RE/lmm *

Decision No. 85627 ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of SOUTHERN CALIFORNIA GAS COMPANY for Authority to Increase Rates for Gas Service Due to Fuel Cost Adjustment. (Filed by Advice Letter No. 916).	Application No. 55676 (Filed April 23, 1975; amended May 16, 1975)
In the Matter of the Application of SAN DIEGO GAS & ELECTRIC COMPANY for Authority to offset the Increased Costs of Purchased Gas. (Advice Letter Filing No. 332-G).	Application No. 55677 (Filed May 7, 1975; amended May 16, 1975)
Application of Southern California Gas Company for authority to increase rates for gas service pursuant to fuel cost adjustment procedure. (Filed by Advice Letter No. 911).	Application No. 55544 (Filed March 6, 1975)
Application of San Diego Gas and Electric Company for authority to increase rates for gas service pursuant to fuel cost adjustment procedure. (Filed by Advice Letter No. 328-G).	Application No. 55543 (Filed March 6, 1975)

(Appearances listed in Appendix A)

O P I N I O N

The four applications listed in the caption, two for Southern California Gas Company (SoCal) and two for San Diego Gas and Electric Company (SDG&E), are all offset proceedings under purchased gas adjustment (PGA) clauses. All resulted in interim rate increases, the two earlier filed applications, resulting in interim decisions D.84291 and D.84290, both dated April 1, 1975, are here only for the purpose of determining the effect of the Tax Reduction Act of 1975 (TRA), which increased the investment tax credit (ITC) effective January 21, 1975. This issue will be discussed later in the opinion.

D.84569 dated June 17, 1975 in A.55676 granted SoCal a PGA rate increase of $25,668,000. On the same day D.84570 in A.55677 granted a derivative PGA rate increase of $2,569,000 to SDG&E as a result of SoCal's rate increase in D.84569. These two decisions ordered the rate increases spread on a uniform cents per therm basis to all classes of service until September 16, 1975, when the increases were to be applied only to non-residential schedules, with the proviso in D.84569 that SoCal's rates for resale customers (which include SDG&E) shall be set "without burdening their non-residential customers in any greater degree than those of SoCal". On June 24, 1975 Examiner Phillip E. Blecher issued a ruling consolidating these two applications for further hearing into the rate structure. On July 29, 1975 a limited rehearing was granted in both applications (pursuant to D.84726 and D.84727) for the limited purposes of determining whether the increases should be applied on a basis other than a uniform cents per therm and for further consideration of the issue of rate design. The decisions also ordered both utilities to collect rates on a uniform cents per therm basis until further order and made the previous orders (D.84569 and D.84570) subject to refund and/or reduction, should it be determined that SoCal has a reduced revenue requirement resulting from its ITC election under TRA. In D.84727 the ITC issue was not raised, but the entire rate increase granted therein was subject to refund or reduction (in the event that any such refund or reduction was required of SoCal under Schedule G-61, the schedule applicable to SDG&E). Pursuant to the examiner's ruling, A.55676 and A.55677 were consolidated for hearing on the issue of rate structure. These hearings were held from July 21, 1975, to August 19, 1975. The matter was submitted on the latter date subject to the filing of briefs, which were timely filed by eight parties. These hearings considered the following issues: (1) Whether the rate spread to non-residential customers by the Commission in D.84569 and D.84570 was the proper course of action under the circumstances; (2) if so, how could this rate spread be properly implemented, and (3) if not, how should these rates be structured? Collateral issues, such as the definition of residential and non-residential customers, restructuring of rate schedules not previously classified in those terms, and the meaning of the Commission's language in D.84569 which authorized the passing of the rate increase to SoCal's wholesale customers also became important. Further, since the submission of this matter on the Miller-Warren Energy Lifeline Act, effective January 1, 1976, became law (Public Utilities Code Section 739). This new law created a substantial impact on the issues to be determined here, as we will discuss later.

I. RATE SPREAD

The Evidence

All parties except the staff advocated the adoption of a uniform cents per therm rate spread on the general theory that the PGA is an offset only of the cost of gas and that this commodity cost should be spread uniformly among all its users. The staff recommended a rate spread that differed primarily in degree from the rate spread that had previously been authorized in D.84569 and D.84570. The staff witness recommended that the rate increase be spread to the lowest price tailblocks and up through the tailblocks in ascending order until all the rates were uniform. This is the staff's interim goal on the path to an inverted rate structure.1/ The staff bases its recommendation on the grounds that: (1) The conservation signal would be the same for all; (2) the administration would be easier for the presently overburdened staff; (3) gas would be priced tending toward its real value rather than its cost (value here meaning - as compared to the price of alternate fuels); and (4) after the first disproportionate increase each class of service would be impacted identically by changes in the cost of this commodity. The major disadvantages of this rate structure are that it departs from traditional and historical ratemaking concepts because the impact would be largest on the lowest priority customers, the level of service would no longer be important, cost as a factor in setting rates would no longer be as significant, the present rate structure and price priority system would be completely altered, and as curtailment of the commodity increased, future rate increases would be greater since the impact of the rate increase would be spread over a smaller number of customers.

The industrial witnesses contend that the assignment of the higher cost to the lowest priority users (commercial and industrial customers) negates the cost of service (cost allocation) theory of setting prices for commodities and will not have any beneficial effect on conservation of those users since they are already doing everything they can to conserve gas because of its relatively high cost. They also believe it would work adversely on conservation by the smaller (residential) users since no increase in rates would promote both the use of more gas and less efficient use of that gas which is available. General Motors presented an expert witness who testified, substantially, that rates should be set on the basis of

1/ In an inverted rate structure, the highest priority users (residential) pay the lowest price, while the lowest priority users pay the highest price. This is directly contrary to the existing and traditional rate pricing structures.

the cost of service and that utilities are really not in the business of selling a product but selling a service of delivering fuel to the end user. Thus, the cost of distribution and/or delivery should be allocated according to the respective costs of the various classes of customers. (The staff witness testified that the cost of service and cost allocation method of setting rates was never adopted by this Commission as the sole criterion for setting rates, but has been used as one of the criteria.) The industrial witnesses further testified that to upset the traditional relationship of rates would work a tremendous hardship on them and eventually the economy of California, particularly where California was in the lead in upsetting the traditional rate structure.

Discussion

Rates authorized to be charged by a utility must be reasonable, justified, and sufficient. Historically, this Commission has held that the primary test of reasonableness is cost of service.

In discussing rate design considerations in Re Pacific Gas and Electric Company, Decision No. 84902 issued September 16, 1975 in Applications Nos. 54279, 54280, and 54281, at mimeo. pp. 132-133, this Commission said:

> ". . . The design of rates is essentially an exercise of opinion and judgment in which we are bound by the statutory requirements that rates of California utilities be just, reasonable, and sufficient, and that there be no unreasonable difference in rates and charges, either between localities or between classes of service.17/ [17/ Public Utilities Code Sections 451, 453, and 728.] The Legislature, having established these guidelines, has left their implementation to the judgment of the Commission.
>
> "Over the years a generally accepted set of attributes of a good rate structure has evolved. These are:

> Production of the revenue requirement.
> Simplicity and ease of understanding.
> Stability of revenue.
> Fair apportionment of cost of service.
> Discouragement of wasteful use.
> Encouragement of efficient operation of system.
>
> "In the attempt to design rates possessing these attributes, various factors are usually considered. These are:
>
> Cost of service.
> Historical rate structure.
> Competitive conditions.
> Value of service, including 'what the traffic will bear'.
> Adequacy of service.
> Customer acceptance."

Among these alternatives, "cost of service" is regarded as paramount by a wide variety of regulatory commissions and scholars, and is advanced by many parties to this case as the most equitable and feasible choice. It is worth noting, however, that there is considerable ambiguity both in the term and in its application.

"Cost" can refer to actual historical cost, or to "marginal" or "incremental" cost--in other words, we can be speaking of the average cost of providing <u>existing</u> levels of service, or of the additional cost imposed by furnishing an <u>additional</u> unit of service. In broadest outline, a choice between these two definitions of cost is a choice between two competing goals of utility rate setting: equity and efficiency. Fairness to different groups of customers may be thought to require that the costs charged to each be actual, "bookkeeping" costs--the costs actually experienced by the utility in purchasing the equipment, fuel and labor needed to provide service. On the other hand, economic efficiency generally dictates that the price of a service be related, not to its cost in some previous period, but to the current cost of replication.

In setting the overall earnings allowed to a utility, this Commission--like many others--has opted for fairness. Setting all rates on the basis of "incremental" costs would, in a period of rapid inflation, produce grossly excessive revenues for utilities. Conversely, in a period of rapid technological progress and stable prices, a rate set on incremental costs might fail to produce sufficient revenue to keep the utility in business. Thus historical cost is used for the purpose of setting the overall level of rates.

It is argued, by analogy, that historical costs should also be used to set rates among various customer classes. But this conclusion does not automatically follow from the premise. It is administratively more difficult, as well as logically more questionable, to apportion historical costs among various customer classes than to use the total of such costs to set a revenue requirement. Most types of utility equipment serve more than one class of customer; a single pipeline, for example, may carry gas for a large manufacturer, a small farmer, a distant householder, and an LNG storage facility. While there are numerous formulae for making a pro rata allocation of such joint costs, they are all in large degree arbitrary. More importantly, such formulae bear no necessary relation to a pricing system designed to achieve an efficient allocation of resources.

In the simplified world of theoretical economics, efficient resource allocation requires that all prices be set equal to their "incremental" costs. In that way, prospective users of a service are confronted with the real cost to society of providing that service--a cost based on the current valuation of goods and services, not on outmoded historical costs.

As has been indicated, however, our system of regulation precludes setting all utility rates equal to the incremental cost of service. The excess revenues which such rates would produce must be scaled down to the utility's historically-based revenue requirement.

Once more, theoretical economics has an answer: services for which there is great elasticity of demand should be priced closest to marginal cost; inelastically demanded services should perform the task of reducing total revenues to the revenue requirement. The reasoning is straightforward. A price varying from marginal cost is a "wrong signal"--it tells prospective purchasers to use too much (or too little, if the price is above marginal cost) of the service in question. If, to meet the constraints of regulation, <u>some</u> prices must diverge from marginal cost, they should be the ones least likely to encourage distorted consumption patterns. If a service is inelastically demanded then, by definition, price does not have too much to do with consumer's decision as to how much to purchase. Thus offering below-marginal cost rates for these services will result in the least distortion from the optimal level of consumption.

This principle is subject to numerous qualifications in theory, and one embracing disability in practice. To apply the elasticity test (known in economics as the "inverse elasticity rule"), one must know something about the demand elasticities of various customer classes. But reliable information on this question is lacking. We agree with the parties who contend that the "inverse elasticity rule" does not offer a precise guide to rate setting. But neither does any other method of cost allocation.

In our view, the usefulness of the "inverse elasticity rule" is that it addresses the right question: which customer classes are most likely to conserve in response to prices? Even without a reliable numerical estimate of elasticities, we can make a common-sense answer to these questions and modify that answer as future research makes data available.

A word is in order about our understanding of the term "conservation." Two definitions could be given:

(a) The reduction in wasteful usage of gas.

(b) The reduction of total usage of gas.

These definitions are compatible if conservation is defined with reference to economic efficiency. Under current conditions, gas rates provide an incentive to use too great a volume. The cost of new supplies of gas is likely to be two or more times greater than the average historical price. Reducing total usage of gas is thus reducing wasteful uses of gas--defined as uses which would not occur if gas were priced at its full incremental cost. Conservation, then, means elimination of any use of gas which is not worth to consumers what it costs society to produce.

Efficiency is closely related, not simply to conservation, but to fairness. While there is no universally agreed criterion of fairness in any economic situation, we think that a system of rates which encourages efficient allocation is also a fair system. It does, to be sure, make distinctions among different classes of user, but the distinctions are rational ones and are not based on any arbitrary preferment.

We have concluded, then, to make conservation <u>in the sense of efficient allocation of gas</u> the keystone of the rate structure. Since the "inverse elasticity rule" cannot be applied without vastly more detailed data, we have decided simply to adopt its most general lesson: that rates should vary according to the likely ability of different classes of customers to adjust their consumption patterns. For this reason, we have adopted a "lifeline" policy for gas as well as electricity, under which a differential will be establsihed between the rate for basic, minimum household needs and for other usage. This policy accords with the policy adopted by the legislature in the Miller-Warren Lifeline Act, which finds that "Present rate structures for gas and electricity...encourage wastefulness by large users" and directs the Commission to "designate a lifeline volume of gas and a lifeline quantity of electricity which is necessary to supply the minimum energy needs of the average residential user" for specified end uses.

These changes in rate structure represent only a first effort toward the goal of encouraging conservation and careful use of energy. We intend to monitor closely the effect of these rate structure revisions and to make any necessary changes to assure that the rates are equitable and effective in encouraging conservation. We will, in addition, explore the possibilities for offering direct incentives in rates for the purchase of cost-effective solar appliances or conservation hardware.

We have chosen to place such heavy stress on conservation because we are convinced that a vastly accelerated conservation effort is vital to California's economic and environmental future. The natural gas shortage has already caused serious economic dislocation and a grave increase in air pollution through the substitution of fuel oil for gas in electric generation. Future supplies require the costly development of geographical or technological frontiers; in some cases, risks of safety, national security, or environmental damage may also be involved. Needless usage of gas will impose a heavy financial cost on California consumers and a health cost on residents. Conservation, along with continued assurance of necessary supply, must have the highest priority in the action of this Commission and of the utilities we regulate. Toward that end, the Commission has established a Conservation Staff Unit, directed the utilities to file periodic reports of their conservation programs, and set a policy of varying the rate of return allowed to utilities depending on the vigor, imagination, and effectiveness of their conservation efforts. We welcome the participation of the parties in this case--business, labor, agricultural, residential consumer, environmental, and other groups--in a continuing effort to devise effective conservation policies.

In this case we will adhere to our lifeline policy of placing the burden of rate increases on above-lifeline consumption at least until such time as the rate for lifeline rise is 25 percent below the average system rate. We will not order any decrease in the lifeline rates, as we believe that such a decrease would be misleading in a period of rapidly rising energy costs.

II. INVESTMENT TAX CREDIT (ITC)

The TRA of 1975, effective January 21, 1975, amends Section 46(f) of the Internal Revenue Code (IRC) of 1954 by increasing the investment tax credit for public utility property from four to ten percent for distribution property and from seven to ten percent for transmission property. For 1975 the increased credit for SoCal's transmission plant amounts to approximately $260,000 which translates into a revenue requirement equivalent of approximately $559,000, which is to be flowed through to the ratepayers. SDG&E's increased ITC for transmission plant is $21,700, equivalent to a revenue requirement of $46,900. There is no dispute as to these items. TRA provides three options for treatment of the additional credit, described as follows:

Option 1: Reduction of rate base with a pro rata restoration each year. (Since this option is not pertinent to the issues in this matter we shall not discuss it further.)

Option 2: Immediate credit to income taxes which is flowed through on a pro rata basis over the life of the property (ratable flow-through).

Option 3: Immediate flow-through of the full amount of the credit (full flow-through).

SoCal and SDG&E both timely notified the Internal Revenue Service of their elections of Option 2. Prior to the elections by SoCal and SDG&E of Option 2 all their previous ITC has been flowed through immediately to the ratepayer. In Exhibit 25 SoCal has indicated that the additional ITC to be realized under TRA for 1975 is $2,060,000 which translates into an annual revenue requirement of $4,426,000. Under Optinn 2 the sum of $114,000 would be flowed through to decrease the cost of service over each of 39 years. Under full flow through of the increase the entire revenue requirement would be flowed through in one year which means that in the year 1975 the difference in total revenue requirement is $4,312,000 ($4,426,000 less $114,000).

Presently it appears that SDG&E is in a "no tax" situation in 1975 (even without ITC). SDG&E has been found to need emergency relief in D.85018 dated October 15, 1975. In Exhibit 26 SDG&E shows that Option 3 would generate $521,000 in additional ITC for 1975 (assuming tax liability in at least that amount). This translates to an additional gross revenue requirement of $1,126,300. TRA Section 46(f)(2) provides that if the taxpayer makes an election for ratable flow through no credit shall be allowed "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 allowed by Section 38...." This means that if the state regulatory agency orders a faster than ratable flow through of ITC for ratemaking purposes after the utility has opted for ratable flow through, the increased ITC will be lost to the utility.

On June 17, 1975 C.9915, our investigation into the effect of ITC, was discontinued because the Commission was unable to agree on a result, though concurring opinions were filed by Commissioners Holmes, Ross, and Batinovich which indicate that they believed it would be prudent for the eligible utilities to elect the full flow through option, Option 3.

The basic position of the utilities is indicated in Exhibits 25 and 26 and briefs filed herein. Under Section 46(f)(8) each had an option to select one of the treatments of the ITC increase listed there. Each opted for Option 2, the ratable flow through method, and each believes it was the most prudent decision for substantially the following reasons:

1. It is difficult for the utilities to compete in raising funds in the capital market in recent years because of higher

construction costs, high inflation rates, generally increasing interest rates, lower utility earnings and reduced revenue growth due to declining energy supplies and the need for conservation. Therefore the increased ITC flowing through ratably increases its internal cash flow and decreases its need to go to external sources (debt and equity financing, for example), and leaves more cash available to meet urgent capital requirements (which shall increase in the coming years).

2. The increased cash flow is maximized without any cost to the ratepayers since the increased ITC is a form of interest-free loan by the government to the utilities. This is the way Congress intended TRA to function.

3. The additional cash flow generated by ratable flow through will not only reduce external financing requirements, but will have a favorable effect on the cost of money which still must be borrowed, as bond ratings would be helped, the cost of debt and equity capital will be reduced to the extent that the ITC reduces new capital requirements, and not as much capital will have to be raised in the open market.

4. It will increase the pre-tax interest coverage, facilitating the sale of securities and resulting in a lower interest rate, which the ratepayers would eventually pay.

5. Under Option 3 the full benefit of the increased ITC will go to today's ratepayers. This is essentially unfair because spreading the increase ratably over the expected life of the property would pass the benefit through to those people who are paying for the property in rate base and would more closely match revenue and expenses generated by the same property.

6. It provides a more economical source of capital than is otherwise available.
7. The language and legislative history of TRA establishes a congressional intention to provide an incentive to invest in plant and new sources of supply.
8. If this Commission forces a faster than ratable flow through the additional six percent ITC granted by Section 46(f) will be forfeited. This will have the effect of penalizing the utility because its rates would be reduced without the compensatory reduction in tax expense afforded by ITC.
9. Additionally, SoCal indicates that the imputation by the Commission of faster flow through of the additional ITC will amount to retribution against the company for exercising a lawful right to freely elect the method by which the additional ITC is utilized.

Southern California Edison Company (Edison), which selected Option 2, supports the position of SoCal and SDG&E, and cited some similar problems unique to electric utilities in support of this position.

Senate Finance Committee Report 94-36 indicates: "Under the bill, if a regulatory agency requires the flowing through of a company's additional investment credit at a rate faster than permitted, or insists upon a greater rate base adjustment than is permitted, the additional investment credit is to be disallowed, but only after final determination is put into effect."

The staff and the City of Los Angeles (LA) indicate that the utility should be either penalized or the rate should be adjusted in such a manner as to immediately flow through the benefit of ITC to the ratepayers because of the imprudent management of the company in selecting other than Option 3. SoCal believes that this procedure would not prevent the forfeiture of the increased ITC, since under the tax laws and the proposed IRS regulation5/ indicates that any reduction of cost of service which may be made as a result of any accounting treatment of ITC would create a forfeiture. SoCal and SDG&E maintain that both Options 2 and 3 flow through the entire ITC to the ratepayers, the difference being in the period of time over which it takes place. This is one year for an immediate flow through or 39 years (approximately) under ratable flow-through. The utilities believe that it is more prudent for the utility and more just to the future ratepayers to flow through the credit ratably so as to benefit all future ratepayers over the life of the property which is generating the credit.

SDG&E maintains the appropriate test for prudent utility management is one based on the established legal concept of the reasonable man: Has the utility acted reasonably and exercised sound judgment under all the circumstances? It argues that D.85018 dated October 15, 1975, granted SDG&E interim emergency rate relief and contains express findings that the utility could not issue mortgage bonds at the present time; that its inability to issue securities to meet present financial requirements constitutes a financial emergency requiring immediate interim rate relief; that until SDG&E's earnings are sufficient to allow it to issue additional securities the present financial emergency will continue and that without its estimated construction program, its ability to provide adequate service may be impaired.6/ In D.84600 dated June 24, 1975 in A.55596, where we

5/ Proposed Reg. 1.46-5(b)(2)(1).

6/ Findings 5, 10, 11, and 12 of D.85018.

granted SDG&E authority to sell and lease back its office building we found that SDG&E could not issue mortgage bonds at that time and needed additional capital in 1975.[7/] This was two days prior to the election of Option 2 by SDG&E. SDG&E maintains its election of Option 2, though before the fact, furthered the Commission's intention in granting it interim relief.

The staff position is that prudent management required the selection of immediate flow through (Option 3), since those who are actually paying the taxes of the utility, (the ratepayers), are entitled to reap the benefit of the tax savings. The staff maintains that the benefits to the company are minimal and that Option 3 represents the largest reduction in revenue requirement because of the greatly reduced tax expense, while Option 2 represents the least reduction in revenue requirement because of the length of the expected life of the property involved (estimated to be 39 years), which results in about a 2½ percent per year ratable reduction. The Commission has previously adopted full flow through treatment of ITC in the past whenever possible. All major energy utilities have been operating on that basis California, though with some variations. The staff also takes the position that the election of Option 2, particularly with the knowledge that it could result in a forfeiture of ITC (as to distribution properties) must be considered as managerial imprudence which should result in a substantial penalty by the Commission. The staff indicates that SoCal's disregard of the ratepayer's interest is evidenced by its concept of sharing where under Option 2 SoCal will receive 38/39ths of the benefits in 1975 and the ratepayers will

---

7/ Findings 1 and 5 of D.84600.

receive the remaining 1/39th. Staff also takes the position that a penalty for managerial imprudence does not result in the reduction of tax expense or any other expense normally considered in determining the cost of service of a California utility, nor does TRA bar a penalty for managerial imprudence, thus, no forfeiture would result from such action. The staff concludes that SoCal should be penalized for managerial imprudence and recommended a penalty in the neighborhood of $4,000,000 to $4.5 million for SoCal to make clear that it cannot arrogantly disregard the interest of its ratepayers and to make the ratepayers whole or nearly whole.

LA maintains that SoCal's cost of gas increase must be reduced by a total refund of $4,981,000, consisting of revenue requirements generated by the increased ITC. LA maintains that Option 2 results in maximum rates, minimum benefits, and a collection of phantom taxes from ratepayers (rates based on tax liabilities not actually incurred by the utility), and places on the ratepayers the burden of an unreasonable expense due to an imprudent management decision. LA and the City of San Diego also maintain it results in an impermissible involuntary capital contribution from ratepayers. (City and County of San Francisco vs. PUC, 6 Cal 3d 119 129.) It also maintains that the normalization method (Option 2) is actually the most expensive method of raising capital as the ratepayers would have to provide the utility $4,300,000 in rates to allow the utility $2,000,000 in capital. LA also states that failing to find that the choice of Option 2 is an imprudent decision will not only harm the ratepayers but will reward imprudent utility management at the expense of the prudent management of companies which elected Option 3, such as PG&E. (City and County of San Francisco vs. PUC, supra.) LA states SoCal is interested in quickly passing on cost of gas increases but wishes to retain tax decreases, and should not be permitted to have it both ways. It also maintains that in A.55345 (SoCal's pending general rate case) the utility did not reduce its requested return on equity as a result of the additional ITC (but actually increased it), thus making the ITC a windfall to the utility to be used as desired.

Discussion

Assuming, without deciding, that the utilities were correct in their assertion that by exercising Option 2 their financial risk has been significantly reduced, this Commission cannot ignore such a circumstance. In its brief filed October 23, 1975, for example, SoCal said in part:

> "The cash flow generated by the ratable flow-through method will reduce SoCal's external financing requirements and will have an actual and favorable effect on SoCal's cost of money. It is believed that SoCal's election will have a positive impact on its bond ratings and cost of debt and equity capital. SoCal's capital requirements will be reduced to the extent that the portion of the credit invested in rate base reduces the company's new capital requirements. Also, SoCal will not have to raise the equivalent amounts in the open market at today's high interest rates. Furthermore, ratable, flow through will increase SoCal's before-tax interest coverage, thereby facilitating the sale of securities and resulting in a lower rate of interest for payment by the consumers." (Pp. 4-5.)

We do, of course, have the continuing duty in line with The City of Los Angeles v PUC, S.F. No. 23215, decided December 12, 1975, to consider the effect of the utility's election on the risk characteristics of its securities and other financial conditions.

It is our informed judgment that a rate of return adjustment downward of 0.25 percent will best recognize the reduction of risk claimed by SoCal in its choice of Option 2. The rate base to which the 0.25 percent rate of return adjustment reduction shall be applied is that set forth in Exhibit 4, presented by SoCal, of $824.5 million on a 1974 test year.

SDG&E is in a different situation. Because of the likelihood of a very low tax liability for this company, election of Option 3 would not have had the same benefits for ratepayers as it would for other utilities, such as SoCal, which have positive tax liabilities. However, we will again review this issue in SDG&E's next general rate proceeding and make whatever adjustments that appear appropriate at that time. There is again no dispute over the flow-through treatment of SDG&E's ITC relevant to its transmission facilities, in the amount of $46,900.

Findings

1. This Commission has never used the cost of service ratemaking theory as the sole criterion for setting rates, but considers the cost of service as one of many factors in ratemaking.

2. Pursuant to the directions contained in the Lifeline Act this Commission instituted C.9988 to determine the matters required thereunder. The hearings there will be considered as an extension of the work in C.9804, C.9642, and C.9884 regarding rate design and structure. The Lifeline Act defines "residential" as meaning domestic human needs end-use. This Commission expects that the final lifeline rates and rate designs will be determined in C.9642, C.9884, and C.9988.

3. We have previously indicated that the amount of 75 therms is a reasonable lifeline basis for spreading rates for increased gas costs. Seventy-five therms of general service gas use is reasonable in these matters as a lifeline quantity, pending final determination in C.9988.

4. The lifeline rates should not be decreased because a decrease in the lifeline rates would be misleading in a period of rapidly rising energy costs. Therefore the existing rate spread as originally ordered in these offset proceedings shall continue in effect.

5. A rate of return adjustment downward of 0.25 percent on an $824.5 million rate base will best recognize the reduction of risk claimed by SoCal in its choice of Option 2.

6. Because of the likelihood of a low tax liability for SDG&E, no rate adjustment will be ordered herein, except with respect to the accrued ITC on its transmission facilities. This sum, which was not in dispute, amounts to $46,900.

Conclusions

1. With respect to SoCal, a rate of return adjustment downward of 0.25 percent on an $824.5 million rate base is appropriate. This adjustment, translated into the corresponding gross revenue amount by SoCal, should be refunded on a uniform cents per therm basis to all customer classes (since this is the manner in which the increase granted by D.84291 was spread). SoCal should be ordered to file a refund plan within thirty days after the effective date of this order.

2. SDG&E should be ordered to refund the sum of $46,900 (together with any refund obtained from SoCal pursuant to this order) on a uniform cents per therm basis (since this is the manner in which the increase granted by D.84290 was spread). SDG&E should be ordered to file a refund plan for these sums by advice letter within thirty days after the approval by this Commission of SoCal's refund plan.

O R D E R

IT IS ORDERED that:

1. With respect to SoCal, a rate of return adjustment downward of 0.25 percent on an $824.5 million rate base, translated into the corresponding gross revenue amount, is ordered to be refunded on

a uniform cents per therm basis to all classes, pursuant to a refund plan to be filed by applicant within thirty days after the effective date of this order, which must be approved by this Commission.

2. San Diego Gas & Electric Company is required to refund $46,900 as the increased investment tax credit for 1975 on its transmission property, together with any sums required to be refunded to San Diego Gas & Electric Company by Southern California Gas Company pursuant to paragraph 3 of this order. This refund is to be made on a uniform cents per therm basis to all classes pursuant to a refund plan to be filed by advice letter of applicant within thirty days after Commission approval of the refund plan required to be filed under paragraph 1 of this order. The refund plan filed hereunder must be approved, with or without amendments and additional hearings, by this Commission.

The effective date of this order shall be twenty days after the date hereof.

Dated at San Francisco, California, this 30th day of MARCH, 1976.

I will file a written dissent.
William Symons Jr.

I will file a written dissent
Vernon L. Sturgeon

President

Leonard Ross
Robert Batinovich
Commissioners

APPENDIX A

LIST OF APPEARANCES

Applicant: William M. Pfeiffer and David B. Follett, by David B. Follett, Attorney at Law.

Protestants: Herman Mulman, for Coalition for Economic Survival; Jules Kimmett, for Concerned Citizens of Burbank.

Interested Parties: Chickering & Gregory, by Donald J. Richardson, Jr., and David A. Lawson, Attorneys at Law, for San Diego Gas & Electric Company; Burt Pines, City Attorney, by Leonard L. Snaider, Deputy City Attorney, for the City of Los Angeles; John W. Witt, City Attorney, by William S. Shaffran, Deputy City Attorney, for the City of San Diego; Manley W. Edwards, Utility Rate Consultant, for the City of San Diego; Rollin E. Woodbury, H. Robert Barnes and Norman G. Kuch, by Norman G. Kuch, Attorney at Law, for Southern California Edison Company; Gordon Pearce, Attorney at Law, and John H. Woy, for San Diego Gas & Electric Company; Alexander Googooian, Attorney at Law, for the City of Bellflower; Henry F. Lippitt, 2nd, Attorney at Law, for California Gas Producers Association; Brobeck, Phleger & Harrison, by Gordon E. Davis and Thomas G. Wood, Attorneys at Law, for California Manufacturers Association; Robert Russell, for Department of Public Utilities and Transportation of City of Los Angeles; M. H. Furbush, by J. C. Russell, Jr., for Pacific Gas & Electric Company; Gary H. Twisselmann, for Ford Motor Company; Philip A. Stohr, Attorney at Law, for General Motors Corporation; Frank J. Dorsey, Attorney at Law, for Consumer Interest of the Executive Agencies of the United States.

Commission Staff: Janice Kerr, Attorney at Law, Edmund J. Texeira, and G. L. Way.

A. 55676)
A. 55677) D. 85627
A. 55544)
A. 55543)

COMMISSIONER WILLIAM SYMONS, JR., Dissenting

1. Imprudence. If there is "imprudence" exercised in the case before us, the imprudence is that of the Commission majority, not Southern California Gas Company.

It is dangerously clear to me that the majority is playing "chicken" with the Congress and the Internal Revenue Service. The majority's ruse, to work a penalty on the gas company without labeling it such, is transparent. Such Commission action runs the serious risk of losing the approximate 4½ million dollar increased investment tax credit from the Federal Government to the gas company. If the gas company refunds that amount to the ratepayers pursuant to today's order, and then, as a consequence loses eligibility for the tax credit, the company will have to pay a second time to the taxing authorities in Washington, D.C. While the hardship falls immediately on the gas company, by unnecessarily eliminating a reasonable program of encouragement and assistance in needed capital investment, it works to the detriment of the gas customers of Southern California in the longer term.

2. Prudence. A considered approach to the severe energy supply problem of California counsels foregoing the quick thrill of a rate reduction today when it means compounding tomorrow's problems. Southern California Gas Company, as well as other gas companies across the land,

A. 55676)
A. 55677) D. 85627
A. 55544)
A. 55543)

face a severe test in the capital markets of raising the immense funds for necessary plant facilities and to develop replacement alternatives for today's diminishing supply of natural gas.

Congress, seeing the particularly acute problem of the utility industry, took steps to help remedy the problem in the Tax Reduction Act of 1975. As an inducement and aid to capital investment, it provided that where qualified investments were made, the Federal Government was willing not to collect, but to forgive, a calculable sum of taxes otherwise due the federal treasury. It is only speciously argued that the intent of this credit was to lower utility bills immediately. The legislative history, as well as a fair reading of the act itself, convince us of that. It is an increase in the Investment Tax Credit and designed to foster exactly that -- investment. By choosing Option 2 (ratable flow through of the credit over the useful life of the property), Southern California Gas Company has made a prudent choice in light of the economic realities and the enormous capital requirements facing the company in the years ahead.

3. Penalty. Congress, in dealing with funds due the United States Treasury, clearly has the authority to set the framework for their use. In increasing investment tax credit, Congress specified that power to select which option was to apply, was to lie with utility management, uncoerced by regulatory agencies. If that free exercise of choice was not permitted, requisities for the increased investment tax credit were not met. Today's majority of this Commission came dangerously close to such interference in Case 9915, last June, but then backed away.

However, now when Southern California Gas Company has chosen one of the options legally and properly available to it, retribution descends.

Though today's decision styles the penalty in the language of reduction of authorized rate of return, it is apparent to me that it is little more than a ruse. The company, which took Option 2 for its long-term benefits in improving the capital investment picture, is deprived in one swoop of all benefit. It has the same effect as immediate flow through, and exposes the company to the danger of serious tax liability.

This action is suspect by its very design and is deficient in its lack of a record to support it.

How was the figure of 0.25% reduction in rate of return derived? No basis is provided in the decision but the unstated amount of reduction works out to $4,430,000. This is so remarkably close to the amount of investment tax credit of $4,426,000 as to lead me to believe that the 0.25 figure was derived to exactly eliminate the savings on the investment tax credit.

I find support in this thought by the fact that not one shred of evidence was taken, such as data on comparable companies in similar circumstances, in establishing this new figure for rate of return as appropriate.

One additional important matter should be noted. The company is presently authorized an 8.50% rate of return. Ostensibly, the majority's order would reduce this to 8.25%. Yet, an essential factual question to ask before then going on to find a 4½ million dollar refund due is whether the company is actually earning at its 8.50% level.

A. 55676)
A. 55677) D. 85627
A. 55544)
A. 55543)

Our only previous finding in this case (A. 55676), D. 84569 dated June 17, 1975, (Finding 5) was that even with the PGA, Southern California Gas Company would not exceed applicant's authorized 8.50% rate of return. Under uncontested exhibits before us at that time, if the company were granted a $31.3 million PGA its adjusted recorded rate of return for 1974 of 7.55% would rise to 8.47%. However, in that decision we granted $25.7 million and the resulting rate of return was left unstated but clearly not the authorized 8.50%. This puts us on notice that if we seek to reduce realized rate of return we have to make a factual inquiry into what rate of return is actually being experienced. If the company is only currently earning 8.0%, to require full refund of 4½ million dollars would be to lower their rate of return nearer to 7.75% than 8.25%.

To proceed without these necessary inquiries, I believe shows the reduction in rate of return up for what it is -- an artifice to penalize the company and effect immediate flow through. I cannot see how it can otherwise but jeopardize Southern California Gas Company's eligibility to qualify for the increased investment tax credit, and this is a deplorable and unwise action.

4. Rate Spread Discussion. The departure from primary attention to cost of service in rate design is announced in this decision. Though it does not have operative effect in this order and is therefore dicta, this discussion should not pass as firmly accepted Commission doctrine. See Decision 85559 in Case 9804, Majority and Minority Reports to the Legislature as well as the added comments of Commissioner Holmes.

San Francisco, California
March 30, 1976

William Symons, Jr.
WILLIAM SYMONS, JR.
Commissioner

A. 55676

COMMISSIONER VERNON L. STURGEON, concurring in part and dissenting in part

I dissent to that part of the order which requires Southern California Gas Company to file rates which will effect a downward adjustment of 0.25 percent on an $824.5 million rate base. While its claimed purpose is to offset the financial advantage or, as they put it, the reduction of risk which the company claims it accomplished by the selection of option 2, it is quite clearly a thinly-disguised gimmick, a devious method to penalize it for imprudence for exercising the second of three options made available by Federal law.

Further, it is an act of utmost irresponsibility to quantify such financial advantage in the absence of any evidence that utilities generally have exercised option three. I know of no major utility other than PG&E which has made such a selection.

It cannot, in my opinion, be imprudent for a utility to follow policy established by Federal tax law.

It cannot be imprudent for a utility which is hard pressed to meet expanded capital demands arising out of gas supply shortages to make a selection which it is convinced will best accomplish future goals and in the long haul benefit both its customers and shareholders.

San Francisco,
California
March 30, 1976

Vernon L. Sturgeon
VERNON L. STURGEON
Commissioner