFF RECOMMENDATION:

Approve Staff's Application to defer changes in Avion Water Company Inc.'s (Avion or Company) federal income tax obligation resulting from H.R.1 Tax Cuts and Jobs Act of 2017 (H.R.1 or Tax Act), docketed as UM 1936, for the twelve-month period beginning March 1, 2018, calculated to be $357,069 (through December 2020), for the twelve-month period beginning March 1, 2019, calculated to be $247,024 (through December 2020), and for the twelve-month period beginning March 2, 2020, to be determined once the appropriate financial data is available.

DISCUSSION:

Issue

Whether the Commission should approve Staff's Application to Defer Changes in Avion's Federal Tax Obligations Resulting from H.R.1 – Tax Cuts and Jobs Act (Application) for the twelve-month periods beginning March 1, 2018, March 1, 2019, and March 2, 2020.

Applicable Rule or Law

Beginning with the date of the application, the Commission may approve the deferral of identifiable utility expenses or revenues, the recovery or refund of which the

Commission finds should be deferred in order to minimize the frequency of rate changes for the fluctuation of rate levels or to match appropriately the costs borne by and benefits received by ratepayers. ORS 757.269(2)(e) and (4). Unless subject to an automatic adjustment clause under ORS 757.210(1), amounts deferred are allowed in rates to the extent authorized by the Commission in a proceeding under ORS 757.210 to change rates and upon review of the utility's earnings at the time of application to amortize the deferral. ORS 757.259(4); OAR 860-027-0300(9). The Commission's final determination on the amount of deferrals allowable in the rates of the utility is subject to a finding by the Commission that the amount was prudently incurred by the utility. ORS 757.259(5).

Analysis

Tax Act Deferral Background

On December 22, 2017, President Donald Trump signed H.R.1 – Tax Cuts and Job Act, with most provisions going into effect on January 1, 2018. The Tax Act amends sections of the 1986 code, most notably the reduction in the federal corporate income tax rate from 35 percent to 21 percent. The change in the corporate income tax rate also results in excess deferred income tax (EDIT) assets and liabilities that must be reversed. Water companies have an additional change in that Contributions In Aid of Construction (CIAC) amounts are taxable under the Tax Act.

On March 1, 2018, Staff filed a deferral application (Docket No. UM 1936) "to defer, for later rate-making treatment, the effects of H.R.1 on Avion's tax liability" with the intent of tracking the net impacts of the Tax Act to pass onto customers. At the time the Application was filed, the impacts of the Tax Act were unknown. Staff filed additional applications to reauthorize deferral of the Tax Act impacts in 2019 and 2020.

Taxes in Current Rates

The income tax expense currently included in Avion's base rates was approved in its last general rate case (Docket No. UW 171) and does not reflect any of the provisions of the Tax Act. Therefore, the Tax Act benefits are not currently reflected in Avion's base rates.

As mentioned above, the Tax Act resulted in the taxability of CIAC for water utilities, which was not present prior to The Act. The CIAC-related tax obligation will be due to the taxing bodies for the year in which the CIAC is assumed, and will be paid along with other taxes paid for the year in which the CIAC is received. Also beginning in year one, and then for each year over the tax life of the asset, water utilities will claim the tax depreciation of the CIAC assets, which functions as a deduction to the utility's taxable income (CIAC Tax Benefits). For this reason, the taxability of CIAC will not increase the overall amount of taxes paid by water utilities, since the asset will eventually be fully depreciated for tax purposes, but instead it creates a timing issue. Avion explained that the timing issue can create a substantial financial hardship for a small utility, which may not have sufficient cash on hand to pay these taxes up front in year one. Additionally, Avion represented that multiple consecutive years of such circumstances would be likely to impact a small utility's ability to operate to the detriment of Avion's customers. Finally, Avion noted that due to the effects of inflation, the tax payments on CIAC would ultimately result in the utility subsidizing development projects.

Staff Findings and Discussion

1. Categories to Defer

The purpose of this proceeding is to identify the amount of tax benefits to be deferred, for the benefit of Avion's ratepayers. Full consideration of the tax benefits includes the following computational elements:

- Annual Tax Rate Benefits - The decrease in the annual revenue requirement due to changes in how taxable income from operations is determined, the effect of reducing the statutory federal rate from 35 percent to 21 percent, and changes in allowable tax credits, etc. For Avion, the tax rate changed from 34 percent to 21 percent based on their prior rate case.[1]

- EDIT - Revaluation of deferred tax obligations at the new lower statutory rate resulting in excess deferred income taxes (EDIT).
  - Federal law provides that the return to ratepayers of EDIT related to utility plant must generally comply with the Average Rate Assumption Method (ARAM). Failure to adhere to the ARAM methodology would terminate the Company's ability to use accelerated depreciation methods for tax purposes. These amounts are generally referred to as "protected" EDIT.
  - EDIT unrelated to utility plant and plant related EDIT not subject to the ARAM methodology may be returned to customers using any reasonable amortization method. These amounts are generally referred to as "unprotected" EDIT.

- CIAC Tax Benefits – As described above, Avion is collecting the taxes created by the taxability of CIAC from contributors and a method for returning the related CIAC Tax Benefits needs to be determined.

2. Deferral Methodologies

[1] See Docket No. UW 171, Order No. 17-496.

Staff used the following methodologies to determine the 2018 and 2019 Tax Act benefits subject to deferral. Deferred amounts for the period between March 2, 2020, and the Company's rate-effective date from its pending rate case will be determined once the appropriate financial data is available:

- Annual Tax Rate Benefits - Staff calculated a *pro forma* operating income for purposes of determining the tax benefit due to the change in the federal income tax rate to 21 percent. To develop its *pro forma* operating income, Staff made adjustments to the results reflected in the Company's Annual Results of Operations Report to remove unusual items and incorporate adjustments similar to those made in UW 171 – the Company's most recent general rate case. In Staff's view, this method provides the most accurate measure of the Company's income with respect to the revenue requirement in a general rate case based on the most recently available actual data, and provides a reasonable and appropriate proxy for the Tax Act benefits. Avion identified no other changes to its tax obligation as a result of other changes in how taxable income from operations is determined, changes in allowable tax credits, or other features of the Tax Act.

- EDIT – Avion provided a spreadsheet with all depreciable regulated utility assets, which Staff analyzed for accuracy. The spreadsheet calculated Avion's EDIT by comparing deferred taxes calculated using the 34 percent rate in effect prior to The Act to deferred taxes based on the 21 percent income tax rate in The Act. Avion indicated it has no "unprotected" EDIT.

- CIAC Tax Benefits - In ADV 723, Avion added Schedule No. 8 to require developers to fund the additional tax obligation resulting from the new taxability of CIAC. The Company agreed that it would keep accurate and detailed records of contributors (both customers and developers) of CIAC tax fees pursuant to Schedule 8, and that the CIAC Tax Benefits should be enjoyed by those persons paying the tax liability.

3. 2018, 2019 and 2020 Deferral Amounts

- Annual Tax Rate Benefits – Staff created a spreadsheet (Table 1) that calculates the difference in revenue requirement between the previous (34 percent) and the current (21 percent). The *pro forma* results for 2018 were used and a result of $333,082 (through December 2020) was calculated for deferral. The *pro forma* results for 2019 were used and a result of $213,823 (through December 2020) was calculated to be deferred. Staff will determine the 2020 amount once the appropriate financial data is available.

- ARAM – Avion provided a spreadsheet with all depreciable regulated utility assets, which Staff analyzed for accuracy. The yearly amount of potential deferral was also added to the above spreadsheet for 2018 and 2019. A result of $23,987 (through December 2020) for 2018 and $33,201 (through December 2020) for 2019 was calculated to be deferred. Staff will determine the 2020 amount once the appropriate financial data is available.

- CIAC Tax Benefits – Avion has indicated that tracking CIAC Contributors over the life of the CIAC assets is problematic, as "the development companies are often created only for the life of a particular project—which is typically much shorter than the life of the CIAC asset—and are then dissolved upon completion of that project." Staff is working with the Company to determine a best method for returning the benefit. Staff is not requesting approval of a specific CIAC Tax Benefit amount at this time, but seeks approval for deferring CIAC TAX Benefits to be calculated at a future time.

Excluding CIAC Tax Benefits, for 2018 Staff calculated a total deferred amounts related to the Tax Act of $357,069. Excluding CIAC Tax Benefits, for 2019 Staff calculated a total $247,024 of Tax Act benefits to be deferred. Staff will determine the 2020 amount once the appropriate financial data is available. Consistent with long-standing Commission precedent, deferred amounts related to the Annual Tax Rate Benefits and EDIT will earn interest at the utility's authorized Rate of Return. Due to the specific circumstances related to Avion's CIAC Tax Benefits, Staff recommends deferred amounts earn interest at the Modified Blended Treasury (MBT) rate, with the amounts of interest calculated monthly and reflecting the accumulated CIAC tax benefits as of that point in time. This use of the MBT rate is appropriate in this case because the CIAC Tax Benefits represent a relatively straightforward, certain, and measureable event. The Commission typically applies the MBT rate to accrue interest during the amortization period of deferrals in recognition of the fact that there is less risk associated with the determination and collection of those amounts during the amortization period than during the deferral period. Avion, through grossing up the taxes through its Schedule No.8 is requiring the contributors to pay all the taxes associated with the taxability of CIAC in the year the CIAC was contributed. The CIAC Tax Benefit is simply a means of passing the associated tax benefits (which will equal the amount of the initial tax gross-up) back to customers.

4. Future Ratemaking Treatment - Amortization / Earnings Test

Staff and Avion expect the amortization mechanism of the deferrals will be addressed in Avion's currently pending General Rate Case. All deferrals are subject to an earnings review prior to amortization. Staff and the Company have agreed that for Annual Tax

Rate Benefits and EDIT, deferred amounts should be subject to an earnings test, and the earnings level threshold will be set at the Company's authorized ROE. While Staff is not requesting approval of any aspect of the amortization in rates as a result of this memo, Staff felt it was important to address the parties' expectations regarding amortization to give the Commission a more complete picture of what has transpired to date in this docket. Staff and the Company have agreed that an earnings test will not be applied to CIAC tax benefit deferred amounts.

Staff and the Company agreed to employ an earnings test associated with amortization of the sum of the Annual Tax rate and EDIT benefits. Staff and the Company also agree that using Avion's most recent rate case RoE of 9.5 percent[2] (59 percent Equity equals 5.61 percent Weighted RoE) was most appropriate in calculating the amount to be amortized (i.e., passed back to customers after application of the earnings test), as this is the Company's authorized RoE during the deferral period.

Should the earnings test above ultimately be adopted by the Commission, Avion will be required to pass back Annual Tax Rate and EDIT benefits only to the extent passing back the sum of those benefits will not result in Avion earning less than its authorized RoE described above during the specific deferral periods.

For illustrative purposes only, Staff calculated the deferral amount as if an earnings test were applied for 2018 and 2019 Annual Tax Rate Benefits and EDIT in Table 1 below. For 2018, Avion earned a Weighted RoE of 6.72 percent (B9), which is above its authorized Weighted RoE of 5.61 percent (F9), by 1.11 percent. Staff calculated $303,804 (D5) as the principal amount of deferral, but the amortization of that deferral, along with associated interest, would be reduced to $289,314 (E1) when an earnings test is applied. For 2019, Avion earned a Weighted RoE of 4.35 percent (B9), which is below their authorized Weighted RoE of 5.61 percent (F9), by 1.26 percent. Staff calculated $224,950 (D5) as the principal amount of deferral, but the amortization of that deferral would be reduced to $0 when an earnings test is applied. The table below illustrates these results:

[2] See Docket No. UW 171, Order No. 17-496.

Table 1						
2018	A	B	C	D	E	F
Line No.	**Description**	2018 Normalized 21%	2018 Normalized 34%	Tax Diff * Gross up	Amt to Auth RoR	2018 at 21% & Auth
1	Revenues	9,315,012	9,315,012		(289,314)	9,025,698
2	Operating Expenses	5,993,637	5,993,637		(868)	5,992,769
3	Other (Excl Inc. Taxes)	1,328,875	1,328,875			1,328,875
4	State Income Taxes	119,080	119,080		(19,960)	99,119
5	Federal Income Taxes	321,856	544,586	(303,804)	(56,382)	265,474
6	Net Income	1,551,564	1,328,834		(212,104)	1,339,461
7	Rate Base	19,046,988	19,046,988			19,046,988
8	ROR	8.15%	6.98%			7.03%
9	Weighted ROE	6.72%	5.55%			5.61%
2019	A	B	C	D	E	F
Line No.	**Description**	2019 Normalized 21%	2019 Normalized 34%	Tax Diff * Gross up	Amt to Auth RoR	2019 at 21% & Auth
1	Revenues	9,184,412	9,184,412		351,990	9,536,402
2	Operating Expenses	6,274,534	6,274,534		1,056	6,275,590
3	Other (Excl Inc. Taxes)	1,431,638	1,431,638			1,431,638
4	State Income Taxes	82,025	82,025		24,285	106,309
5	Federal Income Taxes	210,203	375,122	(224,950)	68,596	278,800
6	Net Income	1,186,012	1,021,093		258,053	1,444,065
7	Rate Base	20,534,455	20,534,455			20,534,455
8	ROR	5.78%	4.97%			7.03%
9	Weighted ROE	4.35%	3.55%			5.61%

Conclusion

For the reasons stated above, Staff concludes that the deferral of Avion's Tax Act benefits for 2018, 2019, and 2020 should be approved. The method for returning the benefit to the customers will be determined in a separate ratemaking proceeding, which may include the currently pending 2020 Avion General Rate Case, docketed as UW 181.

PROPOSED COMMISSION MOTION:

Approve Staff's application for the Deferral of 2018, 2019, and 2020 Net Benefits Associated with the Tax Cuts & Jobs Act, docketed as UM 1936, for the twelve-month period beginning March 1, 2018, calculated to be $357,069, for the twelve-month period beginning March 1, 2019, calculated to be $247,024, and for the twelve-month period beginning March 2, 2020, to be determined once the appropriate financial data is available.