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**CA-23**

**BEFORE THE PUBLIC UTILITIES COMMISSION  
OF THE STATE OF CALIFORNIA**

Application of California-American Water  
Company (U210W) for Approval of the  
Monterey Peninsula Water Supply Project and  
Authorization to Recover All Present and Future  
Costs in Rates.

A.12-04-019  
(Filed April 23, 2012)

**REBUTTAL TESTIMONY OF MICHAEL J. RENO OF ERNST & YOUNG, LLP  
ON BEHALF OF CALIFORNIA-AMERICAN WATER COMPANY**

**ERRATA**

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**ERRATA**

**I. INTRODUCTION**

Q1. Please state your name, business address and position.

A1. My name is Michael Reno. I am an executive director in Ernst & Young LLP’s National Energy Practice. My business address is 1101 New York Avenue, NW, Washington, District of Columbia, 20005-4213.

Q2. On whose behalf are you testifying in this proceeding?

A2. I am testifying on behalf of California-American Water Company (“California American Water”).

Q3. What is your educational and professional background?

A3. I graduated from the Kansas State University with a Bachelor of Science degree in Business Administration, with an emphasis in accounting, in 1987, and a Masters of Science, with an emphasis in accounting, in 1988. After completion of my Masters of Accounting, I joined Deloitte Tax LLP, formerly Deloitte Haskins & Sells. In 2012, I joined Ernst & Young LLP as an executive director in the National Energy Practice. I am a Certified Public Accountant, licensed in the District of Columbia and in Virginia. I have

1 practiced public accounting for over 24 years. In my practice, I provide tax services to the  
2 regulated water, electric and gas utilities. I regularly assist clients with tax planning,  
3 supporting and explaining tax reporting positions, and tax return reviews. My experience  
4 includes providing advice on accounting for income taxes and performing tax provision  
5 reviews. In addition, I regularly consult with companies regarding tax accounting and its  
6 impact on the rate setting process as well as compliance with the normalization rules.  
7 Additionally, I am a frequent speaker at industry seminars and conferences on the topic of  
8 tax accounting for rate-regulated utilities. I have spoken at the Edison Electric Institute  
9 tax committee meetings and the American Gas Association tax committee meetings in  
10 addition to other industry meetings.

11  
12 **II. PURPOSE OF REBUTTAL TESTIMONY**

13 Q4. What is the purpose of your rebuttal testimony in this proceeding?

14 A4. The purpose of my testimony is to explain the general tax principles and the potential tax  
15 consequences associated with the different proposals for financing the Monterey  
16 Peninsula Water Supply Project (“MPWSP” or “Project”). Since the parties have not  
17 agreed to pursue a specific financing proposal at this time, my testimony does not offer an  
18 opinion on the actual tax consequences of any specific proposal. Rather, I will discuss the  
19 potential tax consequences of certain proposals.

20  
21 **III. OVERVIEW**

22 Q5. Can you explain your understanding of the financing proposals?

23 A5. Yes, each proposal contains two to four elements, the sum of which will fund the Project.  
24 The first element, is the equity component, which represents a direct investment in the  
25 Project by California American Water. The second element is Surcharge 2, which is the  
26 portion of the Project financed through a direct contribution of funds from customers.<sup>1</sup>

27 <sup>1</sup> See generally the Direct Testimony of David P. Stephenson filed April 23, 2012, Sections IV, V, and VI. The  
28 Division of Ratepayer Advocates (“DRA”) proposes certain changes to Surcharge 2. See generally the DRA Report  
on California-American Water Company’s Application For The Monterey Peninsula Water Supply Project, A.12-04-  
307683766.1

1 The third element is the debt component, which is the portion of the Project funded by  
2 borrowed funds. The fourth element involves the public agency financing proposals,  
3 which involve a proposed “contribution” of funds to California American Water by a  
4 public agency such as the Monterey Peninsula Water Management District (“MPWMD”),  
5 a Special Purpose Entity (an “SPE”) established by a governmental entity or another  
6 governmental entity.

7  
8 Note that I use the term “contribution” in a non-technical sense when discussing the  
9 public agency financing proposals. As explained later in this testimony, and in Michael  
10 Barrett’s testimony, the proceeds California American Water receives from the public  
11 agency may be either sales proceeds or loan proceeds and the classification of those  
12 proceeds may have significant tax and accounting consequences.

13  
14 Q6. Can you explain the public agency financing proposals?

15 A6. Mr. Larkins, on behalf of MPWMD, offers several public agency financing proposals.<sup>2</sup>  
16 Specifically, Mr. Larkins recommends: (1) that California American Water engage in tax-  
17 exempt securitization borrowing; or (2) that California American Water engage in  
18 traditional tax-exempt borrowing through the issuance of tax-exempt Certificates of  
19 Participation (“COPs”) by MPWMD.<sup>3</sup>

20  
21 The testimonies of Mr. Larkins, Mr. Stoldt (also on behalf of MPMWD), and DRA all  
22 assume that the use of tax-exempt securitization borrowing and traditional tax-exempt  
23 borrowing through the issuance of tax-exempt COPs by MPWMD would be treated as a

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24 019 filed February 22, 2013, Chapter 6. Please note that this contribution from customers is distinct from the public  
agency “contribution” that I also discuss in my testimony.

25 <sup>2</sup> See generally the Direct Testimony of Robert Larkins, filed February 22, 2013. Mr. Larkin’s testimony indicates  
26 that his alternatives are designed to reduce or replace the portion of the Project funded by Surcharge 2 but it appears  
27 that he also intends for his alternatives to reduce or replace portions of the debt component proposed by California  
American Water as well.

28 <sup>3</sup> Mr. Stoldt, on behalf of MPWMD, also discusses tax-exempt securitization borrowing and tax-exempt Certificates  
of Participation in detail. See generally the Direct Testimony of David J. Stoldt, filed February 22, 2013.

1 public agency “contribution” for ratemaking purposes. According to MPWMD and DRA,  
2 if those alternatives are considered public agency “contributions,” the portion of the  
3 Project funded by either of those methods would be excluded from the rate base as well as  
4 the book basis of the Project. As I will explain, there is uncertainty about tax treatment of  
5 these alternatives. If the “contribution” proceeds are subject to federal and state income  
6 tax, the amount available as a cost offset to rate base will be reduced by 40% or more.  
7

#### 8 **IV. TAXATION AND THE PUBLIC AGENCY FINANCING PROPOSALS**

9 Q7. Can you briefly explain the tax-exempt securitization borrowing proposed by MPWMD?

10 A7. Yes, under the proposed tax-exempt securitization borrowing, the California legislature  
11 would authorize the California Public Utilities Commission to issue a financing order.  
12 Pursuant to the financing order, California American Water would acquire an intangible  
13 property right authorizing it to impose and collect a non-bypassable surcharge on  
14 California American Water customers sufficient to pay-off tax-exempt debt issued by a  
15 public agency. California American Water would sell the intangible property right to the  
16 public agency in exchange for the proceeds of debt issued by the agency. California  
17 American Water then collects the non-bypassable surcharge from its customers and remits  
18 the proceeds to the public agency, which uses the proceeds to service the debt.  
19

20 Q8. Can you briefly explain the traditional tax-exempt borrowing through the issuance of tax-  
21 exempt COPS by MPWMD?

22 A8. Yes, under this proposal, California American Water effectively sells an intangible right,  
23 participation in a revenue stream, to a public agency in exchange for proceeds of COPS  
24 issued by the public agency. California American Water then collects a surcharge from its  
25 customer and remits the surcharge proceeds to the public agency, which uses the proceeds  
26 to service the COPS.  
27

28 Q9. Can you summarize the public agency financing proposals?

1 A9. Yes, in both instances, California American Water sells an intangible right to a public  
2 agency in exchange for the proceeds of a tax-exempt debt issued by the public agency. In  
3 addition, in both instances, California American Water collects a surcharge from its  
4 customers that it remits to the public agency and the public agency uses those proceeds to  
5 service the debt or the COPs. As I understand them, the proposals exclude the portion of  
6 the Project funded through the public agency “contribution” from rate base.

7  
8 It is important to note that in explaining the public agency financing proposals, I use the  
9 words “sell” and “contribution” in a non-technical sense. Because the public agency  
10 financing proposals are vague, it is not clear whether California American Water is selling  
11 an intangible right to a future revenue stream to the public agency or whether California  
12 American Water is issuing debt secured by a future revenue stream to the public agency.  
13 As I will explain, whether the IRS views the proceeds that California American Water  
14 receives from the public agency as proceeds from the sale of an intangible asset or as  
15 securing a debt of the public agency, will determine the federal income taxation of the  
16 funds. My colleague Michael Barrett will explain that whether California American  
17 Water sells the intangible asset to, or uses the asset to secure a debt of, the public agency  
18 also has significant financial accounting consequences.

19  
20 Q10. Can you explain the tax treatment of the funds received by California American Water  
21 from the public agency?

22 A10. Yes, unless an exception applies, the general rule under Internal Revenue Code (the  
23 “IRC”) § 61(a) and the related regulations is that the proceeds California American Water  
24 receives from the public agency would be included in California American Water’s gross  
25 income for tax purposes.

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1 Q11. Are there any exceptions to the general rule that would exclude the funds California  
2 American Water receives from the public agency from California American Water’s  
3 taxable income?

4 A11. Yes, there are two exceptions to the general rule of IRC § 61(a). First, in certain limited  
5 instances, the funds may be characterized as Contribution In Aid of Construction (a  
6 “CIAC”) to a water utility. Second, in other limited instances, the Internal Revenue  
7 Service may treat the funds as loan proceeds, which are excluded from gross income and,  
8 thereby, excluded from taxable income.

9  
10 Q12. Can you explain the CIAC exception?

11 A12. Yes, IRC § 118(c) excludes a CIAC to a water utility from the utility’s taxable income if  
12 the CIAC meets a series of detailed requirements provided in IRC § 118(c).

13  
14 Q13. Would the funds received by California American Water from the public agency qualify  
15 for the CIAC exception in IRC § 118?

16 A13. The funds received by California American Water from the public agency are probably  
17 not CIAC under IRC § 118(c). In Private Letter Ruling (“PLR”) 200747008<sup>4</sup> the IRS held  
18 that funds received by a regulated utility from a public agency were not non-shareholder  
19 contributions to capital under IRC § 118 because the public agency intended to have its  
20 investment repaid, plus interest. The financing mechanism through which the utility in  
21 PLR 200747008 received funds from a public agency was similar to the public agency  
22 contributions proposed in this case.

23  
24 PLR 200747008 stands for the proposition that whether a distribution of funds is a  
25 contribution for purposes of IRC § 118 depends on the transferor’s intent. In PLR  
26 200747008, the IRS concluded that the public agency did not intend to contribute funds to

27  
28 <sup>4</sup> PLR 200747008 (Issued August 28, 2007).



1 the utility because it intended to have its investment repaid and the utility enacted a  
2 surcharge on its customers and used the proceeds of that surcharge to repay the public  
3 agency's investment.

4  
5 Q14. Would the IRS apply PLR 200747008 to the public agency "contributions" proposed in  
6 this case?

7 A14. Not necessarily, it is important to understand that the law in this area is uncertain and that  
8 PLR 200747008 only binds the IRS to provide a specific tax treatment to a specific  
9 taxpayer based on a specific set of facts. PLR 200747008 provides insight into how the  
10 IRS may view the public agency contributions proposed in this case but it does not require  
11 the IRS to treat the public agency contributions proposed in this case in a certain manner.  
12 Nevertheless, based on the guidance provided in PLR 200747008, I believe it is likely that  
13 the IRS would not consider the funds California American Water receives from the public  
14 agency to be a "contribution" for tax purposes because the public agency intends that  
15 California American Water pay back the funds with interest.

16  
17 Q15. What are the general tax and ratemaking consequences to California American Water if  
18 the conclusion in PLR 200747008 applies?

19 A15. If the conclusion in PLR 200747008 applies to the proposed public agency  
20 "contributions," the funds California American Water receives from the public agency  
21 would not be a tax-exempt contribution for federal income tax purposes. Thus, California  
22 American Water would include the funds received from the public agency in its gross  
23 income, and, thereby, its taxable income, unless some other exclusion applies.

24  
25 Q16. If the funds received by California American Water are not a non-taxable contribution  
26 under IRC § 118, would the IRS treat the funds as non-taxable loan proceeds?  
27  
28

1 A16. The answer to this question is uncertain. Revenue Procedure (“Rev. Proc.”) 2002-49<sup>5</sup> and  
2 Rev. Proc. 2005-62<sup>6</sup> created a “safe-harbor” for the treatment of certain legislatively  
3 authorized transactions entered into by a utility in which legislation permits a utility to  
4 recover certain specified costs through a surcharge based on consumption by its  
5 customers. If a proposed public agency “contribution” falls under the safe-harbor, the IRS  
6 may treat the funds received by California American Water as non-taxable loan proceeds.  
7 That said, the safe-harbor is extremely narrow and the IRS will not issue rulings on  
8 whether a taxpayer meets the safe-harbor’s requirements.<sup>7</sup> Therefore, even if a proposed  
9 public agency “contribution” appears to meet the safe-harbor’s requirements, California  
10 American Water cannot be certain that the IRS will not subject the funds it receives from  
11 the public agency to federal income taxation.

12  
13 Q17. Can you explain the safe-harbor provided by these revenue procedures?

14 A17. Yes. For purposes of brevity, I will confine my discussion to Rev. Proc. 2005-62. Rev.  
15 Proc. 2005-62 applies to an investor owned public utility that, pursuant to specified cost  
16 recovery legislation, receives an irrevocable financing order from a state agency that  
17 determines the amount of certain specified costs the utility may recover through  
18 qualifying securitization of an intangible property right created by the special legislation.

19  
20 Rev. Proc. 2005-62 treats the issuance of bonds or COPs secured by the intangible  
21 property right to collect a surcharge from customers as an obligation of the utility. In  
22 other words, if the public agency contribution meets the requirements of Rev. Proc. 2005-  
23 62, the IRS treats the funds received by California American Water from the public  
24 agency as loan proceeds, which are not included in its taxable income.

25  
26 \_\_\_\_\_  
<sup>5</sup> Rev. Proc. 2002-49 (Issued July 22, 2002).

27 <sup>6</sup> Rev. Proc. 2005-62 (Issued September 12, 2005).

28 <sup>7</sup> Rev. Proc. 2009-3, § 3.01(3) (Issued January 5, 2009).

1 Q18. Can you briefly explain the requirements a utility must meet to qualify for the safe-harbor  
2 in Rev. Proc. 2005-62?

3 A18. Yes, first, the utility must be an investor-owned public utility subject to the regulation of a  
4 state public utility commission. Second, a state legislature must enact specified cost  
5 recovery legislation that permits the utility to recover certain costs. Rev. Proc. 2005-62  
6 provides a list of detailed criteria that the legislation must meet. Third, the utility must  
7 participate in a qualifying securitization, defined in Rev. Proc. 2005-62. It is important to  
8 understand that if the legislation does not meet all of the criteria and/or the utility does not  
9 participate in a qualifying securitization, the safe-harbor does not apply and the funds are  
10 considered taxable income.

11  
12 Q19. Does the proposed tax-exempt securitization alternative qualify for the safe-harbor under  
13 Rev. Proc. 2005-62?

14 A19. Since the details of the proposed tax-exempt securitization alternative are not final, I  
15 cannot opine on whether it meets the requirements of Rev. Proc. 2005-62. I can say that  
16 the tax-exempt securitization alternative as outlined in Mr. Stoldt's memorandum<sup>8</sup> does  
17 not appear to meet all the qualifications of Rev. Proc. 2005-62. For example, among other  
18 things, Rev. Proc. 2005-62 requires that a financing entity that is wholly owned, directly  
19 or indirectly, by the utility issue the debt.

20  
21 Q20. Does the proposed "traditional" tax-exempt borrowing alternative qualify for the safe-  
22 harbor under Rev. Proc. 2005-62?

23 A20. Since the details of the traditional tax-exempt borrowing alternative are not final, I cannot  
24 opine on whether it meets the requirements of Rev. Proc. 2005-62. I can say that the  
25 traditional tax-exempt borrowing alternative as outlined in Mr. Stoldt's memorandum<sup>9</sup>  
26 does not appear to meet all the qualifications of Rev. Proc. 2005-62. For example, among

27 <sup>8</sup> Direct Testimony of David J. Stoldt, Exhibit WD-1, filed February 22, 2013.

28 <sup>9</sup> Direct Testimony of David J. Stoldt, Exhibit WD-1, filed February 22, 2013.

1 other things, Rev. Proc. 2005-62 requires that a financing entity that is wholly owned,  
2 directly or indirectly, by the utility issue the debt. Furthermore, even though Rev. Proc.  
3 2005-62 purports to apply to COPs in certain instances, I am not certain the IRS would  
4 stand by that language.

5  
6 Q21. Can you describe the general tax and ratemaking consequences if the public agency  
7 “contributions” do not qualify for the Rev. Proc. 2005-62 Safe-Harbor?

8 A21. Yes, the funds received by California American Water would not be considered a tax-  
9 exempt contribution for federal income tax purposes. Thus, the proceeds California  
10 American Water receives from the financing entity are subject to federal and state income  
11 taxes.

12  
13 Q22. Is there any way to be certain that the funds received by California American Water will  
14 not be subject to federal income tax?

15 A22. No, the IRS will not issue a private letter ruling in circumstances involving any investor  
16 owned utility seeking cost recovery through (i) the creation of an intangible property right;  
17 (ii) the transfer of that intangible property right; or (iii) the securitization of the intangible  
18 property right.<sup>10</sup> Specifically, the IRS will not issue a ruling on whether the funds  
19 received by the utility from the public agency should be included in the utility’s gross  
20 income, the taxable year the funds should be included in the utility’s gross income (if  
21 any), and the determination of the amount of income that should be included in the  
22 utility’s gross income (if any). Nor will the IRS issue a ruling on whether the payments to  
23 the utility are a loan proceeds for federal tax purposes.

24  
25 Q23. Based on your experience, would you recommend that the CPUC order California  
26 American Water to implement one of the public agency financing proposals?

27  
28 <sup>10</sup> Rev. Proc. 2009-3, § 3.01(3) (Issued January 5, 2009).

1 A23. ~~No.~~ Not at this time. Based on the information available at this time, I have concerns  
2 about the viability of the proposed public agency financing proposals because there is  
3 significant uncertainty in this area of tax law and the potential consequences, federal and  
4 state income taxation of the proceeds California American Water receives from the public  
5 agency “contributions,” are too severe and would undermine the objectives of California  
6 American Water and the Commission. Moreover, the IRS will not issue guidance on how  
7 it will tax the funds received by California American Water from the public agency. I am  
8 particularly concerned about the COP financing alternative because I believe that an  
9 attempt to meet the safe-harbor would be disadvantageous as the safe-harbor is extremely  
10 narrow and the costs and difficulty associated with structuring a transaction to fall within  
11 the safe-harbor are significant, especially considering that the IRS will never issue a  
12 binding ruling that the taxpayer complies with the safe-harbor.

13  
14 Q24. Are there any other alternatives that would give more certainty to the public agency  
15 contributions?

16 A24. Yes, actual CIACs in which a state and local government, developer or another party  
17 provides funds without a repayment obligation, i.e., a CIAC that qualifies under IRC §  
18 118(c), are common in the water utility industry. The tax law is clear that a CIAC  
19 provided to a water utility taxable so long as the tax basis of the asset is reduced by the  
20 amount of the contribution and certain other requirements are met. Thus, a government  
21 could obtain funds through bonds securitized by increased property taxes or another  
22 revenue source and contribute those funds to California American Water. So long as  
23 California American Water is not obligated to repay the contribution and the other  
24 requirements of IRC § 118(c) are met, the IRS would not view the contribution as either  
25 the sale of a revenue stream or a debt. In addition, the IRS will provide additional  
26 certainty in the form of a private letter ruling that the contribution is not subject to tax.

1 **V. CONCLUSION**

2 Q25. How would you recommend the Commission and the interested parties resolve the tax  
3 issues associated with the public agency financing proposals?

4 A25. The Commission and the parties should be aware that the tax consequences of the public  
5 agency financing proposals may have a significant impact on customer's rates and should  
6 account for that impact in their models. Because of the uncertainty surrounding the tax  
7 treatment of the public agency public agency financing proposals and the costs and  
8 difficulty associated with meeting the safe-harbor, I would recommend that the  
9 Commission consider if other financing alternatives, such as a qualified IRC § 118(c)  
10 CIAC, might be more appropriate.

11  
12 Q26. Does this conclude your rebuttal testimony?

13 A26. Yes, it does.  
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# ATTACHMENT 1

Name:	Michael J Reno
<i>Executive Director, Tax Services National Tax Ernst &amp; Young LLP</i>	
<p>Mike is an Executive Director with the National Tax Department based in Washington DC. He serves as a Power and Utility Industry specialist. Mike has more than 24 years experience and joined Ernst &amp; Young in 2012. He is focused on providing tax services to the energy industry and has experience serving regulated electric and gas utilities including multinationals and foreign-owned companies. He has regularly assisted clients in the areas of planning, supporting and explaining tax reporting positions and by performing tax return reviews. He experience includes providing advice with respect to accounting for income taxes and performing tax provision reviews. In addition, he regularly consults with companies regarding tax accounting and its impact on the rate setting process as well as compliance with the normalization rules. His work with utility companies has also included consultation and representation with respect to IRS controversies; drafting/reviewing Form 3115s (Application for Change in Accounting Method), including meeting with IRS officials; performing deferred tax studies; and consulting related to investment tax credits, Treasury grants and production tax credits for alternative energy projects. In addition, Mike has also been involved in due diligence with respect to merger and acquisitions involving power, utility and alternative energy companies.</p> <p>Mike received a BS and Masters in Accounting from Kansas State University.</p>	



**Michael J. Reno | Executive Director | National Tax**

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