AP / NB

Decision No. 83778

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of General Telephone Company of California, a corporation, for authority to increase its rates and charges for telephone service.	Application No. 51904 (Petitions for Rehearing Filed November 26, 1971 and December 6, 1971)
Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of General Telephone Company of California.	Case No. 9100

(Appearances Are Listed In Appendix A)

OPINION ON LIMITED REHEARING

In Decision No. 79367 dated November 22, 1971 this Commission established new rates for General Telephone Company of California (General). In that decision the Commission found reasonable for the purpose of authorizing rate increases a rate of return of 8.3% on General's intrastate rate base of $1,142,635,000 for the test year 1970, which required an increase in General's annual intrastate gross revenues amounting to $40,288,000. State and federal income taxes for the test period were computed using accelerated depreciation with normalization in conformity with Interim Decision No. 77984 dated November 24, 1970 in Application No. 51774 of The Pacific Telephone and Telegraph Company (Pacific) and made applicable to General in this proceeding by Interim Decision No. 78133 dated December 22, 1970.

The record leading to Decision No. 77984 consisted of oral argument only. The Commission refused to accept any evidence and struck evidence previously received on the subject of accelerated depreciation.

On November 26, 1971 the California Supreme Court annulled Interim Decision No. 77984 (City and County of San Francisco v Public Util. Com. (1971) 6 C 3d 119) stating: "For failure to consider lawful alternatives in calculation of federal income tax expense the decision of the Commission must be annulled. *** Upon further consideration the Commission should consider whether to adhere to the 1968 method of determining federal income tax expense and whether to adopt the accelerated depreciation and normalization method adopted by the decision before us. Because these methods involve fictitious allowances for tax expense and because they provide results which in the light of current federal income tax law are either harsh on the utility or the ratepayers, the Commission may also consider alternative approaches which strike a balance between these two extremes." (6 C 3d at 130.)

On petitions filed by the cities of Long Beach and Los Angeles on or about November 26, 1971, and December 6, 1971, respectively, the Commission, by Decisions No. 79431 dated November 30, 1971 and No. 79532 dated January 4, 1972, granted rehearing of Decision No. 79367 limited to the issue of the appropriate allowance for tax depreciation to be adopted for rate-making purposes. Requests for a stay of Decision No. 79367 were denied and the increased rates authorized were made subject to possible refund. The rates authorized by the decision became effective on December 12, 1971. Decision No. 79367 is now final in all respects other than to the limited extent specified in the rehearing order.

After due notice, rehearing was held before Commissioner Symons and Examiner Main, evidence was adduced, briefs were filed, and the Commission appeared fully informed to determine the appropriate tax depreciation method to be adopted for ratemaking purposes and to determine possible refunds. The issues requiring resolution were:

I - Would General qualify for accelerated depreciation under federal tax law if the Commission were to use other than a normalization method of accounting in fixing General's rates?

II - Should General's state corporation franchise tax expense be computed on the basis of accelerated tax depreciation with flow-through?

III - Should a penalty be levied against General if General was imprudent in not adopting accelerated depreciation with flow-through when this option was available as part of its federal tax basis?

IV - Because the initial year effects of accelerated depreciation are atypical of ensuing years, what adjustments, if any, should be made for ratemaking purposes?

V - Should General's current rates be reduced because of the reduction in revenue requirement?

VI - Are refunds in order and if so, in what amount?

However, this matter was not submitted for decision at that point early in 1973. Instead it was held open to encompass certain impending developments. In this regard, on or before

May 31, 1973, a pivotal addition to proposed federal income tax regulations was made which, if adopted, would contravene an indicated disposition of Issue IV above. The proposed regulations concern, of course, the reasonable depreciation allowance for public utility property (I.R.C. 1954, Section 167(l)).1/

It was not until May 29, 1974 that these regulations, with certain amendments, were approved by the Commissioner of Internal Revenue. Shortly thereafter, we made provision in several proceedings, including the Pacific rate case, Application No. 53587, et al, and this rehearing, for briefs to be filed no later than July 3, 1974 on matters raised by the final regulations.

On July 23, 1974, the Commission issued Decision No. 83162 in the Pacific rate case. Issues I, II, and IV, enumerated above, were also issues in the Pacific rate case. These issues will be resolved herein in consonance with the determinations made in Decision No. 83162.

Another further development since the rehearing was held bears directly on Issues V and VI. It is Decision No. 81824 dated August 28, 1973 in General's wage offset case, Application No. 53164. That decision has such bearing through its authorizing rates designed to bring General's intrastate revenues, including settlements, into balance, based on the 1970 level of operations, with an allowed 8.3 percent rate of return.

This matter, after those further developments, now stands ready for decision.

1/ (l) indicates lower case "L" throughout this decision.

Issue I - Would General qualify for accelerated depreciation under federal tax law if the Commission were to use other than a normalization method of accounting in fixing General's rates?

The pertinent provisions of the federal tax statute (26 U.S.C. Section 167(l)) read:

"( ) Reasonable allowance in case of property of certain utilities.

(1) Pre-1970 public utility property.

(A) In general. In the case of any pre-1970 public utility property, the term 'reasonable allowance' as used in subsection (a) means an allowance computed under

(i) a subsection (l) method, or

(ii) the applicable 1968 method for such property.

Except as provided in subparagraph (B), clause (ii) shall apply only if the taxpayer uses a normalization method of accounting.

(B) Flow-through method of accounting in certain cases. In the case of any pre-1970 public utility property, the taxpayer may use the applicable 1968 method for such property if

(i) the taxpayer used a flow-through method of accounting for such property for its July 1969 accounting period, or

(ii) the first accounting period with respect to such property is after the July 1969 accounting period, and the taxpayer used a flow-through method of accounting for its July 1969 accounting period for the property on the basis of which the applicable 1968 method for the property in question is established.

(2) Post-1969 public utility property. In the case of any post-1969 public utility property, the term 'reasonable allowance' as used in subsection (a) means an allowance computed under

(A) a subsection (l) method.

(B) a method otherwise allowable under this section if the taxpayer uses a normalization method of accounting, or

(C) the applicable 1968 method, if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period.

* * *

"(3)(D) Applicable 1968 method. The term 'applicable 1968 method' means, with respect to any public utility property.

(i) the method of depreciation used on a return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969,

(ii) if clause (i) does not apply, the method used by the taxpayer on a return for the latest taxable year for which a return was filed before August 1, 1969, with respect to its public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service, or

(iii) if neither clause (i) nor (ii) applies, a subsection (l) method.

* * *

(3)(G) Normalization method of accounting. In order to use a normalization method of accounting with respect to any public utility property.

(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for rate-making purposes and for reflecting operating results in its regulated books of account, and

(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

Because General was not using a flow-through method for its July 1969 accounting period (26 U.S.C. 167(l)(1)(B), (l)(2)(C)) nor for the latest taxable year for which a return was filed before August 1, 1969 (167(l)(3)(D)) it cannot qualify for accelerated depreciation under a flow-through method. For its pre-1970 property General is restricted to the use of straight-line depreciation because its "applicable 1968 method" is also a "subsection (l) method" (167(l)(1)(A)). For its post-1969 property General must also use straight-line depreciation unless it normalizes its accelerated tax depreciation both for ratemaking purposes and in its regulated books of account (167(l)(2)(A) and (B); (l)(3)(G)).

The point at issue is whether regulatory action can affect General's eligibility to use accelerated tax depreciation for its post-1969 property. General contends that it would not qualify for such accelerated depreciation if the Commission were to use other than a normalization method of accounting in fixing rates. Only the staff, among all the parties to this proceeding, rigorously disputes this contention. In so doing the staff proffers an interpretation of subparagraph 167(l)(3)(G) which would render its application independent of the ratemaking treatment accorded by a regulatory agency. The staff stresses that this subparagraph applies only to the taxpayer and asserts that "Congress studiously omitted any reference to action by state regulatory bodies in order to avoid ... constitutional arguments ...".

In its opening brief the staff sets out its interpretation through the following discussion:

> "The key provisions are Subsections (l)(3)(G)(i) and (ii) for they define how a taxpayer can comply with the normalization method of accounting required by 167(l)(2)(B). Both (l)(3)(G)(i) and (ii) require the taxpayer to do certain things. There is absolutely no reference to action by any state regulatory agency. The taxpayer must, for example, use the same method to compute its tax expense and depreciation expense for purposes of establishing its cost of service for rate-making purposes or the taxpayer must make adjustments to a reserve in computing its cost of service for rate-making purposes. General has selected option (ii) and has made adjustments to a reserve in its showing before the Commission herein. That is all that is required of General and it thus is in literal compliance with the provisions.

> "General asserts that something more is required; that unless this Commission sets rates on the basis of normalization General would not comply with (ii). But the statute does not say what General wants it to say. Congress could easily have so provided. It could have said 'If a state regulatory agency sets rates on a basis other than set forth herein the taxpayer will not be allowed to take accelerated depreciation.' or Congress could have just precluded state regulatory agencies from setting rates on a flow-through basis. Congress did neither."

Accordingly, the staff asserts that subsection 167(l) would in no way preclude General from taking accelerated depreciation even though its rates are based on flow-through and that subparagraphs (l)(2)(B) and (l)(3)(G) are clear and frank on their face and require no reference to legislative history. The staff further asserts that its interpretation does not lead to absurd consequences.

General characterizes the staff's interpretation of the statute as one of flow-through for rate-making purposes and normalization for tax purposes. It asserts that such an interpretation is unsupportable by any principle of statutory construction, runs counter to the interpretation by every regulatory agency, state and federal, that has considered the matter, and is contrary to the clear language of the statute. General argues in part as follows:

> "The Staff, however, has by its contrary interpretation of the statutory language raised an ambiguity, making resort to the legislative history a necessity. That the term 'establishing its cost of service for rate-making purposes' (26 U.S.C. 167(l)(3)(G)(i)) refers to the action of the regulatory body, not the taxpayer, is unequivocal in the Senate Report (U.S. Code Congressional and Administrative News 91st Congress, 1st Session, 1969, pp. 2205-2206):
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> > 'In all other cases, (other than flow-through) accelerated depreciation is to be permitted only if the utility normalizes the deferred income taxes. The taxpayer is permitted to

elect straight-line depreciation as to this new property. If the taxpayer seeks to use accelerated depreciation, the regulatory agency may permit it to normalize; if the regulatory agency does not, the taxpayer must use straight line depreciation.'

'The committee amendments provide that the requirement of normalizing is not met by simply normalizing the regulated books of account of the utility if these books of account may be ignored by the regulatory agency in setting rates. Under the committee amendments, while the regulated books of account are to be used as the basic source of information these books are not to control if the current rates of the utility are set by reference to the flow-through method. This is done because the use of flow-through in setting rates would produce the revenue loss the bill seeks to avert.'

"The contemporaneous interpretation of the language and the manner in which it is enforced by the Internal Revenue Service is found in Temporary Income Tax Regulations (Tax Reform Act of 1969, Paragraph 13.13, June 25, 1970, 35 F.R. 10518) as follows:

'(2) Normalization taxpayers. In the case of a taxpayer which did not use the flow-through method of accounting for its July 1969 accounting period or thereafter with respect to any of its public utility property, it will be presumed that such taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for rate-making purposes with respect to its post-1969 public utility property. The presumption described in the preceding sentence shall apply only in the absence of an expression of intent (regardless of the manner in which such expression of intent is indicated) by the regulatory agency (or agencies), having jurisdiction to establish the rates of such taxpayer, which indicates that the policy of such regulatory agency is in any way inconsistent with the use of the normalization method of accounting by such

> taxpayer or by a class of taxpayers of which such taxpayer is a member. The presumption shall be applicable on January 1, 1970, and shall, unless it is rebutted, be effective until an inconsistent expression of intent is indicated by such regulatory agency....'"2/

Our interpretation of Section 167(l) is in agreement with General's. As we read this tax statute it virtually has to appear implicit in subparagraphs 167(l)(2)(B) and (l)(3)(G) that the taxpayer's cost of service and rates for utility service, as established by the regulatory agency having jurisdiction, must reflect the normalization method of accounting if the taxpayer is to qualify under these subparagraphs to take accelerated tax depreciation for its post-1969 property. Simply put, the reason for this is that it would be pointless from the standpoint of tax revenue for only the taxpayer to normalize. In addition, unless both the utility taxpayer and the regulatory agency normalize, an absurd accounting requirement would result.

If compatible regulatory action were not implicit in these subparagraphs, the tax statute would fail to discriminate for post-1969 property between non-flow-through and flow-through taxpayers from the standpoint of tax revenue where the regulatory agency chooses to set rates on the basis of flow-through for a non-flow-through taxpayer. Such an inconsistency would be most unlikely as an intended outcome of the tax law as well as an

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2/ Superseded by Income Tax Regulations Section 1.167(l)- 1(h) prescribed by T.D. 7315, approved May 29, 1974, (39 FR 20194). Subparagraph (4)(ii) of Section 1.167(l) - 1(h) substantially embodies the quoted portion of the temporary regulation, however.

irrational departure from the concept of accelerated tax depreciation with normalization[3/] as it has been applied in utility regulation since the inception of accelerated depreciation in the 1950's.

In addition, in that case, the utility taxpayer's regulated books of account still would be required by clause (i) of subparagraph 167(l)(3)(G) to reflect operating results by the normalization method of accounting, even though the regulatory agency elects to employ the flow-through method in establishing the taxpayer's cost of service and rates for utility service.[4/] Thus, without such an implicit requirement controlling the eligibility of utility property for accelerated tax depreciation, clause (i) would not have the intended impact on taxes but would nevertheless impose the related accounting requirement. It is also unlikely that this would be an intended outcome of the tax statute. Not only then would it be an ineffective tax measure, but it would not be consistent with good accounting or regulatory

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3/ "Normalization" means that the utility's depreciation is determined on a straight-line method for its regulated books of account and for ratemaking purposes while its income taxes are computed by a faster method of depreciation and the difference between the taxes that would have been due under the straight-line method and those actually paid under the accelerated method are credited to a reserve to be used for the payment of income taxes at some time in the future when the taxes payable on an accelerated basis exceed the taxes payable on a straight-line basis, i.e., "the crossover point".

4/ To keep its regulated books of account on the flow-through method of accounting for its post-1969 property, the taxpayer would have to qualify to take accelerated tax depreciation under subparagraph 167(l)(2)(C), which would indicate that the taxpayer also qualifies under (l)(1)(B) to do so for its pre-1970 property.

practice, which requires a utility's accounting conform, where practicable, to the ratemaking treatment adopted by the regulatory agency.

In the staff's interpretation set out hereinabove of subparagraph 167(l)(3)(G), clause (ii) is construed to preclude imposition of this incompatible accounting requirement. This construction is wrong. The staff indicates that where clause (ii) is employed it renders inoperative clause (i). On the contrary clause (i) requires, independently of the operation of clause (ii), the taxpayer to use the same method of depreciation to compute both its tax expense and depreciation expense for, among other things, reflecting its operating results in its regulated books of account. Neither clause (i) nor clause (ii), incidentally, requires the taxpayer to make adjustments to a reserve for the express purpose, indicated by the staff, of computing the taxpayer's cost of service.

Attempts to interpret subparagraphs 167(l)(2)(B) and (l)(3)(G) in such a way as not to alter the taxpayer's eligibility thereunder, if its cost of service and its rates for utility service are established on a flow-through method by the regulatory agency having jurisdiction, are destined to result only in interpretations which do not carry out the purposes of Section 167(l). The flow-through method has a doubling-up effect in reducing the tax liability of companies such as General, affects tax revenues accordingly, and thus bears on a basic purpose of Section 167(l). (See page 16, below.) The record in this proceeding is clear concerning congressional intent or purpose here: Congress intended to stem a loss in tax revenues by preventing regulated utilities' switching to accelerated tax depreciation with flow-through.

Consistent with the foregoing analysis and our holding on the constitutional question about to be discussed, we conclude that General would not qualify for accelerated depreciation under federal tax laws if the Commission were to use other than a normalization method of accounting in fixing General's rates.

The staff argues in its brief that the interpretation of Section 167(l) necessary to reach this conclusion renders Section 167(l) unconstitutional; that is, in violation of the 10th Amendment of the United States Constitution.5/ In response General urges that Section 167(l) is within the taxing power of Congress (U.S. Const., Art. 1, Sec. 8, cl. 1)6/ as enlarged by the necessary and proper clause (U.S. Const., Art. 1, Sec. 8, cl. 18).7/ It is argued that the Supremacy clause thereby becomes operative and renders the Tenth Amendment inapplicable.8/

5/ The Tenth Amendment provides:

> "The powers not delegated to the United States by the Constitution, nor prohibited to it by the States, are reserved to the States respectfully, or to the people."

6/ Article 1, Section 8, cl. 1 grants Congress the:

> "...Power to lay and collect Taxes...to pay the Debts and provide for the common Defense and general Welfare of the United States...."

7/ Article 1, Section 8, cl. 18 empowers Congress:

> "To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers..."

8/ Article VI states in part that:

> "This Constitution, and the Laws of the United States which shall be made in pursuance thereof...shall be the supreme Law of the Land...any thing in the Constitution or Laws of any State to the Contrary notwithstanding...."

To see whether in enacting Section 167(l) Congress has exceeded its Constitutional authority to levy taxes and use tax policy to fortify economic activity, our analysis will focus upon the purposes of Section 167(l), the fundamental concept of a reasonable allowance for tax depreciation, and the extent to which Section 167(l) impinges upon the extensive regulatory scheme under which this Commission regulates the utilities under its jurisdiction. First, however, we should call attention to a further action of Congress bearing directly on the staff's far-reaching but tenuous presumption that Congress studiously omitted any reference in Section 167(l) to action by state regulatory bodies and it did so because the statute would be void in its face if such reference were included.

This further action, a part of the Revenue Act of 1971, reinstated with some revisions the investment tax credit (ITC) repealed by the Tax Reform Act of 1969. The ITC, now termed the job development investment tax credit, reduces current tax liability, is computed by applying a stated percentage (usually 4 or 7%) to the dollar amount of specified qualifying plant additions, and results in an outright tax savings as contrasted to accelerated tax depreciation which can result in tax deferrals. To the point is Section 46(e) of the Internal Revenue Code.

Section 46 (e) is explicit as to the rate-making treatment of the ITC required by regulatory agencies to prevent the credit from being disallowed.9/ As in the case of accelerated tax depreciation under Section 167(l), the ITC as a general rule will not be available on otherwise qualifying public utility property where all of the benefit from it would be flowed through currently to the consumer.

9/ Section 46(e)(4) Limitation --

"(A) . . . The requirements of paragraphs (1) and (2) regarding cost of service and rate base adjustments shall not be applied...to disallow the credit..before the first final determination which is inconsistent with paragraph (1) or (2)... Thereupon, paragraph (1) or (2) shall apply to disallow the credit...

"(B) ...a determination is a determination made with respect to public utility property...by a...commission or similar body described in subsection (c)(3)(B) which determines the effect of the credit allowed by section 38...

(i) on the taxpayer's cost of service or rate base for ratemaking purposes, or..."

Section 46(c)(3)

"(B) ...the term 'public utility property' means property used predominantly in the trade or business of the furnishing or sale of--

(i) electrical energy, water, or sewage disposal services,

(ii) gas through a local distribution system or

(iii) telephone service, telegraph service by means of domestic telegraph operations...

if the rates for such...have been established or approved...by a public service or public utility commission or other similar body of any State or political subdivision thereof..."

Proceeding now to our analysis, the purpose of Section 167(1) is to provide a reasonable depreciation allowance for utility property as a deduction in computing taxable income and to do this in such a way as to afford some protection to federal tax revenues. The fundamental basis of a reasonable depreciation allowance is "...the exhaustion, wear and tear (including...obsolescence)...of property..." (Section 167(a)). The concept of a reasonable allowance extends beyond this fundamental basis to regular or ratable depreciation as generally typified by the straight-line method and further extends to accelerated depreciation as typified by the double declining balance and the sum of the year-digits methods (Section 167(b)).

By and large straight-line depreciation in the case of utility property is responsive to the fundamental basis whereas accelerated depreciation for such property arbitrarily departs from that basis in order to provide substantially larger allowances in the earlier years of a depreciable asset's service life. The resultant reduction in tax liability in such earlier years from using accelerated instead of straight-line depreciation provides:

1) A source of internally generated funds, which can be used for plant modernization and expansion, if normalization is used; or
2) A doubling-up effect in reducing taxes to further reduce utility rates, if flowed through into those rates.

In explanation of this doubling-up effect, for each dollar of deferred taxes which is excluded from the total cost of service or revenue requirement under the flow-through method it is necessary to exclude an additional amount of $.92308 for federal income tax, based on the 48% tax rate, less any state income taxes associated with the resultant reduction in net pre-tax income. Stated another way, federal tax revenues are reduced directly as a result of the increased tax depreciation and further reduced because the increased tax depreciation results in an increase in net earnings after taxes which is reflected in a reduction in utility rates.

Congress has structured Section 167(l) to limit tax revenue losses by making flow-through a closed option available only to a regulated company whose property was on accelerated depreciation with flow-through just prior to the enactment of Section 167(l). The closure of this option, taken together with the legislative mandate this Commission operates under to establish just and reasonable rates, compels the conclusion that the statute in question effectively, albeit indirectly, requires this regulatory agency in ratemaking to normalize where probably it would otherwise use flow-through.

The staff argues that "It is unalterable that Congress cannot, through the guise of a Revenue Act, undertake to regulate activities which are reserved solely to the states." This, however, does not mean that Congress may not regulate through taxation for those purposes that are necessary to the raising of revenues. Indeed, the U.S. Supreme Court has upheld in numerous instances statutes wherein the tax imposed has some regulatory, suppressive, or restrictive effect.10/

10/ Lewis v United States (1955) 348 US 419, 99 L ed 475; United States v Kahriger (1953) 345 US 22, 97 L ed 754; United States v Sanchez (1950) 340 US 42, 95 L ed 47; Steward Machine Co. v Davis (1937) 301 US 548, 81 L ed 1279; Sonzinsky v United States (1937) 506, 81 L ed 722; J. W. Hampton Jr. & Co. v United States (1928) 276 US 394, 72 L ed 624; Nigro v United States (1928) 276 US 322, 72 L ed 600; Alston v United States (1927) 274 US 289, 71 L ed 1052; Florida v Mellon (1927) 273 US 12, 71 L ed 511; United States v Dormus (1919) 249 US 86, 63 L ed 493; McCray v United States (1903) 195 US 27, 49 L ed 78; Re Kollock (1897) 165 US 526, 41 L ed 813.

In the case of Section 167(1) there clearly is a direct relationship between its restrictive or regulatory nature and the tax revenues Congress seeks to preserve.

There is, however, another argument raised by the staff in the form of rhetorical questions which must be considered. Simply stated, the question is whether there are any limitations on the extent to which Congress may exercise its taxing powers in raising revenue.

Both the record in this case and past Commission decisions support the conclusion that the benefits flowing from accelerated depreciation are more properly characterized as tax savings rather than tax deferrals. Analyzing Section 167(1) in this light, it follows that Congress is requiring this Commission to recognize a greater tax expense for rate-making purposes than the utility is liable for under the tax statute. The requirement is imposed under the penalty of eliminating the accelerated depreciation option to the utility taxpayer if the regulatory body does not conform with the statutory requirements.

Stated another way, Congress has enacted a law which requires this Commission to recognize a tax expense based on a 48% tax rate in setting rates when, in fact, the utilities' effective tax rate is 38%.[11] If the Commission does not comply with this requirement, the effective tax rate of the utility is increased to 48%. The effect of such a requirement is the control of this Commission by Congress whereby ratepayers are required to pay higher rates (through higher tax expense for rate-making purposes) in order not to decrease the taxable revenues of the utility. Congress is using its power to

11/ The percentages used are arbitrary figures.

regulate the reasonable allowance for depreciation to produce this effect. Such power is obviously related to the collection of tax revenues and, therefore, not unlawful under the general analysis discussed above.

In addition, there is authority which supports the power of Congress to promote economic objectives through taxation (Cincinnati Soap Co. v United States (1937) 301 US 308, 81 L ed 1122; J. W. Hampton & Co. v United States, supra, (1928) 276 US 394, 72 L ed 624).

Indeed, as early as 1789 Congress enacted a tariff act which stated that:

> "It is necessary for the support of government, for the discharge of debts of the United States, and the encouragement and protection of manufacturers, that duties be laid on goods, wares, and merchandise imported." (1 Stat. 24.)

In Norman v Baltimore and Ohio R.R. Co. (1935) 294 US 240, 79 L ed 885 the Supreme Court upheld the validity of legislation prohibiting gold clauses in contracts. In explaining the constitutional source of this power the Court stated:

> "The broad and comprehensive national authority over the subjects of revenue, finance and currency is derived from the aggregate of powers granted to Congress, embracing the powers to lay and collect taxes, to borrow money, to regulate commerce with foreign nations and among the several states, to coin money, regulate the value thereof, and of foreign coin, and fix the standards of weights and measures and the added express power...to make all laws which shall be necessary and proper for carrying into execution the other enumerated powers."
> Legal Tender Case (Juillard v Greenman (1877) 110 US 439, 28 L ed 211).

In addition to its concern for preserving tax revenues, there is evidence in the present record which indicates that Congress was interested in other matters when it enacted Section 167(l). The intent of Congress in providing taxpayers with accelerated depreciation was to provide stimulation for investments in new plant and equipment. To the extent that tax benefits resulting from accelerated depreciation are passed on to the ratepayers, this goal is frustrated. Moreover, it was believed that accelerated depreciation with flow-through would cause a misallocation of resources by making the cost of capital goods higher for regulated industries than for unregulated industries.

Thus, it appears to us that Congress was acting within its constitutional boundaries when it enacted Section 167(l). This tax measure is designed for the purpose of regulating the reasonable allowance for depreciation. It may be that the type of regulation contained in Section 167(l) is somewhat unique in that it reaches to the control of General's revenues. However, considering the economic goals sought by Congress, in addition to the attempt to preserve tax revenues, we conclude that the staff's arguments must be rejected and that Section 167(l) is constitutional.

Issue II - Should General's state corporation franchise tax expense be computed on the basis of accelerated tax depreciation with flow-through?

Under California tax law accelerated depreciation is available to General as part of its state tax basis. Under such law General is not precluded from using flow-through.

The staff has shown in Table 1 of Exhibit 5-R a projection by years for the period 1970 through 1985 of the tax reducing effect of using accelerated depreciation in comparison with straight-line depreciation. The state income tax reductions from accelerated depreciation are there projected to increase from $296,000 in 1970 to $2,249,000 in 1975 and to reach $3,302,000 and $3,547,000 in years 1980 and 1985, respectively. The summation of the 16 annual reductions in the period projected is shown as $40,874,000. A part of such annual reductions in state tax is offset, however, by the effect of a corresponding decrease in deductions from taxable income in computing federal income tax.

The staff advocates that we compute General's state tax expense on the basis of accelerated depreciation with flow-through. This staff recommendation is consistent with the views expressed by the Supreme Court in City of Los Angeles v Public Util. Com. (1972) 7 C 3d 331 and was not contested by any of the parties in this limited rehearing.

We agree that General's state tax expense should be computed on the basis of accelerated depreciation on its post-1969 property with flow-through.

Issue III - Should a penalty be levied against General if General was imprudent in not adopting accelerated depreciation with flow-through when this option was available as part of its federal tax basis?

Because of losses in settlement revenues and a refund order, which are discussed under Issues V and VI, as well as delays, which were engendered largely by the tax depreciation issue, in processing rate relief sought by General in Application No. 53164, General, we observe at the outset, has in fact had exposure to a substantial adverse financial impact without such a penalty being imposed.

Fundamentally, any revenue requirement adopted for General should be the minimum required to assure continued, adequate, and safe service and should yield reasonable rates to assure adequate service under growth conditions. Such rates will do no more than maintain General's financial integrity and enable it to raise from external sources, at a reasonable cost, the substantial amount of new capital it will require to finance its construction program. With the revenue requirement of $409,690,000 set forth in column (g) of Table 2 under Issue IV being responsive to these constraints (see Decision No. 79367, 72 CPUC 652, 684), any penalty which would lower that requirement would be counterproductive in that it could produce an adverse effect upon the ability of General to provide the quality of service which its subscribers must have and upon its ability to obtain a reasonable cost of financing for its construction program. Also, it is important to exercise care to insure that General is not deprived of its eligibility for accelerated depreciation with normalization for federal tax purposes; imposing a penalty would jeopardize such eligibility.

General has argued in part that the chronology of Decision No. 75873 issued July 1, 1969 imputing flow-through to General for ratemaking purposes, taken together with the ongoing

Congressional deliberations with respect to tax depreciation for regulated industries, effectively precluded General from qualifying for flow-through for federal tax purposes. In response the staff indicated General was under a duty to elect accelerated depreciation prior to issuance of Decision No. 75873, particularly by virtue of the Commission's imputation of accelerated depreciation with flow-through in Pacific's 1968 rate order, Decision No. 74917, 69 CPUC 53.

Although in our discussion of Issue VI we have concluded it would be reaching too far in the circumstances of this case to hold that General was imprudent, a determination on this point is rendered unnecessary here by virtue of a penalty not being, as indicated above, in the interests of either the ratepayer or the utility. Accordingly, we also reject imputing flow-through to General as advocated by the city of San Francisco.

If adopted, the city's approach would deprive General of its eligibility for accelerated depreciation for federal income tax purposes, create a liability of roughly $60 million[12/] to the federal government because of the difference between straight-line depreciation and accelerated depreciation claimed by General since 1970 and, according to the city's witness, expose General to bankruptcy if the situation continued. This approach was advanced by the city under the theory that General should be left with the responsibility of either appealing any adverse decision by the Internal Revenue Service or using its efforts through its elected representatives in Congress to have the tax law changed to enable it to qualify for accelerated depreciation with flow-through.

12/ As of December 31, 1973, the balance in Account 308, operating federal income taxes deferred - accelerated depreciation, was $60,314,275 (General's 1973 Annual Report, Schedule 30 B).

<u>Issue IV</u> - Because the initial year effects of accelerated depreciation are atypical of ensuing years what adjustments, if any, should be made for rate-making purposes?

Consistent with the resolution of Issues I and II, federal income tax will be computed on the basis of accelerated depreciation with normalization and state tax expense will be computed on the basis of accelerated depreciation with flow-through. However, the initial year effects on these bases, by being small in relation to the effects in the ensuing several years, are unrepresentative of a rapidly growing impact and appear to be unsuitable for use in establishing rates which are expected to be in effect for several years. Accordingly, a need for an appropriate rate-making adjustment is indicated.

The premise upon which adjustments of this general kind operate is that with the passage of time changes in operating results occur and accumulate, more in one direction than in the other, sufficient enough to cause a pronounced change in rate of return. The intended purpose of such rate-making adjustments is to cause this pronounced change in rate of return, which can be in either direction, to occur later than it otherwise would. To the extent such adjustments serve this purpose the frequency of comprehensive and protracted ratesetting proceedings with attendant manpower requirements and costs as well as adverse customer reaction related to frequent rate changes is reduced. Several such adjustments were incorporated into our adopted operating results in Decision No. 79367.

Stated another way, rates are fixed prospectively. Accordingly, a fundamental objective is to authorize rates which can be in effect for several years and still provide the utility with a reasonable opportunity to earn on the average neither more nor less than the rate of return found reasonable. Toward this end adjustments are made so that the test year operating results at authorized rates reflect a relationship of revenue requirement, expenses, and rate base expected to be representative of the several years during which the rates may be in effect. It is in this light that we must look beyond 1970 to see whether the accelerated depreciation tax effects represent an extraordinary decrease in cost which would distort the relationship between revenues, expenses, and rate base unless an appropriate adjustment is incorporated into the test year.

We carefully note in this regard that a tax deferral reserve is cumulative in character and represents an important difference in rate base component as between utility companies on straight-line tax depreciation or on accelerated depreciation with flow-through and those on accelerated depreciation with normalization. In the case of a growing utility company such as General this indicates that the denominator on the right side of the equation,

$$\text{Rate of Return} = \frac{\text{Revenues} - \text{Expenses}}{\text{Rate Base}} \times 100\%$$

increases, as a function of both time and plant additions, at a slower rate with normalization than without it. Of course, General, whether on straight-line tax depreciation or accelerated depreciation with normalization, should have the same opportunity to earn whatever rate of return, although not necessarily the same one in both cases, is found reasonable.

In Exhibits 1-R, 4-R, and 5-R, the progression of tax effects of accelerated depreciation, applicable to General's operations, is shown. Data selected from Table 1 of Exhibit 5-R illustrates this progression relative to straight-line depreciation. The data apply to post-1969 plant additions of the total company including interstate operations:

End of Year	Tax Deprec. Differ. (DDB-SL)[1/]	State Tax Effect[2/]	Federal Tax Effect[3/]	Cumulative Federal Tax Effect
	(a)	(b)	(c)	(d)
	(Dollars in Thousands)			
1970	$ 4,234	$ 296	$ 1,890	$ 1,890
1971	12,560	879	5,607	7,497
1972	18,763	1,426	8,321	15,818
1973	22,674	1,723	10,056	25,874
1974	26,254	1,995	11,644	37,518
1975	29,590	2,249	13,123	50,641
1976	33,599	2,554	14,901	65,542
1977	37,735	2,868	16,735	82,277
1978	40,496	3,078	17,960	100,237
1979	42,064	3,197	18,655	118,892
1980	43,448	3,302	19,269	138,161
1981	44,626	3,392	19,791	157,952
1982	45,084	3,426	19,995	177,947
1983	45,483	3,457	20,172	198,119
1984	45,852	3,485	20,335	218,454
1985	46,671	3,547	20,699	239,153

1/ Tax depreciation difference is equal to double declining balance depreciation (DDB) minus straight-line depreciation (SL).

2/ Years 1970 and 1971, Col. (a) x .07; Years 1972-1985, Col. (a) x .076

3/ Years 1970 and 1971; Col. (a) x .4464; Years 1972-1985, Col. (a) x .4435

It can readily be seen from the above tabulated data that the end of the year 1970 effects are small compared with those in the next three years. Furthermore, in the case of the state tax effect, which represents a tax savings to be flowed-through to the ratepayer, the entry for the year 1970 of $296,000 approximates only one-half the full year effect in 1971 and about two-thirds the full year effect in 1972 from the 1970 plant additions. As will be shown in a tabulation to be set out hereinafter, the pattern of contribution to tax effects is similar for plant additions in subsequent years.

In the late 1970's the state tax effects tend to stabilize as indicated by the small percentage change thereafter over the immediately prior year. Significantly, this stability comes about as the share of depreciable plant on accelerated depreciation becomes larger and the diminishing depreciation taken on the undepreciated double declining balance remainder on the earlier plant additions tends to offset the early year accelerated depreciation effects of subsequent plant additions, causing a sort of dynamic balance to come into play. Before the stability occurs, and especially in the initial transition to accelerated depreciation, the deduction from income for depreciation in computing state tax expense would, if reflected without adjustment into the basic relationship of revenues, expenses, and rate base for the test year, represent essentially only the straight-line tax depreciation basis. Thus, instead of having a progressive state tax reducing effect folded into it, this basic relationship would have within it a characteristic that induces tax effects consistent essentially with only the straight-line basis.

In the case of federal tax effects with normalization, the initial year average normalization reserve is substantially less than the reserve of $1,890,000 at the end of year 1970 which in turn represents only about half the full year effect attributable to the 1970 additions. The effect on rate base in 1971 stemming from accelerated depreciation on 1970 additions alone is, according to a staff witness, approximately 3.8 times the effect in the first year. Plant additions in subsequent years also continue to provide accruals cumulatively, causing a further rapid buildup of this reserve as will be next shown.

For the period 1970-73 a recast of the accelerated depreciation tax effects tabulated above has been developed from data underlying Table I of Exhibit 5-R. The recast serves to segregate these effects by vintage plant additions.

End of Year	Tax Depr. DDB-SL	State Tax @ 7%	Fed. Tax Effect	Cumulative Fed. Tax Effect
		(Dollars in Thousands)		
		1970 Additions		
1970	$4,234	$296	$1,890	$ 1,890
71	8,058	564	3,597	5,487
72	6,800	476	3,036	8,523
73	5,190	363	2,317	10,840
		1971 Additions		
1971	$4,502	$315	$2,010	$2,010
72	8,584	601	3,832	5,842
73	7,290	510	3,254	9,096
		1972 Additions		
1972	$3,379	$237	$1,508	$1,508
73	6,471	453	2,889	4,397
		1973 Additions		
1973	$3,723	$261	$1,662	$1,662

The staff recommends in light of many of these considerations that the 1970 base period be modified in determining rates by reflecting second-year flow-through in computing state tax expense and by excluding from the rate base a projected 5-year average deferred federal tax reserve. General opposes these staff proposed ratemaking adjustments, contending that correlative projections for the increase in investment, depreciation expense, and tax expense are needed.

As already developed in some depth in our discussion of this issue, accelerated depreciation provides a continuing and cumulative cost-reducing effect which is extraordinary in relation to the input of straight-line tax depreciation for the markedly predominant pre-1970 property going into the basic relationship of revenues, expenses, and rate base. The correlative projections alluded to by General would tend, of course, to restore this excessive influence of straight-line tax depreciation in the basic relationship, making it less representative of conditions during the period the authorized rates are expected to be in effect.

The correlative projections for the increase in investment, depreciation expense, and tax expense could serve as inputs to determine the additional revenue requirement associated with the plant additions for comparison on some appropriate basis with the additional revenues projected to be generated in those years. The formulation of General's opposition is deficient, however, in that it fails to provide the necessary comparison with the additional revenues while also ignoring the fact that the fast-growing cost-reducing impact of a normalization reserve would not exist if General were on only a straight-line tax depreciation basis. A strong presumption thus exists that the correlative projections of increases in costs cited by General would be offset by increases in revenues.

Consistent with the concept set forth in City of Los Angeles v PUC (1972) 7 C 3d 331, 346, applicable to the ratemaking treatment of out-of-period cost effects which are extraordinary in character, operating results for the test period should allow for the extraordinary trend exhibited by accelerated depreciation effects so that these results will be more representative of future conditions. In our considered judgment this can be done by reflecting into the 1970 test period operating results a projected 3-year (1971-1973) average flow-through in computing state tax expense and a projected 3-year average deferred federal tax reserve as a reduction to rate base. In columns (b) through (e) of Table 1 on page 32, the test year operating results are adjusted accordingly. The end result of these two adjustments is a $2,972,000 reduction in revenue requirement.

We are to desist, however, from implementing the adjustment on the deferred federal tax reserve, as an extraordinary item, in order not to disqualify General's taking accelerated depreciation. By comparing Table 2, on page 33, with Table 1 it can be seen that eliminating the extraordinary item adjustment for federal taxes results in a $1,203,000 reduction in revenue requirement instead of a $2,972,000 reduction. As we said in Decision No. 83162 dated July 23, 1974, supra, (mimeo page 72) in the Pacific rate case:

> "Notwithstanding this discussion we are not making this extraordinary item adjustment for federal taxes. We have read the relevant tax statutes and the explanatory Treasury Regulations published June 7, 1974 (39 F.R. 20194, et seq.), plus the briefs submitted July 3, 1974. Our conclusions are: (1) from a tax viewpoint, treating the extraordinary item adjustment as part of the deferred tax reserve, the adjustment is improper; (2) from a regulatory viewpoint, as a ratemaking adjustment for an extraordinary item, the adjustment is proper; and (3) the Treasury Department is most likely to look at this matter from a tax viewpoint. If we make the adjustment and if the Department does what we expect them to do, they will disallow the accelerated depreciation treatment entirely, compute Pacific's taxes on a straight-line basis, and assess back taxes . . ."

General's reserve for federal income tax deferrals was $60,314,275 at year-end 1973, representing accruals for years 1970 through 1973. Clearly, the $1.8 million reduction in revenue requirement that our extraordinary item adjustment would cause is not worth risking General's eligibility for accelerated depreciation. As further discussed under Issue VI, loss of its eligibility to take accelerated depreciation in those years is not in the interests of either the ratepayer or General.

Prudence has dictated our decision not to implement this extraordinary item adjustment for federal taxes, but we still have some difficulty in perceiving how this adjustment would defeat what we understand to be the intent and purposes of 26 USC Section 167(l), supra. Under Section 167(l) certain limitations operate to preserve tax revenues by controlling the eligibility for accelerated depreciation and prescribing an accounting method. Once the depreciation and accounting methods are fixed in accordance with 167(l), the tax revenues to the federal government from a utility company, such as General, are substantially a function of how close actual operating results approach, from above or below, the rate of return found reasonable, i.e., changes in tax revenues under a given depreciation method are by definition independent of that method but are dependent upon the rate of return achieved.

Thus, to interpret 167(l), as intending in any way to bar adjusting the effects of accelerated depreciation with normalization to make them more representative of the period during which rates are expected to be in effect, appears unsupportable from a standpoint of rational justification, even though out-of-period tax deferrals must be considered. Clearly, that consideration is made essential by their extraordinary growth character.

Equally incongruous is the indicated result without the ratemaking adjustment: a utility's earnings potential exceeding that of a reasonable opportunity to earn the rate of return found reasonable, and thus not representing a proper balance of the interests of the ratepayer and the utility. Stated differently, it can result in a utility earning a return on a substantial portion of the tax deferral reserve, contrary to good ratemaking irrespective of whether the reserve be viewed as capital contributed by ratepayers or an interest-free loan from the federal government.

TABLE 1

General Telephone Company of California

Adjustment of Test Year 1970 Results of Intrastate Operations
for Projected Three-Year Average SCFT Flow-Through and FIT Normalization Reserve

Item	Dec. No. 79367 Adopted Results	3-Year Avg. Effect Flow-Through SCFT	Normalization Reserve FIT	Recast For 3-Year Average Effect	Add'l Rev. Required for 8.3% Rate of Return	Modified Results of Opr. for 8.3% Rate of Return	Dec. No. 79367 Results at Authorized Rates	Difference Representing Reduction in Revenue Requirement
				(Dollars in Thousands)				
(a)	(b)	(c)	(d)	(e=b+c+d)	(f)	(g=e+f)	(h)	(i=g-h)
Operating Revenues	$ 370,973	-	-	$ 370,973	$37,316	$ 408,289	$ 411,261	$(2,972)
Operating Expenses								
Expenses Other Than Taxes	227,252	-	-	227,252	-	227,252	227,252	-
Income Taxes	25,953	(1,113)	534 1/	25,374	19,436	44,810	46,937	(2,127)
Other Taxes	45,337	-	-	45,337	-	45,337	45,337	-
Total Operating Expenses	298,542	(1,113)	534	297,963	19,436	317,399	319,526	(2,127)
Affiliates' Adjustment	(3,107)	-	-	(3,107)	-	(3,107)	(3,107)	-
Net Revenues	75,538	1,113	(534)	76,117	17,880	93,997	94,842	(845)
Rate Base	1,142,635	-	(10,140)	1,132,495	-	1,132,495	1,142,635	(10,140)
Rate of Return	6.61%	-	-	6.72%	-	8.30%	8.30%	-

(Red Figure)

1/ Effect on FIT of M$1,113 reduction in SCFT.

TABLE 2

General Telephone Company of California

Adjustment of Test Year 1970 Results of Intrastate Operations
for Projected Three-Year Average State Corporation Franchise Tax Flow-Through

Item	Dec. No. 79367 Adopted Results	3-Year Avg. Effect of State Corporation Franchise Tax Flow-Through		Recast For 3-Year Average Effect	Add'l Rev. Required for 8.3% Rate of Return	Modified Results of Opr. for 8.3% Rate of Return	Dec. No. 79367 Results at Authorized Rates	Difference Representing Reduction in Revenue Requirement
		SCFT	FIT					
	(Dollars in Thousands)							
(a)	(b)	(c)	(d)	(e=b+c+d)	(f)	(g=e+f)	(h)	(i=g-h)
Operating Revenues	$ 370,973	-	-	$ 370,973	$39,085	$ 410,058	$ 411,261	$(1,203)
Operating Expenses								
Expenses Other Than Taxes	227,252	-	-	227,252	-	227,252	227,252	-
Income Taxes	25,953	(1,113)	534 1/	25,374	20,357	45,731	46,937	(1,206)
Other Taxes	45,337	-	-	45,337	-	45,337	45,337	-
Total Operating Expenses	298,542	(1,113)	534	297,963	20,357	318,320	319,526	(1,206)
Affiliates' Adjustment	(3,107)	-	-	(3,107)	-	(3,107)	(3,107)	-
Net Revenues	75,538	1,113	(534)	76,117	18,728	94,845	94,842	3
Rate Base	1,142,635	-	70 2/	1,142,705	-	1,142,705	1,142,635	70
Rate of Return	6.61%	-	-	6.66%	-	8.30%	8.30%	-

(Red Figure)

1/ Effect on FIT of M$1,113 reduction in SCFT.

2/ Adjustment reflects normalization reserve computed in accordance with Federal Income Tax Regulations Section 1.167(l)-1(h)(6)(ii).

Issue V - Should General's current rates be reduced because of the reduction in revenue requirement?

By reflecting a projected 3-year average state tax effect of accelerated depreciation with flow-through into the 1970 test period operating results, the additional intrastate revenue requirement established in Decision No. 79367 of $40,288,000 is reduced by $1,203,000 to $39,085,000 as shown in Table 2 hereinabove. A part of the former additional revenue requirement of $40,288,000, however, was to be met by $16,335,000 which General would presumably have continued to derive from settlements with Pacific, arising out of increased intrastate toll, multi-message unit, and other charges authorized by Decision No. 78851, in Application No. 51774, but later annulled by the California Supreme Court.

After annulment, the Commission issued, in that Pacific application, Decision No. 80347 which, among other things, had the effect of reducing such settlement revenue from the former figure of $16,335,000 to $10,300,000, or by $6,035,000.[13] About one year later, on August 28, 1973, the Commission issued Decision No. 81824 in Application No. 53164 authorizing increases in General's rates to bring its operating results into balance, on a test year 1970 basis, with an allowed 8.3 percent rate of return.

13/ The Pacific rates established in Decision No. 80347 became effective August 8, 1972. The impact of the annulment of Decision No. 78851 on General's revenues during the period prior to the issuance of Decision No. 80347 will be taken up in the discussion of the refund issue.

For this purpose the operating results were modified to reflect the effect of wage increases, changes in settlement revenues, and certain other items, but no modification of the ratemaking treatment accorded accelerated tax depreciation in Decision No. 79367 was made.

Accordingly, General's current rates, which are largely a product of Decisions Nos. 79367 and 81824, should be reduced so as to yield $1,203,000 less in operating revenues on a 1970 test year basis. An appropriate place for such rate reductions is in basic exchange service charges where all subscribers can experience a rate reduction. In part because of our forthcoming decision in General's Application No. 53935 for a general increase in rates and in part because of the desirability to apply the reduction uniformly, we consider it appropriate to establish a factor to be applied in reducing each subscriber's billing for basic exchange monthly recurring charges for central office lines and trunks. Consistent with Exhibit 6-R that factor should be .01142.

Issue VI - Are refunds in order and if so in what amount?

In Decision No. 79367 dated November 22, 1971, the Commission's use of accelerated depreciation with normalization in fixing General's rates was based upon Interim Decision No. 77984 in Pacific's Application No. 51774. Following the issuance of Decision No. 79367 the Supreme Court on November 26, 1971 annulled the Pacific Interim Decision adopting first year normalization, holding "For failure to consider lawful alternatives in calculation of federal income tax expense, the decision of the commission must be annulled." (City & County of San Francisco v PUC (1971) 6 C 3d 119, 130.)

On June 9, 1972 the Supreme Court annulled Decision No. 78851 granting Pacific's $143,000,000 increase (City of Los Angeles v PUC (1972) 7 C 3d 331). In referring to its earlier holding the Court stated: "Our decision annulling the commission's tax expense decision in City & County of San Francisco v Public Utilities Com., supra, 6 C 3d 119, was filed after the commission had established the rates before us. The commission in the instant decision in fixing the amount of Pacific's federal tax expense followed its tax expense decision. Since the latter decision was annulled, the instant decision must also be annulled." (7 C 3d at 337.)

The additional revenue requirement of General established for the test year 1970 in Decision No. 79367 was $40,288,000. The difference in General's revenue requirement for the 1970 test period as computed by the Commission in Decision No. 79367 using accelerated depreciation with first-year normalization compared with assumed second-year flow-through is $8,637,000 (Exhibit 3-R). The difference in General's revenue requirement for the 1970 test period as computed by the Commission in Decision No. 79367 using accelerated depreciation with first-year normalization compared with the first-year federal normalization/projected three-year average state flow-through basis adopted herein for ratemaking purposes is $1,203,000 as shown in Table 2 under Issue IV.

The parties differ as to a proper basis for refunds. The cities of Los Angeles and Long Beach take the position that the two Court decisions provide a compelling basis for annulling the entire $40,288,000 increase to General in Decision No. 79367. The staff considers that only that portion of the rate order in Decision No. 79367 need be considered invalid which is attributable to the Commission's use of accelerated depreciation with normalization in fixing General's rates. The amount attributable to that portion of the rate order is the $8,637,000 set forth in Exhibit 3-R. It is General's position that City & County of San Francisco is not controlling in this proceeding and any refund depends on the resolution of the tax depreciation issue upon this rehearing. Thus, according to General, it would be the reduction of $1,203,000 in General's intrastate revenue requirement, as shown in Table 2 under Issue IV, which should be used in the computation determinative of any refund required.

We consider the position of the cities unwarranted because of the severability of the dollar impact related to the tax depreciation issue, and without merit because of the Commission's authority under Section 1736 of the Public Utilities Code encompassing the effect of decision after rehearing. Nor does the staff reckon with this code section. According to the staff, the Commission has no choice if it is to avoid retroactive ratemaking but to order refund of that portion of the $40 million increase attributable to the difference between first-year normalization and flow-through, flow-through being the ratemaking treatment of tax depreciation last found reasonable for General (Decision No. 75873 dated July 1, 1969). In its brief, General distinguishes this proceeding from the Pacific case, in which the Court annulled the Commission's decisions, through the following points:

1. "There the Court was faced with a final order. Rehearing had been denied by the Commission. Here the order is not final as to the tax depreciation issue. Rehearing has been granted."

2. "The annulment of the Pacific decision in City & County of San Francisco was based on the procedural defect...No such infirmity exists in this proceeding. Upon this rehearing the Commission will consider lawful alternatives in the calculation of such tax expense."

3. "Because no rehearing was granted in City & County of San Francisco, the Commission's authority under Section 1736 of the Public Utilities Code to rehear the matter and cure any procedural defects therein did not apply. On this rehearing, the Commission has the power to affirm, modify, change or abrogate the original order or decision or any part thereof related to the sole issue on rehearing. Section 1736 reads in pertinent part:

   'The order or decision abrogating, changing, or modifying the original order or decision shall have the same force and effect as an original order or decision, but shall not affect any right or the enforcement of any right arising from or by virtue of the original order or decision unless so ordered by the Commission.'

   "A clear reading of the foregoing confirms that the power to affect rights arising from the original order must extend to the period between the original order and the changed order or the quoted language is meaningless. Thus Section 1736 provides a statutory framework not open to Pacific in City & County of San Francisco whereby in the instant rehearing proceeding, this Commission can purge Decision No. 79367 of any procedural defects regarding normalization and then make an appropriate determination regarding the retention or refund of money collected by General pursuant to Decision No. 79367."

In Decision No. 75873, flow-through was imputed to General for ratemaking. That decision was issued July 1, 1969, about eight months after the November 6, 1968 decision (Decision No. 74917) imputing flow-through to Pacific. Because of this span of some eight months between the decisions, the pivotal question of whether the Commission could have reasonably ordered General, in the rate proceeding leading to Decision No. 79367, to continue the accounting practices imputed in Decision No. 75873 becomes much closer than in Pacific's case.

General argues that the chronology of Decision No. 75873 and the ongoing congressional deliberations with respect to tax depreciation for regulated industries effectively precluded General from qualifying for flow-through for federal tax purposes. In response the staff has indicated General was under a duty to elect accelerated depreciation prior to issuance of Decision No. 75873, particularly by virtue of the Commission's imputation of accelerated depreciation with flow-through in Pacific's 1968 rate order, Decision No. 74917, 69 CPUC 53.

In the circumstances of this case it would be reaching too far, we think, to hold that accelerated depreciation with flow-through became unavailable to General through an imprudent managerial decision. Without that holding, the change in the tax law provides justification to structure in relevant part new rates, pursuant to Sections 454 and 728 of the Public Utilities Code, which comport with the changed tax law.

We concur in General's analysis as to both the statutory authority of this Commission under Section 1736[14/] to correct any procedural and substantive defects concerning the tax depreciation issue existing in Decision No. 79367 and our authority, because rates were collected subject to refund, to make our order effective nunc pro tunc, as well as in General's position regarding the finality of Decision No. 79367 as to all issues other than the tax depreciation issue.

Looking at the problem from another viewpoint, if the staff's position were to prevail General would face consequences which could affect its ability to serve. We note from General's 1973 Annual Report to the Commission that as of December 31, 1973 the reserve for federal income tax deferrals was $60,314,275. According to Internal Revenue Code Section 167(l)(3)(G) and Income Tax Regulations Section 1.167(l) - 1(h)(4), it appears that if we do not invoke our authority under Section 1736 to affirm the pertinent part of the original rate increase authorization in Decision No. 79367, General will have to recompute and pay its federal income taxes for years 1970 through 1973, and perhaps for 1974, on the basis of straight-line depreciation instead of accelerated depreciation. A refund to General's subscribers of about one-third

14/ P.U.Code Section 1736: "If, after such rehearing and a consideration of all the facts, including those arising since the making of the order or decision, the commission is of the opinion that the original order or decision or any part thereof is in any respect unjust or unwarranted, or should be changed, the commission may abrogate, change, or modify it. The order or decision abrogating, changing, or modifying the original order or decision shall have the same force and effect as an original order or decision, but shall not affect any right or the enforcement of any right arising from or by virtue of the original order or decision unless so ordered by the commission."

the size of that amount would in a sense reduce the tax liability, however, to about $50 million, making the impact on General of the refund and net tax liability approximately $70 million.

To prevent such an impact on General, which we do not perceive to be in the ratepayers' best interests--a substantial refund to them notwithstanding--we will invoke our authority under Section 1736 to affirm that part of the original rate increase authorization in Decision No. 79367 corresponding to the treatment accorded accelerated depreciation for federal income tax purposes. Accordingly, only the reduction in General's revenue requirement for state income tax flow-through of $1,203,000 determined herein should be used as part of the basis upon which to determine refunds. The other part of the basis for this determination is the loss of settlement revenues to General together with the refunds already made by General.

The refunds already made by General are attributable to the annulment of Decision No. 78851 while the settlement revenue losses to General are attributable to the annulment of that decision and also to the difference between Pacific's rates authorized in Decision No. 80347 and Pacific's annulled rates. The needed comparison with the $1,203,000 reduction in revenue requirement is developed through the following summary:

> Annulment of Decision No. 78851. In developing the rate spread adopted in Decision No. 79367 $16,335,000 was deducted from the $40,288,000 additional intrastate revenue requirement, the deducted amount being derivable from additional revenues including settlements with Pacific arising out of increased intrastate toll, multi-message, and other charges authorized by Decision No. 78851. Because of the annulment of the latter decision and because of resultant refunds by Pacific pursuant to Decision No. 80345, General experienced a loss of $7 million in settlement revenues. Moreover, the order in

Decision No. 80346 affirmed by Decision No. 81212 requiring General to refund has been upheld upon appeal, increasing the loss to General to $16 million. This loss related to the period the Decision No. 78851 rates were charged, that period being July 23, 1971 through August 7, 1972, inclusive. General's rates established pursuant to Decision No. 79367 became effective December 12, 1971.

For the period December 12, 1971 through August 7, 1972, inclusive, the loss in settlement revenues and through refunds exceeded the $1,203,000 reduction adopted herein in General's intrastate revenue requirement in an amount, as measured on an annual basis, of about $16 million minus the $1,203,000.

Issuance of Decision No. 80347. The difference between Pacific's rates authorized in Decision No. 80347 and its annulled rates effectively reduced the incremental settlement revenues from the $16,335,000 used in Decision No. 79367 to $10,300,000 or by $6,035,000. The Pacific rates established pursuant to Decision No. 80347 became effective August 8, 1972.

For the period after August 7, 1972 until September 23, 1973 the reduction in settlement revenues exceeded the reduction in revenue requirement: $6,035,000 - $1,203,000 = $4,832,000 on an annual basis.

Issuance of Decision No. 81824. The increased rates authorized in General's wage offset case (Application No. 53164) by Decision No. 81824 went into effect September 23, 1973. The increases in rates were designed to bring General intrastate revenues including settlements from Pacific into balance, based on the 1970 level of General's operation, with the 8.3 percent rate of return used in fixing rates in Decision No. 79367.

> For the period after September 22, 1973 until the rate reduction ordered herein is placed in effect, refunds should accrue at an annual rate of $1,203,000 on the basis of the 1970 test year level of General's operation.

Decision No. 81824, by bringing General's rates into balance with an allowed 8.3 percent rate of return on a 1970 test year basis, rendered inappropriate further comparisons with prior refunds and losses in settlement revenues. To achieve this balance, the decision modified test year 1970 operating results by including, among other effects, a three-step wage increase to General's employees -- the last step of which became effective March 5, 1972 -- and a revenue increase to General attributable to the increases in Pacific's rates through Application No. 52794, the Pacific's wage offset case, by Decision No. 79873 dated August 8, 1972.

It may be argued, nevertheless, that any further refunds are inappropriate because the refunds and losses in settlement revenues by General, occurring since its rates established pursuant to Decision No. 79367 became effective December 12, 1971, exceed by several fold the aggregate effect of the $1,203,000 annual reduction in revenue requirement over this same period. This argument is not persuasive. It ignores the fact that after September 22, 1973 General's rates were in consonance with an allowed 8.3 percent rate of return on a test year 1970 basis. Also, if the argument were valid, its logical extension would require deferring the rate decrease herein ordered until the $1,203,000 annual reduction in revenue requirements accumulates to the sum of the refunds made and losses of settlement revenues, above described, during the period December 12, 1971, through September 22, 1973.

In summary, the Commission has the necessary statutory authority under Section 1736 to correct procedural and substantive defects upon rehearing a rate matter and, where the original increase was made subject to possible refund, to order refunds if warranted. Rates affirmed upon rehearing can be made to apply as of the effective date of the original decision. Applied in this way, Section 1736 will protect the interests of both the ratepayer and the utility. In this case where there was substantive error in not flowing through to net revenue the reducing effect of accelerated depreciation on state tax expense, the error is being remedied through the rehearing by segregating that portion of the original rate increase authorization and nullifying its effect by requiring appropriate refunds and rate reductions.

Findings

1.a. The normalization treatment of accelerated depreciation involves a fictitious allowance for federal tax expense. The fictitious allowance, however, would convert to a real part of this expense, consistent with Conclusion of Law 1 below, if normalization is not used, i.e., the utility would be required to pay its federal income taxes on the basis of taking straight-line tax depreciation.

b. Because the federal tax deferral reserve associated with normalization is applied as a reduction to rate base, accelerated depreciation with normalization results in a lower total cost of service than straight-line tax depreciation.

c. General's federal income tax should be computed on the basis of accelerated depreciation on its post-1969 property with normalization.

d. Under Section 167(l) of the Internal Revenue Code, General is not eligible to take accelerated depreciation on its pre-1970 property. For such property General is restricted to the use of straight-line depreciation.

2. General's state tax expense should be computed on the basis of accelerated depreciation on its post-1969 property with flow-through.

3. General's revenue requirement should be the minimum required to assure continued, adequate, and safe service and to provide for necessary expansion to meet future requirements. To reduce General's revenue requirement below this minimum by some form of penalty would not be in the best interests of either the ratepayer or the utility.

4.a. The initial-year effects of using accelerated tax depreciation for ratemaking purposes are small in relation to the effects in the ensuing several years and are unrepresentative of a rapidly growing impact.

b. Consistent with established concepts regarding the ratemaking treatment of out-of-period cost effects which are extraordinary in character, operating results for the test period should allow for the extraordinary trend exhibited by accelerated depreciation effects so that these results will be more representative of future conditions. For this purpose a projected three-year average state tax effect of accelerated depreciation with flow-through and a projected three-year average deferred federal tax reserve as a reduction to rate base should be reflected into the 1970 test period operating results, as shown in Table 1 on page 32.

c. Federal Income Tax Regulations Section 1.167 (l) - (h) (6), however, causes us not to implement the adjustment converting the deferred federal tax reserve to a three-year average level. According to that regulation General would be disqualified from paying its federal taxes on the basis of accelerated depreciation starting in 1970 if such an adjustment is made. General's reserve for federal income tax deferrals was $60,314,275 at year-end 1973, representing accruals for years 1970 through 1973. Clearly, the 1.8 million reduction in revenue requirement that our extraordinary item adjustment would cause is not worth risking General's eligibility for accelerated depreciation.

d. Table 2 set forth on page 33, quantifying a projected three-year average state tax effect of accelerated depreciation with flow-through on the 1970 test year operating results, is adopted. Accordingly, the additional gross intrastate revenue requirement specified in Finding 10 of Decision No. 79367 of $40,288,000 is reduced by $1,203,000 to $39,085,000.

5.a. General's current rates are largely a product of Decision No. 79367 dated November 22, 1971 in Application No. 51904, and Decision No. 81824 dated August 28, 1973 in Application No. 53164.

b. In developing the rate spread adopted in Decision No. 79367, $16,335,000 was deducted from the $40,288,000 additional intrastate revenue requirement, the deducted amount being derivable from additional revenues including settlements with Pacific arising out of increased intrastate toll, multimessage, and other charges authorized by Decision No. 78851. A reduction in settlement revenues from $16,335,000 to $10,300,000 from Pacific to General is attributable to the annulment of Decision No. 78851 and the issuance of Decision No. 80347.

c. In Decision No. 81824 the Commission authorized increases in General's rates to bring its operating results into balance, on a test year 1970 basis, with an allowed 8.3 percent rate of return. For this purpose the operating results were modified to reflect the effect of wage increases, changes in settlement revenues, and certain other items, but no modification of the ratemaking treatment accorded accelerated tax depreciation in Decision No. 79367 was made.

d. Consistent with the ratemaking treatment accorded accelerated tax depreciation in adopted Table 2 herein, General's rates should be reduced so as to yield $1,203,000 less in operating revenues on a test year 1970 basis. An appropriate place for such rate reductions is in basic exchange service charges where all subscribers can experience a rate reduction. A factor of .01142 is to be applied in reducing each subscriber's billing for basic exchange monthly recurring charges for central office lines and trunks.

6.a. General's rates established pursuant to Decision No. 79367 became effective December 12, 1971. Since then, the effects on General associated with annulment of Decision No. 78851 and the issuance of Decision No. 80347 have resulted in a larger decrease in General's intrastate revenues than the reduction in its intrastate revenue requirement determined in resolving the tax depreciation issue herein.

b. Decision No. 81824, by bringing General's rates into balance with an allowed 8.3 percent rate of return on a 1970 test year basis, rendered inappropriate further comparisons with prior refunds and losses in settlement revenues.

c. The increased rates authorized by Decision No. 81824 went into effect September 23, 1973.

d. For service rendered during the period from and including September 23, 1973 until the rate reduction ordered hereinafter is placed in effect, refunds to General's subscribers are in order and should be made on a basis consistent with that rate reduction and in accordance with the refund plan prescribed in Appendix B to this decision.

Conclusions of Law

1. General does not qualify for accelerated depreciation on its post-1969 property unless both General and the Commission normalize General's accelerated tax depreciation for ratemaking purposes and General normalizes its accelerated tax depreciation in its regulated books of account. If these requirements are not met, General will be restricted to the use of straight-line depreciation for its post-1969 property also.

2. Under California tax law accelerated depreciation is available to General as part of its state tax basis. Under such law General is not precluded from using flow-through.

3. The petitions for rehearing in this matter set forth only one ground for rehearing, the treatment of tax depreciation expense. The order granting rehearing limited this rehearing to the tax depreciation issue. Decision No. 79367 is final as to all other issues.

4. Section 1736 of the Public Utilities Code provides authority to correct upon rehearing procedural and substantive defects concerning the tax depreciation issue existing in Decision No. 79367 and to make any necessary modification to the order in that decision effective nunc pro tunc.

5. To the extent and in the manner prescribed in the following order, the rates filed by General pursuant to Ordering Paragraph 1 of Decision No. 79367 should be affirmed, certain refunds should be made, and rates should be reduced.

ORDER ON LIMITED REHEARING

IT IS ORDERED that:

1. The rates filed by General Telephone Company of California pursuant to Ordering Paragraph 1 of Decision No. 79367 are affirmed. This affirmance is made effective as of December 12, 1971, the date upon which such rates were placed in effect; it extends to September 23, 1973, the date upon which rates authorized by Decision No. 81824 became effective, and continues thereafter in a manner consistent with the Decision No. 81824 rates and the rate reduction ordered in paragraph 3 below.

2. General shall place into effect coincident with the effective date of this order the refund plan, applicable to basic exchange service rendered for the period from and including September 23, 1973, until the decrease in basic exchange charges ordered in the next paragraph is placed in effect, prescribed in Appendix B attached hereto.

3. General shall file with the Commission a revised tariff schedule establishing on a provisional basis (until the Commission issues its decision in Application No. 53935, the current General rate case, and revised tariff schedules filed pursuant thereto are placed into effect) a decrease of 1.142 percent applicable to, and only to, basic exchange monthly recurring charges, as set forth in Appendix C attached hereto, for central office lines and trunks of each customer's bill. Such filing shall comply with General Order No. 96-A and shall be made within forty-five days after the effective date of this order. The effective date of the temporary schedule shall be five days after the date of the filing. The temporary schedule shall apply only to service rendered on and after the effective date thereof.

4. General shall notify all connecting telephone companies that provide foreign exchange service from General's exchanges that the foreign exchange filed rates should be reduced by the amount of 1.142 percent applicable to the pertinent local rate portion of the total foreign exchange rate and corresponding refunds made. Such changes in rates for foreign exchange service shall be applicable within forty-five days after the effective date of this order.

In the event the Commission issues its decision in Application No. 53935 and the revised tariff schedules filed pursuant thereto are placed into effect within forty-five days after the effective date of this order, then this order shall be considered amended in the following respects: (a) Ordering Paragraph 3 is vacated; (b) the end of the service period to which refunds apply is changed from the effective date of the decrease in basic exchange charges specified in Ordering Paragraph 3 to the effective date of the revised tariff schedules filed pursuant to the decision in Application No. 53935; and (c) Ordering Paragraph 4 is modified to require for foreign exchange service only the corresponding refunds for that same service period.

The effective date of this order is the date hereof.

Dated at San Francisco, California, this 26th day of NOVEMBER, 1974.

I abstain:

[signature], Commissioner

Vernon L. Sturgeon
President

William Symons Jr.

Robert E. Batinovich

Commissioners

Commissioner THOMAS MORAN
Present but not participating.

APPENDIX A

APPEARANCES

APPLICANT AND RESPONDENT

Albert M. Hart, H. Ralph Snyder, Jr., and John Robert Jones, Attorneys at Law, for General Telephone Company of California.

INTERESTED PARTIES

Roger Arnebergh, City Attorney, by Charles E. Mattson, Deputy City Attorney, Attorney at Law, for City of Los Angeles.
Robert W. Russell and Manual Kroman, for Department of Public Utilities & Transportation, City of Los Angeles.
Arthur Y. Honda, Deputy Attorney, Attorney at Law, and Louis Possner, Chief Engineer-Secretary, Bureau of Franchises and Public Utilities, for City of Long Beach.
Pillsbury, Madison & Sutro, Richard W. Odgers and James B. Young, by James B. Young, Attorney at Law, and Roger P. Downes, Attorney at Law, for The Pacific Telephone and Telegraph Company.
Russell Fitz Patrick, for Senator Tom Carrell.
Thomas M. O'Connor, City Attorney, Milton H. Mares, Deputy City Attorney, and Robert Laughead, for City and County of San Francisco.
Robert J. Logan, Attorney at Law, for City of San Diego.

FOR THE COMMISSION'S STAFF

Janice E. Kerr, Attorney at Law, Tedd F. Marvin, and John J. Gibbons.

REFUND PLAN

Plan for refunds by General Telephone Company of California to its customers.

1. The following procedures shall be followed to refund a part of the charges for basic exchange service rendered on and after September 23, 1973 until the rate reduction ordered in this decision is placed in effect, or until the effective date of revised tariff schedules filed pursuant to a decision in Application No. 53935, whichever occurs first:

A. Basic Exchange Charges (monthly recurring charges) for central office lines and trunks as listed in Appendix C.

Each customer shall be refunded 1.142 percent of the basic exchange monthly recurring charges, for lines and trunks, in his billings by General for service during this period. This will be the total basic refundable amount per customer.

B. Computation of Tax Refunds

City utility tax and federal tax will be computed on individual customer refund using applicable tax codes.

C. Computation of Interest

Interest at the rate of 7 percent per annum shall be applied to the basic refundable amount (excluding taxes).

D. Application of Refund

(1) Current Customers

The refund will be applied as a credit on the customer's bill, not more than 120 days after the refund order. The amount will be reflected as a credit adjustment on the bill. A printed bill insert will accompany each refund.

(2) Former Customers

Refunds will be calculated as for current account customers and, if the refund amount is $1,00 or more, a refund check will be mailed to the last known address of the customer not more than 120 days after the effective date of the refund order. Former customers with an outstanding balance will be credited the refund amount. If the balance resulting is a credit of $1.00 or more, a refund check will be prepared and mailed to the former customer. If the amount was previously written off as uncollectible, the refund will be credited against the written-off amount and a refund check will be issued only if a net credit of $1.00 or more results.

(3) Supersedures

Supersedures involving a closing bill will be handled as a regular final account. Supersedures not involving a closing bill will be treated as continuous service and the refund will be made only to the current account.

(4) Refund Adjustments

Any customer who is dissatisfied with his refund may contact the business office for an explanation and will receive an adjustment, if warranted. Claims must be filed within 90 days of customer's receipt of bill or refund check.

E. Reporting Requirements

General Telephone will file a refund report with the Commission within 90 days of completion of the refunds. The report will contain the following information:

(1) The total basic refundable amounts plus interest due customers.

(2) The total amount credited on bills either initially or through adjustments (Item D(4) above).

(3) The total amount of refund checks issued.

(4) The total amount of refund checks returned as undeliverable.

(5) The total amount of refund checks outstanding and an estimate of the portion which will never be presented for payment.

(6) The total unrefunded amount (1-2-3+4+5 (portion)).

(7) The amount of expense incurred in making refunds and accounts charged therewith.

(8) A proposal for disposal of any moneys due customers but not yet refunded.

2. After General complies with the reporting requirements under Item E above, an appropriate further order or resolution may issue.

A. 51904, C. 9100 SW/NB *

APPENDIX C

Basic Exchange Primary Service Rates

Provisional Tariff

The basic exchange primary service rates to which the decrease of 1.142 percent will be applied, in compliance with Ordering Paragraph 3, are as follows:

	Present Rates	
Service	Los Angeles Extended Area[1/]	All Other Exchanges[2/]
IFB	$12.60	$13.20
IMB	7.65 (80)	-
2FB	10.50	10.50
SUB-B	9.30	9.30
SPCB	7.65	6.60
PBX-TK-Flat	18.90	19.80
PBX-TK-Message (0)	3.80 (0)	-
IFR	5.75	5.95
IMR	2.95 (20)	-
2FR	5.05	5.25
4FR	4.15	4.25
SUB-R	4.75	4.85

1/ Exchanges as listed in page 1 of Exhibit 6-R in A. 51904.

2/ Exchanges as listed in page 2 of Exhibit 6-R in A. 51904.