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Decision No. 84568

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's own motion regarding the investment credit provisions of the 1975 Tax Reduction Act.	Case No. 9915 (Filed May 13, 1975)

John C. Morrissey, Malcolm H. Furbush and Robert Ohlbach, by Robert Ohlbach, Attorney at Law, for Pacific Gas and Electric Company; John Ormasa, Attorney at Law, for Southern California Gas Company; Rollin E. Woodbury, William E. Marx, and H. Robert Barnes, by Rollin E. Woodbury, Attorney at Law, for Southern California Edison Company; Chickering and Gregory, by Donald J. Richardson, David A. Lawson, and Allan Thompson, Attorneys at Law, and Gordon Pearce and John Woy, Attorneys at Law, for San Diego Gas & Electric Company; and Orrick, Harrington, Rowley & Sutcliffe, by James F. Crafts, Jr., Attorney at Law, and Delwyn C. Williams, for Continental Telephone Company of California; respondents.

Margaret V. Sheehan, for California Pacific Utilities; Burt Pines, City Attorney, by Leonard L. Snaider, Deputy City Attorney, for the City of Los Angeles; Robert Russell, for Los Angeles Department of Public Utilities and Transportation; John Witt, City Attorney, by William Shaffran, Attorney at Law, for the City of San Diego; Neal C. Hasbrook, for California Independent Telephone Association; J. William Zastrow, for Utility Commission Rules Committee, California Section, American Water Works Association; George Gilmour, Attorney at Law, and Sylvia M. Siegel, for Toward Utility Rate Normalization; and Thomas M. O'Connor, City Attorney, by Robert Laughead, for the City and County of San Francisco; interested parties.

Timothy E. Treacy, Attorney at Law, Bruno A. Davis, and K. K. Chew, for the Commission staff.

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ORDER DISCONTINUING INVESTIGATION

The Commission not being able to agree on a result in this investigation,

IT IS ORDERED that the investigation is discontinued.

The effective date of this order is the date hereof.

Dated at San Francisco, California this 17th day of JUNE, 1975.

Vernon L. Sturgeon
President

William Symons, Jr.

Leonard Ross

Robert Batinovich
Commissioners

I concur with Commissioner Holmes' opinion. Leonard Ross

I will file a written concurrence

I will file a concurring opinion which was the original order draft in this case.

Commissioner

Commissioner D. W. Holmes, concurring:

On May 13, 1975 the Commission instituted an investigation on its own motion into the effect of the investment credit provisions of the Tax Reduction Act of 1975 (1975 Act) upon all electric, gas, water, sewer, and communications public utilities under the jurisdiction of this Commission which have heretofore elected to flow through the tax credit generated by the Federal Revenue Act of 1971 (1971 Act).

The 1975 Act increased the investment credit for certain public utilities from 4 percent to 10 percent. This increase is applicable to qualified plant expenditures made after January 21, 1975 and before January 1, 1977 and may result in significant federal income tax savings for the years 1975 and 1976.

The 1971 Act permitted public utilities which flowed through the tax benefits of accelerated depreciation on post-1969 public utility property to flow through the full benefit of the investment credit established by the 1971 Act on such property. (26 USC § 46(e)(3).) Various utilities under the jurisdiction of this Commission made such an election under the provisions of the 1971 Act.

A similar election to flow through the full benefits of the additional credit may be made by such utilities under the 1975 Act; or, alternatively, an election may be made to flow through the credit ratably over the life of the property. Such elections must be made by the affected public utilities by June 26, 1975. In the event that no election is made, a rate base adjustment of the benefits of the additional credit is applicable for ratemaking purposes.

This investigation is directed toward determining the effect of the 1975 Act on eligible flowthrough utilities and considering what action this Commission may take with respect to the investment credit provisions of the 1975 Act. A prehearing conference was held the morning of May 21, 1975 and a public hearing was held the afternoon of May 21, 1975 in San Francisco before Commissioner D. W. Holmes and Examiner Robert Barnett, and the matter was submitted.

The 1975 Act made significant changes in the treatment of the investment credit; two such changes are: (1) It increased the credit from 4 percent to 10 percent and (2) it placed some restrictions on the ability of certain utilities to flow through the increased credit to ratepayers. The 1975 Act includes Section 46(f)(8) as follows:

> "(8) PROHIBITION OF IMMEDIATE FLOWTHROUGH. An election made under paragraph (3) shall apply only to the amount of the credit allowable under section 38 with respect to public utility property (within the meaning of subsection (a)(6)(D)) determined as if the Tax Reduction Act of 1975 had not been enacted. Any taxpayer who had timely made an election under paragraph (3) may, at his own option and without regard to any requirement imposed by an agency described in subsection (c)(3)(B), elect within 90 days after the date of the enactment of the Tax Reduction Act of 1975 (in such manner as the Secretary or his delegate shall prescribe) to have the provisions of paragraph (3) apply with respect to the amount of the credit allowable under section 38 with respect to such property which is in excess of the amount determined under the preceding sentence. If such taxpayer does not make such an election, paragraph (1) or (2) (whichever paragraph is applicable without regard to this paragraph) shall apply

> to such excess credit, except that if neither paragraph (1) or (2) is applicable (without regard to this paragraph), paragraph (1) shall apply unless the taxpayer elects (in such manner as the Secretary or his delegate shall precribe) within 90 days after the date of the enactment of the Tax Reduction Act of 1975 to have the provisions of paragraph (2) apply. The provisions of this paragraph shall not be applied to disallow such excess credit before the first final determination which is inconsistent with such requirements is made, determined in the same manner as under paragraph (4)."

It is the interpretation of Section 46(f)(8) that was the principal issue involved at the hearing. That section permits a utility which had elected to flow through the investment credit under the 1971 Act to flow through the increased investment credit under the 1975 Act. It also provides that the taxpayer, if it does not so elect, may choose either a ratable flowthrough method or a rate base deduction method of accounting for the investment credit. The statutory language permitting those three options is set forth in Appendix A of this decision. For convenience, we will discuss the options as Option 1 - rate base adjustment; Option 2 - cost-of-service ratable flowthrough; and Option 3 - full flowthrough.

At the outset some utilities expressed fear that merely by holding the hearing the Commission was jeopardizing the election to be made by the utility. They cite the language in Section 46(f)(8) to the effect that "any taxpayer who had timely made an election under paragraph (3) may, at his own option and without regard to any requirement imposed by an agency [such as the Public Utilities Commission]...elect within 90 days after the date of the enactment of the Tax Reduction Act of 1975...to have the provisions of paragraph (3) apply with respect to the amount of the credit allowable...."

Notwithstanding their fear, four utilities presented evidence concerning their position on the investment credit permitted by the 1975 Act. Pacific Gas and Electric Company (PG&E) has determined to elect Option 3 on a five-year rolling average. The revenue-saving to the ratepayers would be approximately 91 million dollars over the five-year period. Both Southern California Edison (Edison) and Southern California Gas Company (SoCal) have determined to elect Option 2. San Diego Gas & Electric Company (SDG&E) has not yet made a decision but is leaning toward Option 2.

The position of the Utilities Division of the Commission staff is that the Commission should make its preference known for Option 3; the position of the Finance & Accounts Division of the Commission staff indicated that traditionally the Commission, as a matter of policy, has adopted for ratemaking purposes the immediate flowthrough method of treating flowthrough credits. As a practical matter F&A often used a five-year amortization period to level the peaks and valleys that can result from the application of flowthrough. Any change from this method should be made only after a convincing showing by the utilities of their need for additional cash flow. F&A recommends that the utilities justify their choice of methods, other than the flowthrough method, of treating the investment credit and that the Commission consider allowing the utilities to normalize the investment credit in those cases in which there is a need to increase cash flow. The position of the staff is that the Commission should not order the utilities to make any particular election but that the Commission should now indicate to the utilities how it expects to treat the credit when rates are to be fixed, and that at that time the Commission should determine whether or not the utility has acted imprudently in making its choice. The staff recommended that the Commission should indicate that the prudent choice is Option 3. The city of Los Angeles, the city and county of San Francisco, the city of San Diego, and TURN support the staff position.

The evidence presented at the hearing was brief. Edison presented one witness and an exhibit in support of its position to elect Option 2. The witness testified that Option 2 provides the greatest opportunity under the 1975 Act to increase the internal generation of funds, which in turn reduces the need for external funds, and also improves the before-tax interest coverage calculation. In the face of the severe capital shortage problems being experienced by Edison and the current inflationary period, Edison expects to have difficulty in obtaining needed capital from external sources. The investment credit, to the extent that it is retained by Edison, eases this situation. Other persons who commented on behalf of utilities reiterated this position. Both SoCal and SDG&E made arguments similar to Edison's. Arguments were made in opposition to the utilities' position and the staff introduced an exhibit. No other evidence was presented. At the conclusion of the hearing the Presiding Examiner announced his and the assigned Commissioner's tentative conclusion to recommend to the Commission that the Commission should declare that it is prudent for eligible utilities to adopt Option 3.

The utilities' position has two aspects: (1) That this Commission should make no statement at all concerning the 1975 Act, for to do so might be considered coercion by the Treasury Department in violation of Section 46(f)(8) of the Act; and (2) if the Commission does express an opinion, it should not state a preference for flow-through as such a preference would not only be coercive but would also violate the intent of Congress that utilities should benefit from the 1975 Act by retaining the investment credit to provide additional capital for investment.

I reject the idea that we cannot express an opinion concerning the investment credit provisions of the 1975 Act. Certainly we have the right to inform ourselves concerning the nature and interpretation of the statute, and we can think of no better place to obtain such information than at a public hearing where all interested parties of whatever persuasion may come forward and be heard. Even more compelling is our duty to announce our opinion concerning our interpretation of the Act so that those whom we regulate will be given guidance in conducting their affairs. If it comes to our attention that a utility might act imprudently, we should not sit idly by, especially when one of the results of a utility's imprudence would have a detrimental effect on the ratepayers.

The tax accounting election is solely up to the discretion of the utilities. I have no intention to dictate that election. The case of Pacific Tel. and Tel. Co. v Public Utilities Commission (1950) 34 C 2d 822, where the Commission prescribed the terms of a contract between the utility and its affiliate, is a useful guideline. In that case the court reversed the Commission on the ground that the Commission could not prohibit a utility from entering into an imprudent contract but that the proper remedy was to protect the ratepayer by disallowing the effects of the imprudence by proper ratemaking adjustments. (34 C 2d at 830.) The Commission need not, however, sit back and watch a situation develop without indicating that the utility may be making a poor choice. To the extent that the Commission knowingly remains silent in the face of a potentially imprudent act on the part of a utility would, in itself, be an act of imprudence on the part of the Commission.

We must analyze a utility's choice as it pertains to tax options and, if it has acted unfairly against the best interests of the ratepayers, we are compelled to make ratemaking adjustments to protect the ratepayers from management's imprudence. This concept has been frequently emphasized by the Commission and the courts.

> "We freely recognize, as does the Commission, that there are many areas and many situations which must remain within the jurisdiction of management. However, it has long been recognized that the establishment of public utility charges involves the assessment of costs for a public service. Basic to the purpose of the Natural Gas Act is a design of regulation concerned with final adoption of rate charges fairly intended to protect the public interest. Necessarily, the area of tax policies embraces managerial decisions directly reflected in the cost of natural gas supplies for the use of the ultimate customer. Here it seems to us quite reasonable and logical to recognize as inherent in the Commission the duty and requirement to exercise its expertise in evaluating the entire tax effect of managerial judgment. If such elected tax policies do not fairly indicate a reasonable and prudent business expense, which the consuming public may reasonably be required to bear, following the required hearing and review procedures, then federal regulatory intervention is required." (Midwestern Gas Transmission Company v Federal Power Commission (7 Cir. 1968) 388 F 2d 444, 448.)

> "The establishment of public utility charges involves the assessment of all reasonable costs for a public service, including taxes. In the initial instance, whether for financing, operating expenses or plant composition, most utility costs arise from the exercise of managerial judgments. Generally, when management judgments produce results which are unfair to the ratepayer, regulation steps in." (P.T.&T. Co. (1968) 69 CPUC 53, 62.)

> "Income tax expense must be considered by the commission in establishing Pacific's cost of service. [Citing cases.] However, 'the primary purpose of the Public Utilities Act is to insure the public adequate service at reasonable rates without discrimination; and the commission has the power to prevent a utility from passing on to the ratepayers unreasonable costs for materials and services by disallowing expenditures that the commission finds unreasonable.' [Citing cases.]"
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> "The same rule applies where the utility resorts to accounting practices which result in unreasonably inflated tax expense." (City and County of San Francisco v Public Utilities Com. (1971) 6 C 3d 119, 126.)

The argument that it is the "intent of Congress" that utilities should retain the investment credit deserves short shrift. When a statute is clear on its face, there is no need to determine the intent of Congress when applying the statute. This statute provides for three options, one of which is flowthrough. The utilities are free to choose flowthrough or either of the other two options. To the extent that Congress intended anything, it is certain that it intended that flowthrough be one of the options.

I agree with the recommendation of the Presiding Examiner and assigned Commissioner that it would be prudent for eligible utilities to elect Option 3. I make this statement based upon my reading of the statute, my experience and expertise with the issue of flowthrough versus normalization, with my understanding of the current financial situation of the utilities involved, and with my regard for the rights and interests of the ratepayers. I recognize that the question of imprudence on the part of a particular utility may not arise at all or if it does arise will be in the context of a rate case where all parties may present evidence on the issue of imprudence. I cannot exclude the possibility that on an individual basis there may be some utilities which can show that their choice was not imprudent.

In reaching my recommendation in this case I have considered the arguments of the utilities to the effect that it would be prudent for them to elect Option 2 because such election would assist the utilities in generating internal cash for plant expansion. For example, Edison asserts that total capital expenditures are currently estimated to be $3.2 billion over the five-year period 1975-1979. This five-year requirement is double the $1.6 billion capital expenditures for the preceding five-year period and will necessitate a substantial amount of external financing. Exclusive of refunding requirements, over 60 percent of such capital expenditures must be obtained from external sources through the issuance of securities. Normalization of the tax credit will reduce the requirement for obtaining external funds. I am also aware that normalization will improve the utilities before-tax interest coverage which, for many utilities, has been dropping. I recognize that improved interest coverage makes external financing easier. And I recognize that many utilities, such as Edison, are selling their common stock at below book value. Financing by means of selling additional common stock would result in a dilution in the value of current stock and would require earnings to support dividends. To the extent that normalization reduces the need for equity financing it will alleviate the effects of the dilution and will add to the utilities' financial strength.

Against the benefits to the utilities that normalization would bring, I have weighed the benefits of flowthrough. Under flowthrough the company simply passes on to ratepayers the benefits it receives in lowered taxes. This is the other side of the theory used by the utilities when they seek a cost of gas increase. If it is reasonable for a utility to pass on an extraordinary increase in expense, such as an increased cost of gas, it is equally reasonable for a utility to pass on an extraordinary decrease in expense, such as a decreased tax. If this was not a decrease in taxes but was a decrease in fuel costs, the tariffs of all of the electric and gas utilities in California would require a reduction in rates.

Whenever it has a choice the Commission has always rejected normalization and chosen flowthrough. This is no more than enforcing the traditional regulatory concepts that utilities have a duty to minimize expenses and that ratepayers shall be charged only for the expenses of the utility and for taxes "as paid". The principle of taxes as paid and the principle that investors supply capital and not ratepayers were most recently recognized in City and County of San Francisco v PUC (1971) 6 C 3d 119, 129 where it is stated:

> ". . . it is clear that requiring ratepayers to put up the capital...is contrary to the basic principle of utility rate setting. The basic principle is to establish a rate which will permit the utility to recover its cost and expenses plus a reasonable return on the value of property devoted to public use. (Citation omitted) By permitting Pacific to include in its costs such charge for federal taxes greatly in excess of its actual federal tax expense, the commission is deviating from this basic principle."

Finally, I have considered the practical effect of the consequences of normalization on the ratepayers. For example, in 1975 SoCal will receive $2,060,000 in tax credits. Under Option 3 it could reduce rates to consumers by $4,426,000. Under Option 2 rates would be reduced by only $114,000 and net investment tax credits would be $53,000. The actual tax credit under both methods is $2,060,000. If Option 2 is used, ratepayers would provide the utility with $4,312,000 more in rates than under Option 3 ($4,426,000 minus $114,000). The utility would, however, have only $2,000,000 more in tax credits ($2,060,000 minus $53,000). Ratepayers would have to provide the utility $4,300,000 in rates to give the utility $2,000,000 in capital. On its face this is a most imprudent means of raising capital.

After weighing the arguments, I feel that it is prudent for eligible utilities to elect Option 3, flowthrough.

This Commission is aware of the problems of the utilities in raising capital and in meeting their expenses. As a result of that awareness we have provided various methods by which utilities may obtain prompt rate relief outside of a general rate case. Those methods include Advice Letter filings, offset relief, and interim relief pending a general rate case. I see no reason to abandon traditional methods of regulation.

Dated at San Francisco, California, this 17th day of June, 1975.

D. W. Holmes, Commissioner

APPENDIX A

Internal Revenue Code 26 USC § 46

(f) Limitation in case of certain regulated companies.-

(1) General rule.-Except as otherwise provided in this subsection, no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer-

(A) Cost of service reduction.-If the taxpayer's cost of service for ratemaking purposes is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection); or

(B) Rate base reduction.-If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

Subparagraph (B) shall not apply if the reduction in the rate base is restored not less rapidly than ratably. If the taxpayer makes an election under this sentence within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary or his delegate, the immediately preceding sentence shall not apply to property described in paragraph (5)(B) if any agency or instrumentality of the United States having jurisdiction for ratemaking purposes with respect to such taxpayer's trade or business referred to in paragraph (5)(B) determines that the natural domestic supply of the product furnished by the taxpayer in the course of such trade or business is insufficient to meet the present and future requirements of the domestic economy.

(2) Special rule for ratable flow-through.-If the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary or his delegate, paragraph (1) shall not apply, but no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer-

(A) Cost of service reduction.-If the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit allowable by section 38 (determined without regard to this subsection), or

(B) Rate base reduction.-If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

(3) Special rule for immediate flow-through in certain cases.-In the case of property to which section 167(I)(2)(C) applies, if the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary or his delegate, paragraphs (1) and (2) shall not apply to such property.

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COMMISSIONER BATINOVICH, CONCURRING.

I concur with the determination that it is prudent for eligible utilities to elect the third option - flowthrough. However, I must stress that flowthrough is not necessarily the only prudent election. There are circumstances and conditions under which other elections might also be shown to be prudent.

I regard the tax benefits conferred on the utilities by election of the other options to be "windfall" in nature, and I believe that the benefit from such windfall should be shared by the ratepayers. I suggest that there may be substantial benefits to the ratepayers from other than a relatively slight rate reduction. Specifically, I propose as follows:

The rate base should be permanently reduced by the amount of the increased tax credit (in the same manner that I propose to reduce rate base to reflect the gain from the sinking fund redemption of bonds). The internally generated funds should be applied to the development of technology in the areas of conservation and development of alternative, less costly, energy sources. The May 1975 issue of Progress, the PG&E publication, discusses some of the alternative sources of power now being explored, not nuclear or fossil fuel but solid waste, geothermal, tidal, wind, and solar. By allocating substantial capital to the development of these alternatives we may be able to offer the ratepayers the only meaningful long-term benefit -- an assured source of energy at a reasonable price. The Commission would appoint a committee that would be

delegated the function of coordinating the efforts of the participating utilities and to assure the ratepayers that the dollars being spent, pursuant to this prudent election, were in fact being spent prudently.

Until electric utility companies are given financial incentive to develop new, less costly sources of fuel, I would expect little or no progress and therefore I would propose that the ratepayer and utility share in the savings of alternate fuels from today's present value of the equivalent oil cost pursuant to §456 of the Public Utilities Code.

Since both the shareholder and consumer will benefit from this proposal, the shareholders should participate in the contribution at least to the extent of accepting a self-imposed moratorium on any increases of dividends over present rates until such time as this energy crisis has been resolved. Furthermore, I would consider any increase in the dividend rate to be an imprudent allocation of resources.

In my opinion there will be no meaningful resolution to the energy crisis until electric utility companies have developed, built and are operating plants using substitute forms of present fuels that have a lower and relatively constant cost and hopefully endless availability.

Dated: June 17, 1975

San Francisco, California

Robert Batinovich, Commissioner