

## Calculation of the Capital-Related Revenue Requirements for WCCP Capital Expenditures

### A. Capital-Related Revenue Requirement

The capital-related revenue requirement recorded in the Wildfire Risk Mitigation Balancing Account (WRMBA), which is based on Plant-In-Service, includes depreciation expense, applicable taxes, SCE's applicable return associated with SCE's capital expenditures, and interest.

#### 1. Capital Additions and Plant-In-Service

Capital expenditures are not included in rate base until the assets are ready for service. The accounting for this is prescribed by the Federal Energy Regulatory Commission (FERC). When incurred, capital expenditures record to FERC Account 107, CWIP.<sup>1</sup> While in CWIP, costs typically accrue capitalized financing costs, referred to as AFUDC,<sup>2</sup> at rates based on a prescribed formula in the FERC Uniform System of Account (USOA). Once the assets are ready for service, cumulative costs, including both corporate overheads and AFUDC, are transferred from CWIP to Plant-In-Service as Capital Additions. At this same time, AFUDC accruals are stopped, the cumulative balance is included in rate base, and depreciation expense begins.

##### a) Depreciation Expense

To provide service to its customers, SCE incurs expenses and makes capital expenditures. Generally Accepted Accounting Principles (GAAP) and the application of FERC USOA govern whether a particular cost should be capitalized or expensed. While SCE earns a return on its capital assets by applying an authorized rate of return to its rate base, SCE's return of investors' capital occurs through depreciation expense. Depreciation expense, recorded in the WRMBA, is accrued at depreciation rates authorized in SCE's applicable General Rate Case (GRC). Depreciation provides

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<sup>1</sup> "CWIP" stands for "Construction-Work-In-Progress."

<sup>2</sup> "AFUDC" stands for "Allowance for Funds Used During Construction."

a mechanism for the recovery of the original cost of the capital expenditures, and the future cost to retire those assets over their useful life. Depreciation expense is calculated, starting from the date Capital Additions are recorded as Plant-In-Service. The recorded Plant-In-Service is the base to which the annual depreciation rate is applied.

**b) Income Taxes**

The recovery of costs recorded in SCE's WRMBA includes the related income tax expense. For ratemaking purposes, income tax expense is a function of revenue requirement, cost-of-service amounts, and capital expenditures, as adjusted to comply with income tax rules. Total income tax expense is equal to the current federal and state income tax expense plus the deferred income tax expense.

Current income tax expense is computed by multiplying taxable income by the applicable income tax rate. Taxable income is computed by applying Income Tax Adjustments to book net operating revenue to conform to federal and state tax rules.

To compute the deferred income tax expense, Income Tax Adjustment amounts that are subject to the tax normalization method of accounting treatment required by Internal Revenue Code (IRC) Section 168(i)(9) or that are authorized by the Commission to be normalized (hereinafter simply referred to as "normalization") are multiplied by the applicable income tax rate. The tax normalization rules of the IRC and related guidance state that, for ratemaking purposes, if the depreciation method permitted by the IRC differs from the book depreciation method used for cost-of-service purposes, then a taxpayer is required to credit the resulting amount of taxes deferred to a reserve for deferred taxes, i.e., to an accumulated deferred income tax (ADIT) balance sheet account that is included in the adjustment to rate base.

Income Tax Adjustments not subject to normalization are accorded “flow-through” tax treatment. Under flow-through treatment, any tax benefit or detriment associated with Income Tax Adjustments flow directly into rates without any offsetting deferred income tax expense or benefit. Only the current income tax expense would be affected by these Income Tax Adjustments. Accordingly, under flow-through ratemaking, tax positions that reduce current income tax expense benefit current ratepayers as SCE claims these accelerated tax deductions.

Primarily, there are three types of Income Tax Adjustments used to derive income tax expense for purposes of calculating WRMBA-related revenue requirements: tax depreciation, tax repairs deduction, and cost of removal.

**(1) Tax Depreciation**

For Federal income tax purposes, assets placed in service after 1980 are depreciated using either the Accelerated Cost Recovery System (ACRS) or the Modified Accelerated Cost Recovery System (MACRS) under IRC Section 168. ACRS and MACRS generally provide greater annual depreciation deductions in the early years of an asset’s life than typically allowed for financial reporting (i.e., “book”) purposes. SCE utilizes ACRS/MACRS depreciation to the extent permitted by the IRC and has reflected these depreciation amounts in this proceeding. Differences between tax depreciation under IRC Section 168 and depreciation expenses for ratemaking and book purposes are subject to normalization.

California has never adopted ACRS/MACRS depreciation and instead permits the asset depreciation range (ADR) methodology, which typically includes straight-line, the sum of the years-digit, or other acceptable declining balance approach over its depreciation period. The ADR rules are not subject to the normalization requirements of IRC Section 168(i)(9). Therefore, flow-through tax treatment applies to these state tax depreciation differences, and also to pre-1981 (i.e., pre-MACRS/ACRS) federal tax depreciation adjustments.

**(2) Tax Repairs Deduction**

This Income Tax Adjustment reflects the book-tax difference for expenditures that are deductible as repairs for tax purposes when incurred but capitalized for book purposes. For tax purposes, SCE applies the repair deduction guidance in IRS Revenue Procedures 2011-43 and 2013-24. The notable feature of these revenue procedures is these procedures define “units of property” more broadly than the applicable regulatory accounting guidance. These more expansive unit of property definitions generally result in the deduction of expenditures for tax purposes that typically are capitalized for book purposes. The IRC does not require repair deductions be normalized. Therefore, SCE utilizes flow-through tax treatment for these differences.

**(3) Cost of Removal**

Removal costs are deductible for income tax purposes when they are incurred. For book purposes, removal costs are estimated and accrued over the life of the asset as a component of book depreciation expense. Removal costs associated with assets depreciable under IRC Section 168 are accorded normalization treatment, whereas removal costs associated with assets not depreciable under IRC Section 168 are generally accorded flow-through tax treatment.

**c) Property Taxes**

SCE has an obligation to pay ad valorem (property) taxes to the taxing authorities of each state in which taxable property is located. Taxable property is derived from the capital expenditures, net of accumulated depreciation and deferred taxes and adjusted by an assessment value ratio. Property tax expense is a function of taxable property and the applicable property tax rate.

**d) Return on Rate Base**

SCE calculated the rate of return on rate base, using the currently authorized rate of return of 7.87 percent, as approved in Decision (D.)22-12-031 (as

corrected in D.23-01-002) and Advice 5120-E. On a recorded basis, SCE will update its rate of return on rate base to be consistent with the then-current authorized rate of return.

e) **Interest**

The balance recorded in the WRMBA accrues monthly interest, using the three-month non-financial commercial paper rate, as specified in SCE's Commission-approved WRMBA tariff.