ORDER NO. 18 072

ENTERED FEB 27 2018

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UM 1631

In the Matter of AVION WATER COMPANY, INC. Request for Waiver of OAR 860-036-2380.	ORDER

DISPOSITION: STAFF'S RECOMMENDATION ADOPTED

At its public meeting on February 27, 2018, the Public Utility Commission of Oregon adopted Staff's recommendation in this matter. The Staff Report with the recommendation is attached as Appendix A.

BY THE COMMISSION:

Michael Dougherty
Chief Operating Officer

PUBLIC UTILITY COMMISSION OF OREGON

A party may request rehearing or reconsideration of this order under ORS 756.561. A request for rehearing or reconsideration must be filed with the Commission within 60 days of the date of service of this order. The request must comply with the requirements in OAR 860-001-0720. A copy of the request must also be served on each party to the proceedings as provided in OAR 860-001-0180(2). A party may appeal this order by filing a petition for review with the Circuit Court for Marion County in compliance with ORS 183.484.

ORDER NO. 18 072

ITEM NO. CA12

PUBLIC UTILITY COMMISSION OF OREGON
STAFF REPORT
PUBLIC MEETING DATE: February 27, 2018

REGULAR ____ **CONSENT** X **EFFECTIVE DATE** **February 28, 2018**

DATE: February 14, 2018

TO: Public Utility Commission

FROM: Stephen Hayes

THROUGH: Jason Eisdorfer, Bryan Conway, and Bruce Hellebuyck

SUBJECT: AVION WATER COMPANY INC.: (Docket No. ADV 723/Advice No. 18-01), Include Tax Liability Cost Attributable to Contributions In Aid of Construction.

STAFF RECOMMENDATION:

The Public Utility Commission of Oregon (Commission) should approve Avion Water Company's (Avion or Company) Advice No. 18-01 request to begin charging the tax liability attributable to Contributions in Aid of Construction (CIAC) and approve the request for less than statutory notice (LSN) for good cause shown.

Staff also recommends that the Commission waive OAR 860-036-2380 for good cause shown.

DISCUSSION:

Issue

Whether the Commission should approve Advice No. 18-01, effective for service on and after February 28, 2018, whereby the tariff PUC Oregon No. 6 is modified to add provisions for charging taxes attributable to CIAC which were not applicable to water companies prior to recent tax law changes and whether good cause has been shown for the LSN.

Applicable Rule or Law

Under ORS 757.205(1), a public utility must file schedules showing all rates, tolls, and charges for service that have been established and are in force at the time. The Commission may approve tariff changes if they are deemed to be fair, just and reasonable. ORS 757.210. Tariff revisions or corrections may be made by filing revised sheets with the information required under the Commission's administrative rules, including OAR 860-022-0005 and OAR 860-022-0025. Filings that make any change in rates, tolls, charges, rules, or regulations must be filed with the Commission at least 30 days before the effective date of the changes. ORS 757.220. The Commission is permitted to allow rate changes with less than statutory notice upon good cause shown. ORS 757.220.

OAR 860-036-2380 addresses ratemaking treatment for CIAC. The provisions of the rule require the water utilities to record CIAC on a separate plant and depreciation schedule. Plant assets are recorded at market value, and CIAC is recorded at an equal value. CIAC related assets are then depreciated in the same manner as purchased assets, and amortization is taken at an amount equal to depreciation expense. This has the overall effect of an expense that is tracked, but results in no ratemaking effect.

OAR 860-036-1000(3) provides that the Commission may waive, upon request or its own motion, any Division 36 rule for good cause shown.

Analysis

Avion filed its Advice 18-01 in response to changes resulting from the recently passed H.R.1 – Tax Cuts and Jobs Act (H.R.1. or the Act) [1], which among other changes, changed the taxability of CIAC for water utilities. Avion is concerned about its tax liability for this year in light of the amount of CIAC development it expects to assume given the growth in the Bend, Oregon, area.

Definition of CIAC
For water utilities, the Commission defines CIAC as "any money, services or property received by a water utility to fund capital investments at no cost to the company and with no obligation to repay."[2] One common example for water utilities is a developer installing the distribution lines for a subdivision, and then transferring that water infrastructure to the water utility at no cost. Regulated water utilities record that property

[1] See 26 U.S. Code Section 118.
[2] OAR 860-036-2380(2).

and/or funds in Account 271 - Contributions in Aid of Construction. The plant is recorded at net book value on the utility's books, but as discussed more fully below, does not receive rate base treatment, like utility financed capital, because it did not require a cash outlay from the water utility.

Recent Tax Law Changes
In December 2017, the 115th United States Congress passed the Act. The Act was signed into law on December 22, 2027 by President Trump, with most provisions going into effect on January 1, 2018. The Act contains provisions that impact regulated utilities' federal tax obligations, including a general reduction in the corporate income tax rate and the taxability of CIAC contributions made to water utilities.

Prior to the Act, water companies had a tax exemption related to CIAC that was not available to energy and telephone utilities (i.e., CIAC was not treated as taxable income by water utilities). That exemption is no longer present in 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. For this reason, the taxability of CIAC will not increase the overall amount of taxes paid by water utilities, it simply creates a timing issue.

The primary impact on water utilities will be the need for funds to pay the near term tax obligation caused by the CIAC taxability. As is discussed below, this need to fund the near term tax obligation may cause a large and unpredictable need for funding and is the primary driver behind Avion's filing.

The Act also contains numerous other provisions, including a reduction to the corporate tax rate that is used for setting general rates. Due the lengthy and complex nature of the Act, it is not possible at this time to identify the specific changes in Avion's federal tax obligations that may be impacted by the Act. Complicating this further is the fact that the United States Treasury Secretary may develop rules related to the new tax law that could modify the Act's application, including potentially restoring the CIAC exemption for water companies.

Avion's Filing / CIAC Taxability
Avion is the first water utility to approach the Commission with a tariff change related to the Act.

Avion's filing addresses one specific component of the Act – the taxability of CIAC. As discussed above, prior to the Act, water companies had a tax exemption related to CIAC. As a result, water utilities had no income tax obligation associated with their receipt of CIAC. Under the Act, CIAC contributions will now be treated as taxable income by water utilities.

Avion proposes to collect this increase in its tax obligation by "grossing-up" the CIAC it receives to reflect this new tax obligation. As a result, developers and customers contributing CIAC under Schedule No. 7, Schedule No. 8 or Schedule No. 12 will also provide Avion with payment equal to the tax obligation Avion will incur as a result of the taxability of the CIAC.

Avion's filing is based on the presumption that the developers/customers should pay the additional CIAC-related income tax as they are the cost causers of the additional taxes (i.e., there would be no additional taxes if the developers/customers were not contributing CIAC). Avion states it has communicated with developers with whom they regularly do business regarding the added cost related to CIAC tax liability. Avion states there is no way to communicate with all potential developers about the new cost associated with CIAC.

Staff also considered the option of treating the additional cost as a general cost and socializing the additional taxes as a general cost of business to be borne by all customers, similar to any other income tax obligation.

As part of our review, Staff asked how other states were addressing this new development for water utilities; of the six states responding, all said they allowed the contributors to pay the tax liability. Staff also reviewed the proceeding conducted by the California Public Utility Commission (CPUC) when a similar elimination of the same exemption for water companies occurred in 1986. Staff also reviewed the CIAC tax treatment for Oregon's regulated natural gas distribution utilities, and concluded that the tax on CIAC is generally paid by the developer/customer seeking the line extension.

Avion expressed significant concern regarding its ability to fund the additional tax liability resulting from the taxability of CIAC in light of the developments it anticipates receiving in 2018. Staff requested an estimate of the CIAC related tax obligation Avion anticipates for each month of 2018 and 2019. Avion stated it simply could not answer that question, and that the potential CIAC tax related cash requirements make it very difficult to plan and budget, which may put capital projects at risk. Finally, Avion indicated that the recent changes to the Urban Growth Boundary in the Bend area will also result in an uptick in project development and make the CIAC taxes even more difficult to plan for.

Avion's filing is silent on the remaining impacts of the Act.

Applicability of OAR 860-036-2380.
In 2003, the Commission adopted an administrative rule to establish its policy for the treatment of CIAC for ratemaking purposes. When adopting its policy, the Commission considered comments from the Water Issues Steering Committee (WISC). Regarding CIAC, WISC recommended that the Commission "prohibit CIAC from being included in utility ratemaking," but with the purpose of addressing issues with zero or negative rate base, which is financially harmful to the utility.[3] The taxability of CIAC was not an issue at the time that the Commission implemented its policy, as it was exempt from the Internal Revenue Code's definition of gross income.

The original rule was subsequently repealed and replaced when the Commission revised its Division 36 rules. It was renumbered to OAR 860-036-2380, and minor changes were made to the contents in an effort to improve the organization and clarity of the rule.[4] The rule continues to require water utilities to record and track CIAC, but such a manner that it has no ratemaking effect.

The Act's change in status for CIAC means that, unlike when the Commission's CIAC rule was adopted (and subsequently amended), water utilities are incurring a CIAC related expense in the provision of service to customers.

<u>Conclusion</u>

Staff finds Avion's arguments regarding both the need for and structure of its proposed Schedule No. 8 compelling and recommends approval of its proposed Schedule No. 8. Staff also requests a waiver of OAR 860-036-2380. Departure from the Commission's overarching policy to exclude CIAC from ratemaking is supported by good cause shown, and Staff notes that the more specific policy—to ensure that utilities do not

[3] AR 447, Order No. 03-287.
[4] AR 595, Order No. 17-017.

erode their rate base due to inclusion of CIAC for ratemaking purposes—remains preserved by Staff's waiver request.

However, Staff further finds that addressing one aspect of the Act, while not addressing other impacts, does not result in a fair balance between the interests of customers and the Company. Therefore, Staff plans to file an application for deferred accounting, similar to those filed late last year for energy utilities, which will allow all the impacts of the Act to be tracked for later ratemaking treatment.

Staff has discussed with the Company its intent to file a deferral to track, for later ratemaking treatment, the impacts associated with the Act. The Company has agreed that it will not oppose Staff's deferral application, that it will keep accurate and detailed records of contributors (both customers and developers) of CIAC tax fees pursuant to Schedule 8, and that the depreciation tax benefit should be enjoyed by those persons paying the tax liability.

The Company has also agreed that it will refund any amounts collected under Schedule 8 in the event the CIAC taxability is repealed for any reason, including the development of rules by the United States Treasury Secretary which restore the prior exemption granted to water utilities.

Staff recommends that the Commission grant Avion's expedited treatment of its advice letter by filing an LSN. The Company has indicated that time is of the essence for this filing in light of the development schedule of several projects, and has been responsive and cooperative with Staff in fully investigating the Company's request. After reviewing and considering information submitted by the Company staff concludes that good cause has been shown for approving the LSN.

PROPOSED COMMISSION MOTION:

Allow Avion's amended Advice No. 18-01 to go into effect with the less than statutory notice for services rendered on and after February 28, 2018.

Waive, for good cause shown, OAR 860-036-2380, and allow ratemaking treatment for the tax effects of CIAC following the passage of the Act.

Avion.ADV.723.Advice.18.01