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ORIGINAL

Decision 84 05 036 MAY 2 1984

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's own motion into the method to be utilized by the Commission to establish the proper level of income tax expense for ratemaking purposes of public utilities and other regulated entities.	OII 24 (Filed September 6, 1978)

(See Decision 93848 for appearances.)

Additional Appearances

Donald M. Clary, Attorney at Law, for Southern California Edison Company; and William H. Edwards, and Craig M. Buchsbaum, Attorneys at Law, for Pacific Gas and Electric Company; respondents.

FINAL ORDER

I. Introduction

In the order that instituted this investigation we stated:

> "The determination of reasonable allowable ratemaking expenses for federal and state income taxes is a matter of continuing concern to this Commission in its effort to establish reasonable utility rates. We wish to fully analyze certain past policies and methodologies employed to arrive at a reasonable allowance for test-year income tax expense, and to consider alternatives."

We listed ten specific issues that we expected the parties to address. We recognized that resolution of these specific issues would have significant implications for such matters as rate of return and cash flow, and directed parties proposing substantial changes to quantify the resulting effect on net earnings, and to submit proposals that would allow the utilities to remain financially healthy. Three additional issues were included by Administrative Law Judge's ruling.

On March 27, 1979 the Commission issued Decision (D.) 90096 for the purpose of clarifying an apparent misinterpretation by several respondents and interested parties regarding the issues to be enumerated in this OII. We stated on page 1 of D.90096 "...the Commission does not wish to hear further evidence or argument on decisions which we have heretofore reached with regard to normalization as opposed to flow-through issues. The issues were not intended by the Commission to be introduced in this OII, and we affirm that such issues will not be addressed in this case." Accordingly, we shall not rule on any issues which would result in a change from our current policy.

During the course of this proceeding the Economic Recovery Tax Act of 1981 (ERTA) was enacted. In recognition of ERTA's significant immediate and long-term implications for rate-making, the Commission staff (Staff) requested that utility respondents be required to furnish information regarding impacts of ERTA for the record in this proceeding. This matter was bifurcated, with ERTA as the subject of the first phase, leaving the generic ratemaking question for the second phase.

The first phase culminated in D.93848, dated December 15, 1981. Limited rehearing of D.93848 was ordered by D.82-02-131. Rehearing was held on October 8, 1982. By this decision we resolve the matter reheard, as well as complete the second phase.

This entire matter was finally submitted following 22 days of public hearing and the receipt of 74 exhibits. Evidence in this second phase was offered by Staff, Southern California Edison Company (Edison), Pacific Gas and Electric Company (PG&E), Southern California Gas Company (SoCal), San Diego Gas & Electric Company (SDG&E), The Pacific Telephone and Telegraph Company (PT&T), General Telephone Company of California (General), Continental Telephone Company (Continental), Southwest Gas Corporation (Southwest), California-American Water Company (Cal-Am), Arthur Andersen & Company (Andersen), Dean Witter Reynolds, Inc. (Witter), First Boston Corporation (First Boston), and Merrill Lynch White Weld Capitol Markets Group (Merrill Lynch). Briefs were filed by Staff, Edison, PG&E, SoCal, SDG&E, PT&T, General, Sierra Pacific Power Company (Sierra), Continental, Andersen, and the cities of Los Angeles, San Diego, and San Francisco (Cities).

II. Issues Presented

The order instituting this investigation lists the following issues to be considered in this proceeding.

1. Whether, for purposes of computing estimated test-year income tax expense, interest expense allocated to nonutility operations, i.e., so-called "below-the-line" interest, should be used as an income tax deduction in arriving at the amount of the regulatory allowance for income taxes.

2. Whether expenses disallowed by the Commission for ratemaking purposes (e.g., dues and donations, etc.) should be included as income tax deductions in computing estimated test-year income tax expense.

3. Whether, for purposes of computing estimated test-year income tax expense, the impact of nonutility and affiliated entities operations as reflected in consolidated income tax returns should be considered.

4. Whether, for purposes of calculating test-year income tax expense, reduced income taxes resulting from the deductions for tax purposes of deferred energy costs should be considered.

5. What levels of investment tax credit should be utilized in calculating test-year income tax expense.

6. What differences exist between estimates of revenues and expenses used for ratemaking purposes to calculate income tax and the revenues and expenses recorded and reported on income tax returns.

7. Differences between deductions claimed by utilities for ratemaking purposes and those used on income tax returns (e.g., repair allowance, tree trimming allowance, accelerated depreciation, etc.)

8. Differences between state and local taxes claimed by utilities for ratemaking purposes and those used on income tax returns (e.g., State Corporation Franchise Taxes).

9. Effect of net operating loss carry backs and carry forwards and investment tax credit carry backs and carry forwards on income taxes actually paid.

10. What tax rate should be assumed when establishing a net-to-gross multiplier (to convert a net income requirement to the necessary gross billing revenue increase).

11. Such other income tax related issues as may be developed by the evidence to be presented in this proceeding.

The Administrative Law Judge's ruling added the following issues:

1. What should be the appropriate ratemaking treatment of affiliate's income tax liability for purposes of Gas Exploration Development Adjustment (GEDA) and Energy Exploration Development Adjustment (EEDA)?

2. How should the incremetal California franchise tax rate be used for ratemaking purposes?

3. What is the appropriate ratemaking treatment for income tax purposes of the inclusion or exclusion of short-term debt from the capital structure?

The provisions of ERTA have rendered moot any further consideration of the fifth issue recited in the original order regarding the level of investment tax credit that should be used in calculating test-year income tax expense.

III. Discussion

A. Introduction

The record reflects near unanimity of opinion on the part of utility and financial industry parties regarding each of the specific issues. Therefore, in the discussion that follows, individual parties will not be identified, except as necessary. The term "Industry" will be used to identify their consensus position.

In the original order we stated our expectation that the Finance, Operations, and Legal Divisions of the Staff would fully participate. Accordingly, the Directors of the Finance Division (Boneysteele) and the Operations Division (Davis) each prepared extensive testimony and submitted to cross-examination. A subsequent staff reorganization left Davis as Director of the Revenue Requirements Division, a consolidation of the Operations and Finance Divisions. Where Davis and Boneysteele disagree, their positions are identified by name. Where they agree, their positions are identified as Staff positions. The Legal Division took no position on any issue in the second phase of this proceeding.

B. The Cities' Position

In their brief, Cities offer the proposition that taxes should not be taken into account for ratemaking. If this position were to prevail, then analysis and discussion of these specific issues would not be necessary.

Cities have simply repeated the position they took in the first phase of this proceeding. In D.93848 we considered this matter and stated:

> "We are not inclined to consider such a monumental change in fundamental ratemaking practices based on such a limited record. The second phase of this proceeding is a suitable vehicle for San Francisco to more fully develop its position and we defer any judgment accordingly." (Mimeo p. 11).

Cities chose to make no further showing in this regard. Accordingly, we will consider this matter no further.

C. Whether, for purposes of computing estimated test-year income tax expense, allocated to nonutility operations, i.e., so-called "below-the-line" interest should be used as an income tax deduction arriving at the amount of the regulatory allowance for income taxes.

The current practice in the development of income taxes for rate fixing is to exclude as a tax deduction the interest expense associated with nonutility plant and investment. By far the greatest dollar amount of nonutility investment is represented by construction work in progress (CWIP). Such CWIP is classified as nonutility because it is plant that is not used and useful for utility operations.

The utility recovers this interest expense by capitalizing the debt or interest cost via the debt component of the Allowance for Funds Used During Construction (AFUDC). The amount to be capitalized is the net amount of the interest expense, after effect of income taxes, or approximately 50% of interest expense. This method is called the "net method," and is consistent with the Uniform System of Accounts provision that interest during construction includes the "net cost...of borrowed funds."

Excluding such interest expense as a tax deduction in the income tax calculations for rate fixing in the test-year results in the test-year income taxes being greater than if calculated on an "as-paid" basis. However, because the tax effect of the AFUDC is credited to plant, rates for future ratepayers will be lower due to the lesser depreciation of, and return on, the net cost of borrowed funds in plant accounts.

Two alternate methods are also discussed in the record. One of these is the "gross method," which would give the current ratepayer the full benefit of the tax deduction in the year the tax deduction is taken on the utility's tax return, and then add the full amount of interest expense to the capitalized asset. This has the effect of reducing the cost to the current ratepayer, but increasing it at a later time to the future ratepayer.

The other method is the "Boneysteele gross method." Under this method the gross AFUDC rate is used and the allowance for income taxes is reduced, but the utility is allowed an increased return on equity so that its cash flow is not reduced.

Davis and the Industry support the continued use of the net method. Boneysteele recommends that the Commission adopt the gross method adjusted to allow the higher return on equity.

Davis approached this issue in terms of which method is more beneficial to the ratepayers, and found that he could not provide a definitive answer. To ascertain the cost to the ratepayers for purposes of comparing the methods, he designed a mathematical model to compare the present worth of the alternatives -- whether the lower income taxes represented by the tax effect of the interest expense associated with CWIP should be reflected currently on a flowed-through basis to net operating revenues, or reflected as a reduction in utility plant with lesser depreciation and return over the life of the plant. Based on these calculations, he concluded that if the present worth value to present ratepayers is in the range of 10% or more, and utilities under the Rate Case Plan are not expected to file rate applications more frequently than once every two years, then the gross method of calculating AFUDC rates together with the use of the AFUDC as a current deduction in income tax calculations for rate fixing would be less costly to the ratepayers, even if the Commission gives consideration to the negative qualitative factors of using the gross method by authorizing a higher return on equity. For the purpose of this analysis, he assumes that the same ratepayer will be there to either benefit or pay for the additional costs.

Davis testified that "during the current financial scenario in the economy," the net method is the appropriate method. He bases his opinion on his mathematical model and on his observation that allowed rates of return are trending upward, which, when combined with other negative qualitative factors associated with changing methods, would result in a higher cost to the ratepayers. He also supports the net method because it relates costs to the consumption of capital, resulting in future ratepayers paying only their portion of the cost.

Boneysteele disagrees with the premise that such matters as CWIP and nuclear fuel in process of refinement are "nonutility" in nature. He observes that these items are classified as utility plant by the Uniform System of Accounts. He concludes that since CWIP and nuclear fuel are obviously utility property, it follows that the interest associated with that property should be taken as an interest deduction in determining an allowance for income taxes.

He considers the net method to be analogous to normalization of accelerated depreciation, and subject to many of the same counter-arguments. He warns that the public realization that utilities are authorized to collect through rates taxes that are not actually paid has an adverse effect on the credibility of the regulatory commission and the utilities.

The Industry vigorously supports the use of the net method. These parties point out that CWIP is not included in rate base in California, and therefore does not constitute a financial burden to the ratepayers until such facilities are put into rate base. They claim that the Boneysteele gross method would result in current ratepayers immediately receiving the benefits of the tax savings resulting from the interest deduction on debt used to finance plant under construction, even though such benefits occur prior to the plant being put in rate base. This would mean that the tax benefits attributable to interest expense would be provided to current ratepayers, who had not assumed any of the financial burdens related to the new plant.

They argue that either gross method violates a fundamental concept of tax law -- in order for a taxpayer to deduct an expenditure or to depreciate a capital asset in arriving at the taxpayer's taxable income, the taxpayer must be liable for and/or incur the financial detriment resulting from the expenditure, or must be the party bearing the financial burdens of ownership in the asset. Thus, they conclude that either gross method is inequitable.

Industry also warns that the financial markets are unlikely to view the higher rate of return recommended by Boneysteele as a beneficial development, if the higher return replaces lost cash flow resulting from a change to the gross method. They suggest that even if cash flow is maintained in the short run, the financial markets may require a still higher rate of return in order to account for what may be perceived as a methodology which could reduce the security of their investment. Investors may view the higher rate of return associated with a change from the net method to the gross method as only a temporary phenomena. They claim that such a perception would harm both the ratepayer and the utility shareholders, in that the ratepayers would face higher rates to pay for increased debt costs.

We are satisfied that the net method has been reasonably applied and that no change is necessary. Therefore, we provide for the continued use of the net method.

Our primary consideration is the matching of interest expense with the rate base treatment of the investment. We agree that the net method is consistent with the exclusion of CWIP from rate base. If the present ratepayers do not bear the burden of financing new plant, if follows that their rates should not be lower based on the tax consequences of that investment in new plant.

This conclusion does not depend on Davis' present worth analysis, which does not distinguish between present and future ratepayers. Even if the cost to the ratepayers as a whole is found to be higher using the net method, the net method more fairly matches the benefits and burdens as to present versus future ratepayers.

We also share Industry's concerns regarding the impact of a shift from the net method to the gross method. The additional rate of return allowed using the gross method may appear inadequate to investors (and too generous to ratepayers).

We recognize that the use of the net method contributes to the disparity between taxes allowed and taxes paid. However, the purpose of this proceeding is not necessarily to eliminate such disparities. In this instance the disparity results from the consistent application of a principle that we have found to be in the public interest, the exclusion of CWIP from rate base. We are not persuaded that regulatory credibility is enhanced by a change in these well-founded policies.

D. Whether expenses disallowed by the Commission for ratemaking purposes (e.g., dues and donations, etc.) should be included as income tax deductions in computing estimated test-year income tax expense.

The Commission has consistently disallowed for ratemaking purposes such expenses as donations, dues, and contributions to charitable, social and political organizations, as well as expenses for legislative advocacy and certain types of advertising. There are also other expenses that, in the course of a rate proceeding, may be contested by Staff or by interested parties and which the Commission may decide to disallow.

The Commission has consistently calculated income taxes for ratemaking purposes based on the cost of service developed from adopted expenses, which excludes the various disallowed expenses. This method results in adopted income taxes higher than otherwise, because the disallowed expenses are not included as tax deductions. Both the Staff and the Industry recommend that the present practice continue.

Staff points out that since the dues, donations and other nonrecognized expenses are not included in the revenue requirement, their incidence cannot fall on the ratepayer. If these expenses were not incurred, earnings would be higher. The taxing authorities have chosen to mitigate the burden on the donor (the stockholder) by assuming half of the contribution themselves. Staff takes the position that this is properly a matter between the taxpayer and the taxing authorities which the Commission should not intrude.

Staff argues that if the Commission were to include such expenses as a deduction in calculating taxable income, stockholders would be penalized by a reduction in their net income equal to the full amount of the expenditures, because they would have no offsetting tax deduction. Conversely, ratepayers would benefit because rates would reflect both the amount of the disallowed expenses and the revenue effect of the reduced income taxes. If the shareholders decided not to make the nonrecognized expenditures, they would be deprived of authorized net income in an amount equal to the tax effect of the disallowed expenses.

Staff states that this analysis should also apply to types of expenses that are not controllable by utility management and which the Commission has disallowed for ratemaking, both as operating expenses and as income tax deductions. Staff illustrates this point with two specific examples: the ratemaking treatment applied to a plant acquisition adjustment, and the ratemaking treatment applied to capital gains on utility property sold under threat of condemnation. Staff proposes the past practices be continued.

Staff further suggests that the discussion is not complete without consideration of the treatment of extraordinary expenses that occurred prior to the test-year and which are included as an amortization item in the adopted test-year operating expenses, such as abandoned project costs. The cost of abandoned projects has been reflected in the utility's tax return to offset taxable income in the year the projects were abandoned. However, for book purposes, the cost was amortized over a five-year period. For ratemaking, such amortized costs are included in operating expenses and in the income tax calculation, allowing for cost recovery on a dollar-for-dollar basis over the amortization period. Staff proposes that this treatment continue.

The Industry witnesses uniformly testified that expenses that are not allowed for ratemaking should not be used as ratemaking tax deductions. These parties agree that since the ratepayers do not contribute to these expenses, the shareholders bear the full burden. Therefore, the shareholders are entitled to the benefit of the lower income tax resulting from deducting such items in arriving at the amount of taxes to be paid. They conclude that if the Commission did include these deductions in calculating estimated tax expense, the shareholders would suffer an unjustified loss of net income equal to the full amount of the disallowed tax deduction, while the ratepayers would receive an unjustified windfall arising from rates based on tax benefits that did not belong to them.

We agree with Staff and Industry that the present method of treating these costs is reasonable and should be continued. We are persuaded that these parties have fairly weighed the competing considerations.

The term "disallow" is itself a bit misleading, which may contribute to any controversy over this point. Ratemaking is better understood as a matter of constructing an overall revenue requirement, based on estimates of reasonable costs, than as a matter of disallowing unreasonable expenses. The Commission authorizes rates at the lowest reasonable level necessary to ensure safe and adequate service. It is the responsibility of the shareholders, through their utility management, to ensure that the utility operations are performed in a prudent and efficient manner, thereby generating the net income to provide a reasonable return on their investment. The net income is available for either distribution to the shareholders or capital reinvestment based on the policy of the board of directors. The choices of disbursement are at the directors' discretion. If they wish, for whatever reason, to make disbursements for donations, dues, or contributions to charitable, social, and political organizations, or to promote their corporate image through institutional or public relations advertising, the Commission should not reduce their earnings.

E. Whether, for purposes of computing estimated test year income tax expense, the impact of nonutility and affiliated entities operations as reflected in consolidated income tax returns shall be considered.

It is the practice of the Commission, in calculating the test-year income tax expense, to assume a separate return basis considering solely utility operations. By making this assumption the Commission presumes that the utility will pay the income taxes generated by the adopted rates. However, because of a utility's affiliated or nonutility operations, its actual income tax liability will be determined as one member of a consolidated tax return. Thus, income taxes collected through authorized rates may not actually be paid, but may be used to offset tax losses of other nonutility and affiliated members of the consolidated return.

The consolidated tax return of the utility and its affiliates is measured by the algebraic sum of the taxable income that each member contributes to the consolidated return. If any member has negative taxable income, the taxes paid by the consolidated group will result in an effective tax rate less than the statutory tax rate. The issue that arises is whether the income tax rate used for ratemaking should be the effective tax rate of the consolidated group, instead of the statutory tax rate.

Staff witness Davis recommends continuing the separate return calculation. He observes that in a free enterprise system the credo of capitalism is to maximize profit. He suggests that it is inconceivable that the shareholders of the consolidated group are willing to maintain any operation in a losing position. Rather, one should expect that action will be taken to improve earnings so that past losses will be recovered. On this basis he concludes that negative income taxes of a member of a consolidated group may be properly considered as a deferred asset to be used to offset future tax liabilities that will result from future profits. If the Commission were to allocate, through the vehicle of a lower effective tax rate, a portion of the deferred assets of a member of the consolidated group, ratepayers will benefit through lower rates because of the lower effective tax rate resulting from the consolidated return. However, if the member that had earlier had the tax loss later experiences a positive tax position, the amount of the deferred asset used to reduce utility rates would have to be returned to the member through higher utility rates.

Davis does provide for an exception to his general preference for the separate return method. He states that if it can be shown that the consolidated group is in a permanent loss position, then the Commission should consider the impact that consolidated income taxes would have on the effective tax rate to be used in calculating the adopted income taxes in setting rates. As an example, he cites the case of Air California, and the Westgate bankruptcy.

Staff witness Boneysteele supports the use of the consolidated return tax data for purposes of the test-year income tax calculation. He states that the allowance for income taxes should be based on best estimates of taxes that will be actually paid, not on hypothetical figures nor a nonexistent circumstances. He contends that the ratemaking income tax allowance for a utility that is not by itself a taxpayer should relate to, and be a fair share of, taxes actually paid by the group filing the consolidated return.

He argues that reasonable ratemaking procedures prescribe that a utility is entitled to recover in rates all proper utility expenses actually incurred, including income tax expense, but no more than what is reasonably expected to be incurred by a utility in providing service to its customers. Any transfer of funds from a public utility to an affiliate, unless in exchange for goods or services useful in the operations of the utility, does not result in an expense which is necessary for its operation and should not be allowed for ratemaking purposes. He characterizes such a payment as more in the nature of a dividend from the affiliate to the parent. He states that to allow a utility to recover in rates an income tax expense not related to its fair share of taxes as paid on the consolidated return would be a violation of basic regulatory procedures.

Instead, Boneysteele recommends that the Commission adopt a policy whereby a reasonable allowance for income taxes of utilities which participate in the filing of consolidated income tax returns will be based on the effective tax rate that the Commission estimates will be actually paid by the consolidated group. In order to level out years of unusual profits or losses of nonregulated affiliates, he proposes that a five-year average of net nonregulated business losses be used for developing effective tax rates. In computing the five-year average, he suggests that net operating losses of the nonutility affiliates first be offset against the taxable income of the other nonutility affiliates, if any. If there is any remaining net operating loss, that residue would then be offset against the taxable income of the utility.

The Industry strongly supports the continued use of the separate return method. These parties unanimously agree that the separate return method fairly and reasonably determines the utility's tax expense for ratemaking purposes, while the effective tax rate approach would unjustly and unreasonably pass without compensation tax benefits which belong to shareholders.

The Industry position is that a consolidated income tax return is essentially the combination of separate company tax returns. Filing a consolidated tax return does not ordinarily provide any tax savings that are not equally available by filing separate returns. The tax liability for utility operations is the same whether a consolidated return or separate returns are filed. This tax liability is computed by applying the statutory rate provided in the Internal Revenue Code to the taxable income of the utility operations and subtracting allowable tax credits. This statutory rate is the same whether the utility files separately or as a member of a consolidated return. Furthermore, the utility taxable income and resulting tax liability is the same whether the utility files separately or is included in a consolidated return. Any utility positive tax liability is not reduced by any nonutility negative tax liability. If the utility joins in the filing of a consolidated tax return, that consolidated return is used to net positive and negative tax liabilities of the various companies comprising the consolidated group. The clearing of a negative nonutility tax liability against a positive utility tax liability does not eliminate or reduce the utility tax liability.

Industry argues that ratepayers would receive a windfall using the consolidated return method because a regulatory policy which employs a consolidated effective tax rate whenever it is less than the statutory tax rate results in permanently assigning to current ratepayers the tax benefits associated with certain utility and nonutility costs, even though the ratepayer had no interest in paying for the much larger associated cost and risk borne by the shareholder or affiliate which created the tax benefit. The shareholders or affiliates absorb the cost, and the ratepayers receive the related tax benefit. Industry points out that, if the consolidated effective tax rate were used, utility rates would be reduced by 100% of the tax benefits of nonutility tax losses. These tax losses are attributable to nonutility tax deductions arising out of nonutility operations. The expenses which created the nonutility tax deductions were paid by the shareholder or affiliate and are not recoverable from the ratepayers.

Industry states that the use of a consolidated effective tax rate, whenever it is less than the statutory tax rate, would result in arbitrary and capricious utility rates, as amounts charged ratepayers would depend upon the results of operations of a utility's nonutility affiliates. Industry states that rates would go down when the nonutility affiliates as a group incur tax losses and increase when the nonutility group shifts from losses to profits. It concludes that such a connection between utility rates and nonutility affiliates profits or loss operations is not logical and would lead to arbitrary and capricious results for both current and future ratepayers.

Industry further argues that the use of a consolidated tax rate would amount to confiscation in that it permanently assigns to ratepayers the entire benefit emanating from nonutility tax losses. Tax losses are assets in that they ordinarily provide an immediate or near term cash benefit. These assets belong to the shareholders who bore the expenses which created the tax loss, and thus, are entitled to the related tax benefit. Any reduction in rates on tax benefits accruing from nonutility tax losses is equivalent to the regulatory commission making a gift of a shareholder asset to the ratepayers and constitutes confiscation of shareholder property. Moreover, if a regulatory commission reduces rates to reflect the tax benefit of the nonutility tax losses, the results would be to penalize the shareholders for attempting to realize tax loss benefits through a consolidated tax return. To lower a utility's tax expense in its cost of service as a result of nonutility tax losses that could have been carried back or forward by the nonutility affiliates in a separate return deprives the nonutility group of valuable property rights belonging to these companies.

We are convinced that the separate return method is the more reasonable basis for calculating test-year income tax expense. Therefore, we provide for no change from the present practice.

We are satisfied that Industry has fairly stated the rationale for the separate return period. We see no public interest that is served by making utility rates a function of profits or losses in nonutility affiliates, as would result from the consolidated return method. Further, we are persuaded that a tax loss is an asset that would be taken either without compensation and without due process of law, or with compensation but for no useful purpose.

The consolidated return method would cause utility rates to rise or fall inversely from affiliate earnings. Rates could rise simply because of the tax accounting choices of the parent corporation. Reasoning through this proposition one would find an affirmative duty on the part of the Commission to examine the reasonableness of the parent corporation's decisions that have an effect on the tax position of the nonutility affiliates, because of the impact on the cost of service of the utility affiliates. Since every decision of the parent affects the tax position, we would be greatly expanding the scope of our oversight. The only effective solution would be to preclude the utility from being operated as an affiliated company, which, if within our jurisdiction, would still only restore the separate return method.

If the utility cost of service is reduced by a nonutility tax loss, then a taking has occurred. If the utility cost of service is later increased by the recognition of the deferred asset value of the tax loss when the nonutility affiliate is profitable, then there is compensation for the taking. But merely because this method may be lawful does not render the practice fair or wise.

Such treatment still makes present utility rates a function of affiliate operations, a result that has already been found unreasonable. It also introduces an element of discrimination between present and future ratepayers, since rates will be lower or higher depending on when tax losses occur and when recovery of the deferred asset is recognized. We see no public interest that is served by such discrimination that is not even related to utility operations.

In this and other instances in this decision we address general principles and adopt methods that correspond with our policy judgments. We do not intend to foreclose consideration of extraordinary solutions to extraordinary problems and will consider alternatives in approprite circumstances. The Air California-Westgate situation might have been such a case. The burden of proving that an exception should be made is on the proponent.

F. Whether, for purposes of calculating test-year income tax expenses, reduced income taxes resulting from the deduction for the tax purposes of deferred energy costs should be considered.

Test-year results of operations are based on "zero base" energy rates for revenue and "zero base" cost of energy included in operating expenses. The rationale for this approach is that energy costs are recovered through offset ratemaking procedures that include balancing accounts.

The problem, as it concerns income taxes, arises when there is a substantial over-or undercollection at the end of a taxable period. The Commission requires that over-or undercollections be deferred on the books of the utilities, whereas the Internal Revenue Service (IRS) requires that, as a general rule, the amount of any deduction or credit shall be taken in the taxable year as determined by the method of accounting employed. Consequently, for income tax purposes the over-or undercollections cannot be deferred, but rather must be considered in determining taxable income. The result is that in a period where there is an overcollection, actual income taxes will be higher than book, and when there is an undercollection, actual income taxes will be lower than book.

Staff and Industry agree that the nature of these adjustment procedures is such that periods of overcollection will be followed by periods of undercollection so that results will tend to level out between periods. While it may reasonably be assumed that every taxable period will show either an over-or under-collection of revenue, any imbalance will be corrected in subsequent periods, so that ratepayers and utilities are both adequately protected.

Since the initiation of this proceeding we have twice changed the Energy Cost Adjustment Clause (ECAC) procedures to introduce more risk into the recovery of fuel costs. Thus, the absolute dollar-for-dollar recovery of reasonable fuel costs is no longer assured. We see nothing about these changes that detracts from the position supported by Staff and Industry and see no basis for any change from the present method of treating energy costs for income tax purposes.

G. <u>What levels of investment tax credit should be utilized in calculating test-year income tax expense?</u>

In the interim opinion (D.93848) we recognized that ERTA requires that investment tax credits be normalized. Thus, this issue is moot except to the extent it relates to the rehearing of D.93848 which is discussed below.

H. What differences exist between estimates of revenues and expenses used for ratemaking purposes to calculate income tax and the revenues and expenses recorded and reported on income tax returns?

Under the Rate Case Plan general rate case decisions for major utilities are based on a future test period, relying on estimates of operating results made prior to the test-period. It is highly improbable the recorded amounts experienced in the calendar year will be exactly equal to the amounts adopted in the decision for operating revenue, operating expenses, income taxes, other taxes, and rate base. This is also true for the estimate of the tax deductions used to calculate the adopted income taxes included in the adopted results. Thus, it occurs that the difference between income taxes adopted and income taxes paid results partly from these differences between test-year estimates and recorded results.

Staff and Industry agree that such differences are inherent in the use of future test periods for ratemaking. They warn that differences in income taxes between estimated and actual cannot be isolated from other factors in determining whether an adjustment should be made to the test-year estimate. Any review of differences would have to include the effects of differences of all estimates for revenues, operating expenses, income taxes and return on investment. Any prospective adjustment based on past over- or underestimates would have to take into consideration the overall effect of the differences for all components of the test-year. Under these circumstances parties recommend no change in the present ratemaking procedure.

The only exception is that Staff witness Davis does recommend that utilities be ordered to submit to the Commission for our approval accounting and ratemaking adjustments for the treatment of reduced test-year income taxes resulting from changes in regulations, where IRS regulations allow the taxpayer to amend its prior returns to claim recovery of taxes resulting from changes in tax regulations, where one of these amended returns is for a test-year on which rates were authorized, so that the Commission may decide what rate adjustment (if any) should be made. His rationale is that if the new regulations had been in effect at the time of the test-year (and the amended return can be construed as such), the income taxes and therefore the adopted rates would have reflected the revised levels of income tax expense.

Since income taxes are derived residually, we agree that individual factors should not be isolated for purposes of comparing estimated and recorded results. Obviously, if the utility earnings are substantially less than authorized, then a comparison of estimated and actual income taxes is misleading.

Moreover, an across-the-board comparison of estimated and recorded results is not useful for any purpose other than informational, because it is consistent with test-year ratemaking. Taken to their logical conclusion, post test-year adjustments lead to a guaranteed rate of return. Thus, we have limited such adjustments to narrowly defined purposes such as adjustments to revenue to reflect deviations in sales.

We agree that changes in tax laws may be taken into account in ratemaking, but we decline to go so far as proposed by Davis to require utilities to submit adjustments reflecting reductions in taxes. As a general proposition we observe that changes in tax laws may increase as well as reduce tax liabilities, so that fairness would require that any procedure would allow for recognition in either direction. Further, it may be likely that such changes would be insubstantial in themselves or offsetting among themselves, so that no action would be necessary. Therefore, we choose to limit the exercise of our discretion in this regard to changes that appear permanent and substantial, and leave to interested parties the burden of filing appropriate pleadings when a change in the tax laws suggest that a change in rates is necessary.

I. <u>Differences between deductions claimed by utilities for ratemaking purposes and those used on income tax returns (e.g., repair allowances, tree-trimming allowance, accelerated depreciation, etc.).</u>

The tax laws either permit or require reporting procedures that differ significantly from those required by either generally accepted accounting principles or the applicable uniform system of accounts. These differences are usually in the form of timing differences which permit or require taxpayers to recognize expenses earlier than is generally allowed under generally accepted accounting principles. There are a number of overhead type expenses that are capitalized on the utility's books as part of the cost of property, but are deducted currently for income tax purposes, such a pension costs, sales tax, use tax, payroll tax, social security tax, the cost of removal and repair allowance. Other items that are capitalized for book purposes but taken for tax purposes on a current basis also include property taxes, administrative and general expenses (in some cases) and unemployment taxes. The practice has been to flow-through some of these tax benefits to present ratepayers in the form of lower income tax expense.

Industry contends that, rather than flowing through all tax benefits resulting from such tax-timing differences to current ratepayers, the Commission should adopt comprehensive interperiod tax allocation so that the tax benefit is shared by both current and future ratepayers, by providing the tax reduction resulting from the tax deduction to the future ratepayer while providing the current ratepayer with the time value of that tax benefit by reducing rate base by the amount of deferred taxes. Industry claims that because the deferred taxes resulting from this interperiod matching are used to reduce rate base, the current ratepayer realizes reduced operating expense and reduced capital costs in the form of reduced return requirement resulting from the rate base reduction. When the interperiod timing difference arises from a cost capitalized for book purposes, this procedure produces the same result as if the tax benefit were used as a direct credit against the plant cost of the asset giving rise to the tax deferral. Industry argues that the interests of current and future ratepayers are protected by this method, since each derives the tax benefits resulting from those expenses included in rates.

Industry cites other benefits that it claims would be achieved by recognizing these matters as timing differences, and not dealing with these deductions as current expenses for income tax calculations. These include the following:

1. In the long run, customer rates should be lower, because future cost of service would not be burdened with prior years' costs which have been deferred to customers of the future.

2. Investor valuation of California utilities would be improved because:

   a. Utilities would be following the accounting followed by all nonregulated business enterprises with whom they must compete for capital.

b. Internal cash flow and interest coverage ratios would be improved, thus requiring less outside financing.

c. Because utility rates should be lower in the long run, the utility has a better opportunity to service and recover its debt and equity.

d. The utility and its customers would be better protected should the tax laws be revised to reduce or remove existing tax benefits.

Regarding changes in tax laws, Industry points to the enactment of ERTA with its mandatory normalization requirements, leaving California utilities with a large amount of deferred taxes related to accelerated depreciation (in excess of book) previously flowed-through to ratepayers. Industry argues future tax changes may eliminate some of the other timing differences, or may require normalization similar to the way that ERTA affected depreciation. Industry warns that the failure to recognize now that these are timing differences which may not be available in the future could create significant problems for California utilities if such changes should occur.

The arguments of Industry are similar to the arguments that were made in connection with the issue of normalizing or flowing through the tax benefits of investment tax credits and accelerated depreciation. With the enactment of ERTA, Congress has decided that issue in favor of normalization. The aftereffects of the normalization required by ERTA, however, are still reverberating through California's utilities and ratepayers. We prefer to have a better opportunity to assess the effects of ERTA normalization on our regulated industries before adopting the additional normalization requirements advocated by Industry. For the present, we will continue our current policy regarding flow-through treatment of timing differences consistent with applicable tax law.

J. Differences between state and local taxes claimed by utilities for ratemaking purposes and those used on income tax returns (e.g., State Corporation Franchise Taxes).

The state income tax deduction for federal tax purposes is the amount of tax paid in the prior year. The state tax deduction computed for ratemaking purposes has been based on the current test-year. In the case of ad valorem taxes, a utility may deduct in the current year the full amount of ad valorem taxes due on property held as of March 1st, even though one-half of the amount is not payable until the following year. For ratemaking purposes utilities record the ad valorem taxes actually payable in the current year. These practices result in some differences between taxes paid and test-year income tax expense for ratemaking purposes.

Although several alternative methods of making these calculations are discussed, neither staff nor any other party recommends a change from the present practice since they believe that the present practice yields a reasonable result over time. Under these circumstances we see no basis for a change.

K. <u>Effect of net operating loss carry backs and carry forwards and investment tax credit carry backs and carry forwards on income taxes actually paid.</u>

Neither carry backs nor carry forwards have been considered in calculating the appropriate test-year income tax expense. Staff witness Davis recommends continuing the present practice, while Staff witness Boneysteele recommends that the effects of carry backs and carry forwards be considered in the determination of test-year allowances for income taxes. Industry supports Davis' position.

Davis states that considering tax losses in determining tax expense amounts to "double jeopardy" for the utility shareholder. He points out that the Commission in previous rate decisions allowed income taxes associated with the authorized return on equity, which included tax deductions as well as investment tax credit attributable to the test-year. If, for whatever reason, the utility is not able to earn its return, an operating loss may result, with possible negative taxable income. If the Commission then uses this tax loss to offset income taxes for future rates, the stockholders will be financing lower rates for future ratepayers. Then, if at some future period the utility is in a tax position, it will not have the deferred tax credit to offset the current tax liability because the credit was used previously to reduce rates.

Boneysteele states that this issue is directly related to the question of consolidated returns in which nonutility affiliates incur losses, which is discussed above. However, he observes that utilities filing separate returns may also incur net operating losses for tax purposes. His original recommendation was that in either case carry forwards should be considered in the tax calculation. However, under cross-examination he revised his position to provide that if the tax loss was a straightforward loss that reflects the results of operations, then he would not take that operating loss and reflect it as a carry forward in the future test-year. However, if it is a loss that resulted from differences other than the results of operations, he would recommend that it be carried forward so that the ratepayers would not contribute to taxes that had never been paid.

Industry contends that Boneysteele's position is contrary to the basic equities inherent in such circumstances and would shift a tax benefit that clearly belongs to the utility and its shareholders to the ratepayers. Industry argues that the level of test-year income tax should be based on taxes that will result from what the Commission determines to be the proper level of the cost of operations, including the authorized return, for the test-year. If the level of taxes is reduced to reflect abnormal conditions such as carry backs or carry forwards, then the level of taxes will be deficient in relation to the test-year, resulting in a shortfall in rate of return. If in a year prior to the test-year the utility incurred a net operating loss for tax purposes, its expenses exceeded its income in that earlier year. Either a prior test-year took into account the net operating loss in computing rates, or the utility incurred an unexpected loss. Industry argues that either the loss has already been considered in a prior test-year, or recognition of the loss would reduce unfairly the utility's actual tax expense in the current year on account of unanticipated actual losses in years prior to the test-year.

We agree that the practice of excluding carry backs and carry forwards from the test-year calculation of income taxes is well-founded and should continue. Therefore, we adopt the position taken by Davis and Industry.

The question as it relates to consolidated returns is subsumed in the discussion of that issue in Part III D. above. We find nothing unique about carry backs and forwards that requires separate consideration of this issue apart from our treatment of consolidated returns generally. Therefore, we continue to exclude nonutility carry backs and carry forwards from the income tax calculation.

There may be any number of reasons why a utility would be in a carry back or carry forward position at the time of a rate case. However, in any case the loss must fall into either of the categories described by Industry. If the deductions or credits have been previously taken into account in setting rates, then it would be unfair to take them into account again. If the deductions or credits have not been previously taken into account in setting rates, it would be unfair to allow the ratepayers to enjoy the benefits of lower tax expense when they have not borne the burden of the associated costs. We find that the practice of excluding carry backs and carry forwards from the test-year income tax calculation reasonably matches benefits and burdens and should be continued. To do otherwise would be to intrude into the area reserved for management. A tax loss may be the result of timing choices that a utility makes under the tax laws. If carry backs and carry forwards are lost to shareholders, management may make choices that reflect ratemaking rather than accounting considerations, in order to maximize return. In turn, we would be obliged to examine management's choices on behalf of ratepayers. We would be moving beyond regulation into matters that are between the taxpayer and the IRS.

L. <u>What tax rate should be assumed when establishing a net-to-gross multiplier (to convert a net income requirement to the necessary gross billing revenue increase)?</u>

Projected return deficiencies at existing rates must be grossed-up by a net-to-gross multiplier to develop additional revenue requirements because of the increase in revenues required to yield a specified net operating income subject to taxes. Staff and Industry agree that the proper tax rates to be used in establishing the net-to-gross multiplier are the statutory income tax rate for federal taxes for all utilities, and the statutory rate for the California State Franchise Tax for utilities whose operations are entirely in California. For those operating within and without the state, the allocation procedure under the unitary tax concept must be considered. This circumstance requires special analysis and consideration on a company-by-company basis.

We accept this consensus as dispositive of this issue.

M. <u>What should be the appropriate ratemaking treatment of affiliate's income tax liability for purposes of GEDA or EEDA?</u>

GEDA and EEDA mechanisms were established by the Commission to encourage California utilities to explore for and develop gas and energy reserves. The programs are administered through subsidiaries or affiliates of various California utilities and are subject to Commission regulation.

Under GEDA and EEDA the utility advances funds to its subsidiary or affiliate. The funds are obtained from the utility's shareholders and debt holders. The utility is allowed to earn a rate of return on its net unrecovered investment in qualified projects equal to the current rate of return on rate base authorized for the utility.

When establishing GEDA or EEDA rates, the Commission has treated the subsidiary's or affiliate's tax liability on a separate return basis, using the statutory rate for federal and state taxes. The rate base to which the allowed rate of return is applied is the amount of net funds advanced by the utility to fund the operations authorized on GEDA and EEDA projects, reduced by the deferred tax reseves.

Industry recommends that these practices continue. Staff takes no position.

We are satisfied that the present method of treating GEDA and EEDA related income tax liability is consistent with the principles adopted in this decision and is reasonable.

N. How should the incremental California franchise tax rate be used for ratemaking purposes?

The Commission presently uses the statutory rate to determine the ratemaking California Franchise Tax expense (CCFT) expense for those utilities operating exclusively within California. For those utilities which have multi-state operations or participate in the filing of a combined report with parent or affiliated companies, the unitary method is used. The unitary method is predicated upon an allocation of California operations to outside California operations. The Commission determines the ratemaking CCFT expense at present rates using the utility's effective tax rate and at proposed rates using an incremental rate. The incremental rate is used in developing the net-to-gross multiplier.

Staff witness Davis supported the continuation of the Commission's present policy. Industry generally responded that the statutory rate be used, with appropriate allocation of income from outside California to California approximating allocation of California income to taxing jurisdictions outside the state.

We adopt the position taken by Davis.

O. <u>What is the appropriate ratemaking treatment for income tax purposes of the inclusion or exclusion of short-term debt from the capital structure?</u>

Present ratemaking policy excludes short-term debt from the capital structure used to determine rate base. Consistent with that treatment, short-term debt is also excluded from the determination of income tax for general ratemaking, reflecting the principle that costs and benefits should be matched.

Industry supports this principle and accepts its application in either case -- whether short-term debt is included in or excluded from the capital structure. Staff offers no comment.

We find this matching principle consistent with other positions adopted in this decision and will continue to apply it.

P. The Crossover Problem

The Internal Revenue Code permits the taxpayer to not only depreciate an asset over a shorter life than that used for book depreciation, but also to accelerate the timing of the depreciation deduction through liberalized tax depreciation methods. When an accelerated method is used, tax depreciation on a specific asset or group of assets is highest in the initial year and steadily decreases throughout the life.

In California in the past most utilities have immediately flowed through the tax benefits resulting from accelerated depreciation tax methods. The steadily decreasing tax depreciation of a group of assets was offset by additional tax depreciation deductions arising from new plant additions. Utilities will no longer be allowed to immediately flow-through the current tax benefits from accelerated tax depreciation on post-1980 property additions because ERTA provisions require that for post-1980 property additions the timing difference between tax depreciation and the amount computed by using book depreciation rates times the tax basis of the property be normalized. Thus, the accelerated portion of the depreciation on assets subject to ERTA is not available to shelter previously flowed-through tax benefits as the crossover point is reached on pre-1981 assets. ("Crossover" in this context refers to the situation where book depreciation on an individual vintage of property becomes greater than tax depreciation on that same vintage of property.)

There is a large amount of deferred taxes related to accelerated depreciation (in excess of book) that has been flowed through to ratepayers in California. This accumulated amount of previously flowed-through benefits must be recovered over the remaining life of the pre-1981 assets. Unless some other approach is adopted, utility rates will rise every year simply to recover this accumulated deficiency until the amount of flow-through tax benefits is fully recovered.

Staff witness Pretti originally proposed letting the crossover occur naturally for property accounted for on a flow-through method by equalizing the remaining tax depreciation on flow-through property, but only after the crossover point is reached and then only over such property's remaining tax life. However, as Industry points out, book life is almost always longer than tax life, and Pretti's approach would not leave any tax depreciation for the portion of book life left remaining after the tax life is finished. Thus, ratepayers in that period would not receive any of the tax depreciation benefits even though they will be paying for book depreciation. After cross-examination and further consideration, Pretti indicated that the crossover question should be handled on a case-by-case basis.

Industry witnesses have advanced somewhat different proposals for the immediate levelization of the remaining tax depreciation benefits for property additions previously on flow-through, so that the impact of book depreciation exceeding tax depreciation, and the corresponding two-for-one collection problem, can be equalized among future ratepayers. In recognition of their different proposals and their different circumstances, several Industry parties joined with Pretti in recommending that a case-by-case approach be adopted.

In such circumstances we are persuaded that a case-by-case approach is necessary in order to recognize the differences among the utilities, and we adopt this policy in this proceeding.

IV. Rehearing

As stated above, rehearing was granted by D.82-02-131 dated February 17, 1983, limited to:

> "... receipt of evidence and argument on the issue of whether current ratemaking procedures provide an adequate method of reflecting the nuances of normalization so that use of the AAA and AA methods is not required..."

for purposes of ERTA. Following one additional day of hearing in which staff witness Pretti testified, the matter was submitted based on oral argument by Cities and written briefs by several Industry parties.

In D.93848 we found that the AAA and AA methods were devised to respond to circumstances that no longer prevail and that existing ratemaking procedures allow for adequate recognition of the nuances of normalization so that these more specialized methods are not presently required. Thus, we concluded that conventional normalization should be applied. Upon rehearing Pretti testified as follows:

> "It is quite clear that the Commission's current ratemaking procedures have changed significantly since the AAA and AA methods were originally adopted in 1977; no longer are items held constant from year-to-year. The circumstances at the time D.87838 was issued were such that the AAA and AA methods represented a fair and reasonable method of normalization, recognizing the increase in tax benefits realized during the four-year span between general rate cases with cost of service held constant. With the advent of the policy of having general rate cases for major utilities every two years together with attrition allowances for the year subsequent to the test-year, the Commission has in effect, instituted a form of annual ratemaking. This form of annual ratemaking recognizes changes not only in the elements of cost of service and rate base, but also the changes in the deferred tax reserve resulting from ACRS and ITC, and in the case of Option 2, the change in the unamortized ITC. In fact, since the AA method recognized the changes relating to ITC on an annual basis, there is no difference with the Commission's current procedures.

> "In addition, current procedures more accurately reflect increases in the deferred tax reserve since they are made yearly, whereas, the AAA method utilizes estimates based on a four-year period. Therefore, both ratepayers and the companies are better protected in the event that actual plant additions differ significantly from estimates."

Based on a study that compares the difference in the ratemaking effects between the use of conventional normalization and the AAA and AA methods, using current procedures, Pretti concluded:

> "The AAA and AA methods were adopted by the Commission with the intent of reflecting the tax savings realized by utilities in rates charged to customers, consistent with tax regulations. At that time the average time interval between rate cases was approximately four years. If the time interval between rate cases was other than four years, it is my opinion that the Commission would have selected a period within which an average would be computed consistent with actuel experience.
>
> "The Commission's current procedures accomplishes the goals of the AAA method to a much greater degree of accuracy because all elements used in determining rates are reviewed on an annual basis. While the AAA method was a reasonable and valid method of normalization, it has become outmoded in the current regulatory environment.
>
> "It is my recommendation that the Commission continue to use conventional normalization in determining fair and reasonable rates. Under current procedures, conventional normalization more accurately reflects actual conditions, and offers both the ratepayers and the utilities better protection against unforeseen changes."

Industry agrees with Pretti and strongly supports our original findings and conclusion in this regard.

Cities argue that the question of which normalization method to use should be based on the individual circumstance of each utility at the time of its rate case. Cities suggest that ratemaking procedures may change as conditions change and that it is unnecessary and erroneous for the Commission to adopt a general policy in such circumstances. They conclude that the matter should be simply deferred from this generic proceeding to individual general rate cases.

Industry warns that even the prospect that the AAA and AA methods would be applied would impose a significant detriment to the financial stability of California utilities. Industry argues that there is a significant risk that AAA and AA do not meet the statutory normalization requirements, and points to a substantial body of material in support of that proposition. If ineligibility were to occur, Industry warns that the result would be devastating to utilities and their ratepayers.

We affirm our original decision. While we agree that the enactment of ERTA did not affect the lawfulness of AAA and AA, we find no basis for even considering their further application in light of Pretti's unrebutted testimony that changed circumstances no longer warrant their use. We are persuaded that conventional normalization techniques are appropriate in the current context.

The only reason for continuing to assert the usefulness of AAA and AA would be a perceived need to maintain a consistent posture while the questions of their suitability were unresolved. However, the potential past tax liability associated with their use has been rendered moot by legislation, so there is no longer any need to consider such implications.

V. Findings of Fact

1. The current practice in the development of income taxes for rate fixing is to exclude as a tax deduction the interest expense associated with nonutility plant and investment.

2. By far the greatest dollar amount of nonutility investment is represented by CWIP.

3. Such CWIP is classified as nonutility because it is plant that is not used and useful for utility operations.

4. The utility recovers this interest expense by capitalizing the debt or interest cost via the debt component of AFUDC.

5. The amount to be capitalized is the net amount of the interest expense, after effect of income taxes, or approximately 50% of interest expense.

6. This method is called the "net method."

7. Excluding such interest expense as a tax deduction in the income tax calculations for rate fixing in the test-year results in the test-year income taxes being greater than if calculated on an "as paid" basis.

8. Because the tax effect of the AFUDC is credited to plant, rates for future ratepayers will be lower due to the lesser depreciation of, and return on, the net cost of borrowed funds in plant accounts.

9. The Commission has consistently disallowed for ratemaking purposes such expenses as donations, dues, and contributions to charitable, social and political organizations, as well as expenses for legislative advocacy and certain types of advertising.

10. There are also other expenses that, in the course of a rate proceeding, may be contested by Staff or by interested parties and which the Commission may decide to disallow.

11. This method results in adopted income taxes higher than otherwise, because the disallowed expenses are not included as tax deductions.

12. It is the practice of the Commission, in calculating test-year income tax expenses, to assume as separate return basis considering solely utility operations.

13. Because of a utility's affiliated or nonutility operations, its actual income tax liability will be determined as one member of a consolidated tax return.

14. If any member has negative taxable income, the taxes paid by the consolidated group will result in an effective tax rate less than the statutory tax rate.

15. Tax losses are assets that belong to the shareholders who are responsible for the expenses which created the tax loss, and thus are entitled to the related tax benefit.

16. Test-year results of operations are based on "zero base" energy rates for revenue and "zero base" cost of energy included in operating expenses.

17. The Commission requires that over or undercollections be deferred on the books of the utilities, whereas the IRS requires that as a general rule, the amount of any deduction or credit shall be taken in the taxable year as determined by the method of accounting employed.

18. In a period where there is an overcollection, actual income taxes will be higher than book, and where there is an under-collection, actual income taxes will be lower than book.

19. The nature of these adjustment procedures is such that periods of overcollection will be followed by periods of under-collection so that results will tend to level out between periods.

20. It is highly improbable that recorded amounts experienced in the calendar year will be exactly equal to the amounts adopted in the decision.

21. The difference between income taxes adopted and income taxes paid results partly from differences between test-year estimates and recorded results.

22. There are a number of items that are capitalized for book purposes but taken for tax purposes on a current basis.

23. The practice to flow-through these tax benefits to present ratepayers in the form of lower income tax expense is reasonable.

24. The matching of benefits and burdens between current and future ratepayers is reasonable.

25. The state income tax deduction for federal tax purposes is the amount of tax paid in the prior year, while the state tax deduction computed for ratemaking purposes has been based on the current test-year.

26. Neither carry backs nor carry forwards have been considered in calculating the appropriate test-year income tax expense.

27. If deductions or credits have been previously taken into account in setting rates, it would be unfair to take them into account again.

28. If the deductions or credits have not been previously taken into account in setting rates, it would be unfair to allow the ratepayers to enjoy the benefits of lower tax expense when they have not borne the burden of the associated costs.

29. Projected return deficiencies at existing rates must be grossed-up by a net-to-gross multiplier to develop additional revenue requirements because of the increase in revenue required to yield a specific net operating income subject to taxes.

30. When establishing GEDA and EEDA rates, the Commission has treated the subsidiary's or affiliate's tax liability on a separate return basis, using the statutory rate for federal and state taxes.

31. The rate base to which the allowed rate of return is applied is the amount of net funds advanced by the utility to fund the operations authorized as GEDA and EEDA projects reduced by the deferred tax reserves.

32. Present ratemaking policy excludes short-term debt from the capital structure used to determine rate base.

33. In California in the past most utilities have immediately flowed-through the tax benefits resulting from accelerated depreciation.

34. The steadily decreasing tax depreciation of a group of assets was offset by additional tax depreciation deductions arising from new plant additions.

35. Utilities will no longer be allowed to immediately flow-through the current tax benefits from accelerated depreciation of post-1980 property additions because of ERTA.

36. There is a large amount of deferred taxes related to accelerated depreciation (in excess of book) that has been flowed-through to ratepayers in California.

37. This accumulated amount of previously flowed-through benefits must be recovered over the remaining life of the pre-1981 assets.

38. Utility rates will rise every year to recover this accumulated deficiency until the amount of flow-through tax benefits is fully recovered.

39. The policy of general rate cases every two years for major utilities together with attrition allowances for the year subsequent to the test-year is effectively annual ratemaking.

40. This form of annual ratemaking recognizes changes not only in the elements of cost of service and rate base, but also the changes in the deferred tax reserve resulting from ACRS and ITC, and in the case of an Option 1 or 2 election, the change in the unamortized ITC.

41. Current procedures more accurately reflect increases in the deferred tax reserve, since they are made yearly, whereas the AAA method uses estimates based on a four-year period.

42. Ratepayers and utilities are better protected in the event that actual plant additions differ significantly from estimates.

VI. Conclusions of Law

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1. The net method is consistent with the exclusion of CWIP from rate base and should continue to be applied.

2. The present method of treating disallowed costs is reasonable and should be continued.

3. The separate return method is the more resonable basis for calculating test-year income tax expense.

4. Energy costs should not be taken into account in calculating test-year income taxes.

5. Post test-year adjustments are inconsistent with test-year ratemaking.

6. Tax timing differences should continue to be flowed-through consistent with applicable tax regulations.

7. The ratemaking treatment of state and local taxes yields a reasonable result over time.

8. Carry backs and carry forwards should be excluded from the test-year income tax calculation.

9. The statutory rate should be used for establishing the net-to-gross multiplier for utilities operating entirely in California.

10. For utilities operating within and without the state, the allocation procedure under the unitary tax must be considered on a case-by-case basis.

11. The present method of treating GEDA and EEDA related income tax liability is reasonable.

12. Short-term debt excluded from the capital structure used to determine rate base should be excluded from the determination of income tax.

13. Remaining tax benefits and costs of property previously on flow-through should be reviewed on a case-by-case basis.

14. Conventional normalization should be applied in compliance with the Economic Recovery Tax Act.

15. Since the subject matter of this investigation has been thoroughly explored in this and prior decisions, the OII should be terminated.

O R D E R

IT IS ORDERED that:

1. Respondents shall prepare and present their next general rate filings in conformance with the policies and principles adopted in this decision.

2. OII 24 is closed.

This order becomes effective 30 days from today.

Dated MAY 2 1984, at San Francisco, California.

VICTOR CALVO
PRISCILLA C. GREW
DONALD VIAL
WILLIAM T. BAGLEY
Commissioners

I dissent.
LEONARD M. GRIMES, JR., Commissioner

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY.

Joseph E. Bodovitz, Executive Director