

1987 Cal. PUC LEXIS 195; 25 CPUC2d 299; 86 P.U.R.4th 520

California Public Utilities Commission

September 10, 1987 ; As Amended September 10, 1987

Decision No. 87-09-026, Investigation No. 86-11-019 (Filed November 14, 1986)

Reporter

1987 Cal. PUC LEXIS 195 *; 25 CPUC2d 299; 86 P.U.R.4th 520

In the Matter of the Investigation on the Commission's own motion into the methods to be utilized by the Commission to establish the proper level of expense for ratemaking purposes for public utilities and other regulated entities due to the changes resulting from the 1986 Tax Reform Act

Core Terms

gross-up, ratepayer, contributor, refund, customer, column, depreciate, discount rate, plant, federal tax, recommend, rate base, discount, water company, rate of return, tax payment, government agency, connection fee, pay tax, ratemaking, relocate, defer, telephone company, annual, present value, statewide, calculate, condemn, energy, telephone

Counsel

[*1]

(Appearances are listed in Appendix A.)

Panel: Stanley W. Hulett, President; Frederick R. Duda, G. Mitchell Wilk, John B. Ohanian, Commissioners

Opinion

OPINION

(Phase 1)

Summary

This decision authorizes the methods which utilities may adopt to recover the federal tax imposed upon contributions-in-aid-of-construction and advances for construction pursuant to the Tax Reform Act of 1986. Prior to 1987 contributions and advances were not taxed. This decision places the burden of the tax on the contributor or advancer and is based on the premise that the person who causes the tax pays the tax. No contribution or advance, no tax. This decision authorizes, as the principal method of recovering the tax, a method by which the contributor of the property or cash or the person making the advance pays the tax by paying, in addition to the contribution or advance, the present value of the future tax burden. The decision provides a formula, called Method 5, for computing this present value.



Method 5 requires utilities to advance part of the tax. For those small utilities which cannot afford to make the advance the decision authorized Method 2, which permits them to collect the entire tax from the [*2] contributor or the advancer. In 1988, at the 34% federal tax rate, under Method 2 an advance or contribution of \$ 1,000 would require an additional \$ 515 to cover the federal tax. Under Method 5 the tax portion would be approximately \$ 273. (In 1987, at the 40% federal tax rate, Method 2 requires a \$ 670 gross-up and Method 5 requires a \$ 350 gross up.) The other methods discussed in the decision, in one form or another, would have placed the entire burden of the tax on the ratepayer.

This decision was originally issued as a proposed decision, to which a number of parties commented. Pacific Gas and Electric Company (PG&E), while generally supporting the proposed decision, points out that the Method 5 formula neglected to include an optional statewide pre-tax rate of return and recommends that a pre-tax rate of return of 17% should be used in the gross-up calculation. Other commenters made the same suggestion and PSD supports it. We have modified the decision to explain and adopt the 17% return. PG&E also recommends that minor changes in tax law assumptions should not trigger revised advice letter filings and PG&E proposed language and findings to incorporate this concept. [*3] We will adopt it. Finally, PG&E recommends that utilities be made whole for CIAC tax costs attributable to CIAC received after December 31, 1986, but attributable to prior contracts. We will not accept this recommendation. Not only should ratepayers not be burdened with the tax caused by a contributor, but also we have considered that this tax was known to have been contemplated by Congress for at least a year before it was imposed (See Appendix B - the House Committee Report is dated December 7, 1985) and a utility could have, by contract or tariff modification, protected itself and its ratepayers from the tax.

Southern California Edison company (Edison) comments that the proposed decision is not clear regarding the possibility that a state tax may be applied to the federal tax gross-up collected from the contributor under Method 5. We believe that Conclusion 12 provides for the state tax collection if and when the state tax is imposed. Edison, with others, also recommends that when refunds are required the utilities be given 120 days to make refunds and 140 days to submit a summary report because of the magnitude of refunds to be processed. We will adopt the recommendation. [*4] Finally, Edison recommends that the decision should authorize recovery through rates of any penalties, interest, or taxes incurred if the Internal Revenue Service (IRS) deems Method 5 a violation of the tax normalization rules and imposes additional taxes, penalties, and interest. As it is this Commission that is authorizing Method 5, those utilities that adopt it should not bear any penalties imposed by the IRS if it is found to be a violation of the tax normalization rules. We will adopt Edison's recommendation.

San Diego Gas & Electric Company comments that the proposed decision does not provide for collection of the federal tax component of the contributions made during the period January 1, 1987 through and including February 10, 1987, and recommends that the utilities be authorized to apply Method 3 to recover that federal tax. We do not agree. Contributions during the period in question were covered by tariff. The contributor should not be required to pay more than the tariff provides, nor should the ratepayers.

PSD asserts that by giving utilities the option of choosing the Maryland Method, which does not impact ratepayers, those utilities which choose Method 5 may [*5] be considered imprudent. PSD's argument overlooks the point that taxes are a cost of business which utilities are entitled to recover in rates and charges. A utility may voluntarily absorb a tax or may, because of its imprudence, be prohibited from passing a tax through to its customers, but in the usual course of business it is allowed to recover the tax. The Maryland Method gives a utility the option to absorb part of the tax; we can't order the utility to adopt it. It should be noted that if a utility chooses none of the listed options it has chosen to absorb the tax itself, and we understand some utilities are expected to do just that.

California Water Service Company and San Jose Water Company seek clarification of the rate of return to be used by utilities having more than one operating district. We will provide the option of using for each district its last rate of return or the statewide rate of return. They request an example of a tariff schedule and the accounting procedures which should be followed. We will provide them. Finally, they (and California-American Water Co. and Citizens Utilities Co. of Calif.) are concerned about how to refund advances for construction. [*6] We will expand our discussion of this important process.

The City of Mountain View recommends that the Commission should instruct the utilities that in the case of a government agency contribution involving threat of condemnation or a "public benefit" project, the utility should accept the contribution net of tax if the government agency agrees to bear the risk of future tax liability. It argues that the proposed decision leaves the choice of requiring a gross-up to the utility whereas, because the potential for tax liability from a government agency contribution is relatively small, the choice should be with the agency. There is merit to the argument. To require a gross-up by a public agency where there is a good possibility that the gross-up will be refunded with interest will only delay or prevent public works beneficial to the entire community. We are confident that a public agency will fulfill its agreement to reimburse the utility for taxes, interest, and penalties should the contribution prove nonexempt. However, should the government agency fail to fulfill its obligation to reimburse we will authorize the utility to be made whole by a charge against the ratepayers. **[*7]**

The Cogenerators of Southern California request clarification with regard to which utilities may utilize Method 2 for federal tax purposes and which may use Method 2 if a state tax law change is enacted which makes CIAC taxable. Our intent is to limit Method 2 to small water companies and small telephone companies. We will clarify our decision in this regard.

The comments of Southern California Gas Company and the City of Sunnyvale echo those of other commenters and need not be repeated. The comments of the California Building Industry Association and Southwest Gas Corp. merely reargue the policy choice that the ratepayer should pay the tax. We reject the argument.

Background

On October 22, 1986, President Reagan signed into law the Tax Reform Act of 1986 (the Act), which significantly affected all public utilities in California, and hit like a bomb (although one that gave considerable advance warning) among the privately-held public water utilities.

On November 14, 1986, this Commission instituted this investigation into the ratemaking implications of the Act. All utilities, with minor exceptions, were made respondents. At the prehearing conference held on January 9, 1987, **[*8]** Administrative Law Judge Robert Barnett set a schedule for workshops and hearings to be held in connection with the investigation. Among other matters, he determined that the tax law changes resulting in the taxability of contributions-in-aid-of-construction (contributions or CIAC) and refundable advances would be addressed first.

January 30 was set as the deadline for filing comments on the contributions issue with workshops to begin on February 9. In a letter dated January 15, 1987, the Public Staff Division of the Commission (PSD) requested respondents to address the following issues in their comments on contributions:

1. Circumstances under which it would be viable to collect contributions on a gross of tax method.
2. Circumstances under which it would not be viable to collect contributions on a gross of tax method.
3. The collections of a contribution gross of tax discounted for the present value of the future tax benefits which will result from the tax depreciation on the contributed plant.
4. A proposed ratemaking treatment for each of the circumstances described in numbers 1, 2, and 3.
5. The ratemaking methodologies to pass back to ratepayers the benefits derived **[*9]** from the tax depreciation which will be claimed on contributed plant.
6. An estimate of the revenue requirement impact based on either the 1987 adopted test year results of operations, the 1987 attrition year adopted results of operations, or the latest test year adopted by the Commission, whichever is applicable.

Under *Section 118 of the Internal Revenue Code* (the Code) prior to amendment by the Act, amounts were excluded as a contribution to the capital of a utility if such amounts of money or other property:

1. Constituted a "contribution-in-aid-of-construction";



2. Satisfied the expenditure rule (in the case of contributions of money); and
3. Were excluded from the utility's rate base for ratemaking purposes.

Contributions-in-Aid-of-Construction

"Contributions-in-aid-of-construction" are any items or amounts contributed to a "regulated public utility" to the extent that the purpose of the contribution is to provide for the expansion, improvement, or replacement of the utility's facilities (Prop. Reg. Sec. 1.118-2(a)). A "regulated public utility" is a utility required to furnish electrical energy, gas, water or sewage disposal services **[*10]** to members of the general public (I.R.C. Sec. 118(b)(3)(C)).

Specifically excluded from the definition of a contribution-in-aid-of-construction are "customer connection fees." The term "customer connection fee" includes any payment made to the utility for the cost of installing a connection from the utility's main line to the customer's line as well as any amount paid as a service charge for stopping or starting service (Proposed Reg. Sec. 1.118-2(a)(3)).¹

The regulations proposed under I.R.C. Sec. 118 set forth three examples of contributions-in-aid-of-construction:

1. A developer constructs utility facilities (e.g., water lines and a water tower) and turns over these facilities to a utility;
2. A developer furnishes the necessary funds to the utility to construct the facilities; and
3. A municipality pays a utility to relocate facilities which are being destroyed in connection with road construction (Prop. Reg. Sec. 1.118-2(a)(2)).

In addition to the foregoing examples, the proposed regulations provide by **[*11]** inference that refundable advances also are included within the definition of a contribution-in-aid-of-construction. In the specific example of a refundable contribution, a developer contributes cash to a utility for utility construction subject to an agreement that a percentage of the receipts from the facility over a fixed period will be refunded to the developer (Prop. Reg. Sec. 1.118-2(e)).

Expenditure Rule

Under pre-Act law, the receipt of money could be excluded as a contribution only if the related expenditure occurred before the end of the second taxable year after the taxable year in which the amount was received. The amounts in question had to be expended for the acquisition or construction of tangible property used in the utility's trade or business. (Prop. Reg. Sec. 1.118-2(b).)

In the case of money contributed after a facility was placed in service, the money could not be excluded as a contribution unless, at the time the facility was placed in service, there was a binding agreement that the utility was to receive the amount as reimbursement for the cost of the facility. In addition, in the case of such a contribution, the utility must have excluded an amount **[*12]** equal to the contribution from the adjusted tax basis of the facility. (Prop. Reg. Sec. 1.118-2(d).)

Rate Base Exclusion

A final requirement for exclusion of a contribution from the utility's taxable income was that such amounts were not included in the utility's rate base for ratemaking purposes. (I.R.C. Sec. 118(b)(1)(C).)

Tax Act Changes

¹ Under pre-Act law, connection fees did not qualify as contributions-in-aid-of-construction and, hence, were taxable. They remain taxable after the Act.

Effective January 1, 1987, the Act repealed the foregoing exclusion for contributions. Specifically, the Act provides that a nontaxable capital contribution does not include any contribution-in-aid-of-construction or any other contribution as a customer or potential customer (Act Sec. 824(a)). Instead, such contributions must be reported as an item of gross income. (H. Rept. 99-426, pp. 643-644.)²

A literal reading of the statute leads to the conclusion that any contribution which previously was included within the definition of a contribution-in-aid-of-construction is no longer excluded from income under section 118. Moreover, "any other contribution as a customer or potential customer" is also no longer excludible. Because relocation [*13] payments, refundable advances, contributions of tangible property, and monetary contributions all were included within the definition of a contribution-in-aid-of-construction, it would appear that all these items have now become taxable.

The legislative history confirms the foregoing statutory interpretation (H. Rept. 99-426 at pp. 643-644 and H. Conf. Rept. 99-841 at II-324). In this respect, Congress has stated its intention that a utility report as gross income the value of any property, including money, that it receives to provide, or encourage the provision of, services to or for the benefit of the person transferring the property. For this purpose, a utility is considered as having received property to encourage the provision of services if the receipt of the property is a prerequisite to the provision of the services, or if the receipt of the property otherwise causes the transferor to be favored. Congress stated that the person transferring the property will be considered as having been benefited if he is the person who will receive the services, a former owner of the property that will receive the services, an owner of the property that will receive the services, or [*14] if he derives any benefit from the property that will receive the services. Some commenters believe this broad legislative intent is likely to result in the statutory change having a wide scope resulting in the taxability of practically all monetary and property transfers to utilities, whether for line extensions, special facilities, or other purposes.

The Commission's Pre-Act Treatment

Prior to 1987 utilities were allowed to receive CIAC from their customers through existing operating rules and rate schedules authorized by the CPUC. Utilities also receive CIAC under other special arrangements (e.g., state highway relocations). CIAC includes contributions of both cash and property. In general, contributions are non-refundable; however, certain contributions under mainline extension rules and temporary service rules, are refundable for specified periods of time. These contributions are often referred to as refundable advances. Non-refundable CIAC are credited to the appropriate plant accounts, offsetting the cost of the facilities installed for the benefit of contributing customers. As a result, they are excluded from the utility's rate base for ratemaking purposes. Refundable [*15] advances are credited to the appropriate plant account and for ratemaking purposes are applied as a reduction to the utility's rate base. If the advances are not refunded or are only partially refunded within the time limit prescribed by the rules, the remaining balance of such advances is credited to the appropriate plant accounts and treated as non-refundable CIAC.

Customer connection fees are collected under the utility's appropriate rule and were taxable under prior law and will continue to be taxable. Under one method of accounting for the connection fees, utilities are authorized to increase rate base (by debiting deferred taxes) for the payment of income taxes attributable to connection fees. Under this procedure, rate base is reduced (by crediting deferred taxes) as depreciation deductions attributable to connection fee assets are allowable. When an asset is fully depreciated for tax purposes, the initial rate base increase (reflected by the debit deferred tax) will have been eliminated (by the accumulated rate base credits from depreciation deductions). During the interval between the initial payment of the tax and the time when an asset is fully depreciated for tax [*16] purposes, the general ratepayer is required to pay for the tax-timing difference through increased rate base. Under another method, utilities are authorized to collect the tax currently in rates.

The Commission's Initial Response to the Act

² The complete House of Representatives Report on this issue is set forth in Appendix B.

On December 10, 1986, the Evaluation and Compliance Division of the CPUC staff issued a letter suggesting that utilities may wish to consider collecting all CIAC "gross of federal income tax" from contributing parties effective on January 1, 1987. The CPUC staff letter further stated that in the absence of such collection, there would be risk of a "permanent shortfall."

In response to this letter, effective January 1, 1987, the major utilities, SoCalGas, PG&E, Edison, and SDG&E, started collecting CIAC gross of federal tax as well as gross of state franchise tax in anticipation of the state adopting similar CIAC legislation retroactive to January 1, 1987. In February the Commission directed all utilities to reduce their gross-up rate to 67% to reflect only federal tax liabilities and to refund with interest (i) all amounts collected which were earmarked for state income taxes associated with CIAC, for the period January 1, 1987 through February 10, 1987, and (ii) all collections of federal and state income taxes in excess of certain costs for the period January 1, 1987 through February 10, 1987; CIAC gross-up amounts were made subject to further adjustment pending a final decision in these proceedings. To facilitate possible future adjustments, the utilities were required to maintain memorandum accounts to enable them to make any required adjustments.

The Workshops

Initially, the workshop participants agreed that the concerns of water utilities were substantially different from those of other utilities. As a result, the workshops were divided into two groups -- one applicable to water utilities and the other applicable to all other utility respondents. But the outcome of both workshops was the development of five alternative ratemaking methods to address the federal taxability of CIAC.

Method 1: Contribution Flow-Through, Utility Financed

Under this method, the utility would:

- (1) Continue to require contributors to make CIAC payments as under prior law without grossing-up for any additional tax;
- (2) Credit such receipts to miscellaneous operating revenues rather than crediting those receipts to plant in service [*18] as is done today; and
- (3) Reduce rates to flow-through these contributions to customers currently (this is the way miscellaneous operating revenues are treated for ratemaking purposes).

Under this option, the contributing customer will continue to pay the construction cost of new facilities as has been the case in the past. That payment, however, will now be immediately passed to all customers in the form of reduced rates. All customers will then be responsible for paying such amounts through depreciation plus carrying costs, over the life of the asset for which such contribution was received. In effect, the utility will be financing the new facilities instead of the contributing customer (its contribution would be flowed-through currently to the general ratepayers). This procedure avoids the accrual of any current income tax liability.

The treatment of refundable advances under this method is as follows: the difference between taxable advances and deductible refunds (i.e., refunds attributable to post-1986 contributions) is flowed-through to decrease rates (when advances exceed refunds) or increase rates (when refunds exceed advances, as is expected in the future). This procedure [*19] avoids any current tax liability increase (or decrease) attributable to the receipt or refund of advances.

Under Method 1, assuming a \$ 1,000 contribution with a 30-year life, the contributor pays no gross-up, there is an \$ 808 revenue reduction in year 1, the contribution is rate based, and over time the ratepayer pays \$ 3,121 (Appendix C).

Method 2: Full Tax Gross-Up, Cost on Contributor

Under this method, the CIAC is grossed-up for the full amount of the federal tax and is charged to the contributor. The grossed-up portion of the contribution would be used to pay the applicable taxes. The amount remaining after

taxes are paid would be credited to the appropriate plant account as was done under pre-tax law. As a result, there would be no net increase in rate base. Depreciation deductions, which are allowable over the tax lives of the contributed assets, would be flowed-through to the general ratepayer.

In the case of refundable advances, the developer should pay a full tax gross-up initially. To the extent the advance is refunded, it should be refunded with a tax gross-up. The treatment of depreciation benefits in the interim is a matter for the CPUC to decide.

Under Method [*20] 2, assuming a \$ 1,000 contribution with a 30-year life, the contributor pays a gross-up of \$ 515; the ratepayer pays nothing and receives the benefits from the tax depreciation on the contribution.

Method 3: Rate Base, Cost on Ratepayer

Under this method (1) no gross-up to the contributor would be charged, (2) the utility would pay the tax on CIAC, and (3) the tax would be treated as a debit to deferred tax, increasing rate base. As related depreciation tax benefits of the contributed facilities are received, deferred taxes would be credited.

In other words, the initial tax on CIAC would result in a rate base increase; however, over time, as the contributed facilities are depreciated, rate base would be reduced. In this way, the tax cost would be spread out in rates over the tax life of the facility rather than resulting in a current increase in ratemaking tax expense (see Method 4, below). This method is identical to that already approved by the CPUC for treating taxes paid under customer connection fee rules.

Refundable advances are easily handled under this method: taxable advances are debited to deferred taxes (as is the case with non-refundable CIAC) and deductible refunds [*21] are credited to deferred taxes.

Under Method 3, assuming a \$ 1,000 contribution with a 30-year life, the contributor pays no gross-up, the tax portion of the contribution is rate based, and over time the ratepayer pays \$ 519 (Appendix C).

Method 4: Full Tax Gross-Up, Cost on Ratepayers

This method (1) does not charge any gross-up to the contributor, and (2) reflects all tax costs currently in general rates. Revenue requirements are increased currently for the tax by debiting current tax expenses for ratemaking purposes. However, over time, the revenue requirement would be reduced by the tax depreciation allowed on the contributed facilities. These tax benefits would be flowed-through to general ratepayers, by crediting current tax expense for ratemaking.

In the case of refundable advances, current tax expense would be debited upon the receipt of a taxable advance and credited upon the payment of a deductible refund. Depreciation benefits should be flowed-through to ratepayers as above, until the advance is refunded. After that time, the remaining depreciation benefits would have to be normalized.

Under Method 4, assuming a \$ 1,000 contribution with a 30-year life, the contributor [*22] pays no gross-up, the ratepayer pays \$ 493 in year 1, the contribution is rate based, and over time the ratepayer receives back \$ 544 (Appendix C).

Method 5: Rate Base, Cost on Contributor

Under Method 5, the tax costs incurred on CIAC would be paid by the utility and debited to deferred taxes thereby increasing rate base. Deferred taxes would be credited, thereby reducing rate base, as the related depreciation tax benefits of the contributed facilities are received. Up to this point, Method 5 is identical to Method 3 described above. However, under Method 5, the revenue requirement increases attributable to ratebasing the tax on CIAC would be offset by increasing charges to the customer making the CIAC.

Specifically, under this method, customers making taxable CIAC would pay an additional amount at the time of the contribution which would be credited to deferred revenues net of income taxes thereby reducing rate base. The

deferred revenues would be amortized over the tax life of the facilities acquired with the CIAC by crediting Miscellaneous Revenues effectively offsetting the revenue requirement impact of ratebasing the tax on CIAC. In this way, the general ratepayers would [*23] be made whole by the specific contributor for the taxcost they have assumed.

Under Method 5, assuming a \$ 1,000 contribution with a 30-year life, the contributor pays a gross-up of \$ 273 (based on an 11.44% discount rate) , the tax portion of the contribution is rate based, and over time the ratepayer pays \$ 113 (Appendix C).

The procedure for treating refundable customer advances should be consistent with the principles outlined above.

In summary, the five methods are:

1. CIAC is treated as revenue and passed through to general customers. Plant is rate based and the revenue requirement is charged to general customers.
2. CIAC from developers is grossed-up for tax. Benefits of future tax depreciation are passed through to general customers.
3. The tax on CIAC is rate based. The revenue requirement is charged to general customers.
4. The tax on CIAC is charged currently to general customers. The benefits of future tax depreciation are passed through to general customers.
5. CIAC from developers is grossed up for the net present value of the revenue requirement for rate base treatment of the tax on CIAC.

Methods 1, 3 and 4 place the burden of the tax on the general [*24] ratepayer; Method 2 places it on the contributor; and Method 5 shares the burden between contributor and general ratepayer.

The Positions of the Parties

Public Staff Division (PSD)

PSD states, in its opinion, the IRS will assess taxes on "practically all monetary and property transfers to utilities." PSD recommends (i) Method 5 for all major gas, electric, water, and telephone utilities and that a 12.00% discount rate be uniformly employed, (ii) Method 2 for small water companies (Class B, C, and D) and small telephone companies which do not possess the financial resources to assume the burden, even in part, of the tax, and (iii) that Methods 5 and 2 apply, where recommended, to all CIAC, including any uncertain areas, except where the utility has concluded that the event is nontaxable.

PSD believes that the general ratepayer should not be burdened with the total CIAC tax liability when the acquisition of service directly relates to the customer receiving the service. On the other hand, there is some overall benefit to general ratepayers from service area expansion so the contributor should not be burdened with the total tax liability either. The major utilities are in a position [*25] to provide a share of the tax burden and recover this cost over time from general ratepayers. Method 5 shares the tax burden between the contributor and the ratepayer and represents the next lowest net present value to the ratepayer after Method 2, CIAC gross of tax. Method 5 is more reasonable than Methods 1, 2, 3, and 4, because these methods all require the ratepayer or the contributor to bear the full burden of the tax.

Methods 1, 3, and 4 place the tax burden entirely on the general ratepayers. Method 3, while having the advantage of fairly level annual rate impacts, results in a significantly higher overall cumulative revenue requirement than Method 5. Method 4 not only is defective in the latter respect, but it also suffers the disability of large annual revenue changes in the initial years including a high initial year revenue increase. Method 1 is superficially attractive in that it would produce a significant initial year revenue decrease. However, the Method 1 initial year

decrease is followed by a second year significant increase in rates and results in the highest overall revenue requirement to general ratepayers.

PSD does not share the view of some utilities that [*26] use of Method 5 might violate the normalization requirements of Federal tax laws, since the "flow through" benefits under Method 5 are to the contributor, not the ratepayer. Moreover, it is not a violation of normalization requirements because the method normalizes the tax benefits of the utility contribution. The PSD witness testified that there was no "normalization problem" under Method 5.

Employment of Method 5 requires use of a discount rate. PSD Exhibit 2 originally contemplated the use of different discount rates for each utility, but at the hearing PSD recognized the administrative desirability of a uniform statewide rate. Therefore, PSD recommends that a 12.00% discount rate be used for all the utilities to the extent that Method 5 is adopted. This figure is based on the most recent rates of return for major utilities in California, including major water companies, a range of 11.31% to 13.05%. This rate would be utilized in successive years until changed by the CPUC.

Small water companies and small independent telephone companies do not necessarily possess the financial resources to bear any portion of the tax burden of taxable CIAC. Utilities in this category simply [*27] cannot pay the tax and then obtain the funds necessary to construct the required plant either through long-term debt or equity. For these utilities PSD recommends that Method 2, CIAC gross of tax, be adopted as an option for them. While this proposal puts the full burden of the tax on contributors, the tax cost is partially offset by the tax benefit which the contributor receives by being able to deduct the CIAC gross of tax as an operating expense deduction for tax return purposes. PSD recognizes the negative aspect that potential contributors may decide to seek service from adjacent municipal utility systems not burdened with the CIAC tax problem, or decide not to develop, thereby deterring system expansion. While these situations may occur, PSD does not see any alternative to adopting Method 2 as an option for utilities in this category.

PSD observes that much of the hearing was devoted to discussions of what might be excluded from taxable CIAC, which largely dealt with governmental relocation payments. PSD is sympathetic to those concerns and originally recommended no tax be collected with respect to uncertain items. PSD felt this placed the risks appropriately on the utility [*28] rather than the ratepayer and would stimulate the utilities to seek speedy resolutions before the IRS. However, in its brief, PSD says that the record shows that failure to gross-up for uncertain items could lead to revenue deficiencies which would ultimately be the burden of the general ratepayer; failure to collect tax on uncertain items could result in significant interest and penalty costs if the items are found to be taxable. Prospective collection from contributors presents difficulties. Consequently, PSD now recommends that Method 5 (or 2 where recommended) be applied to the uncertain items by the utility when the utility deems that such items are potentially taxable. PSD urges the utilities to seek speedy determinations from the IRS and recommends that the Commission, through its staff, participate to that end.

The Energy Utilities

Pacific Gas and Electric Company (PG&E)

PG&E's testimony, exhibit (Exhibit 1), and brief contain the most thorough analysis of the CIAC issue in this proceeding. During the workshops, PG&E agreed to shoulder this burden and it did an excellent job; it is to be commended.

PG&E recommends that Method 5 be applied to all transactions which [*29] are not customer related. Ratepayers should not bear the burden of a CIAC tax incurred for the benefit of a non-customer, particularly where the contributor-entrepreneur is a supplier of gas or electricity to the utility. Ratepayers who are already paying suppliers a price based on avoided cost principles should not be asked, in effect, to pay more than their avoided costs by incurring the burden of a CIAC tax.

For customer-related transactions, however, PG&E recommends that the CPUC adopt either Method 1 or Method 3. Although PG&E is concerned about cross-customer subsidization issues, PG&E believes these concerns are outweighed by the additional contributor and administrative costs which would result from a gross-up procedure.

PG&E classifies customer-related transactions as contributions received under all rules and rate schedules except Rules 2 and 21.³ All contributions which do not fall within the customer-related category (i.e., contributions received under Rules 2 and 21, as well as contributions received outside PG&E's operating rules) would be classified as non-customer related.

Certain [*30] Rule 2 contributions do involve customers rather than suppliers; however, because these charges relate to installation of special facilities for the sole benefit of the contributor (without benefit to the system generally), PG&E believes that these transactions also do not merit the favorable treatment PG&E proposes be applied to customer-related transactions generally. Instead, these transactions should be treated in the same manner as other non-customer contributions.

PG&E finds Method 1 attractive as a method for handling customer-related transactions. This method avoids incurring a current tax by flowing-through the contribution to the general customer. (In effect, the utility finances the contributed facilities.) This method achieves a primary goal of keeping customer-related contributions at current levels, while it also arguably keeps the general ratepayers whole, depending on the discount rate assumption. Nevertheless, PG&E is concerned over the potentially large financing requirements which may eventually be required should this method be selected. For this reason, PG&E recommends that if Method 1 is adopted, it have an opportunity to review continuation of this method [*31] in its next general rate case or when its CIAC financing requirements exceed \$ 100 million annually, whichever is earlier. In addition, because of difficulties associated with estimating CIAC, PG&E recommends that balancing account treatment for CIAC be implemented (at least in the short-term), if this method is adopted.

Finally, PG&E submits that Method 1 should not be extended to contributors in non-customer transactions because Method 1 places shareholder funds at risk for the benefit of the contributing party and under Method 1 the general ratepayer will be made whole only under certain present value assumptions. If the present value discount rate is less than 15%, the general ratepayer would be incurring costs attributable to the contribution. This is unfair if the customers are already paying a negotiated price based upon their avoided costs for the suppliers' output.

PG&E finds Method 3 attractive for customer-related transactions. Although the tax on CIAC is not borne by the contributors, PG&E does not view this as a fatal shortcoming, largely because there are many instances of cross-customer subsidization throughout ratemaking. Method 3 is appealing to PG&E because [*32] of its simplicity: contribution charges do not have to be adjusted in customer-related transactions and estimation errors can be corrected in subsequent general rate cases.

PG&E does not believe Method 3 should be applied, however, in non-customer transactions. Specifically, in supplier situations, it would be inequitable for ratepayers to pay any of the costs attributable to a supplier transaction, where they are already paying a price for output which theoretically reflects their avoided costs. Moreover, the QF position is that a QF contribution has very limited economic benefit to the utility (see page 48 below). Given this fact, it clearly would be unfair for the utility or its ratepayers to bear the burden of any of the tax costs attributable to a QF contribution. As the QF's believe that nearly all benefits from the contribution are realized by the QF contributor, PG&E submits that the QF contributor should pay the tax liability not ratepayers as a whole.

PG&E favors applying Method 5 to contributions received in non-customer transactions. This method (1) reflects future tax benefits in the gross-up calculation, thereby reducing the contributors' up-front payment, and [*33] (2) helps assure that general customers are made whole for costs properly attributable to the specific contributor. PG&E is also sympathetic with the purpose of Method 5 -- to place the burden of CIAC tax costs on the contributor

³ Rules 2 and 21 cover special facilities requested by the customer.

-- in customer-related CIAC transactions. To the extent the CIAC is attributable to a particular customer, PG&E agrees that it is desirable that the customer responsible for the CIAC bear the burden of the applicable tax.

On balance, however, PG&E does not favor applying Method 5 to customer-related transactions, but would rather avoid the gross-up requirement in these situations. It argues that although the cross-customer subsidization issue is entitled to great weight, there are many instances where cross-customer subsidization occurs. Therefore, it is not essential that inter-customer equity be achieved in customer-related transactions (e.g., transactions governed by Electric Rules 15 and 15.1 and Gas Rule 15).

Second, PG&E is concerned about the potential adverse competitive impacts of applying Method 5. The water companies have expressed concern regarding the loss of potential customers to municipal utilities (who would not charge a gross-up) [*34] and Southern California Gas has expressed concern that imposing the gross-up on the contributor would result in potential gas customers instead utilizing all electric homes. PG&E shares these concerns in jurisdictions where it supplies only the gas commodity and, in other jurisdictions, where it faces potential municipal competition.

Finally, PG&E is concerned about the potential administrative burdens associated with collection of the gross-up. However, these concerns, PG&E believes, can be substantially alleviated if the following conditions are satisfied:

(i) The utility should be given the unfettered discretion to collect the CIAC gross-up in those transactions the utility deems are taxable. This discretion is essential if the utilities are to avoid becoming involved in continual, costly disputes with contributors who believe their CIAC is not taxable.

(ii) The utilities should not be asked to continually analyze tax avoidance schemes. The cost of analyzing these many and varied proposals is significant and would constitute an unreasonable burden on the utility.

(iii) The CPUC should recognize that the Method 5 gross-up is only an approximation. The necessity to revise [*35] the gross-up percentage should be minimized, once conforming state law has been reflected. For administrative simplicity (and to avoid continual advice letter filings), the CPUC should establish limitations on gross-up revisions (e.g., revisions would occur every third general rate case, or earlier, if the gross-up would change by a specific percentage (e.g., plus or minus 15%)). This will create a level playing field so that minor changes in assumptions (which would not trigger a change in the gross-up percentage) could benefit either ratepayers or contributors.

Assuming the foregoing conditions are satisfied, PG&E asserts that Method 5 would not present significant administrative problems. Moreover, PG&E believes other concerns raised at the hearings regarding the implementation of Method 5 are overstated. For example, PG&E is not concerned regarding questions raised about the ratemaking mechanics of Method 5. Method 5 is essentially the same as Method 3, except that gross-up money is available to offset rates. Mechanically, the gross-up reduces rate base on a net of tax basis, and is flowed back to ratepayers over the tax life of the CIAC assets gross of tax. In this way, [*36] ratepayers are made whole for the tax costs included in rate base. The regulatory accounting treatment can be adapted to the ratemaking procedure the CPUC adopts.

PG&E is also unconcerned with normalization questions raised about Method 5. PG&E agrees with PSD Witness Infante that Method 5 would not result in a normalization violation. If a utility believes that a problem exists with this method, it should submit an IRS ruling request, subject to CPUC review. In the unlikely event that an unfavorable ruling is received, the CPUC should modify Method 5 at that time so as to cure the normalization problem.

PG&E (and every other party) agrees that the CPUC clearly cannot bind the IRS; the IRS will make its own interpretation of the tax laws, regardless of the Commission's decision in this proceeding. PG&E Witness Kay testified that merely because PG&E collected a gross-up and paid tax to the IRS would be irrelevant to an IRS determination on the taxability of the transaction; the IRS will issue a ruling based on their interpretation of the law, not on the taxpayer's treatment of the item.

PG&E strongly supports the position that all contributions to the utility should now be [*37] presumed taxable. Effective January 1, 1987, the Act repealed the income tax exclusion for the CIAC. Specifically, the Act provides that a non-taxable capital contribution does not include any contributions-in-aid-of-construction or any other contribution as a customer or potential customer (Act Sec. 824(a)). Instead, such CIAC must be reported as an item of gross income.

In PG&E's opinion a literal reading of the statute leads to the conclusion that any contribution which previously was included within the definition of a CIAC is no longer excluded from income. Moreover, "any other contribution as a customer or potential customer" is also no longer excludible. Accordingly, the CPUC should presume that all CIAC is now taxable. This would include relocation payments, refundable advances, contributions of tangible property and all other items or amounts contributed to provide for the expansion, improvement, or replacement of the utility's facilities. It is clear that the statutory change was intended to raise revenue and any IRS interpretation allowing CIAC to be excluded from taxation is likely to be narrowly prescribed.

PG&E concludes that the Commission should not second-guess [*38] the IRS regarding items which may or maynot be taxable. Until IRS guidance is received, the gross-up should be presumed applicable to all CIAC transactions, unless the utility -- generally at its own risk -- deems that an exemption applies.

PG&E submits that this procedure is not unfair to the contributor. If a contributor believes it has a good case to exclude its contribution from taxable CIAC treatment and the utility does not agree, the contributor should take its case to the IRS. PG&E believes that because of the interest in the CIAC matter, the IRS will issue a prompt ruling in those areas where it believes the law allows the contribution to be excluded. A favorable ruling would allow the utilities to refund the gross-up to the contributor with interest. However, failure of the IRS to issue a prompt ruling in response to public pressure, including that of the CPUC, will clearly indicate that treating the subject transaction as non-taxable entails significant risk. It is precisely these kinds of transactions where a gross-up should be applied.

PG&E, however, proposes that the utilities should be allowed to waive the gross-up in circumstances where they deem the tax would [*39] not apply. This includes joint poleand trenching costs, payments qualifying under IRC Code Section 1033, and the public benefit exception. This adds needed flexibility to Method 5. Future IRS interpretations may specify situations, particularly in the relocation area, where the tax would not apply. In addition, in certain limited situations, primarily involving IRC Section 1033 condemnations, the utility may be prepared to waive the gross-up in the absence of an IRS ruling.

The essential point is that it should be the utility (in the absence of IRS clarification) -- not the CPUC -- which determines the circumstances under which the tax gross-up is applied. PG&E Witness Kay testified that PG&E has the expertise to make a judgment call on the taxability of a particular item on a transaction by transaction basis. And PG&E concedes that if a utility voluntarily waives a gross-up and the transaction is ultimately determined to be taxable, the utility generally should not be made whole from the general customer.

PG&E is sympathetic with the position that the utilities should not be entitled to gamble with the ratepayers' money, by unilaterally waiving the gross-up in tax areas [*40] that are uncertain. If the CPUC selects Method 5, the contributor should be responsible for the CIAC tax if it is incurred, not ratepayers generally. The utilities should not be encouraged to gamble with the ratepayers' money. On the other hand, PG&E is concerned that it not be forced to impose gross-ups to protect itself financially in those areas where the tax law appears clear, but where no IRS determination has been issued. An IRS ruling in a clear tax matter -- even one of national importance, such as the CIAC issue -- may take up to one year.

PG&E, therefore, proposes that the CPUC allow the utilities a special rule which places ratepayers at risk, but only for a limited period and only for limited items. Based on evidence set forth by PG&E and others, PG&E believes that the rule should be limited to interpretations under IRC Section 1033 and joint pole and trenching costs. It should apply for only one year after the decision. And, to obtain the benefit of this provision, the utility should be required to (1) notify the CPUC of its position within 60 days of the decision in this proceeding, and (2) promptly

submit a ruling request to the IRS on the issue. If a favorable [*41] IRS ruling was not obtained within the one-year period, the utility would no longer be authorized to waive the gross-up at ratepayer risk.

PG&E agrees that the CPUC should not be concerned in this proceeding with methods of tax avoidance. Testimony has been introduced regarding various ways to avoid the tax. Loans, letters of credit, and change in ownership policy have all been suggested. However, no detailed proposal discussing the financial, accounting, tax and/or operational aspects associated with implementing such proposals have been introduced into evidence.

Witness Kay stated that both loans and letters of credit entered into in connection with CIAC transactions will receive close scrutiny by the IRS to determine if they are an impermissible method of tax avoidance. Similarly, he testified that allowing the contributor to retain ownership so as to avoid a taxable transfer to the utility would also invite IRS scrutiny. Unless there is substance to a revised ownership arrangement, the IRS is likely to hold that the utility is continuing to receive a taxable transfer. In view of the foregoing, there clearly is an insufficient record for the CPUC to order any tax avoidance [*42] scheme in this proceeding. In addition, PG&E urges the CPUC to provide no encouragement to those groups who, without IRS approval, would expect PG&E to implement tax avoidance schemes with unclear tax consequences.

PG&E is concerned with the administrative costs it may incur in seeking to implement the many and potentially varied approaches that contributors may suggest to avoid taxes. Unless PG&E is compensated for these administrative costs from the contributor, PG&E's general ratepayers would be inappropriately subsidizing costs which are properly the responsibility of the contributor. PG&E strongly recommends, therefore, that the CPUC's decision allow it to charge contributors for administrative expenses it incurs in analyzing their proposals, including legal, and accounting costs, in the same way it charges the contributor for the CIAC tax expense. PG&E's tax, legal, and accounting services are not a "free good" and they will be over-utilized if the utility is not allowed to pass on its costs to the contributor.

PG&E asserts that it should be made whole for CIAC tax costs attributable to CIAC received after December 31, 1986, but attributable to prior contracts and arrangements. [*43] PG&E will receive some contributions in 1987 (and later years) which are attributable to contracts entered into before 1987. Some of this CIAC will relate to billings for 1986 work which was not paid in 1986. Other CIAC will be received subject to agreements and understandings entered into prior to 1987 which may not afford PG&E the right to impose a gross-up. In those cases, PG&E should be made whole from ratepayers, by being allowed to include the CIAC tax in rate base.

Finally, PG&E urges the Commission to address the treatment of CIAC for California tax purposes. PG&E expects California conformity legislation to impose a tax on CIAC, retroactive to January 1, 1987, but no such legislation has been enacted to date. In the interim, PG&E believes that the 67% federal tax rate gross-up will be subject to California tax. The gross up cannot satisfy the expenditure rule for nontaxable CIAC. Moreover, it is possible the state tax authorities will take the position that the CIAC itself is taxable, even in the absence of conforming legislation. In this regard, it should be noted that California never adopted a provision comparable to Code Section 118(b), which was the statutory [*44] basis for excluding CIAC from income under pre-Act law. California has historically followed federal law in this area without specific legislative authority (see Legal Ruling No. 362, Cal. Tax Rept. Para. 205-022 (FTB 1973)) (Exh. 1, p. 17).

Any CPUC decision should provide procedures which (1) allow the utilities to be made whole from ratepayers for any retroactive California CIAC tax liability, not previously reflected in a gross-up (this may be done in connection with Phase II of the Tax OII), and (2) authorize an additional state tax gross-up, if California conforms to federal law, on a basis consistent with the calculation of the federal tax gross-up.

San Diego Gas & Electric Company (SDG&E)

SDG&E recommends a modified form of Method 5. SDG&E asserts that it "will incur the additional tax due to contributions received from contributors and thus the additional tax is attributable to those contributors. That tax liability should be borne by the contributors."

SDG&E intends to compute the present value of the tax benefit more directly than the rate base technique contained in Method 5. Under SDG&E's proposal, the so-called "Maryland Method,"⁴ the present value of the tax [*45] benefits is computed utilizing the utility's authorized rate of return as the discount factor. The current tax shortfall would be funded by the utility shareholder. The shareholder would receive the normal utility rate of return through the tax benefit associated with the tax depreciation of the CIAC. Under SDG&E's proposal, there would be no chance for an increase to general ratepayers. There would be no impact upon SDG&E's capital budget and there would be only a minor impact on cash flows to pay the discounted present value of future tax benefits.

Method 5, under ideal conditions, approximates the Maryland Method. However, in SDG&E's opinion, the Maryland Method has advantages over Method 5 both in simplicity and in protection of the general ratepayer. While the Maryland Method does introduce some additional shareholder risk, that risk is small and appears to be fair and balanced.

With regard to the items where there is doubt as to taxability, SDG&E proposes to gross those items up using the Maryland Method until clarification can be received from the IRS. When the IRS rules that any doubtful [*46] items are indeed not gross income subject to taxation, SDG&E would return the gross-up amounts plus interest to the contributor. Such a methodology maintains general ratepayer indifference to these contributions. Any method involving no gross-up for tax until after an IRS ruling requires that the utility and potentially the utility's general ratepayers will bear the burden of the additional tax. SDG&E opposes taking that risk.

SDG&E states that its recommendation is based on the philosophy that costs should follow cause, a position endorsed by the Commission as a general theory for rate design, (D.86-12-095, mimeo. p. 106) and should be used for allocating the tax on CIAC. It says that no party to this proceeding has demonstrated any good reason why the general ratepayers should be burdened with all or any portion of the additional tax. The Commission should continue its cost based rate policy to include cost based recovery of the tax on CIAC.

SDG&E contends that the two arguments most often used to support the proposition that the general ratepayers should bear the tax is specious. The first is that the overall Act was designed to be revenue neutral so all ratepayers should [*47] share the costs and benefits. While SDG&E agrees that the Act was revenue neutral on a total taxpayer basis, it was clearly not Congress' intent that it be revenue neutral toward each and every taxpayer. In fact, the House Report demonstrated that the repeal of the tax free contributions to utilities was clearly intended to impact those who benefited from the services received from the utility. Since Congress decided to tax contributions based upon the fact that the donating party receives a benefit, it is only appropriate that the Commission charge the additional tax to that benefited party.

The second reason advanced for allocating the tax to the general ratepayer is that the general ratepayer benefits by the addition of customers to the system. SDG&E believes it is unreasonable to allocate costs today based upon the outdated thesis that growth is beneficial. Higher general cost is the rule for new residential service connections in SDG&E's service territory. Since new residential customers actually increase the cost to SDG&E's other customers, it would be inappropriate to also transfer the tax cost of adding those customers to SDG&E's general ratepayers.

SDG&E says that [*48] Method 5 has several disadvantages compared to the Maryland Method. First, Method 5 is only neutral to general ratepayers on a present value basis. Since the examples shown in the workshops generally showed a slight decrease in rates in the early years, those decreases had to be offset by increases in rates in later years in order to have a zero present value impact. Any method which rate bases a portion of the CIAC has such a potential for increases in rates.

An advantage of the Maryland Method over Method 5 is the relative simplicity of the calculation. The Maryland Method requires one relatively straightforward computation to arrive at the net gross-up. Method 5 requires that the future cost of the rate based tax related revenues be discounted and offset in some fashion by the contributions. The net present value of the streams of contribution payback and revenue requirement is zero.

⁴ The Maryland Method was first used by the Maryland Public Service Commission.

Lastly, SDG&E believes that the potential for an adverse normalization ruling by the IRS is lower with the Maryland Method than with Method 5 because the Maryland Method does not involve any rate base calculation or computation which impacts SDG&E's regulated rates. Since Method 5 involves [*49] rate base and the regulated rates of the utility, there appears to be a higher potential that the IRS will view it as a violation of normalization requirements.

In regard to determining which transactions are subject to tax, SDG&E supports the proposal to tax all contributions from all contributors, including government agencies (except for relocations) until the IRS rules. Any other position, it argues, places the utility general ratepayer in the position of taxpayer of last resort should a contribution prove to be taxable and the contributor unavailable to pay the tax. SDG&E's ratepayers should not be placed in this position.

Southern California Edison Company (Edison)

Edison recommends Method 3. It argues that even though CIAC may be required to serve an individual, Edison's other ratepayers undeniably receive benefits from CIAC related to undergrounding and service area expansion. Those benefits have been recognized by the Commission as benefits for the utility's ratepayers. In Decision 73078, the Commission, in support of its long-range program for converting existing overhead utility distribution lines to underground, at ratepayer expense, cited the considerable aesthetic [*50] values and safety and reliability features associated with underground construction. Those benefits cannot be disregarded in considering the appropriate recovery of the tax on CIAC, and should be considered in deciding whether or not Edison's general ratepayers should bear costs associated with CIAC. Additionally, Method 3 minimizes the tax attributed to CIAC and thus avoids the problem of paying tax on tax. Method 3 also eliminates the risk of fluctuation in a discount rate which may be affected by general economic conditions, since it is a direct recovery of the tax through rate base.

Edison rejects Method 2 because contributors are required to pay the tax on CIAC, but are denied the tax depreciation benefits associated with the contribution. The tax the contributor must pay is calculated to include a tax-on-tax component which causes the highest grossed-up contribution. Method 2 is the most detrimental approach since it substantially increases the tax liability and is the most costly for the contributor.

Method 5 is also rejected because, Edison believes, the calculation of the tax is dependent on the discount factor used. Method 5 thus places additional risk on the ratepayer [*51] if the initial discount rate results in the undercollection of tax. Additionally, Method 5 is administratively difficult. Edison asserts it will add to its accounting, billing, and record keeping functions.

Edison asks that pending IRS interpretation, all CIAC should be considered taxable. Edison fears that if the Commission undertakes to reach decisions on whether the IRS will or will not later determine that a particular aspect of CIAC is taxable, the result is an increased risk to the ratepayer that certain CIAC found by the Commission to be nontaxable would later be taxed. If so, utilities, and of course their ratepayers, could be found liable for additional payments of interest and penalties, thus increasing long-term costs.

The fact is, Edison asserts, the entities that have the authority to determine the taxability of CIAC are the IRS and the courts, and not the CPUC or any parties to this proceeding. Absent a firm basis for concluding that certain CIAC are not taxable, which firm basis does not yet exist, the utilities should be able to collect the tax on all CIAC until such time as a legal determination is otherwise made.

Finally, Edison recommends that utilities [*52] be permitted to collect state tax applicable to CIAC or, at least, applicable to the federal tax gross-up on CIAC. It argues that although a utility's receipt of CIAC is currently not considered taxable income under California state tax law the California legislature is expected to conform state tax law to include the changes in the Act retroactive to January 1, 1987; therefore, the Commission should allow utilities to recover those taxes. Moreover, the federal tax gross-up of CIAC is considered by many to be presently taxable for state income tax purposes, and the Commission should adopt a provision in this proceeding for the recovery of that tax, subject to refund with interest.

Pacific Power & Light Company (PP&L)



PP&L recommends Method 3. It asserts that its CIAC in 1986, 1987, and 1988 will be approximately \$ 66,000 in each year, and compares that with PG&E's expected 1987 CIAC of \$ 60 million, SDG&E's \$ 43 million, and Edison's \$ 105 million. Further, its California service area is extremely depressed; its marginal cost of power is below average cost; and it is in the midst of an economic development program to attempt to bring new customers to the area. Finally, it [*53] estimates that the annual revenue impact on its ratepayers using Method 3 is an increase of \$ 3,000 which, when determining rates, is lost in rounding. It points out that it has recently had a general rate case in which its rates were set through 1989, so Method 3 will probably have no effect on ratepayers. Because Methods 2 and 5 can discourage new investment and because Method 5 has administrative disadvantages it recommends Method 3.

Southern California Gas Company (SoCalGas)

SoCalGas recommends either Method 3 or Method 4, which treat CIAC tax liability in the same manner as other tax expenses, as a general ratepayer obligation to be collected in rates as an ordinary business expense.

SoCalGas is particularly concerned that the price signals Methods 2 and 5 would send are artificial and would have a negative impact on the operations of gas only utilities. Although SoCalGas believes gas is the most efficient energy source for most household uses, including space heating, water heating, cooking and clothes drying, it notes that it is not absolutely necessary that new housing be equipped with natural gas. Electricity, on the other hand, is essential, whether or not the cost [*54] of new connections is artificially inflated. SoCalGas asserts that either Method 2 or 5 would increase the cost of new housing equipped with natural gas by more than \$ 1,000 per unit, which could very well cause developers to install electric-only equipment, even though natural gas is more efficient.

SoCalGas argues that the result of the Commission's adopting either Method 2 or 5 would not be in the public interest, or in the interest of new or existing ratepayers. Existing ratepayers benefit from the addition of new customers because fixed costs are spread over a greater level of sales, but Method 2 or 5 would artificially discourage the addition of new customers to SoCalGas' system. New customers benefit from the use of natural gas because it is the most efficient energy source for most household uses, but Method 2 or 5 would artificially increase the initial cost of obtaining natural gas service. Society benefits when energy resources are allocated most efficiently, but Method 2 or 5 would discourage the efficient use of natural gas. The adoption of Method 3 or 4 would eliminate those adverse impacts.

The Water Companies

Citizen Utilities Company of California (Citizens) [*55]

Citizens and its subsidiaries consist of seven water companies and one small telephone company. It recommends that the Commission adopt Method 3 as the primary procedure, but allow certain smaller utilities the option to choose Method 2. It strongly objects to Method 5, which it characterizes as an "administrative monster." And it advises that in all situations where taxability is uncertain that the utilities be permitted to provide currently for taxes.

Citizens argues that Method 3 is preferable because it is easily administered. No gross-up to the contributor is charged and the tax would be treated as a debit to deferred tax. While this would increase rate base in the short term, over time, as contributed facilities are depreciated, rate base would be reduced. Most, if not all, utilities already have accounting and ratemaking procedures in place for calculating, recording, auditing, and adjusting deferred income taxes. Method 3, Citizens states, merely follows currently accepted and easily implemented procedures.

Citizens opposes Method 4 because that method results in substantial current increases in ratemaking tax expense which require a large increase in year one and [*56] beyond. Method 1 also is bad because it results in a significant rate decrease in year one, followed by a substantial increase in rates in year two; this is not the proper signal to be given to ratepayers.

In regard to Method 2, Citizens recommends that it must be allowed to "smaller" utilities (undefined) to provide needed flexibility. Certain smaller water and telephone utilities do not have the financial resources to pay the tax on CIAC under any method and, therefore, Method 2 must be permitted or the utility could not accept any contributions.

Citizens opposes Method 5 because it foresees great administrative burdens. It argues that Method 5 would require the utilities to set up additional accounting systems to maintain data on a year-to-year basis (separately by discount rate and type of property) and to maintain records sufficient to provide satisfactory audit information to PSD. The utilities would also face additional administrative difficulties, potential disputes, and conflicts resulting from the situation where contributors of actual utility plant are charged an additional cash amount for the tax gross-up. Disputes regarding the valuation of the item being contributed [*57] would be likely and these could involve possible litigation or subsequent IRS revaluation long after the contributor has gone. These administrative difficulties under Method 5 would be even more severe for the smaller, less sophisticated companies, whose financial and staffing resources are already stretched to the limit. Assume, for example, that utility plant given as a CIAC was valued at \$ 100,000 by the utility and contributor and the Method 5 discounted advanced income tax amount was paid by the contributor. A dispute with the IRS over this valuation (an event that would occur several years after the actual contribution) could result in substantial litigation and additional taxes being due.

The Commission will also suffer from administrative problems associated with the use of Method 5. Various parties pointed out the continuing administrative role of the Commission under Method 5. Advice letter proceedings would be inevitable in dealing with changes in gross-up calculations, rate changes, and tax changes under Method 5. If the Commission adopts Method 5, it will have to hold subsequent hearings to establish new utility record-keeping requirements.

In regard to the discount [*58] rate that is required by Method 5, Citizens objects to a statewide discount rate because a statewide rate would not provide an accurate reflection of the discount rate required by each utility or each utility district or operating unit. Different rates of return require different discount rates. Individual ratepayers might file formal complaints if a statewide rate were used, which would place an added burden on the utilities, the Commission staff, and the Commission.

Advice letter proceedings would still be necessary, and internal administrative procedures would be required to account for changes to contributors and for changes in the tax and gross-up formulas. There would also be significant difficulties in setting up accounting systems to maintain the data on a year-to-year basis, keeping the data separate by discount rate and by type of property, and maintaining records that would provide satisfactory audit information to PSD.

Citizens argues that in subsequent years, changes in the discount rate would affect repayment of advances and refunds. Newly purchased assets would be evaluated differently, and the tax component on CIAC would have to be maintained separately for each [*59] asset with a different depreciable life for each year. For example, a refund required in year four from an asset received and taxed in year one could be refunded at a different discount rate than an asset received and taxed in year two, even though refunded in year four, if the Commission decided to change the discount rate in year two. A similar problem would occur if depreciation rates in any given year or if federal or state tax rates or depreciation rules were to change. Another problem under Method 5 would occur where assets are refurbished (extending the useful life) or retired early (shortening the useful life).

An additional draw back under Method 5, especially for the smaller utilities, relates to the recovery of tax depreciation in future years. When the discount rate is initially set, the utility is assuming that there will be sufficient taxable income in future years to reduce taxes and recover the benefit given to the contributor in year one. However, small water companies may have no taxable income in a given year; if Method 5 were adopted, the utility would never be able to recover the tax depreciation, unless on a carry-forward or carry-back basis.

Finally, [*60] Citizens fears that Method 5 violates the tax normalization rules. While there is no definitive answer to the question of whether Method 5 violates the normalization rules and jeopardizes the use of accelerated depreciation, the recent tax law changes raise this as an issue which must be considered. It argues that Method 5

uses future accelerated depreciation benefits to reduce current taxes payable to the federal government. Since this discounting theory is a new concept, currently untested before the IRS and tax courts, it is possible -- even probable -- that the IRS could determine that this is merely an attempt to use the accelerated depreciation that is required to be normalized to reduced current taxes.

One reason for the requirement of normalization of accelerated depreciation is that the benefit is intended to be used for capital formation. The flow through of the benefit to the developer could be viewed as an improper use. If the flow through tax expense is deemed to be a violation by the IRS, the utilities and their customers could be subject to loss of benefits. Citizens believes this issue should be thoroughly explored before the Commission adopts Method 5. The [*61] exploration should result in a clear position statement from the IRS which accepts the discounting procedure and which provides acceptable methods of calculating discount rates.

California Water Service Company (CWS) and San Jose Water Company (SJW)

CWS/SJW recommend Method 3 for those water companies that are able to advance the tax (usually Class A water utilities) and Method 2 for all other water companies. CWS/SJW objects to PSD's lumping the Class A's with energy and telephone utilities. They assert that CIAC constitutes a much larger segment of a water utility's operations than for energy and telephone utilities and must be considered separately.

CWS/SJW oppose Method 5 because of, among other reasons, competitive disadvantage. They argue that water utilities are small non-integrated systems serving individual local communities. Many of these systems serve areas that are directly adjacent to either municipal or district systems with which they must compete for expansion of their service area. Both SJW and several of CWS's 21 water systems are in direct competition with municipally-owned water systems. Requiring a developer to pay an additional amount (25% to nearly [*62] 50% depending on tax rates, 2 discount rates, and state tax assumptions under Method 5) is bound to have an effect on the water company's ability to grow. The developers will migrate toward service at the least cost. Developers without alternative systems to choose from can be expected to pressure cities to initiate takeovers of investor-owned systems or start up their own systems. They note that a proliferation of new small water utilities, whether investor-owned or mutuals, is not in either the Commission's or the public's best interest.

CWS is so concerned over the possibility of either losing its water system or seeing it stagnate that it has not charged developers with any of the tax liability associated with main extensions so far this year. CWS is currently bearing the entire tax risk on these contracts if the Commission rules against its proposal. It says that Method 5, if applied to water utilities, would have serious adverse effects on ratepayers from the loss of system growth. A larger customer base to spread current fixed costs over results in lower rates than would otherwise exist if no new growth occurred. For water utilities the loss of growth could result [*63] in significantly higher rates over 3 time.

Method 5, CWS/SJW believe, is administratively unwieldy. They point to numerous water districts, each with its own discount rate, discount rates changing every year, complexities of advice letter filings, major changes in accounting methods, and the need for uniform accounting and refund procedures. CWS has averaged 140 CIAC contracts a year recently and SJW has averaged 220. They assert the administrative burden of serving those contracts is unreasonable. Method 3, they say, requires only minimal accounting entries.

Because water companies take many advances subject to refund CWS/SJW recommend that the Commission institute a contribution-only rule and eliminate all advances. This, it is said, will make administration easier, no matter which method is adopted. Refunds cause complicated accounting entries and will lead to significant differences between customers who contribute plant by way of CIAC and those who contribute by way of refundable advances. On the same amount of money or plant, both would pay the same gross-up, but only one would obtain refunds.

Finally, they request that utilities that did not collect CIAC grossed-up [*64] prior to the date of a decision in this matter be allowed to include the tax payment in rate base.

The Telephone Utilities



Pacific Bell (Pacific)

Pacific states that, in its case, the relatively small amount of CIAC it receives does not justify the complexities and administrative burdens of billing and collecting a tax gross-up from specific contributors. The amounts involved for the energy utilities are much larger than for Pacific and, therefore, Pacific should be treated differently. Pacific prefers the simplicity of Method 4 over Method 3 but, given the support for Method 3 at the hearing, Pacific views Method 3 as totally acceptable.

Pacific estimates its annual taxable CIAC receipts at approximately \$ 5 million, compared to total annual revenues of approximately \$ 8.5 billion. Under Method 4, the \$ 4 million increase in revenue requirements to Pacific's customers in the first year would be approximately one-twentieth of one percent of its annual revenue. The first year percentage impact would be even smaller under Method 3, since Method 3 spreads the tax costs over the tax life of the CIAC plant.

Pacific compares the relative annual amounts of taxable CIAC payments [*65] estimated by the major utilities:

Utility	Annual	CIAC As	
	Taxable	Annual	% of
	CIAC	Revenue	Revenue
PG&E	\$ 60M	\$ 7.5B	.8%
SDG&E	43M	1.7B	2.5%
SoCal Gas	15M	4.5B	.3%
Edison	85M	5.0B	1.7%
Weighted Average			1.1%
Pacific	\$ 5M	\$ 8.5B	.06%

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The table shows that the major energy utilities' taxable CIAC receipts, as a percentage of annual revenues (1.1%), are approximately 18 times that of Pacific (0.06%). Even if the amounts involved for the major energy utilities justify the administrative burdens of a tax gross-up method, Pacific submits that its amounts of CIAC do not. Pacific estimates its CIAC for 1986, 1987, and 1988 to be \$ 5 million each year.

Pacific asserts that Method 5 present numerous administrative difficulties and should be rejected on that basis, especially for Pacific since its CIAC revenue is so small. First, a tax gross-up represents a change from the existing procedures. This means designing and implementing new procedures. Second, CIAC contributors will object to a gross-up. Refusals to pay and other disputes are inevitable. Contributions of property could be a fertile source of controversy. A contributor who [*66] is irritated at having to construct facilities and then turn them over to the utility will now be required to pay cash also. Once the property contributor gets over the surprise of the cash requirement, he will be in for an additional shock when the utility values the property (and thereby determines the additional cash gross-up requirement) based on the utility's estimated costs of constructing the property. Valuation disputes are a certainty. Lastly, the discount percentage will be controversial, as well as the method of arriving at the discount. Pacific argues that the administrative complexities associated with a gross-up method may become justified at significant levels of taxable CIAC payments, but with Pacific's taxable CIAC payments amounting to 1/20 of one percent of revenues, Pacific submits that, in its case, the administrative complexities are simply not justified.

Pacific points out that customer connection fees were taxable prior to the Act, because they were specifically excluded from the definition of CIAC. Since there is a similarity between CIAC payments and customer connection fees, Pacific urges us to look at the ratemaking methods currently used by the [*67] energy utilities for customer connection fees. Pacific says that apparently the Commission does not apply a tax gross-up method to the energy utilities' customer connection fees. For example, PG&E uses a ratemaking method for customer connection fees that is identical to Method 3. 7 Similarly, SDG&E uses Method 4 for customer connection fees.

Utility	Annual Customer Connection Fees (CCFs)	Annual Revenues	CCF As % of Revenue
PG&E	\$ 3.0M	\$ 7.5B	.04%
SDG&E	\$ 2.7M	\$ 1.7B	.06%
Weighted Average			.06%

PG&E's annual taxable CIAC payments (\$ 60M) are 20 times its customer connection fees (\$ 3M). SDG&E's annual taxable CIAC payments (\$ 43M) are 16 times its customer connection fees (\$ 2.7M). For PG&E and SDG&E combined, customer connection fees are approximately .06% of annual revenues. This figure agrees very well with Pacific's taxable CIAC payments as a percentage of annual revenues.

Pacific argues that no party has suggested that a tax gross-up method should be applied to the energy utilities' customer connection fees. However, PSD (and SDG&E) have proposed gross-up methods for taxable CIAC payments. The only apparent reconciliation between this [*68] seemingly inconsistent treatment is that the customer connection fee amounts are much lower than the taxable CIAC amounts. Since Pacific's taxable CIAC payments are at the same relative level as PG&E's and SDG&E's customer connection fees, it does not appear possible to reconcile the existing treatment of customer connection fees with Pacific's being required to use a gross-up method for its taxable CIAC.

Citizens Utilities Company of California (Citizens)

Citizens operates a small telephone company in a rural area of the state. It argues that small telephone companies should be treated in the same manner as small water companies. Its argument is set forth in the section on water companies, page 32 of this decision.

The Government Agencies

The Cities

The League of California Cities, a voluntary association of all 444 incorporated cities in California, and the cities of Los Angeles, San Diego, and Mountain View, (the Cities) take the position that a public utility should be required to take a contribution net of tax in two situations where benefit to the public as a whole is shown:

1. In situations involving condemnation, or the threat of imminence of condemnation, where [*69] the utility reasonably believes that the nonrecognition-of-gain treatment under Section 1033 of the Code ⁵ is applicable under existing law, the contribution to the utility should be a nontaxable event and should not be subject to Section 118(b).

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2. In situations where Section 1033 is not applicable, but the contributions to the utility are for a public benefit purpose -- such as undergrounding existing utility lines in the public right-of-way, line extensions to a new municipal facility such as a library, governmental relocations, or for a redevelopment project -- the Commission should require such contributions to be taken by the utility net of tax.

⁵ [Section 1033\(a\)\(1\) of the Internal Revenue Code \(26 USCA § 1033\)](#) (a)(1)) states:

"(a) If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted--

"(1) Into property similar or related in service or use to the property so converted, no gain shall be recognized."

Should the IRS in a ruling later find that such contributions [*70] for "public benefit projects" are taxable under Section 118(b), the Cities split on the appropriate treatment by the utilities. Some choose Method 3 and some choose Method 5.

The Cities are concerned that their contributions to utilities for what they characterize as "public benefit projects," such as the undergrounding of overhead utility distribution lines, government relocations, and redevelopment projects will be increased by the federal tax gross-up of 67%, thereby delaying or preventing much needed capital improvement projects. An example of the gross-up as it affects current projects of some cities is: San Leandro, \$ 250,000; Sunnyvale, \$ 670,000; San Ramon, \$ 49,000; Manhattan Beach, \$ 863,400; Santa Fe Springs, \$ 56,000; San Pablo, \$ 30,081; Mountain View, \$ 500,000; and Lancaster, \$ 594,397.

The Cities quote the House Report for the proposition that where it is "clearly shown that the benefit of the public as a whole was the primary motivating factor in the transfer," the transfer will not be taxable to the utility. The Cities assert that the tests set out in the House Report state that a person transferring the property will be considered as having been benefitted [*71] where the person or entity transferring the property either (1) receives the services, (2) is an owner of the property that will receive the services, (3) is a former owner of the property which will receive the services, or (4) if he derives any benefit from the property that will receive the services. Under those tests, payments to a utility for undergrounding existing facilities on either public property or in the public right-of-way should not be included as CIAC since the transferor is (1) not the recipient of the service, (2) and (3) has no present or past ownership rights in the property that will receive the service, and (4) will not derive any benefit from such property beyond its primary benefit to the public as a whole.

The Cities define a "public benefit project" as a project located either on public land or in the public right-of-way which primarily benefits the public as a whole. In addition to undergrounding the Cities argue that Section 118(b) should not be applicable to contributions by a city for redevelopment projects since redevelopment projects by statutory definition are for a public benefit purpose.

Under [California Health and Safety Code Section 33000](#) [*72] et seq., a designated redevelopment project requires a finding that a "blighted area" exists. A "blighted area" is characterized by buildings or structures which are "unfit or unsafe to occupy . . . and are conducive to ill health, transmission of disease, infant mortality, juvenile delinquency, and crime . . ." Whenever the redevelopment of blighted areas cannot be accomplished by private enterprise, the redevelopment agency may employ the power of eminent domain to spend public funds for these purposes and to redevelop or rehabilitate the blighted areas. The spending of such public money to redevelop blighted areas requires a finding that it is "in the interest of health, safety and welfare of the people of the State and of the communities in which the areas exist." Thus, under California statute, designated redevelopment projects, by definition, benefit the public's health, safety and general welfare by redeveloping blighted areas. The Cities do not believe that the Commission should leave it up to the utilities' discretion as to what is a "public benefit project." They want the Commission to set forth clear parameters as to what types of projects should be considered to [*73] be "public benefit projects."

The Cities, and at least some of the utilities agree, that when a contribution is made to a public utility as the result of a threat of condemnation by a government entity under Section 1033, the contribution received by the utility will be "totally tax free, bypassing CIAC". Thus, a contribution to a utility made pursuant to a threat of condemnation by a government entity will be excludible from the utility's income under Section 1033. This condemnation procedure would be applicable to undergrounding and other relocations, such as moving utility lines to provide for road widening. The Cities suggest that a letter threatening condemnation should satisfy the IRS.

If the Commission requires³ the utilities to take the contributions for public benefit projects net of tax and the IRS later finds that such contributions are taxable events under Section 118(b), the Cities are divided as to who shall pay the resulting taxes, interest and penalties. Most cities would choose Method 3 but some would opt for Method 5.

California Department of Transportation (Caltrans)



The position of Caltrans is that the utility is not required to pay income tax on money [*74] or property received from Caltrans when Caltrans requires the utility to relocate utility facilities under the threat of condemnation in order to clear a right of way for the construction or improvement of a state highway. The receipt of money or property by the utility is exempt under either Code Section 1033 or the "public benefit" theory discussed in the House Report.

Caltrans asserts that the state legislature has long recognized and declared that the construction, improvement, and maintenance of state highways are public uses and for the benefit of the public as a whole. ([Streets and Highways Code Section 90](#), section 92, section 104; [Code of Civil Procedure section 1230.030](#), section 1240.010.)

Caltrans argues that when⁴ it orders a utility to relocate facilities, it is doing so under threat of condemnation and there is no increase in the utility's plant, capital, service capacity, or cash which could be considered taxable. Caltrans pays the utility relocation costs after the utility has expended the funds for the work and knows its actual costs. When a utility facility is relocated, there [*75] is replacement in kind of that which the utility had in place originally, and the service provided after the relocation is the same as that provided before. Therefore, under Section 1033 "no gain shall be recognized."

Nevertheless, should the IRS determine a tax is due on the relocation payment then Caltrans recommends that the utility recover its costs from the ratepayers through Method 3, not from Caltrans. Caltrans argues that if a tax is due, it is because the utility has received a benefit and therefore should assume the burden of the tax; and as the tax is a cost of doing business the utility should recover that cost, as it does all other costs, from the ratepayers.

The Private Entities

The California Building Industry Association (CBIA)

CBIA recommends either Methods 1, 3, or 4; except that water utilities should be granted flexibility to use Method 2 or 5 depending upon their financial condition. CBIA is a statewide organization representing the home building and residential construction industry. The 5,500 companies that make up CBIA construct over 70% of the housing built in California each year. CBIA asserts that several of the proposals before the Commission, [*76] specifically Methods 2 and 5, will needlessly increase the cost of housing in California while ostensibly promoting the interests of utility ratepayers. CBIA believes that support of Methods 2 and 5 is based upon a false or misplaced sense of economy and that Commission adoption of either Methods 1, 3, or 4 would better serve the interests of California and all of its citizens.

It argues that the policy considerations that have been cited as justification for adoption of Method 2 or 5 are: (1) the cost causer or the one who receives the benefit from making the contribution should pay all or a portion of the associated expenses; and (2) the utilities' general ratepayers should be shielded from undue cost impacts occasioned by CIAC.

CBIA asks whether it is appropriate for the Commission to select a ratemaking treatment for CIAC on the basis that the one who is ostensibly causing the cost and receiving the benefits should be responsible for costs associated with his actions? CBIA believes that this policy alone cannot support adoption of either Method 2 or 5. First, there has been no change in the behavior of the contributor that has caused an increase in tax liability. It is Congress [*77] that has visited the increased tax expenses upon California's utilities.

Secondly, while a contributor certainly receives electric, gas, or telephone service for his contribution, this resulting benefit has traditionally been viewed as part of a utility's obligation to serve. As such, both the costs of providing utility service and the benefits enjoyed by the utility as a result of extending service have been absorbed by the utility's general ratepayers. The Commission's currently authorized treatment of utility service extensions is directly analogous. Tax liability associated with CIAC on service extensions has historically been treated as a general ratepayer obligation. There is nothing different about distribution line extensions that requires the Commission, for the first time, to start attributing⁷ specific items of taxable income/deductions to individual customers.

CBIA also argues, for the same reasons given by Citizens, that Methods 2 and 5 are inherently unfair and administratively difficult to apply.

Finally, CBIA contends that the impact of Methods 1, 3, and 4 on the general ratepayer is minimal, e.g. for SDG&E a customer with a monthly bill of \$ 100 would have [*78] a 10 cent increase and a Pacific customer would see a 5 cent increase per \$ 100. In contrast, the impact on developers is substantial and will result in significantly higher housing costs.

CBIA presented testimony containing case studies of six different residential subdivisions scheduled for development in various locations throughout California. These six case studies demonstrate the total increase in residential construction costs as well as the increase in costs for individual dwelling units occasioned by utility treatment of CIAC on a gross of tax basis.

New Residential Developments	Increase In Unit Project Cost	Increase In Unit Costs Occasioned By Gross of Tax Treatment of CIAC
(1) City of Fresno 169 units (Gas & Electric)	\$ 149,777	886
(2) City of Corona 111 units (Gas & Electric)	145,162	1,307
(3) City of Danville 110 units (Gas & Electric)	112,199	1,020
(4) City of San Diego 86 units (Gas & Electric)	82,011	954
(5) City of Fontana 25 units (Water)	12,169	487
(6) City of San Jose 63 units (Water)	77,853	1,236

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CBIA asserts that these numbers are substantial to the individual developer and/or [*79] individual homeowner who is confronted with these unforeseen costs. It is inevitable that such costs will prove, in some cases, the difference between a development moving forward or not and an individual's purchasing a home or not. It concludes that there is simply no compelling reason, including the interests of the general ratepayers, that requires the Commission to cause such a result.

The Qualifying Facility Operators (QFs)

Three QFs, Basic American Foods, Gilroy Foods, and Luz Engineering (the Group), take the position that contributions from a QF have no value and therefore will not be subject to tax. As a consequence, no gross-up should be assessed on the contribution even if Method 2 or 5 is adopted. They argue that "it is the value of the contribution-in-aid-of-construction to the utility which is included in the utility's income, and, in the case of the [the Group], that value is de minimus," citing the House Report that "the Committee intends that a utility include in gross income the value of the property received. . . ." Further, they say that even if the QF gives cash to a utility⁹ to construct a transmission line that cash would not be taxable to the utility [*80] if it is "restricted to a specific use." (Revenue Ruling 59.92, 1959-1 C.B.11; Bittker, Federal Taxation of Income, Estates, and Gifts (Warren, Gorham & Lamont, 1981, p. 6-4.) The Group argues that no value, or wealth, accretes to the utility when the QF supplier

transfers a transmission line to the utility. The net asset value of the utility has not been increased; nor has it received capital upon which to earn income. Using an example where the QF makes an occasional purchase on the transmission line, they believe, even in this context, that the value to the utility is de minimus compared to the cost of the line. They advise the utility that its "correct tax position is to report no income upon receipt of the contribution." They conclude by recommending that to the extent the IRS imposes a tax it should be borne by the ratepayers.

The Cogeneration Service Bureau (Bureau) recommends Method 1 because it avoids the severe financial impact on developers, QFs, and individual customers. It argues that this impact is less than the impact from Methods 3 or 4. Under Method 1 ratepayers will actually have lower electric rates for the first six years because of the continuing effect of [*81] annual contributions reducing their rates. The Bureau supports the Group's argument that a transfer by a QF to a utility has no value to the utility. Finally, the Bureau urges the Commission to support customer and QF ownership of special facilities as an alternative which avoids taxes on CIAC, and to encourage utilities to make available operating and maintenance agreements for customer-owned facilities.

Discussion

For the reasons set forth below, for contributions and refundable advances, we will adopt Method 5, which places the major portion of the tax burden on the contributor, for all utilities except small water companies and small telephone companies, for whom we adopt Method 2. Our rationale is that the contribution is the taxable event; since the contributor causes the tax the contributor should pay the tax. No contribution; no tax. We will also permit utilities to choose not to collect the tax from the contributor but absorb the tax itself, without passing it on to the ratepayers.

Method 1

Method 1 treats the CIAC as revenue, general revenue is reduced in the year of the contribution, the contributed plant is rate based, and the ratepayer pays the tax and all other [*82] costs. Under this proposal (and Methods 3 and 4), the contributor - the person who benefits - pays nothing toward the tax while the ratepayer pays everything. Method 1, although superficially attractive because of the revenue decrease in year 1 is the most costly over time; there is a significant increase in rates in year 2 which continues for the life of the asset resulting in the highest overall revenue requirement.

PG&E, which finds some merit in Method 1, also agrees it has shortcomings. It refers to the large financing requirements which are required by this method, the difficulties with estimating CIAC thereby requiring a balancing account, and that shareholder funds are at risk for the benefit of the contributing party. If the contributor is a QF, the ratepayers are already paying a negotiated price based upon their avoided costs for the suppliers' output.

Because of the severe impact on the ratepayer and for the reasons stated above, Method 1 is rejected.

Method 2

(1) Contributions in Aid of Construction

Method 2 provides for complete gross-up by the contributor at the utility's incremental federal tax rate. The ratepayer pays nothing. The contributor is denied [*83] the tax depreciation benefits associated with the contribution, and the contributor pays a tax-on-tax, which causes this method to be the highest grossed-up contribution; the most money is being sent to Washington with no commensurate benefit to the contributor or the ratepayer. However, the ratepayer benefits from the depreciation on the contribution.

Nevertheless, Method 2 is the only method that small water companies and small telephone companies can use because their customer base and revenue stream are so low that they either cannot advance the tax payment or cannot increase rates to recover the tax. Without permitting Method 2 many utilities could not accept any contributions. We agree that those utilities which cannot finance the tax in any way other than Method 2 should be able to adopt it, but we do not believe we should designate those utilities. They know their financial positions better

than we do. And, because the consequences of choosing Method 2 are so drastic (it is likely that contributions will be reduced substantially), each utility should be permitted to make its own choice. We will provide that any qualified utility wishing to adopt Method 2 may do so upon [*84] filing an appropriate tariff. Those utilities which are qualified to adopt Method 2 are all Class B, C and D water utilities and all telephone utilities except Pacific, General Telephone Co., Continental Telephone, Co., Roseville Telephone Co., and Citizens Telephone Company.

(2) Refundable Advances

For the application of Method 2 to refundable advances other factors have to be considered. Under current ratemaking practice, the ratepayer provides a revenue requirement equal to the book depreciation on plant financed by advances. This provides the utility with the funds to refund the plant portion of the advance, but the refund of the tax portion of the advance must come from another source. Because refundable advances are now considered taxable income, refund payments by the utility will be tax deductible. This could be a source of funds for the tax portion refund, but the benefit resulting from the deductibility of the refund payment is realized only if the utility is in a taxable position. For small water and telephone companies, this is not always the case. To permit a refund in this situation would place the burden of the refund on the ratepayer and would create a bookkeeping [*85] morass for the small utility, thereby increasing its costs, again burdening the ratepayer. To eliminate this potential burden on the ratepayer and the small utility, we will authorize a refund of only the plant portion of the advance. Any benefits accruing from the deductibility of the refund payments will inure to the ratepayer.

(3) Tax Rate

The development of the gross-up requires the use of the utility's federal tax rate. Each utility will develop the gross-up at its own incremental federal tax rate on both contributions and refundable advances. If the utility is not in a taxable position for the year in which the gross-up is collected, there is no tax liability. The utility should refund the tax to the contributor. If a utility collects a gross-up calculated by using an incremental tax rate that is more than its actual incremental rate, the difference between what was collected and what should have been collected should be refunded to the contributor. If the gross-up collected from the contributor is less than the tax liability, the utility shall not burden the ratepayer with the difference.

Appendix D sets forth the elements of the Method 2 program and the appropriate [*86] accounting entries.

Method 3

This method would rate base the tax payment. There is no gross-up on the contributor; the utility pays the tax and debits deferred taxes; and the ratepayer pays a return on the increased rate base. Other than SDG&E and PSD and those who must choose Method 2, all utilities and all other parties would accept this method. Method 3 is identical to that already approved by this Commission for treating taxes paid under customer connection fee rules. Method 3 is comparatively simple. Contribution charges do not have to be adjusted, there is no tax-on-tax, and estimation errors can be corrected in general rate cases. Having ratepayers contribute the tax under this method is not a harsh result, it is argued. Ratepayers receive benefits from contributed plant as the utility grows, the customer base expands, and there are more customers to cover fixed expenses. Additionally, when the contribution concerns undergrounding of telephone and transmission lines the customer benefits from improved aesthetics and increased safety and reliability.

SDG&E and PSD object to Method 3. SDG&E argues that costs should follow cause, the Commission's general theory of rate [*87] design. The Commission's cost based rate policy should be carried over into contributions. The argument that the ratepayer benefits from the contribution is, in SDG&E's opinion, specious. Growth is no longer beneficial. Higher cost is the rule for new residential service connections in SDG&E's service territory and since new residential customers actually increase the cost to other customers, it is inappropriate to also transfer the tax cost of adding those customers to the system.

PSD points out that Method 3 results in a significantly higher overall cumulative revenue requirement than Method 5 and shifts the burden from the person causing the tax and receiving the benefit of the service to the ratepayer.

We reject Method 3. Regardless of its so-called ease of administration, it requires the ratepayers to pay the tax caused by the contribution. We believe that the person who causes the tax should pay it. Those who argue that because the tax on some connection fees is now being paid by the ratepayer, contributions should be treated similarly are looking at the problem from the wrong end of the telescope. It may be time to change our connection fee policy to conform to our [*88] contribution policy.⁶ Here we are talking about dollars - not theory - and all the recondite arguments cannot avoid the essence of Method 3. Group A is being asked to pay the taxes caused by Group B. In its most pristine form the evidence presented by the California building industry cannot be bettered. The table on page 46 shows that for 564 new homes, the imposition of the CIAC tax will increase costs by \$ 579,171 or an average of \$ 1,027 per home. (This is under our current 67% gross-up rule; Method 5 would reduce this by 48%.) The building trade association states that those numbers are substantial to the individual developer and individual homeowner and therefore they want someone else to pay the tax. We don't blame them. But we are not going to impose the tax that they caused on the ratepayers, many of whom cannot afford new homes, many of whom live below the poverty level. CBIA argues that by requiring builders to pay the tax, we will hurt the building industry and prevent some people from purchasing new homes. We agree with the argument, but it is misdirected. It should be made in Washington.

[*89]

Method 4

Method 4 increases rates immediately to pay the tax. It places the full impact of the tax on current ratepayers with the benefits from including the contribution in rate base received by future ratepayers. No party supported it wholeheartedly, but did so on the theory that any method is better than one that places any portion of the tax on the contributor. We reject the method.

Method 5

(1) Contributions in Aid of Construction

Under Method 5, the utility would report as taxable income the entire taxable CIAC payment, including tax gross-up, and pay the tax. The utility would then add the amount of the tax (excluding the tax on the gross-up amount) to rate base (by debiting deferred taxes), and be allowed to earn a return on such amount until the utility recovers an equivalent amount through tax depreciation of the CIAC plant. The revenue requirement stream over the future tax life of the CIAC plant of the increase in rate base is determined and then discounted back to a net present value at the time of the contribution. That net present value is added to the cost of the contributed plant which becomes the total amount paid by the contributor. (See Appendix E; a [*90] \$ 1,000 plant contribution requires a \$ 273 gross-up.) The development of the gross-up requires the use of the utility's federal tax rate. Large utilities will be at the highest corporate tax rate while smaller utilities will not. Each utility will use its own incremental federal tax rate in developing the tax gross-up under Method 5. Method 5 is the recommendation of PSD for all utilities other than those using Method 2. SDG&E supports a modified version of Method 5, and PG&E supports it for "non-customer" transactions.

Opposition to Method 5 takes a variety of forms. One is the ABC response - anybody but the contributor. Others are more reasoned and can be readily classified. Method 5 is bad, it is asserted, because: (1) it is anticompetitive, (2) it is an administrative horror, (3) it requires a discount rate that will be difficult to ascertain and apply, and (4) it violates the tax normalization rules. We have reviewed these four objections and find them without merit.

The anticompetitive argument was advanced primarily by the water utilities and by SoCalGas. The water utilities argue that any additional cost to developers would force the developers to either deal [*91] with municipalities who do not pay the tax or start their own water company to avoid the tax. In either case the privately held water companies face increased competition and their customers are harmed because the customer base over which

⁶ But this need not detain us. There are a great many factual and policy differences between connection fees and contributions and the treatment of connection fees is not before us.

fixed costs are spread is stagnant. SoCalGas asserts that developers would forego gas installation and opt for all electric homes, these potential customers are lost, fixed costs are more of a burden, gas is not used efficiently, and bypass problems by large users are exacerbated.

We are sympathetic to the competitive problem, especially for the water companies, but we must balance that problem against the interests of the ratepayers. Our first duty is to protect the ratepayers; protection of utilities is secondary. In many instances to protect the ratepayers, we must also protect the utility and that might entail raising rates for one class of user and lowering them for another. However, we are not persuaded that to save water utilities ratepayers must subsidize developers. The water company argument cuts two ways. They are correct in saying that Method 5 will drive developers to the nearest municipality; but Method 3 would require a rate **[*92]** increase and it takes no stretch of the imagination or citation of recent Commission decisions to predict the ratepayer response. Ratepayers will want to know why they pay more for water than the customer of the adjacent municipality. We are not prepared to tell them that we are increasing rates to pay taxes caused by developers to sell homes so that we can save a private water company.

The SoCalGas problem must be seen in perspective. It expects about \$ 15,000,000 in contributions in 1987 on revenues of \$ 4,500,000,000. The tax component of the contributions appears comparatively minor. If SoCalGas does not desire to use Method 5, its stockholders can absorb the tax.

All of the objectors to Method 5 described administrative difficulties that, they assert, are sufficient to require rejection of Method 5. They say new accounting systems would be needed, adjustments would be required yearly, there would be valuation disputes with contributors, discount rate disputes, litigation with contributors and the IRS, advice letter filings, reasonableness hearings, tax law changes, Commission supervision of everything, and many other horrors that only a lawyer's fertile mind can envisage. **[*93]**

We do not view the process with quite such despair. We are not seeking a perfect system; we are seeking a workable system. We understand that the Method 5 gross-up is only an approximation. We would expect that Method 5 would require one computation in regard to the contributor: the present value of the revenue requirement over time. Once that is determined the contributor makes the contribution gross-up for taxes by an amount equivalent to the net present value of the revenue requirement for the tax. The contributor has no further interest in the transaction. Should any part of the equation prove erroneous, the ratepayer will bear the burden or reap the benefit, absent any imprudence on the part of the utility. Should there be imprudence then routine Commission practice would correct the imprudence. All the methods have the same problem of valuation, of tax changes, of new accounting systems, of IRS inquiries. Method 5's administrative problems are no more complex than those of the other methods.⁷

[*94]

The discount rate issue is more complicated than some of the other issues in this case but certainly not so complicated as to render Method 5 unworkable. A discount rate is necessary to determine the present value of the revenue requirement over time attributable to the contribution. A high discount rate will require a lower contribution than a low discount rate. (See Appendix F for examples.) All parties agreed that the discount rate should approximate the utility's rate of return and they fear that a discount rate that varies from utility to utility and one that may change frequently will lead to confusion among the public, administrative difficulties for the utilities, and an increased workload for the Commission. It is argued that changing discount rates would require increased advice letter filings to deal with changes in rate of return, gross-up calculations, and tax changes. To mitigate those concerns, PSD proposed a statewide discount rate of 12% to be used for all utilities adopting Method 5. This number is based on the most recent rates of return for major utilities in California, including major water companies, a range of 11.31% to 13.05%; the rate would be used **[*95]** until changed by the Commission.

⁷ We do not wish to imply that Method 5 is simple; it is not. But its intricacies are a function of the modern tax world and are routinely handled by a conventional computer program. Appendix E sets forth the elements of the program and the appropriate accounting entries. If assistance is needed, the Commission staff is available.

We will adopt the PSD proposal for a statewide discount rate and permit the utility to choose either the statewide rate or its last authorized rate of return.

PG&E pointed out in its comments that the Method 5 gross-up computation also requires the use of a pre-tax rate of return. We agree with PG&E that we should also offer utilities a statewide pre-tax rate of return, to be used by utilities in their gross-up computation if they select the 12% statewide discount rate. Based on the same method we used to derive the statewide discount rate of 12%, we have determined that a statewide pre-tax rate of return should be 17%. This rate, like the discount rate, should be used until changed by the Commission.

A statewide discount rate and pre-tax rate of return will not only eliminate all of the perceived problems associated with separate rates for each utility but it will also remove the possibility of a disallowance by the Commission of items of expense or rate base because of an imprudent discount rate. Adopting the 12% discount rate and the 17% pre-tax rate of return results in a gross-up rate of 37% in 1987 and 28% in 1988. As with all Commission [*96] rules, companies wishing to deviate from the standard may file an application to do so with supporting justification.

Some utilities expressed concern about the potential need to continually revise gross-up percentages. We expect there to be gross-up percentage revisions to reflect the change in the federal tax rate from 1987 to 1988 and (if applicable) potential California conformity legislation. However, we will not require further changes to the gross-up percentage, unless these changes are significant. As a result, we have determined that utilities should not be required to make further changes to the gross-up percentage, unless the change would be at least five percentage points (e.g., from 28% to 33% or from 28% to 23%). Utilities will not be found imprudent for failing to make these minor changes to the gross-up percentage. We recognize that the gross-up computation is only an approximation.

Finally, some utilities argue that Method 5 will violate the normalization rules in regard to accelerated depreciation. It is thought that Method 5 could be construed as using future accelerated depreciation benefits to reduce current taxes, which because it involves a rate base [*97] calculation, a possible impact on regulated rates, and a flow through of benefits to the developer, could be construed by the IRS as a violation of the normalization rules with attendant loss of benefits.

PSD and others believe that Method 5 does not violate the normalization rules. It points out that any "flow through" is to the contributor, not the ratepayer; the tax benefits of the utility contribution are normalized; and should the IRS rule unfavorably Method 5 can be modified to meet the objection. Method 5 should not be rejected merely because of unsubstantiated threats which can be easily cured.

We will adopt Method 5, subject to exceptions discussed in other parts of this decision. Method 5 places the lion's share of the tax burden on the person causing the tax; to the extent the discount rate is not perfectly adjusted, the ratepayer could have some share of the burden; it is not difficult to administer, especially if the utility adopts the statewide discount rate; and the possibility of violating the IRS normalization rules is negligible.

(2) Refundable Advances

The tax gross-up for refundable advances under Method 5 is calculated the same as for contributions under [*98] Method 5. The contributor pays the net present value of the revenue requirement of ratebasing the tax. The utility ratebases the tax thereby earning a return on the tax it pays. Through the deductibility of the advance refunds, the utility recoups the full tax gross-up. The contributor's share of the gross-up should be refunded to the contributor as it is generated. The utility retains the remaining portion of the tax benefit, thereby being reimbursed for its portion of the tax payment. Method 5 as applied to refundable advances will provide a return of the tax gross-up to the contributor and the utility.

Under Method 5, the tax gross-up portion of the advance should be refunded only to the extent it is actually realized through the tax deduction generated by the refund. The ratepayer should not be burdened with refunding the tax gross-up.

The Maryland Method



The method was proposed by SDG&E but received no support. Under this method, the present value of the tax benefits is computed utilizing the utility's authorized rate of return as the discount factor. The current tax shortfall would be funded by the utility shareholder. It is Method 5 with the shareholder funding [*99] the shortfall, not the ratepayer. The shareholder would receive the normal utility rate of return through the tax benefit associated with the tax depreciation of the CIAC. Under this proposal, there is no chance of a rate increase to general ratepayers and there is no impact on the utility's capital budget.

Opposition to the method was on technical grounds citing complexity, administrative difficulty, imprecise estimates, need for future adjustments, etc. But the unarticulated objection was that it puts the tax burden on the contributor and the shareholder rather than the contributor and the ratepayer. As a Commission duty bound to protect the ratepayers, we find it difficult to reject an offer by shareholders to assume a tax burden that would otherwise be an obligation of the contributor or the ratepayers. We will not order the utilities to adopt the Maryland Method but will authorize its use.

Tax Avoidance Methods

Many of the parties presented evidence to show that a particular transaction was not a contribution within the meaning of the Act and therefore not subject to tax and not subject to gross-up. These parties request that we make a finding that for those transactions [*100] the utilities should not collect a tax gross-up on the contribution. This position was strongly championed by government entities and the cogenerators. Other parties requested that we propose alternate methods of plant ownership which would not be subject to gross-up.

However, PSD, PG&E, and all the utilities commenting on this issue expressly ask the Commission not to decide which contributions or forms of ownership are subject to the tax. PSD is sympathetic to those concerns and originally recommended that the tax not be collected in certain situations. But in its brief, it asserted that "the record impresses PSD that failure to gross-up for uncertain items could lead to revenue deficiencies which would ultimately be the burden of the general ratepayer. " PSD points out that it is for the IRS and federal courts to determine which items are taxable and a wrong guess by the utility or by this Commission would leave the utility and ultimately the ratepayer liable for back taxes, interest, and penalties.

PG&E and the other utilities argue that the Commission cannot bind the IRS. The IRS will make its own interpretation of the tax laws regardless of our decision in this proceeding. [*101] The fact that the utility collects a gross-up and pays the tax is not expected to influence the IRS one way or the other on the question of the taxability of the transaction. The IRS will issue its ruling based on its interpretation of the law, not on the taxpayer's treatment of the item.

Although there was testimony and argument regarding change of ownership schemes that would achieve the same result as a contribution but would not be considered a contribution and therefore not be taxable, there was no detailed proposal discussing the financial, accounting, operational, maintenance, and safety aspects which would result from this change of ownership. There is no evidence in the record on which to base a judgment regarding a workable tax avoidance scheme.

On April 16, 1987, the Commission requested comments from all appearances on the tax effect of title to the contributed plant vesting in an entity other than the utility, with the utility continuing to operate and maintain the plant. The Commission also asked whether a cogenerator could use the utility's power of eminent domain to secure any necessary rights of way. Comments from the parties who responded were uniformly negative. [*102]

Soon after the Commission requested comments, the staff of the Joint Committee on Taxation issued the "General Explanation of the Tax Reform Act of 1986." (May 4, 1987.) The report discussed when a transfer of property to the utility will be deemed to occur. For example, a transfer of property to the utility may occur even where the person benefitting from the services nominally retains legal title to the property, if the transaction transfers the rights and obligations of ownership to the utility.

In view of the clear intent of Congress to prohibit such tax avoidance schemes by looking at substance over form, as well as the comments we received in response to our own questions, we decline to authorize or otherwise endorse any such proposals.

By our discussion of tax avoidance schemes, we do not want to encourage groups who, without IRS approval, would expect utilities to implement those schemes with unclear tax consequences and potential liability for interest and penalties. We are also concerned with the administrative costs a utility will incur, especially in its law department, when potential contributors present tax avoidance schemes for evaluation. Unless the utility [*103] is compensated for those costs by the contributor, the general ratepayer will pay the bill. PG&E wants to be able to charge potential contributors for the expense of analyzing their proposals. PG&E's request is reasonable.

The proposals of the government entities and the cogenerators were actually arguments that their contributions would not be taxable by the IRS and, therefore, we should not require the utilities to demand a gross-up. As we have said, those arguments should be made to the IRS. It would be imprudent for us to make that kind of a determination.

Nontaxable Contributions

Whether a particular contribution is or is not taxable raises issues similar to those discussed in the section on tax avoidance schemes. Our policy is that the utility should not put the ratepayers at risk for CIAC taxes to an extent greater than we authorized by this decision. The best procedure to reduce ratepayer risk is to require the utilities to collect the tax gross-up on all contributions. Having said that, we recognize that there are situations when it is extremely unlikely that a tax will be imposed and we should not require a gross-up in that situation, e.g., highway relocations and [*104] other projects involving condemnation or the threat or imminence of condemnation. We also note that the "public benefit" exception should render most contributions by government agencies exempt from tax and therefore not subject to gross-up.

Utilities constantly are forced to make choices which affect taxability and which may turn out wrong, e.g. whether to capitalize or expense a repair; how to classify depreciable assets; whether or not an item is tax deductible, etc. The choice to collect a tax gross-up on contributions is different only insofar as it involves our authorization of utility charges. For two years from the date of this decision, we will not authorize any gross-up on contributions related to condemnation or public benefit projects if adequate assurance is provided. Subsequent to this two-year period, however, we will authorize collection of the gross-up if the IRS has not issued a determination that contributions of that type are nontaxable. In other cases, if the utility believes that a particular contribution is not subject to tax, it need not collect the tax gross-up. But if it has made the wrong decision and the IRS assesses the tax plus interest and penalties, [*105] the entire amount will be a charge against the shareholders, not the ratepayers. On the other hand, if the utility collects a tax gross-up on a contribution which proves not subject to tax, it will be required to refund the amount of the gross-up plus interest.

A case in point is the argument by the cogenerators that their contribution of plant to a utility is not subject to tax because the plant has no value to the utility and only "value" is taxed. If the utility believes that argument it may accept the plant without gross-up, but if the position is rejected by the IRS and back taxes, interest, and penalties are assessed the utility will not pass those costs to the ratepayers; it will either collect from the contributor or absorb the costs itself. The utility, if it wishes, may protect itself by requiring letters of credit or noncash security for the potential tax liability. We neither approve nor disapprove of such methods.

The position of the government agencies is that its contributions are exempt from tax because they fall under the two exceptions to the changed tax law: contributions made under threat of condemnation and contributions which are a public benefit. We have [*106] set out their arguments in the section on Government Agencies. We agree with the argument, but our agreement does not bind the IRS and the problem must still be faced that the IRS may disallow some or all of the government contributions: to protect the ratepayers the utility must assure itself of the nontaxability of a particular contribution and must protect itself. In the case of a government agency, however, it would be sufficient for a limited period to have no more than a contractual right to collect the back tax, interest, and penalties if and when the IRS makes a determination that contributions of that type are taxable. We do not want the

utility gambling with the ratepayers' money, but we recognize that our assumption that contributions are subject to tax may unnecessarily burden government agencies.

Most Contributions are Taxable

From our discussion in the foregoing two sections, we have concluded that all contributions, except by government agencies, should be considered taxable until the IRS rules otherwise. This is generally consistent with the position of PSD (Method 5 should "be applied to the uncertain items"), PG&E ("All contributions and advances should be **[*107]** presumed taxable"), SDG&E ("recommends that the Commission adopt a policy of gross-up on all contributions. . . ."), Edison ("pending IRS interpretation, all CIAC should be considered taxable) and all other utilities addressing this point.

California Taxes

When we authorized utilities to collect CIAC gross of federal income tax, some utilities also collected gross of state franchise taxes, either on the entire transfer or just on the federal tax rate gross-up portion of the transfer. In February, we ordered all utilities who had been collecting the state tax to refund all state tax gross-up amounts with interest. As a result, two questions are presented: (1) Should we now permit utilities to collect the state franchise tax portion of the CIAC in anticipation of a ruling from the state taxing authorities that CIAC is subject to state tax, and (2) Assuming CIAC is subject to state tax commencing January 1, 1987 should we provide for that event in this decision?

Our answer to the first question is 'no'. The question of state taxability of CIAC or state taxability of the federal tax rate gross-up portion of CIAC is now before the legislature and the Franchise Tax Board. We should **[*108]** not anticipate a ruling of taxability, since to do so would add to an already severe economic problem for both contributors and utilities. Our answer to the second question is 'yes', we should provide for the possibility of a state CIAC tax retroactive to January 1. Because we are prohibiting the utilities from collecting the tax and because the tax, if imposed, will be a business expense which is permitted to be recovered in rates, we will allow all utilities who pay the tax to recover it in rates, and we expect the utilities to make appropriate accounting entries to record the transaction. Finally, we will authorize in this decision all utilities to collect an additional state tax gross-up, if California conforms to federal law, on a basis consistent with the calculation of the federal tax gross-up.

Advances for Construction

Some utilities advocate the elimination of advances for construction, reasoning that advances complicate administration and cause significant differences between customers who contribute plant by way of CIAC and those who contribute by way of refundable advances. There is the subsidiary issue of whether advances, if continued, should be refunded gross **[*109]** of tax or net of tax.

Refundable advances make up a large portion of contributions. SDG&E estimates two-thirds of its contributions are in the form of refundable advances. Other utilities have a similarly high proportion of refundable advances. The reasons given to terminate advances are not particularly related to the tax issue, but are inherent in the concept of advances. The issue of termination is neither germane to this investigation nor supported by sufficient evidence to order termination. In fact, the evidence in the record shows a compelling need for the procedure. In regard to the amount of the refund, as previously discussed, we are of the opinion that the refund should be based on the advance including tax gross-up for those utilities choosing Method 5 and on the advance without tax gross-up for those utilities choosing Method 2, subject to the terms of the agreement between the contributor and the utility.

Transition Projects

There will be some contributions made after December 31, 1986 which are subject to contracts or negotiations entered into prior to January 1, 1987. These transitional projects should be treated no differently than any other contribution **[*110]** made after December 31, 1986. To the extent that a CIAC contract was entered between the

contributor and the utility that contract could have a bearing on the outcome of a dispute, but we are not concerned with individual disputes in this investigation.

Failure to Gross-up

Some utilities did not avail themselves of the opportunity to gross-up contributions in accordance with the Commission's invitation. Pacific, at the time of the hearing, did not gross-up contributions.⁸ Its witness candidly admitted that Pacific "probably could not go to the general ratepayer" to pick up any shortfall in revenue caused by the federal tax. Pacific is correct. All utilities were in a position to collect the federal tax from contributors since January 1, 1987 or February 10, 1987 and those that chose not to do so may not now collect that tax from the general ratepayers. The state tax portion, if assessed, will be handled differently, as set forth above.

Method 5 vs. Method 3 Administrative Costs

Two utilities, Pacific and PP&L, have made a strong argument that, as to their situations, they should be permitted [*111] to use Method 3 rather than Method 5 because the administrative costs of Method 5 are a greater burden on the ratepayers than the costs of paying the tax under Method 3. Pacific points out that its annual taxable CIAC is expected to be about \$ 5 million for 1987 and 1988 compared to revenue of \$ 8.5 billion. It asserts that the cost to the ratepayers using Method 3 is probably less than the cost to the ratepayers of the administrative burden of implementing Method 5. PP&L urges the same points. It argues its total California revenue is less than \$ 45 million and it expects no more than \$ 66,000 in CIAC in 1987 and in 1988. If Method 3 is chosen, the revenue impact on general ratepayers is about \$ 3,000 annually while the cost of administering Method 5 is sure to be more. Additionally, PP&L operates in an economically depressed area in California and Method 5 will discourage new business and growth. Lastly, a \$ 3,000 revenue increase is usually lost in rounding and, because of its agreed upon revenue restrictions in 1988 and 1989, Method 3 would have no effect on its general ratepayers.

The arguments of Pacific and PP&L have substance, but when weighed against the general proposal [*112] that the tax should be paid by entity causing it we see no reason to grant an exception to our general rule. Since the effect of the tax appears minimal to both companies perhaps Pacific's earlier decision to absorb the tax is the proper solution for them.

Valuation

One of the problems inherent in all contribution matters when the contribution is an asset rather than cash is valuation of the asset. It was a problem before the CIAC tax change and is now a substantially greater problem because the gross-up is based on the value of the property transferred. We anticipate disputes between contributors and utilities in this area. Our concern is that the utility may undervalue the asset, charge a lower gross-up, and be exposed to back taxes, penalties, and interest. In our regular review of results of operations, we will apply the usual prudence standards to the valuation of CIAC and make adjustments when necessary.

Staff Assistance

It was generally agreed during the hearings that any ruling request presented to the IRS for an interpretation of the contributions rules would be strengthened if the Commission staff joined in the request. We agree that the staff should assist in [*113] regard to certain kinds of contributions, but not all. We believe that our staff should support attempts to have the IRS rule that contributions by state, county, and local government agencies are exempt from the tax on the basis that either (1) the contribution is exempt from tax because it is made under threat of condemnation or (2) the contribution is exempt because it is a public benefit. The staff should not support requests by private contributors for favorable IRS rulings.

Findings of Fact

⁸ On April 1, it filed a tariff incorporating a 67% gross-up factor on CIAC.

1. The Tax Reform Act of 1986 provides, among other things, that a nontaxable capital contribution does not include any contribution-in-aid-of-construction, refundable advance, or any other contribution as a customer or potential customer.
2. The taxable event is the contribution (CIAC) or advance (CAC); no contribution or advance, no tax.
3. Methods 1, 3, and 4 place none of the tax burden on the contributor or advancer and therefore are unreasonable. In addition, Methods 1 and 4 have other elements which render them unreasonable: Method 1 gives all the benefit of revenue reduction to the current ratepayer while placing all the tax and revenue recoupment burden on future ratepayers; [*114] Method 4 places all the burden of the tax payment on current ratepayers and gives all the benefits of depreciation to future ratepayers.
4. Method 5 places the tax burden on the contributor but mitigates the burden by requiring, in addition to the plant contribution, only the present value of the future tax burden. The gross-up is calculated by using the utility's incremental federal tax rate. As the payment by the contributor, by definition, does not completely pay the tax, the utility pays the difference, ratebases the tax on the CIAC net of gross-up, and recovers the difference over time in rate of return, thus causing the ratepayers to share the burden of the tax. Because the gross-up amount paid by the contributor is estimated to offset the future revenue requirements attributable to the tax actually paid, the ratepayers are, to the extent the estimate turns out to be accurate, indifferent. For contributions, Method 5 reduces the federal tax burden on the contributor by approximately 48% of the burden under Method 2. For refundable advances, the contributor pays the same gross-up as for contributions; the utility pays the difference between the contributor's share of [*115] the tax gross-up and the tax liability. The utility earns a return on the tax payment through ratebasing the tax. The gross-up will be refunded to the contributor and the utility will recover its portion of the tax payment as the utility realizes tax benefits through the deductibility of the advance refunds. Between Methods 1, 3, and 5, Method 5 provides the least risk to the utility. Method 5 is reasonable.
5. Method 2 is reasonable for those utilities which do not have an adequate cash flow or customer base to finance the tax under Method 5.
6. The Maryland Method, which shares the tax between the contributor and the shareholders is reasonable.
7. Utilities adopting Method 5 or the Maryland Method may compute the gross-up amount by using either their last authorized rate of return or 12% as the discount factor. Utilities having more than one operating district shall, for each district, use the 12% discount factor or the last authorized rate of return for that district.
8. The administrative burden of using Method 5 is not unreasonable.
9. Although no methods were introduced during the hearings that showed clear and convincing evidence that the IRS would not impose a [*116] tax on a particular transaction, except that contributions resulting from condemnation or the threat or imminence thereof or which are for a public benefit appear to be exempt from tax, [IRS Notice 87-82](#) has clarified the taxability or nontaxability of certain contributions from governmental agencies although some uncertainty still remains regarding the tax treatment of certain types of relocations and undergroundings. Where there is still uncertainty as to whether a tax risk remains, we will allow the utilities to make a determination as to whether they will require the payment of the tax gross-up or be satisfied with a written assurance against adverse IRS determination to be obtained within a time span designated by the utility before the tax gross-up must be paid subject to refund should a favorable ruling be obtained. We caution the utilities that whatever choice they make, the ratepayer may not be charged with back taxes, penalties, or interest.
10. Official notice is taken of Internal Revenue Service Notice 87-82, published in IRS Bulletin No. 1987-51, December 21, 1987, which provides guidance with respect to treatment of contributions in aid [*117] of construction after enactment of Section 824 of the Tax Reform Act of 1986, Public Law No. 99-514.
11. Under IRS Notice 87-82 there is general agreement that payments made by governmental entities which are a prerequisite to the provision of services by the utility are taxable even though such facilities are conducted for the benefit of the community at large.



12. There is general agreement that under [IRS Notice 87-82](#) relocation payments received by utilities under a government program for placing utility lines underground or for the cost of relocating utility lines to accommodate the construction or expansion of a highway and not for the provision of service shall not be treated as a contribution in aid of construction and thus are clearly nontaxable. Utilities shall not require "written assurances" where the transaction is clearly nontaxable.

13. Mountain View disagrees with the Notice that payments for extensions to new public buildings are taxable. Mountain View requests that these payments be continued to be collected net of tax for two years from the issuance of D.[87-09-026](#) to enable the municipalities to obtain regulatory or legislative relief **[*118]** from the IRS's adverse determination regarding payments for line extensions.

14. While the Notice clarifies the taxability or nontaxability of certain contributions, there is still a grey area that needs further resolution involving undergrounding or relocation and the provision of service.

Conclusions of Law

1. Refundable advances should be considered contributions-in-aid-of-construction until the IRS rules otherwise.
2. All contributions and refundable advances should be assumed to be subject to federal income tax until the IRS rules otherwise, except that contributions by governmental agencies which result from condemnation or the threat or imminence of condemnation, or for relocating utility facilities or undergrounding under a government program and does not reasonably relate to the provision of service should not be considered taxable. If the utility believes that there is a risk of taxability of a transaction, it may request adequate written assurance (a contractual promise to pay) from the governmental agency that the risk of a contrary IRS ruling will be borne by the governmental agency or in the alternative require the payment of the tax gross-up. If a favorable IRS **[*119]** determination applicable to a particular type of government agency contribution is not received within a time frame specified by the utility, such transaction is presumed taxable and subject to gross-up until favorable IRS determination is received. In the case where the gross-up is paid and a favorable determination is subsequently received, such payment is subject to refund plus applicable interest.
3. To the extent reasonable the entity causing the taxable event should bear the tax.
4. Method 5 is not anticompetitive, nor does it violate the federal tax normalization rules.
5. Utilities should be allowed to adopt Method 5.
6. Utilities should be allowed to adopt Method 2, but only if the utility is a small water company or a small telephone company.
7. Utilities should be allowed to adopt the Maryland Method.
8. The original choice of method and discount factor should be made by tariff filing and may be changed by advice letter filing. Appendix G sets forth an example of a tariff.
9. Except in the case of a government agency, a utility that fails to charge a gross-up amount should not recover from the ratepayers any tax, penalty, or interest associated with the **[*120]** contribution causing the tax, penalty, or interest.
10. A utility that charges an insufficient gross-up amount because of inadequate valuation of the contribution or improper application of its adopted method of determining the gross-up amount should not recover from the ratepayers any tax, penalty, or interest associated with the contribution causing the tax, penalty, or interest.
11. A utility should be allowed to accept such security as it deems adequate in lieu of cash to provide for the gross-up amount, but should the security prove inadequate, the utility should not recover its loss (including interest and penalties) because of inadequate security from the ratepayer; provided, however, that such losses (including

interest and penalties) may be recovered in rates using Method 3 where the utility receives written assurance from a government agency, but such assurance is insufficient.

12. If a utility is not in a taxable position in the year that it receives a contribution or refundable advance, there is no tax liability. The tax gross-up received from the contributor under Method 2 or Method 5 should then be refunded to the contributor. If a utility collects a gross-up [*121] calculated using an incremental tax rate that is more than its incremental rate, as determined on a ratemaking basis, the difference between what was and what should have been collected should be refunded to the contributor.

13. Because California taxing authorities have not yet determined whether California will follow the federal law on taxable contributions, we will not authorize utilities to gross-up contributions for California taxes. We will authorize all utilities to apply the same method they chose for the federal tax gross-up to gross-up for California taxes, if and when imposed. Should California authorities impose a tax on contributions retroactive to January 1, 1987, we will authorize the utilities to collect that tax from ratepayers for the retroactive period using Method 3.

14. In addition to the change in the gross-up to reflect potential California conformity legislation, we will also authorize a change to reflect the reduction in the federal tax rate from 1987 to 1988. However, we will not require utilities to reflect other changes in the gross-up rate, unless the changes would increase or decrease the rate by five percentage points.

15. Refunds for advances [*122] for construction should be made in the same manner as they are today pursuant to the contract between the developer and the utility. However, the gross-up amount should be part of the refund for Method 5 only, and should be refunded only to the extent that it is actually realized through the tax deductibility of advance refunds.

16. The federal tax on contributions-in-aid-of-construction and refundable advances may be passed on to the ratepayers only under the terms set forth in the following order.

17. Refunds should be made by those utilities which collected grossed-up contributions in excess of that authorized by this decision.

18. Utilities should be required to refund the gross-up amounts associated with any contributions which prove to be not subject to tax, plus interest computed at the average three month commercial paper rate as published in the Federal Reserve Bulletin.

19. Should Method 5 be found to be a violation of federal law then utilities should be permitted to use Method 3 to recover any taxes, interest, or penalties imposed.

20. [IRS Notice 87-82](#) has clarified the taxability or nontaxability of contributions made by governmental [*123] agencies for typical highway relocation or undergroundings and for extensions for new services; however, it leaves uncertain the taxability of certain other relocation and undergrounding work even though payments are made by governmental agency.

21. Utilities should not require written assurance nor collect for tax gross-up where the transaction is clearly nontaxable.

22. Utilities should collect for tax gross-up where the transaction is clearly taxable even though the governmental agency making the contribution may disagree with [IRS Notice 87-82](#).

23. Where the taxability of a transaction is uncertain, utilities may either collect the tax gross-up subject to refund plus interest, or in the alternative obtain written assurance that any tax gross-up would be paid if a favorable IRS ruling is not received within a time period specified by the utility. No utility should be allowed to pass on to the ratepayers any costs or losses associated with accepting written assurances.

ORDER



IT IS ORDERED that:

1. Respondents shall not impose the federal tax on contributions-in-aid-of-construction and refundable advances on their ratepayers except as provided in [*124] Ordering Paragraph 2.
2. All respondents shall notify the Evaluation and Compliance Division and shall file appropriate tariffs not earlier than 7 days after the effective date of this order on not less than 30 days' notice to the public, adopting one, and not more than one, of the following methods of providing for the federal tax on contributions-in-aid-of-construction and refundable advances:
 - a. Method 5 as described in this decision.
 - b. Method 2 as described in this decision, but only if the respondent is a small water company or a small telephone company.
 - c. The Maryland Method as described in this decision.
- 3a. Respondents adopting Method 5 or the Maryland Method shall compute the federal tax portion of the contribution or refundable advance using the respondent's incremental federal tax rate as determined on a ratemaking basis and using either a 12% discount rate or the respondent's last authorized rate of return. Respondents selecting 12% as a discount rate shall also use 17% as the pre-tax rate of return in their Method 5 calculation. Such choice shall be reflected in the tariff filing pursuant to Ordering Paragraph 2.
- b. Respondents adopting Method 2 shall compute [*125] the federal tax portion of the contribution or refundable advance using the respondent's incremental federal tax rate as determined on a ratemaking basis.
4. Upon the effective date of the tariff filed by a respondent pursuant to Ordering Paragraph 2, any Commission decision or resolution as to that respondent in conflict with the filed tariff is revoked.
5. Ninety days after the effective date of this order, all Commission decisions and resolutions in conflict with this order are revoked.
6. Respondents may use Method 3 to collect any California state tax imposed on contributions-in-aid-of-construction or refundable advances, and/or the federal tax gross-up portion thereof from the date the California tax is first announced, if the tax is retroactive to January 1, 1987. Contributions-in-aid-of-construction and refundable advances made after the date the California tax is enacted shall be collected by each respondent in the same manner as it collects the federal tax.
7. Respondents are authorized to make advice letter filings to reflect the reduction in the federal tax rate from 1987 and 1988 and to reflect any changes in the gross-up rate which would increase or decrease [*126] the rate by five percentage points or more.
8. All respondents shall make refunds as follows:
 - a. For those respondents who elect Method 2, all collections in excess of the 67% tax gross-up shall be refunded to the contributor with interest from the date of collection to the date of refund.
 - b. For those respondents who elect Method 5 or the Maryland Method, the difference between the amount collected and the amount computed by the use of Method 5 or the Maryland Method shall be refunded to the contributor with interest from the date of collection to the date of refund.
 - c. Refunds shall be completed within 120 days after the effective date of this order.
 - d. Respondents shall report to the Evaluation and Compliance Division within 140 days after the effective date of this order a summary of all collections of CIAC, the gross-up portion of the collection, if any, and the refunds made, with dates and amounts.



e. Interest shall be computed at the average three month commercial paper rate as published in the Federal Reserve Bulletin.

9. The Executive Director may join in any request he deems appropriate to the Internal Revenue Service to obtain a favorable tax ruling on a contribution-in-aid-of-construction [*127] or a refundable advance made to a respondent by a California state, county, or local government agency on the basis of either (1) the contribution or advance is exempt from tax because it is made under threat of condemnation or (2) the contribution or advance is exempt because it is a public benefit. The Executive Director may acknowledge to the IRS that the Public Utilities Commission of the State of California supports the request.

10. Utilities shall not require any gross-up of contributions by a governmental agency to a utility or written assurance of payment of such gross-up for relocation or undergrounding work and which does not relate to the provision of service by the utility. Where written assurances have been obtained for such contributions, they shall be negated.

11. Where a transaction is clearly taxable, utilities shall require payment of the gross-up for taxes or collect on any written assurances obtained from a governmentl agency for contributions made by a governmental agency to a utility related to the provisions of services by the utility.

12. Where the taxability of a contribution of a governmental agency to a utility is uncertain, a utility may require payment [*128] of the tax gross-up or require a written assurance by the government agency to pay such gross-up if a favorable ruling is not received within a time frame specified by the utility. Payment of such gross-up would be subject to refund including applicable interest upon receipt of a favorable IRS ruling and any written assurance similarly negated. No utility shall be allowed to pass on to the ratepayers any costs or losses associated with accepting written assurances.

13. Respondents shall file appropriate revised tariffs to comply with this order.

14. In all other respects D.87-09-026, as modified by D.87-12-028, remains in full force and effect.

This order becomes effective 30 days from today.

Dated September 10, 1987, at San Francisco, California.

Commissioner Donald Vial, being necessarily absent, did not participate.

Concur By: OHANIAN; WILK

Concur:

JOHN B. OHANIAN AND G. MITCHELL WILK, Commissioners, Concurring:

We concur in today's decision for the reason that we believe the methods we have adopted for collecting federal tax on contributions in aid of construction and refundable advances strike a reasonable balance of the tax burden imposed by the Congress.

We do not agree, however, that [*129] the principal rationale for our decision should be that the entity causing the taxable event should bear the burden of the tax. The effect of the 1986 Tax Reform Act was to consider formerly non-taxable contributions and advances as gross income for federal income tax purposes. As such, this tax is not a cost for utility service in the usual sense which should be borne by new construction. It arises not from the need to serve new development but, rather from changes in federal tax law. We might easily have treated this tax the same for ratemaking purposes as we have always treated utility federal income tax.

We support this decision because it distributes the costs and minimizes the net economic impact of the 1986 Tax Reform Act. Our rationale is the desire to preserve the relative status quo by not imposing the full burden of this abrupt increase in utility costs upon one segment of all those who benefit from public utility services.



We would urge this commission to monitor the impacts of today's decision very carefully during its implementation to ensure that the state's overall economic vitality is not unduly impaired, particularly with respect to the production of affordable [*130] housing and the continued growth of small business enterprise. It may well be that as we implement the tax law changes, we will discover additional ways to improve the balance we achieve today.

Lastly we anticipate that this commission will continue to actively support efforts leading to improvements in the new tax law by the Congress or the Internal Revenue Service.

Appendix

APPENDIX A

LIST OF APPEARANCES

Respondents: Craig Buchsbaum, Attorney at Law, for Pacific Gas and Electric Company; Stod, Rives, Boley, Fraser & Wyse, by Donald N. Furman, Attorney at Law (Oregon), for Pacific Power & Light Company; James D. Salo and John J. Gezelin, Attorneys at Law (Nevada), for Sierra Pacific Power Co.; John R. Asmus, Jr., Attorney at Law, for San Diego Gas & Electric Company; Roy M. Rawlings and Peter N. Osborn, Attorneys at Law, for Southern California Gas Company; Stephen E. Pickett, Carol B. Henningson, and James M. Lehrer, Attorneys at Law, for Southern California Edison Company; Jack A. Socha, Attorney at Law (Utah, Michigan, Illinois, Iowa), for Southwest Gas Corporation; Hathaway Watson, III, Attorney at Law, for AT&T Communications of California, Inc.; Graham & James, by Boris H. Lakusta, [*131] David J. Marchant, Martin A. Mattes, and Robert C. Thompson, Attorneys at Law, for Bay Area Cellular Telephone; John L. Clark, Attorney at Law, for CP National Corp. and Toulumne Telephone Company; Orrick, Herrington & Sutcliffe, by Robert J. Gloistein, Attorney at Law, for Continental Telephone Company of California; Peter K. Plaut, Attorney at Law, for General Telephone Company of California; James L. Wurtz, Attorney at Law (Texas), and Randall E. Cape, Attorney at Law, for Pacific Bell; Mark Stachiw, Attorney at Law, for PacTel Corporation; Pelavin, Norberg, Harlick & Beck, by Alvin H. Pelavin and Jeffrey F. Beck, Attorneys at Law, for Calaveras Telephone Company, California-Oregon Telephone Co., Capay Valley Telephone System, Inc., Ducor Telephone Company, Evans Telephone Company, Foresthill Telephone Co., Happy Valley Telephone Company, Hornitos Telephone Company, Kerman Telephone Co., Pinnacles Telephone Company, Sierra Telephone Company, Inc., The Ponderosa Telephone Co., The Siskiyou Telephone Company, The Volcano Telephone Company, Citizens Utilities Company of California, Sacramento Water District, Felton Water District, Guerneville Water District, Montara Water District, [*132] Telephone Division, Francis Land & Water Company, Jackson Water Works, Inc., and Larkfield Water Company; McCutchen, Doyle, Brown & Enersen, by A. Crawford Greene, Attorney at Law, for California Water Service Company, San Jose Water Company, and Suburban Water systems; Donald L. Houck, for California Water Service Company; Arthur J. Smithson, for Citizens Utilities Company of California; John Barker, for Cal-Am Water; C. W. Porter, for Dominguez Water Corporation - Antelope Valley Water Company; Dan Stockton, for Fruitridge Vista Water Company; William Zastrow, for Peerless Water Company; Fred R. Meyer, for San Jose Water Company; Michael L. Whitehead, Attorney at Law, for San Gabriel Valley Water Company; Joseph F. Young, for Southern California Water Company; Robert O. Randall, for Suburban Water Systems; and Robert T. Adcock, for Alisal Water Corporation, dba Alco Water Service.

Interested Parties: Earl Nicolas Selby, Attorney at Law, for Bay Area Teleport; Thomas Bannon, for California Building Industry Association; Robert E. Burt, for California Manufacturers Association; Leonard Snaider, Attorney at Law, for Louise Renne, City Attorney; Leslie J. Girard and William Shaffran, [*133] for the City of San Diego; Reed V. Schmidt, for the California City-County Street Light Association; C. W. Potter, for California Water Association; Jon F. Elliott, Michel Peter Florio, and Roger A. Schwartz, Attorneys at Law, for Toward Utility Rate Normalization (TURN); Norman J. Furuta, Attorney at Law, for Consumer Interest of Federal Executive Agencies; Gilbert Chong, Attorney at Law, of West Navfacengcom Code 09C, for the Department of the Navy; Sam DeFrawi, for the Naval Facilities Engineering Command; Thomas J. O'Rourke, for O'Rourke & Company; John D. Quinley, for the Cogeneration Service Bureau; Nossaman, Guthner, Knox & Elliott, by Richard C. Harper, Attorney at Law, for Larwin Construction Company; Richard J. Blumenfeld and P. Gregory Conlon, for Arthur Andersen & Co.; Octavio

Lee, for the Board of Equalization, Property Tax Department, Valuation Division; Ed Perez, Assistant City Attorney, for James K. Hahn, City Attorney, City of Los Angeles; Judith Alper, Attorney at Law, for Independent Power Corporation; Ted Bresler, Attorney at Law, for the City of Sunnyvale; Eugene Bonnsetter, Attorney at Law, for the Department of Transportation; Grueneich & Lowry, by Dian [*134] Grueneich, Attorney at Law, for Independent Energy Producers Association, State of California Department of General Services; Heller, Ehrman, White & McAuliffe, by Richard E. Hammond, Attorney at Law, for The Stoneson Development Corporation, O.L.S. Energy; Lindsay, Hart, Neil & Weigler, by Clyde Hirschfeld, Attorney at Law, for Cogenerators of Southern California; Marc G. Hynes, Attorney at Law, for the City of Morgan Hill; Peter MacDonald, Attorney at Law, for the City of Pleasanton; William Marcus, for Independent Energy Producers Association, State of California Department of General Services; Carlos L. Ortega, for the City of Palm Desert; Kadison, Pfaelzer, Woodard, Quinn & Rossi, by Norman A. Pedersen and Rachelle B. Chong, Attorneys at Law, for the City of Mountain View; Jerry A. Riessen, for O.L.S. Energy; William R. Rugg, for the League of California Cities; Fred Shubin, for Landco Builders; Iver E. Skjeie, Attorney at Law, for the Department of Corrections; Armour, St. John, Wilcox, Goodin & Schlotz, by James Squeri, Attorney at Law, for California Building Industry Association; Jack Biggins, for California Cable Television Association; and John Gibbons and Marron, Reid [*135] & Sheehy, by E. Lewis Reid and Diane Fellman, Attorneys at Law, for themselves.

Commission Staff: Timothy E. Treacy and Gilbert Infante.

APPENDIX B

Report of the Committee on Ways and Means House of Representatives (Report 99-426, December 7, 1985)

Contributions in Aid of Construction

Present Law

Under present law, gross income does not include any contribution to capital of a corporation (sec. 118(a)). A corporate regulated public utility that provides electric energy, gas (through a local distribution system or transportation by pipeline), water, or sewage disposal services may treat contributions received in aid of construction as non-taxable contributions to capital (sec. 118(b)).

In order to be eligible to be treated as a contribution to capital, the money or property transferred to the utility must be a contribution in aid of construction, any moneys received must be spent for the intended purpose of the contribution within a specified period of time, and the contribution received in aid of construction (or any property constructed or acquired with such contributions) may not be included in the utility's rate base for rate making purposes.

In addition to the exclusion [*136] from gross income, present law provides that no deductions are allowable with respect to a contribution in aid of construction and that property purchased with contributions in aid of construction have no depreciable tax basis and are not eligible for the investment tax credit (secs. 118(b) and 362(c) (3)).

Reasons for Change

The committee believes that all payments that are made to a utility either to encourage, or as a prerequisite for, the provision of services should be treated as income of the utility and not as a contribution to the capital of the utility. The committee believes that present law allows amounts that represent prepayments for services to be received by corporate regulated public utilities without the inclusion of each payment in gross income. Accordingly, the committee bill repeals the present law treatment and requires the recipient utility to include the value of such contribution in income at the time of their receipt and to depreciate the value of any asset contributed, or purchased with a contribution of cash, over the recovery period of the asset.

Explanation of Precision



The committee bill repeals the provision of present law (Sec. 118(b)) that [*137] provides for the treatment of contributions in aid of construction received by a corporate regulated public utility to be treated as a contribution to the capital of the utility.

The committee intends that the effect of the change is to require that a utility report as an item of gross income the value of any property, including money, that it receives to provide, or encourage the provision of, services to or for the benefit of the person transferring the property. A utility is considered as having received property to encourage the provision of services if the receipt of the property is a prerequisite to the provision of the services, if the receipt of the property results in the provision of services earlier than would have been the case had the property not been received, or if the receipt of the property otherwise causes the transferor to be favored in any way.

The committee intends that a utility include in gross income the value of the property received regardless of whether the utility had a general policy, stated or unstated, that requires or encourages certain types of potential customers to transfer property, including money, to the utility while other types of potential [*138] customers are not required or encouraged to make similar transfers. If members of a group making transfers of property are favored over other members of the same general group not making such transfers, the fact that the contributing members of the group may not be favored over the members of other groups in the receipt of services will not prevent the inclusion of the value of the transfer in the gross income of the utility. For instance, where a utility generally requires developers of multiple tracts of residential housing to transfer property to the utility in order to obtain service, but does not require such a transfer from individual homeowners, the fact that both groups will receive service without preference of one group over the other will not prevent the utility from being required to include in gross income the value of the property received from the developers. Where all members of a particular group make transfers of property to the utility, normally it will be assumed that such transfers are to encourage the provision of services, despite the absence of any formal policy requiring such transfers, unless it is clearly shown that the benefit of the public, as a whole [*139] was the primary motivating factor in the transfers.

The person transferring the property will be considered as having been benefited if he is the person who will receive the services, an owner of the property that will receive the services, a former owner of the property that will receive the services, or if he derives any benefit from the property that will receive the services. Thus, a builder who transfers property to a utility in order to obtain services for a house that he was paid to build will be considered as having benefited from the provision of the services. This will be the case despite the fact that the builder may never have had an ownership interest in the property and may make the transfer to the utility after the house has been completed and accepted.

RATEPAYER BURDEN

Comparison of NPV to the ratepayer for \$ 1,000 Contribution-in-aid-of-Construction (CIAC) - Single Year Contribution Under Methods 1, 3, 4 and 5. Method 2 is not shown because the NPV to the ratepayer is zero.

Assumptions:

1. 34% tax rate.
2. Plant constructed with CIAC assumed to have a 30 year book life and a 20 year tax life.
3. Weighted average cost of capital is 11.44%.
4. Net to [*140] gross multiplier is 1.68.
5. Tax benefit = MACRS times FIT rate.
6. Deferred tax = MACRS - S/L times FIT rate.
7. CIAC is not considered taxable for CCFT.

Method 1

Method 3

Method 4

Method 5



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Period	Single Year	Single Year	Single Year	Single Year
1	\$ 192	\$ 54	\$ 493	(\$ 21)
2	182	51	(41)	(12)
3	175	47	(39)	(5)
4	168	43	(35)	0
5	162	40	(32)	5
6	155	37	(31)	8
7	149	34	(28)	11
8	144	32	(26)	12
9	138	29	(26)	13
10	132	27	(26)	14
11	126	24	(26)	14
12	121	21	(26)	14
13	115	19	(26)	13
14	109	16	(26)	12
15	103	14	(26)	10
16	97	11	(26)	9
17	91	9	(26)	7
18	85	6	(26)	5
19	79	4	(26)	3
20	73	1	(26)	1
21	68	0	0	0
22	64	0	0	0
23	61	0	0	0
24	57	0	0	0
25	54	0	0	
26	50	0	0	0
27	47	0	0	0
28	43	0	0	0
29	42	0	0	0
30	39	0	0	0
Total	\$ 3,121	\$ 519	(\$ 51)	\$ 113

Discount	30 Years	30 Years	30 Years	30 Years
Rate	1 Yr CIAC	1 Yr CIAC	1 Yr CIAC	1 Yr CIAC
10.00%	310	291	215	21
12.00%	160	265	235	13
15.00%	(12)	712	258	3
18.00%	(142)	209	272	(3)
20.00%	(212)	195	279	(6)

[*141]

APPENDIX D

METHOD 2: CONTRIBUTIONS IN AID OF CONSTRUCTION:

Contribution:		1000			
Year	(a) Tax Payment by contributor	(b) MACRS Per Year	(c) MACRS Accum Depr	(d) Tax Benefit of MACRS Annual Depreciation	(e) Net RR after flow- through of depr. benefits
	515				
1		38	38	(13)	(21)
2		72	110	(25)	(41)
3		67	176	(23)	(38)
4		62	238	(21)	(35)
5		57	295	(19)	(33)
6		53	348	(18)	(30)
7		49	397	(17)	(28)
8		46	443	(16)	(26)
9		46	490	(16)	(26)
10		46	536	(16)	(26)
11		46	583	(16)	(26)
12		46	629	(16)	(26)
13		46	675	(16)	(26)
14		46	722	(16)	(26)
15		46	768	(16)	(26)
16		46	814	(16)	(26)
17		46	861	(16)	(26)
18		46	907	(16)	(26)
19		46	954	(16)	(26)
20		46	1,000	(16)	(26)
		1,000		(340)	(570)

Explanation: Contribution: Amount without gross-up

Column a: Amount of contribution times gross-up (51.512% @ 34% tax rate).

Column b: Compute MACRS for each year @ 150% declining balance, half-year convention year 1; switch to s/l when more beneficial.

Column c: Accumulated depreciation.

Column d: Tax rate times [*142] yearly depreciation (col. b).



Column e: NTGM (1.6761) times col. d.

Accounting for Method 2

Journal entries for Contributions (no refunds)

Year 1

1. Cash	1,515	
CIAC		1,000
Taxes Payable		515

To record receipt of contribution and associated tax gross-up.

2. Taxes Payable	515	
Cash		515

To record payment of tax and gross-up (tax-on-tax).

3. Plant	1,000	
Cash		1,000

To record plant financed by contribution;
this is offset by CIAC account.

4. Memorandum account on tax basis of
CIAC plant

received after 12/31/86:

Taxes Payable	13	
Miscellaneous Revenues		13

To flow the depreciation benefits to the ratepayers (MACRS rates times CIAC times tax rate).

METHOD 2: ADVANCES IN AID OF CONSTRUCTION

Refunds payable over 40 years; net of tax; benefits to ratepayers.

Advance: 1000

	(a)	(b)	(c)	(d)
Year	Tax Payment	MACRS	MACRS	Tax Benefit
	by contributor	Per Year	Accum Depr	of MACRS
				Annual
				Depreciation

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Advance: 1000

Year	(a) Tax Payment by contributor	(b) MACRS Per Year	(c) MACRS Accum Depr	(d) Tax Benefit of MACRS Annual Depreciation
1		38	38	(13)
2		72	110	(25)
3		67	176	(23)
4		62	238	(21)
5		57	295	(19)
6		53	348	(18)
7		49	397	(17)
8		46	443	(16)
9		46	490	(16)
10		46	536	(16)
11		46	583	(16)
12		46	629	(16)
13		46	675	(16)
14		46	722	(16)
15		46	768	(16)
16		46	814	(16)
17		46	861	(16)
18		46	907	(16)
19		46	954	(16)
20		46	1,000	(16)
		1,000		(340)
21				
22				
23				
24				
25				
26				
27				
28				
29				
30				
31				
32				



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Advance: 1000

	(a)	(b)	(c)	(d)
Year	Tax Payment	MACRS	MACRS	Tax Benefit
	by contributor	Per Year	Accum Depr	of MACRS
				Annual
				Depreciation

33

34

35

36

37

38

39

40

[*143]

	(e)	(f)	(g)
Year	Tax Deduction	FIT	RR of
	to Utility	reduction	tax
	on Payment	of tax	deduction
	of Adv. Refund	deduction	
1	(25)	(9)	(14)
2	(25)	(9)	(14)
3	(25)	(9)	(14)
4	(25)	(9)	(14)
5	(25)	(9)	(14)
6	(25)	(9)	(14)
7	(25)	(9)	(14)
8	(25)	(9)	(14)
9	(25)	(9)	(14)
10	(25)	(9)	(14)
11	(25)	(9)	(14)
12	(25)	(9)	(14)
13	(25)	(9)	(14)
14	(25)	(9)	(14)
15	(25)	(9)	(14)
16	(25)	(9)	(14)



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	(e)	(f)	(g)
Year	Tax Deduction	FIT	RR of
	to Utility	reduction	tax
	on Payment	of tax	deduction
	of Adv. Refund	deduction	
17	(25)	(9)	(14)
18	(25)	(9)	(14)
19	(25)	(9)	(14)
20	(25)	(9)	(14)
21	(25)	(9)	(14)
22	(25)	(9)	(14)
23	(25)	(9)	(14)
24	(25)	(9)	(14)
25	(25)	(9)	(14)
26	(25)	(9)	(14)
27	(25)	(9)	(14)
28	(25)	(9)	(14)
29	(25)	(9)	(14)
30	(25)	(9)	(14)
31	(25)	(9)	(14)
32	(25)	(9)	(14)
33	(25)	(9)	(14)
34	(25)	(9)	(14)
35	(25)	(9)	(14)
36	(25)	(9)	(14)
37	(25)	(9)	(14)
38	(25)	(9)	(14)
39	(25)	(9)	(14)
40	(25)	(9)	(14)
	(1,000)	(340)	(570)

Explanation: Advance: Amount without gross-up

Column a: Amount of advance times gross-up (51.512% @ 34% tax rate).

Column b: Compute MACRS for each year @ 150% declining balance, half-year convention [*144] year 1.

Column c: Accumulated depreciation.

Column d: Tax rate times yearly depreciation (col. b).

Column e: Amount of advance times 2.5%.



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Column f: Tax rate times col. f.

Column g: NTGM (1.6761) times col. g.

Accounting for Method 2

Journal entries for Refundable Advances (refunds made over a 40-year period).

Year 1

1. Cash	1,515	
CIAC		1,000
Taxes Payable		515

To record receipt of contribution and
associated tax gross-up.

2. Taxes Payable	515	
Cash		515

To record payment of tax and gross-up
(tax-on-tax).

3. Plant	1,000	
Cash		1,000

To record plant financed by contribution; this is offset by CIAC account.

Note that sub-accounts must be established to track and maintain both pre-and post-12/31/86 advances in aid of construction. The amortization of the post-12/31/86 refunds shall be included as a tax deduction in the Results of Operation tax calculation.

APPENDIX E

METHOD 5: CONTRIBUTIONS IN AID OF CONSTRUCTION:

Contribution:**1000**

	(a)	(b)	(c)	(d)	(e)
Year	Tax Payment	MACRS	MACRS	Remaining	Wtd. Ave.
	(by utility)	Per Year	Accum Depr	CIAC Tax	Unrecovered
				Payment	Tax Payment
1	340	13	13	327	334
2		25	37	303	315
3		23	60	280	291
4		21	81	259	270
5		19	100	240	249
6		18	118	222	231

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Contribution: 1000

	(a)	(b)	(c)	(d)	(e)
Year	Tax Payment	MACRS	MACRS	Remaining	Wtd. Ave.
	(by utility)	Per Year	Accum Depr	CIAC Tax	Unrecovered
				Payment	Tax Payment
7		17	135	205	213
8		16	151	189	197
9		16	167	173	181
10		16	182	158	166
11		16	198	142	150
12		16	214	126	134
13		16	230	110	118
14		16	245	95	102
15		16	261	79	87
16		16	277	63	71
17		16	293	47	55
18		16	308	32	39
19		16	324	16	24
20		16	340	0	8

[*145]

Contribution:

	(f)	(g)	(h)	(i)	(j)	(k)
Year	Pre-tax	Rev. Req. on	Discount	Discounted	Apply	After-Tax
	Rate of	Wtd. Ave.	Factor	Rev. Req. on	After-Tax	Rev. Req. on
	Return	Unrecovered	0.1144	Wtd. Ave.	Rate	Wtd. Ave.
		Tax Payment		Unrecovered		Unrecovered
				Tax Payment		Tax Payment
1	0.1614	54	0.8973	48	0.6600	32
2	0.1614	51	0.8052	41	0.6600	27
3	0.1614	47	0.7226	34	0.6600	22
4	0.1614	43	0.6484	28	0.6600	19
5	0.1614	40	0.5818	23	0.6600	15
6	0.1614	37	0.5221	19	0.6600	13
7	0.1614	34	0.4685	16	0.6600	11
8	0.1614	32	0.4204	13	0.6600	9

Contribution:

	(f)	(g)	(h)	(i)	(j)	(k)
Year	Pre-tax	Rev. Req. on	Discount	Discounted	Apply	After-Tax
	Rate of	Wtd. Ave.	Factor	Rev. Req. on	After-Tax	Rev. Req. on
	Return	Unrecovered	0.1144	Wtd. Ave.	Rate	Wtd. Ave.
		Tax Payment		Unrecovered		Unrecovered
				Tax Payment		Tax Payment
9	0.1614	29	0.3773	11	0.6600	7
10	0.1614	27	0.3385	9	0.6600	6
11	0.1614	24	0.3038	7	0.6600	5
12	0.1614	22	0.2726	6	0.6600	4
13	0.1614	19	0.2446	5	0.6600	3
14	0.1614	17	0.2195	4	0.6600	2
15	0.1614	14	0.1970	3	0.6600	2
16	0.1614	11	0.1767	2	0.6600	1
17	0.1614	9	0.1586	1	0.6600	1
18	0.1614	6	0.1423	1	0.6600	1
19	0.1614	4	0.1277	0	0.6600	0
20	0.1614	1	0.1146	0	0.6600	0
				273		180

METHOD 5: CONTRIBUTIONS IN AID OF CONSTRUCTION:

Explanation: Determine amount [*146] of contribution (no gross-up)

Column a: Contribution amount # tax rate (no gross-up)

Column b: Determine MACRS class and declining balance percent, apply half-year convention to first year, cross-over to straight-line when appropriate

Column c: Accumulate total depreciation taken

Column d: Tax payment less accumulated depreciation

Column e: Beginning of year + payment balance + end of year tax payment balance; sum divided by 2

Column f: Compute pre-tax rate of return: If use last authorized capital structure and weighted costs; add embedded cost of debt to weighted cost of preferred stock and equity times NTGM

If use 12% discount rate, use 17% as pre-tax rate of return.

Column g: Column e times column f

Column h: Use either last authorized rate of return or statewide discount factor of 12.00%

Year 1: $1/(1+\text{rate chosen})$



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Year 2: $1/((1+\text{rate chosen})^2)$ [SEE ILLUSTRATION IN ORIGINAL] 2)

Year 3: $1/((1+\text{rate chosen})^3)$ [SEE ILLUSTRATION IN ORIGINAL] 3)

Etcetera: Note that caret stands for exponent in Lotus 2.0

Column i: Column g times column h

Column j: After tax rate, 1988 on: $1 - .34$ (assumes federal tax gross-up not taxable for CCFT purposes)

Column k: 0 Column i times column [*147] j: This column represents net cash received by the utility.

This is the amount that must be given back to the ratepayer to keep them whole. These amounts are amortized in the same manner as received.

METHOD 5: CONTRIBUTIONS IN AID OF CONSTRUCTION:

Contribution:

1000

	(a)	(b)	(c)	(d)	(e)
Year	Tax Payment	MACRS	MACRS	Contributor	Amortization
	(by utility)	Per Year	Accum Depr	After-Tax	Schedule of
				Additional	Additional
				Payment	Tax Payment
					(makes r/p whole)
	340			180	
1		13	13		32
2		25	37		27
3		23	60		22
4		21	81		19
5		19	100		15
6		18	118		13
7		17	135		11
8		16	151		9
9		16	167		7
10		16	182		6
11		16	198		5
12		16	214		4
13		16	230		3
14		16	245		2
15		16	261		2
16		16	277		1
17		16	293		1
18		16	308		1
19		16	324		0



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Contribution: 1000

	(a)	(b)	(c)	(d)	(e)
Year	Tax Payment	MACRS	MACRS	Contributor	Amortization
	(by utility)	Per Year	Accum Depr	After-Tax	Schedule of
				Additional	Additional
				Payment	Tax Payment
					(makes r/p whole)
20		16			0
		340			180

Contribution:

	(f)	(g)	(h)
Year	Net	Weighted	Pre-tax
	Unrecovered	Average	Rate of
	Contribution	Unrecovered	Return
	(cash put up	Contribution	
	by utility)		
	160		
1	179	170	0.1614
2	182	180	0.1614
3	181	181	0.1614
4	179	180	0.1614
5	175	177	0.1614
6	170	172	0.1614
7	164	167	0.1614
8	157	160	0.1614
9	148	153	0.1614
10	139	144	0.1614
11	128	133	0.1614
12	116	122	0.1614
13	103	109	0.1614
14	90	96	0.1614
15	76	83	0.1614
16	61	69	0.1614



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Contribution:

	(f)	(g)	(h)
Year	Net	Weighted	Pre-tax
	Unrecovered	Average	Rate of
	Contribution	Unrecovered	Return
	(cash put up	Contribution	
	by utility)		
17	47	54	0.1614
18	31	39	0.1614
19	16	24	0.1614
20	0	8	0.1614

[*148] 1

Contribution:

	(i)	(j)	(k)
Year	Discount	Gross of	Net
	Rev. Req. on	Tax Amort.	Revenue
	Wtd. Ave	Addl Paymt	Requirements
	Unrecovered	by Contrib	
	Contribution		
1	27	48	(21)
2	29	41	(12)
3	29	34	(5)
4	29	28	1
5	29	23	5
6	28	19	8
7	27	16	11
8	26	13	13
9	25	11	14
10	23	9	14
11	21	7	14
12	20	6	14
13	18	5	13
14	16	4	12
15	13	3	11

Contribution:

	(i)	(j)	(k)
Year	Discount	Gross of	Net
	Rev. Req. on	Tax Amort.	Revenue
	Wtd. Ave	Addl Paymt	Requirements
	Unrecovered	by Contrib	
	Contribution		
16	11	2	9
17	9	1	7
18	6	1	5
19	4	0	3
20	1	0	1
	391	273	118

METHOD 5: CONTRIBUTIONS:

Explanation: Contribution: Use same amount as used on page 1.

Column a: Contribution amount # tax rate (no gross-up)

Column b: Determine MACRS class and declining balance percent, apply half-year convention to first year, cross-over to straight-line when appropriate

Column c: Accumulate total depreciation taken

Column d: Total after tax revenue requirement investment, page 1 col. k (actual cash received by utility).

Column e: Amortization schedule, page 1, col. k. Amortization of net cash received to make r/p whole.

Column f: Year 1 BB = Column a, line 0 less col. e, line 0. Subtract depreciation benefit for year (col. c, line 1); add amortization² of **[*149]** additional tax payment (col. e, line 1);

Total equals ending balance (EB); then use EB as beginning balance (BB) for year 2.

Column g: Col. f: BB + EB divided by 2

Column h: Use either last authorized rate of return or statewide discount factor of 12.00% as basis:

Auth. ROR: use authorized capital structure and weighted costs; add embedded cost of debt to weighted costs of preferred stock and equity, both times NTGM.

Statewide: use 17.00% as pre-tax RDR.

Column i: Column g times column h

Column j: Column 1, page 1

Column k: Column i less column j; this is the amount that must be recovered by the utility from the ratepayers.



Accounting for Method 5

Journal Entries for Contributions (no refunds)

Year 1

1. Cash	1,272	
Deferred Taxes - CIAC	340	
CIAC		1,000
Deferred Revenue		180
Taxes Payable		432

To record receipt of contribution and to set up tax accounts related to CIAC and gross-up.

(\$ 1000 * 34% plus \$ 272 * 34% = \$ 432)

2. Taxes Payable	13	
Deferred Taxes - CIAC		13

To record tax benefits of MACRS depreciation.

3. Deferred Revenue	32	
Miscellaneous Revenue		32

To amortize deferred revenue to misc. revenue over the tax life of the CIAC plant.

This offsets the revenue requirements impact.

4. Plant	1,000	
Cash		1,000

[*150] 3

To record the plant financed by CIAC; this is offset by the CIAC account.

METHOD 5: ADVANCES IN AID OF CONSTRUCTION: Refunds payable over 40 years; gross of tax;

Advance: 1000

	(a)	(b)	(c)	(d)	(e)	(f)
Year	Tax Payment	MACRS	MACRS	Remaining	Wtd. Ave.	Pre-tax
	(by utility)	Per Year	Accum Depr	CIAC Tax	Unrecovered	Rate of
				Payment	Tax Payment	Return
1	340	13	13	327	334	0.1614
2		25	37	303	315	0.1614
3		23	60	280	291	0.1614

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Advance: 1000

	(a)	(b)	(c)	(d)	(e)	(f)
Year	Tax Payment	MACRS	MACRS	Remaining	Wtd. Ave.	Pre-tax
	(by utility)	Per Year	Accum Depr	CIAC Tax	Unrecovered	Rate of
				Payment	Tax Payment	Return
4		21	81	259	270	0.1614
5		19	100	240	249	0.1614
6		18	118	222	231	0.1614
7		17	135	205	213	0.1614
8		16	151	189	197	0.1614
9		16	167	173	181	0.1614
10		16	182	158	166	0.1614
11		16	198	142	150	0.1614
12		16	214	126	134	0.1614
13		16	230	110	118	0.1614
14		16	245	95	102	0.1614
15		16	261	79	87	0.1614
16		16	277	63	71	0.1614
17		16	293	47	55	0.1614
18		16	308	32	39	0.1614
19		16	324	16	24	0.1614
20		16	340	0	8	0.1614

Advance:

	(g)	(h)	(i)	(j)	(k)
Year	Rev. Req. on	Discount	Discounted	Apply	After-Tax
	Wtd. Ave.	Factor	Rev. Req. on	After-Tax	Rev. Req. on
	Unrecovered	0.1144	Wtd. Ave.	Rate	Wtd. Ave.
	Tax Payment		Unrecovered		Unrecovered
			Tax Payment		Tax Payment
1	54	0.8973	48	0.6600	32
2	51	0.8052	41	0.6600	27
3	47	0.7226	34	0.6600	22
4	43	0.6484	28	0.6600	19
5	40	0.5818	23	0.6600	15



Advance:

	(g)	(h)	(i)	(j)	(k)
Year	Rev. Req. on	Discount	Discounted	Apply	After-Tax
	Wtd. Ave.	Factor	Rev. Req. on	After-Tax	Rev. Req. on
	Unrecovered	0.1144	Wtd. Ave.	Rate	Wtd. Ave.
	Tax Payment		Unrecovered		Unrecovered
			Tax Payment		Tax Payment
6	37	0.5221	19	0.6600	13
7	34	0.4685	16	0.6600	11
8	32	0.4204	13	0.6600	9
9	29	0.3773	11	0.6600	7
10	27	0.3385	9	0.6600	6
11	24	0.3038	7	0.6600	5
12	22	0.2726	6	0.6600	4
13	19	0.2446	5	0.6600	3
14	17	0.2195	4	0.6600	2
15	14	0.1970	3	0.6600	2
16	11	0.1767	2	0.6600	1
17	9	0.1586	1	0.6600	1
18	6	0.1423	1	0.6600	1
19	4	0.1277	0	0.6600	0
20	1	0.1146	0	0.6600	0
			273		180

[*151] 4

METHOD 5: Advances, refund with gross-up:

Explanation: Determine amount of advance (no gross-up)

Column a: Advance amount # tax rate (no gross-up)

Column b: Determine MACRS class and declining balance percent, apply half-year convention to first year, cross-over to straight-line when appropriate

Column c: Accumulate total depreciation taken

Column d: Tax payment less accumulated depreciation

Column e: Beginning of year tax payment balance + end of year tax payment balance; sum divided by 2

Column f: Compute pre-tax rate of return: If use last authorized capital structure and weighted costs; add embedded cost of debt to weighted cost of preferred stock and equity times NTGM

If use 12% discount rate, use 17% as pre-tax rate of return.



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Column g: Column e times column f

Column h: Use either last authorized rate of return or statewide discount factor of 12.00%

Year 1: $1/(1+\text{rate chosen})$

Year 2: $1/((1+\text{rate chosen})^2)$ [SEE ILLUSTRATION IN ORIGINAL] 2)

Year 3: $1/((1+\text{rate chosen})^3)$ [SEE ILLUSTRATION IN ORIGINAL] 3)

Etcetera: Note that caret stands for exponent in Lotus 2.0

Column i: Column g times column h

Column j: After tax rate, 1988 on: $1 - .34$ (assumes federal 5 tax gross-up [*152] not taxable for CCFT purposes)

Column k: Column i times column j: This column represents net cash received by the utility.

This is the amount that must be given back to the ratepayer to keep them whole. These amounts are amortized in the same manner as received.

Method 5: ADVANCES IN AID OF CONSTRUCTION:

Refunds payable over 40 years; refunds include tax gross-up.

Advance: 1000						
	(a)	(b)	(c)	(d)	(e)	(f)
Year	Tax Payment	MACRS	MACRS	Contributor	Amortization	Net
	(by utility)	Per Year	Accum Depr	After-Tax Additional Payment	Schedule of Additional Tax Payment	Unrecovered Contribution
	340			180		160
1		13	13		32	179
2		25	37		27	182
3		23	60		22	181
4		21	81		19	179
5		19	100		15	175
6		18	118		13	170
7		17	135		11	164
8		16	151		9	157
9		16	167		7	148
10		16	182		6	139
11		16	198		5	128
12		16	214		4	116
13		16	230		3	103
14		16	245		2	90

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Advance: 1000

	(a)	(b)	(c)	(d)	(e)	(f)
Year	Tax Payment	MACRS	MACRS	Contributor	Amortization	Net
	(by utility)	Per Year	Accum Depr	After-Tax Additional Payment	Schedule of Additional Tax Payment	Unrecovered Contribution
15		16	261		2	76
16		16	277		1	61
17		16	293		1	47
18		16	308		1	31
19		16	324		0	16
20		16	340		0	
		340			180	
21						
22						
23						
24						
25						
26						
27						
28						
29						
30						
31						
32						
33						
34						
35						
36						
37						
38						
39						
40						

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	(g)	(h)	(i)	(j)	(k)
Year	Weighted	Pre-tax	Discounted	Gross of	Net



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	Average	Rate of	Wtd. Ave.	Tax Amort.	Revenue
	Unrecovered	Return	Unrecovered	Addl Paymt	Requirements
	Contribution		Contribution	by Contrib	
1	170	0.1614	27	48	(21)
2	180	0.1614	29	41	(12)
3	181	0.1614	29	34	(5)
4	180	0.1614	29	28	1
5	177	0.1614	29	23	5
6	172	0.1614	28	19	8
7	167	0.1614	27	16	11
8	160	0.1614	26	13	13
9	153	0.1614	25	11	14
10	144	0.1614	23	9	14
11	133	0.1614	21	7	14
12	122	0.1614	20	6	14
13	109	0.1614	18	5	13
14	96	0.1614	16	4	12
15	83	0.1614	13	3	11
16	69	0.1614	11	2	9
17	54	0.1614	9	1	7
18	39	0.1614	6	1	5
19	24	0.1614	4	0	3
20	8	0.1614	1	0	1
			391	273	118
21					
22					
23					
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31					
32					
33					
34					
35					
36					
37					

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	(l)	(m)	(n)	(o)
	Tax Deduction	Tax	Amount of tax	Recovery of
	to Utility	Savings	Savings applied	Cash Outlay
	on payment		to gross-up	by Utility
	of adv. refund			
1	(32)	(11)	(7)	(4)
2	(32)	(11)	(7)	(4)
3	(32)	(11)	(7)	(4)
4	(32)	(11)	(7)	(4)
5	(32)	(11)	(7)	(4)
6	(32)	(11)	(7)	(4)
7	(32)	(11)	(7)	(4)
8	(32)	(11)	(7)	(4)
9	(32)	(11)	(7)	(4)
10	(32)	(11)	(7)	(4)
11	(32)	(11)	(7)	(4)
12	(32)	(11)	(7)	(4)
13	(32)	(11)	(7)	(4)
14	(32)	(11)	(7)	(4)
15	(32)	(11)	(7)	(4)
16	(32)	(11)	(7)	(4)
17	(32)	(11)	(7)	(4)
18	(32)	(11)	(7)	(4)
19	(32)	(11)	(7)	(4)
20	(32)	(11)	(7)	(4)
21	(32)	(11)	(7)	(4)
22	(32)	(11)	(7)	(4)
23	(32)	(11)	(7)	(4)
24	(32)	(11)	(7)	(4)
25	(32)	(11)	(7)	(4)
26	(32)	(11)	(7)	(4)
27	(32)	(11)	(7)	(4)
28	(32)	(11)	(7)	(4)
29	(32)	(11)	(7)	(4)
30	(32)	(11)	(7)	(4)



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	(l)	(m)	(n)	(o)
	Tax Deduction	Tax	Amount of tax	Recovery of
	to Utility	Savings	Savings applied	Cash Outlay
	on payment		to gross-up	by Utility
	of adv. refund			
31	(32)	(11)	(7)	(4)
32	(32)	(11)	(7)	(4)
33	(32)	(11)	(7)	(4)
34	(32)	(11)	(7)	(4)
35	(32)	(11)	(7)	(4)
36	(32)	(11)	(7)	(4)
37	(32)	(11)	(7)	(4)
38	(32)	(11)	(7)	(4)
39	(32)	(11)	(7)	(4)
40	(32)	(11)	(7)	(4)
	(1,273)	(433)	(273)	160)

[*154] 7

Explanation: Advance: Use same amount as used on page 1.

Column a: Advance amount a tax rate (no gross-up)

Column b: Determine MACRS class and declining balance percent, apply half-year convention to first year, cross-over to straight-line when appropriate

Column c: Accumulate total depreciation taken

Column d: Total after tax revenue requirement investment, page 1 col. k (actual cash received by utility).

Column e: Amortization schedule, page 1, col. k. Amortization of net cash received to make r/p whole.

Column f: Year 1 BB = Column a, line 0 less col. e, line 0. Subtract depreciation benefit for year (col c, line 1); add amortization of additional tax payment (col. e, line 1); total = EB.

Then use EB as BB for year 2.

Column g: Col. f: BB + EB divided by 2

Column h: Basis is last authorized ROR or statewide discount rate of 12.00%.

If use auth. ROR: use auth. capital structure & weighted costs; add embedded cost of debt to weighted cost of preferred stock and equity, both times NTGM.

If use 12.00%: Pre-tax ROR is 17.00%.

Column i: Column g times column h

Column j: Column i, page 1

Column k: Column i less column j (This is the amount that must be recovered by [*155] the utility from the ratepayers to finance the contribution).

Columns l, m, n, and o compute the refund to the developer, and the tax savings thereby generated:

Column l: Compute yearly refund: Advance + gross-up times 2.5% (assumes 40-year payback period).

Column m: Apply federal tax rate to yearly refund amount (col. l). This is flowed back to developer on a current basis.

Column n: Portion of tax savings used to fund gross-up refund.

Column o: Utility is made whole for the up-front payment of \$160.

Accounting for Method 5

Journal Entries for Advances in Aid of Construction (AIC) (refunds payable over 40 years)

Year 1

1. Cash	1,272	
Deferred Taxes - AIC	340	
Deferred Charges: Tax Gross-up, AIC	272	
Advance in Aid of Construction		1,000
AIC Tax Gross-up		272
Deferred Revenue		180
Taxes Payable		432

To record receipt of Advance and to set up tax accounts related to AIC and the associated tax gross-up.

2. Taxes Payable	13	
Deferred Taxes - AIC		13

To record tax benefits of MACRS depreciation.

3. Deferred Revenue	32	
Miscellaneous Revenue		32

To amortize deferred revenue to misc. revenue over the tax life of the AIC plant.

This offsets the revenue requirements impact.

4. Plant	1,000	
Cash		1,000

To record the plant financed by AIC; this is offset by the AIC account.



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5. Advances in Aid of Construction	25	
AIC Tax Gross-up	7	
Cash		32

To record the annual refund payment.

6. Taxes Payable	7	
Deferred Charges: Tax Gross-up, AIC		7
To record the tax benefits of the refund payment.		

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APPENDIX F

contributor's federal income tax gross up at various discount rates

FOR A \$ 1,000 CONTRIBUTION-IN-AID-OF-CONSTRUCTION

Year	Discount			Discount		
	Rev. Req.	Factor At	Discounted	Factor At	Discounted	Factor At
	On Tax	11.44%	Rev. Req.	11.50%	Rev. Req.	12.00%
1	\$ 54	0.8973	\$ 48	0.8969	\$ 48	0.8929
2	51	0.8052	41	0.8044	41	0.7972
3	47	0.7226	34	0.7214	34	0.7118
4	43	0.6484	28	0.6470	28	0.6355
5	40	0.5818	23	0.5803	23	0.5674
6	37	0.5221	19	0.5204	19	0.5066
7	34	0.4685	16	0.4667	16	0.4523
8	32	0.4204	13	0.4186	13	0.4039
9	29	0.3773	11	0.3754	11	0.3606
10	27	0.3385	9	0.3367	9	0.3220
11	24	0.3038	7	0.3020	7	0.2875
12	21	0.2726	6	0.2708	6	0.2567
13	19	0.2446	5	0.2429	5	0.2292
14	16	0.2195	4	0.2178	3	0.2046
15	14	0.1970	3	0.1954	3	0.1827
16	11	0.1767	2	0.1752	2	0.1631
17	9	0.1586	1	0.1572	1	0.1456
18	6	0.1423	0	0.1409	1	0.1300
19	4	0.1277	0	0.1264	1	0.1161
20	1	0.1146	0	0.1134	0	0.1037
Tot.	\$ 519	Gross Up =>	\$ 272	-	\$ 271	-

Year	Discount		Discount		Discounted
	Discounted	Factor At	Discounted	Factor At	
	Rev. Req.	12.50%	Rev. Req.	13.00%	Rev. Req.
1	\$ 48	0.8889	\$ 48	0.8850	\$ 48
2	41	0.7901	40	0.7831	40
3	33	0.7023	33	0.6931	33
4	27	0.6243	27	0.6133	26
5	23	0.5549	22	0.5428	22
6	19	0.4933	18	0.4803	18
7	15	0.4385	15	0.4251	14
8	13	0.3897	12	0.3762	12
9	10	0.3464	10	0.3329	10
10	9	0.3079	8	0.2946	8
11	7	0.2737	7	0.2607	6
12	5	0.2433	5	0.2307	5
13	4	0.2163	4	0.2042	4
14	3	0.1922	3	0.1807	3
15	3	0.1709	2	0.1599	2
16	2	0.1519	2	0.1415	2
17	1	0.1350	1	0.1252	1
18	1	0.1200	1	0.1108	1
19	0	0.1067	0	0.0981	0
20	0	0.0948	0	0.0868	0
Tot.	\$ 265	-	\$ 260	-	\$ 254

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APPENDIX G

(Example of Tariff)

Income Tax Component of Contributions and Advances Provision

1. Contributions in Aid of Construction and Advances for Construction shall include, but are not limited to, cash, services, facilities, labor, property, and income taxes thereon provided by a person or agency to (utility). The value of all contributions and advances shall be based on (utility's) estimates. Contributions and advances shall consist of two components for the purpose of recording transactions as follows:

(a) Income Tax Component (ITC), and

(b) The balance of the contribution or advance.

2. The ITC shall be calculated by multiplying the balance of the contribution or advance by the tax factor of %. (Here the utility should determine the tax factor using its adopted method.)

3. The tax factor is established by using Method as set forth in D. in I.86-11-019.



4. The formula to compute Method includes the following factors:

(a) Corporate tax rate of %.

(b) A discount rate of %. (Here insert either 12% or the utility's authorized rate of return.)¹

(c) A pre-tax rate of [*158] return of %. (Here insert either 17% (if the 12% discount rate was used) or the pre-tax rate of return based on the utility's authorized rate of return.)¹

5. Pursuant to D. , this tariff is effective as of February 11, 1987.

OHANIAN; WILK

End of Document

¹ Paragraphs 4(b) and 4(c) should be omitted if Method 2 is adopted.

