

L/WHX:ddm

Decision 84 09 083

SEP 6 1984

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application)
of SOUTHERN CALIFORNIA GAS COMPANY)
to rescind refund orders relative)
to its investment tax credit)
election pursuant to Decisions)
85627, 86117, 86118, and 86691 and)
suspended by Decisions 86154 and)
86684.)
_____)

Application 83-04-63
(Filed April 29, 1983)

ORDER REISSUING D.84-07-068

On July 5, 1984 we signed D.84-07-068 in this proceeding. Subsequently it came to our attention that copies thereof had not been mailed to the parties in Applications Nos. 55676, 55677, 56544 and 54543. As a result we have rescinded D.84-07-068 by D.84-09-082. We now reissue D. 84-07-068 under this new number in order to provide service on all necessary parties and to establish the date of issue hereof pursuant to Section 1731(b) of the Public Utilities Code. Therefore,

IT IS ORDERED that,

1. D.84-07-068 is reissued to read as follows:

Background

In 1976 this Commission issued to Southern California Gas Company (SoCal) certain orders¹ requiring it to refund about \$6 million to its customers. Before any amounts were actually refunded we issued two further orders² which suspended the refund orders pending review by the California Supreme Court.

The initial orders were intended to assure that SoCal's ratepayers received all the economic benefits SoCal derived from changes in the federal tax law regarding investment tax credit, sometimes referred to as ITC. SoCal argued before the California

¹ Decision (D.) 85627, as modified by D.86117 and D.86118 (rehearing denied in D.86681).

² D. 86154 and D.86684.

Supreme Court that the refund orders were in violation of these tax provisions.

The investment tax credit is meant to act as a stimulus to new capital investments by permitting a certain percentage of the cost of such new investments to be credited against the current year's federal income tax liability. The law permitting such tax treatment³ sets forth three options utilities may use to pass the resultant tax savings to their ratepayers for ratemaking purposes.

The first, which is not at issue here, allows the utility to reduce its rate base (value of property devoted to public use) by the amount of the credit and then to restore that amount to rate base proportionately over the useful life of the property acquired through the investment.

The second, ratable flow-through, allows the utility an immediate credit to income taxes which the utility then subtracts proportionately ("ratably") over the useful life of the property from the utility's cost of service (operating expenses). Under ratable flow through the rate base remains unaffected and the tax savings are spread over the useful life of the property thereby lowering rates to future ratepayers during the period of useful life (approximately 39 years in this case).

The third allowable option is called immediate flow-through. It permits the utility to reduce either its rate base or its cost of service by the full amount of tax savings in the year that the savings are realized. Under this option nearly all the benefit of the tax savings goes immediately to the present ratepayers rather than being apportioned over the useful life of the property as would occur under ratable flow-through.

SoCal elected the second option, ratable flow-through. The tax law in question, IRC Section 46(f)(8), contains a provision that says the choice of immediate flow-through must be made at the utility's own election. If the utility chooses ratable flow-

³ Principally, Title 26, United States Code Annotated Section 46, also known as Internal Revenue Code of 1954 (IRC) Section 46.

through and the state regulatory commission adjusts either the utility's cost of service or its rate base to flow through the credit faster than ratably, the credit will not be allowed. We adjusted neither. However, based on SoCal's own assertions, we found that its election of ratable flow-through reduced its financial risk. We concluded that a rate of turn adjustment downward of 0.25% would best recognize the risk reduction, and we ordered such adjustment thereby accomplishing our then intent of assuring that the then ratepayers would receive all the collateral economic benefits accruing from this change in the law. We also stated that this adjustment would not deprive SoCal of its eligibility for the tax credit. See 1976 decisions, *supra*.

The Supreme Court heard SoCal's petition for writ of review and issued a decision, Southern California Gas Company v Public Utilities Commission (1979) 23 Cal.3d 470. In that proceeding SoCal claimed, among other things, that a letter ruling issued to it by the Internal Revenue Service on November 19, 1976 (subsequent to the Commission's decision) stated that the treatment of SoCal's investment tax credit ordered in the Commission's decision would result in disallowance of the tax credit. SoCal concluded that the Commission's decision was based on a false assumption that SoCal would benefit from the tax credit provisions. The Court rejected SoCal's conclusion pointing out that the IRS did not have access to the complete record in the case and that such letter rulings are subject to revocation or modification. The Court concluded that the Commission had neither influenced SoCal to abandon its election of ratable flow-through in contravention of IRC Section 46(f)(8) nor contravened IRC Section 46(f)(2) by adjusting either cost of service or rate base in order to flow through the credit faster than ratably.

Since the issuance of the Supreme Court's decision, three things have occurred. First, the Economic Recovery Tax Act of 1981 was enacted making the issues presented here of primarily historical interest. Second, according to SoCal, IRS examining agents audited SoCal for taxable years 1975 and 1976 and determined that the ITCs for those years would be disallowed. And third, the

relevant tax laws under consideration here were amended by Section 541 of the Surface Transportation Assistance Act of 1982.⁴

As the ITC provisions stood prior to amendment, if a utility elected ratable flow-through but contravened the provisions of IRC Section 46(f)(1) or (2) by virtue of a public utilities commission's order which was inconsistent with these code sections, all the utility's investment tax credits would be disallowed from the time prior to the date the inconsistent order was put into effect⁵ until such time as the regulating commission issued a consistent order. Section 541 amended this by providing that a utility's use of certain described practices, for any time prior to March 1, 1980, would not be treated as inconsistent with IRC Section 46(f)(1) or (2) if the practices were included in the order of a public utilities commission entered before March 13, 1980, so long as no refund or rate reduction had actually been made or that the utility must, within six months of actually making the refunds or rate reductions, enter into a closing agreement with the IRS stating that the utility will pay an amount equivalent to those refunds or rate reductions to the IRS. Of course, this latter requirement would only be operative and the former description would only be relevant where the practices in question were otherwise inconsistent with IRC Section 46(f)(1) or (2) requirements.⁶

⁴ Public Law 97-424, Title V, Subtitle E, Section 541; 96 Stat. 2192, et seq. (herein referred to as Section 541).

⁵ Limited, of course, by the applicable statute of limitations.

⁶ This is made clear by Section 541(c)(5) which, in relevant part, states:

"(5) NO INFERENCE.--The application of...paragraphs (1) and (2) of section 46(f) of the Internal Revenue Code of 1954/ to taxable years beginning before January 1, 1980...shall be determined without any inference drawn from the amendments made by subsections (a) and (b) of this section or from the rules contained in paragraphs, (2), (3), and (4). . . ."

SoCal's Position

SoCal's application to this Commission for an order rescinding the refund orders alleges that the legal climate has materially changed since the California Supreme Court decision in 1979 and that it is now settled that implementation of the refund orders would impose an economic detriment upon SoCal's ratepayers because the action now indisputably violates the requirements of IRC Section 46(f), as amended in 1982 by Section 541. SoCal claims this is borne out by the legislative history of the 1982 amendments which, asserts SoCal, shows that Congress believed this Commission's refund orders misapplied the law thereby jeopardizing the ITC (and certain other) benefits of the three California utilities for which this legislation was apparently drafted. SoCal also claims that Section 541 clarifies congressional intent regarding the proper method of ratably flowing through the ITC in such a way that the Commission's orders are undeniably inconsistent.

The economic detriment to which SoCal refers is the penalty provision of Section 541 which requires the utility, in order to be eligible for ITC tax benefits, to pay the IRS an amount equal to the principal amount of any refund which is inconsistent with the requirements of IRC Section 46(f)(1) or (2). SoCal claims it would have to collect approximately double this penalty amount from its ratepayers in order to generate income sufficient to pay this penalty.

Staff Position

The Commission's staff is split on the question of whether the orders should be rescinded. At the time briefs were filed, Revenue Requirements Division recommended that they should be rescinded because implementation could have a negative impact on SoCal's financial ratios, financing capabilities, and cost of capital and a negative impact on the financial community's perception of California regulation. Further, Revenue Requirements noted that at the very least implementation of the orders will result in lengthy litigation by SoCal in the federal courts and possible loss of the 6% ITC eligibility for 1977 through 1980 were the restrictions of IRC Section 46(f)(4) ultimately found to be applicable.

Legal Division recommends that the motion be denied and SoCal ordered to make refunds and take appropriate steps to preserve its eligibility for the affected ITC. Legal Division states that the auditors' determination mentioned by SoCal is presently being protested and is pending before the IRS Appeals Office in Los Angeles. Legal also disputes SoCal's claim that ratepayers would be responsible for any penalty if SoCal were to be found ineligible for the ITC and points out that the underlying Commission decisions are final and were upheld by the California Supreme Court which specifically rejected SoCal's claim that they would cause SoCal to lose its ITC eligibility. Finally, Legal Division notes that the Commission was not permitted to participate in the process resulting in the letter ruling and claims that SoCal did not present the IRS with any arguments or facts in support of eligibility.

Discussion

The question that must be resolved by the Commission is whether it is in the best interests of SoCal and its ratepayers to order that the refunds be made or to rescind the refund orders and bring this matter to an end.

This situation is similar to the flow-through normalization controversy between the Commission and Pacific Telephone and General Telephone which lasted for many years and was finally resolved by the same Surface Transportation Assistance Act of 1982 discussed earlier. The Surface Transportation Assistance Act of 1982 set forth the procedure for Pacific Telephone and General Telephone to resolve their disputes with the IRS. Provision was also made for SoCal to resolve its dispute with the IRS should it choose to do so.

Thus, if we were to order SoCal to make the refunds, it would be in the position of having to pursue one of the following alternatives:

- a. Pay the deficiency of \$4,942,354, assessed by the IRS for the loss of 6% ITC eligibility for tax years 1975 and 1976 and litigate the issue in the Court of Claims.
- b. Refuse to pay the deficiency and litigate the issue in the United States Tax Court.

- c. Comply with the provisions of the Surface Transportation Act Assistance of 1982 and pay the IRS approximately \$6,179,000 which is equal to the refund amount currently at issue. SoCal Gas would also have to enter into a closing agreement under the provisions of the act, which would prevent further litigation of this issue but preserve eligibility for all 6% ITC at risk. SoCal Gas' net out of pocket costs under this alternative would be \$9,707,000.

Should SoCal not prevail in the courts it will undoubtedly petition the Commission to recover any increased tax liability resulting from the refund orders.^{7 8}

From the beginning of this controversy it has been the Commission's intention that SoCal remain eligible for its ITC benefits. We had concluded, however, and the California Supreme Court agreed with us, that the Commission's .25 percent reduction in rate of return was a legitimate ratemaking adjustment to reflect the reduced risk flowing to SoCal from its ITC election. The IRS has disagreed with us from the beginning and continues to do so. The Congress, through enactment of ERTA, and provision of a procedure for closure in the Surface Transportation Assistance Act of 1982 appears to agree with the IRS. Thus, the risk for SoCal and its ratepayers, should the matter be litigated in a federal court has increased since our original conclusion.

In is our conclusion, after considering the positions of each of the parties, that the best interests of SoCal and its ratepayers would be served by granting SoCal's petition to rescind D.85627, as modified by D.86117 and D.86118.

⁷ In Southern California Gas Company v. Public Utilities Commission, supra 478 fn. 18, the California Supreme Court indicated that if SoCal Gas' tax liability were increased due to the refund orders, it could petition this Commission for appropriate relief.

⁸ In Decision No. 92497, mimeo p. 119, Decision No. 82-12-054, mimeo p. 97 (the Commission's decisions in SoCal Gas' Test Year 1981 and 1983 general rate proceedings), this Commission stated that SoCal Gas may petition for appropriate relief if its tax liability is increased due to the refund orders.

Findings of Fact

1. In D.85627, as modified by D.86117 and D.86118 (rehearing denied in D.86681), this Commission ordered SoCal to refund certain amounts to its ratepayers to reflect a downward adjustment of SoCal's rate of return.

2. Our refund orders, D.85627, as modified, and D.86118, were suspended by this Commission by D.86154 and D.86684 pending California Supreme Court review.

3. The Supreme Court upheld both refund orders in Southern California Gas Company v Public Utilities Commission (1979) 23 Cal.3d 470.

4. In its decision the Supreme Court considered the impact of an IRS letter ruling issued to SoCal on November 19, 1976 and concluded that it was based on an incomplete record, was subject to revocation or modification, and was therefore not binding on the Court or the parties.

5. In 1982 IRS examining agents audited SoCal for 1975 and 1976 and determined that SoCal's ITCs for those years should be disallowed.

6. SoCal has protested the auditors' determination to the IRS Appeals Office in Los Angeles. The protest is pending.

7. Congress amended the ITC statutes in 1982 via Section 541 of the Surface Transportation Assistance Act of 1982.

8. The intent of the Surface Transportation Assistance Act of 1982 was to preserve SoCal's eligibility for ITC for the years at issue with the IRS if this Commission ordered that refunds be made.

9. Continuation of this issue through the ordering of refunds and litigation by SoCal through the courts is not in the best interest of SoCal and its ratepayers.

Conclusions of Law

1. The amendments of Sections 541 of the Surface Transportation Assistance Act of 1982 were included to preserve SoCal's eligibility to claim Investment Tax Credits in the event this Commission ordered that the refunds be made pursuant to D.85627, D.86117 and D.86118.

2. The enactment of ERTA and the Surface Transportation Assistance Act of 1982 has increased the risk that SoCal would not prevail in a Federal Court were it to litigate this matter.

3. The application of SoCal for rescission of our refund orders should be granted.

O R D E R

1. IT IS ORDERED that:

Southern California Gas Company's application requesting that this Commission rescind Decision (D) 86118 and D.85627, as modified by D.86117, is granted.

2. Copies of this decision shall be mailed to all appearances of record in Applications Nos. 55676, 55677, 55544 and 55543, as well as to the parties to this proceeding, together with a letter explaining the fact that this decision, although issued in A.83-04-63, relates to all of the applications listed above and for that reason copies are being provided to all parties therein.

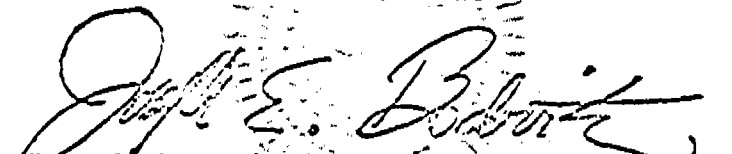
3. This order becomes effective 30 days from today.

Dated September 6, 1984, at San Francisco, California.

LEONARD M. GRIMES, JR.
President

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

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


Joseph E. Bodovitz, Executive Director



ADDRESS ALL COMMUNICATIONS
TO THE COMMISSION
CALIFORNIA STATE BUILDING
SAN FRANCISCO, CALIFORNIA 94102
TELEPHONE: (415) 557

Public Utilities Commission
STATE OF CALIFORNIA

September 6, 1984

FILE NO.

To: Parties to Applications 55676, 55677, 55544,
55543, and 83-04-63

The enclosed Decision 84-09-083, dated September 6, 1984, in Application 83-04-63 relates to Applications 55676, 55677, 55544, and 55543. For that reason the Commission ordered that copies of Decision 84-09-083 be provided to the parties to those earlier proceedings.

Very truly yours,

Mary Carlos
Chief Administrative Law Judge

MC:bg

L/WHK:ddm

Decision 84 03 033 SEP 6 1984

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application)
of SOUTHERN CALIFORNIA GAS COMPANY)
to rescind refund orders relative)
to its investment tax credit)
election pursuant to Decisions)
85627, 86117, 86118, and 86691 and)
suspended by Decisions 86154 and)
86684.)

Application 83-04-63
(Filed April 29, 1983)

ORIGINAL

ORDER REISSUING D.84-07-068

On July 5, 1984 we signed D.84-07-068 in this proceeding. Subsequently it came to our attention that copies thereof had not been mailed to the parties in Applications Nos. 55676, 55677, 56544 and 54543. As a result we have rescinded D.84-07-068 by D._____. We now reissue D. 84-07-068 under this new number in order to provide service on all necessary parties and to establish the date of issue hereof pursuant to Section 1731(b) of the Public Utilities Code. Therefore,

IT IS ORDERED that,

1. D.84-07-068 is reissued to read as follows:

Background

In 1976 this Commission issued to Southern California Gas Company (SoCal) certain orders¹ requiring it to refund about \$6 million to its customers. Before any amounts were actually refunded we issued two further orders² which suspended the refund orders pending review by the California Supreme Court.

The initial orders were intended to assure that SoCal's ratepayers received all the economic benefits SoCal derived from changes in the federal tax law regarding investment tax credit, sometimes referred to as ITC. SoCal argued before the California

¹ Decision (D.) 85627, as modified by D.86117 and D.86118 (rehearing denied in D.86681).

² D. 86154 and D.86684.

2. The enactment of ERTA and the Surface Transportation Assistance Act of 1982 has increased the risk that SoCal would not prevail in a Federal Court were it to litigate this matter.

3. The application of SoCal for rescission of our refund orders should be granted.

O R D E R

IT IS ORDERED that:

Southern California Gas Company's application requesting that this Commission rescind Decision (D) 86118 and D.85627, as modified by D.86117, is granted. *WHC*

2. Copies of this decision ~~and of the Administrative Law Judge's proposed decision~~ shall be mailed to all appearances of record in Applications Nos. 55676, 55677, 55544 and 55543, as well as to the parties to this proceeding, together with a letter explaining the fact that these ^{is} decisions, although issued in A.83-04-63, relate to all of the applications listed above and for that reason ~~copies~~ ^{copies} are being provided to all parties therein. *RTB* *RTB* *RTB*

3. This order becomes effective 30 days from today.

Dated SEP 6 1984, at San Francisco, California.

LEONARD M. GRIMES, JR.
President
VICTOR CALVO
FRISCILLA C. GREW
DONALD VIAL
WILLIAM T. BAGLEY
Commissioners