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ORIGINAL

Decision 88-01-061 January 28, 1988

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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.	I.86-11-019 (Filed November 14, 1986)

(See Decision 87-09-026 for appearances.)

Additional Appearances

Kenneth K. Okel and Kathleen S. Blunt, Attorneys at Law, for General Telephone Company of California, and Scott D. Rasmussen, Attorney at Law, for Southern California Edison Company, respondents.

Mary Lynn Gauthier, for Ranger Telecommunications and for Gauthier & Hallett; Rogers, Joseph, O'Donnell & Quinn, by Allan Joseph, Attorney at Law, for Arthur Andersen & Co.; and William K. Mahn, Attorney at Law, for the Department of Defense, and all other Federal Executive Agencies; interested parties.

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OPINION
(Phase 2)

Summary

This order requires all respondent utilities, not specifically excluded, to file calculations on the effects of Tax Reduction Act of 1986 (TRA 86) and Senate Bill 572 (S.B. 572) on 1987 revenue requirements and 1988 revenue requirements in conformance with the methodologies adopted in this decision. Similarly respondent utilities are required to calculate federal income tax expense for ratemaking purposes for 1988 using the methodology adopted in this decision and file advice letters adjusting their tariffs to reflect the revenue requirement effects of the tax changes. California Corporation Franchise Tax expense issues will be considered later.

The impact of the revenue requirement adjustment, including interest, shall be recorded in the GAC/CAM balancing account for gas utilities and in the ERAM and other appropriate balancing accounts for electric utilities. The larger telephone companies will adjust revenues using a surcharge/surcredit procedure described in this decision and there is a special surcharge account for water utilities also. The Smaller Independent telephone companies (Smaller Independents) are exempted from the filing requirements of this order since the bulk of the tax act effects are automatically adjusted through the settlement process and the effect of the tax act on the remaining local operations is small. Similarly other smaller utilities, namely water utilities, are excluded from the filing requirements of this order if their last adopted test year taxable income is $25,000 or less since the tax rates under the new law remains the same and the other effects are minimal to such small utilities. Those utilities exempted from the filing requirements of this decision shall

address the effects of tax law changes in their next general rate case or offset rate proceeding.

I. Background

On November 14, 1986 the Commission issued its Order Instituting Investigation (OII) 86-11-019 into the ratemaking implications of the Tax Reform Act of 1986 (TRA 86). The OII required the respondent utility companies, Division of Ratepayer Advocates (DRA), (formerly Public Staff Division) and other interested parties to present testimony and exhibits which will demonstrate the impact of the provisions of TRA 86 on utility revenue requirements and to present recommendations and/or alternatives regarding the appropriate ratemaking treatment relating to these issues. The OII made respondents' rates subject to refund as of January 1, 1987 in order to account for changes that might result from this investigation.

At the prehearing conference held on January 9, 1987, Admininistrative Law Judge (ALJ) Robert Barnett set a schedule for workshops and hearings to be held to consider the issues raised in the OII. The tax law change resulting in the taxation of contributions-in-aid-of-construction was separated from other TRA 86 issues and was addressed in Phase 1 of these proceedings and resulted in D.87-09-026. All other TRA 86 issues were addressed in Phase 2 workshops and hearings.

Proposed testimony on Phase 2 issues were filed by DRA, Pacific Bell, Southern California Edison Company (SCE), Southern California Gas Company (SCG), Pacific Gas and Electric Company (PG&E), Roseville Telephone Company, Smaller Independents, Continental Telephone Company of California (ConTel), CP National Corporation (CP), Pacific Power & Light Company (Pacific Power), AT&T Communications (AT&T), Citizens Utilities Company of California and subsidiary water companies (Citizens), General

Telephone Company of California (GenTel), Department of Defense and all other Federal Executive Agencies (FEA), San Diego Gas & Electric Company (SDG&E), and Arthur Andersen & Company.

Hearings on Phase 2 issues were held on June 8 and 10, 1987. The last of the concurrent briefs were received on July 27, 1987. On July 15, 1987 the matter was reassigned to ALJ Kenji Tomita. The matter is now ready for decision.

II. Stipulated Issues

The parties were generally in agreement that the workshops moderated by the Commission Advisory and Compliance Division (CACD), formerly Evaluation and Compliance Division were probably the main reason that only two days of hearings were required. It was also through the workshop process that the parties agreed to stipulations on seven issues. The stipulations are set forth in Exhibit 25, the testimony of Pacific Bell's witness J. R. Best and is reproduced as Appendix A of this order. The stipulation document does not contain a signature page but the parties all recommended that the stipulations on the seven issues be adopted either in their respective exhibits or briefs.

The parties agreed to stipulate to the following seven issues:

1. Reduction in the corporate tax rate, excluding the effect of the corporate tax rate reduction on the deduction of California Corporate Franchise Taxes (CCFT) for Federal income tax purposes. The Federal Income Tax (FIT) rate for 1987 will be 39.95% and for 1988 and subsequent years will be 34%.

2. Flowback of excess deferred taxes resulting from the corporate tax rate reduction. The normalization method of accounting must continue to be used for ratemaking purposes to obtain the tax benefits which result from the use of of Modified Accelerated Cost Recovery System (MACRS). For ratemaking purposes

the average rate assumption method must be used to flow back the excess deferred taxes resulting from the reduction in the corporate tax rate provided individual vintage account property records are available.

3. Repeal of the investment tax credit (ITC). ITC is repealed for 1986 and subsequent years plant additions except for certain transition property. Normalization of prior deferred ITC must be continued even though the credit has been repealed. An issue remains concerning the ITC on plant additions used in setting 1986 rates and is not covered under the stipulation.

4. Modification of the Accelerated Cost Recovery System. MACRS replaces the Accelerated Cost Recovery System (ACRS) for 1987 and subsequent years plant additions. While MACRS retains many of ACRS's original concepts it also adds new classes of property, shifts some property between classes, and replaces the 150% declining balance method for some classes of property with the 200% declining balance method. This tax benefit will have to be normalized.

5. Capitalization of construction period overhead expenses. Overheads which are incurred during the construction process and could be deducted currently for tax purposes prior to TRA 86 must now be capitalized as components of construction cost. These overheads are as follows:

a. Pension and benefit costs.

b. Payroll taxes.

c. Sales and use taxes.

d. Ad valorem taxes.

e. Rental costs for equipment/facilities used in the performance of the long-term contract.

f. Indirect materials and supplies.

g. Depreciation on equipment/facilities used in the performance of the contract.

h. Administrative and general salary expense.

6. Superfund tax. A superfund or "environmental" tax of .12% of a corporation's alternate minimum taxable income (AMTI) in excess of $2 million is required in addition to Federal income tax even if the corporation does not have an AMTI liability. The tax is effective for 1987 and subsequent years.

7. Business meals and entertainment expenses. The business meals and entertainment expenses deduction has been limited to 80% of total qualifying expenditures for 1987 and subsequent years.

The parties agree that the Commission should adopt the stipulations as a basis for determining the revised revenue requirements of the utilities.

Discussion

The workshop process enabled the parties to agree to stipulations on seven issues. There was no objection at the hearings to the stipulations and the parties request that the stipulations be accepted by the Commission and order ratemaking treatment consistent with the stipulations. We concur that the stipulations are reasonable and should be adopted as a basis for determining the revised revenue requirements of the utilities.

III. General Agreement - Other Items

Failure to enter into a stipulation does not necessarily indicate disagreement between the utilities and DRA. Exhibit 27 sponsored by DRA states that general agreement was also reached with respect to the following:

1. The research and experimentation credit is reduced from 25% to 20% in 1986 through 1988.

2. Capitalization of interest under TEFRA--IRC Section 189 was created in 1982 (effective for the 1983 tax year) by TEFRA for

the purpose of changing the way interest during construction was capitalized and/or deducted on non-residential real property for tax purposes and also required the capitalizing of property taxes. Construction period interest and property tax expense were required to be amortized over 10 years.

The Commission deferred adopting a policy on the TEFRA interest and property tax requirements in general rate cases from 1983 through 1986 because of certain unanswered questions. These questions are: what interest rate was required to be used; what was the definition of non-residential real property; and which IRC section, 189 or 266, was more beneficial to ratepayers in the ratemaking setting? Rates were set for this period based upon the tax law prior to TEFRA subject to recovery when the questions were answered. TRA 86 repealed IRC Section 189 for 1987 and subsequent years which isolates the period from 1983 to 1986 during which IRC Section 189 was in effect. The workshop participants agreed that this issue should continue to be deferred until Treasury Regulations relating to these questions are issued.

3. Interest during construction. The workshop process also revealed that there was general agreement on capitalization of interest on qualifying property during construction. In 1986 and prior years, utilities were allowed a current deduction for interest expense (excluding TEFRA provisions). Under TRA 86 utilities will be required to capitalize interest during construction for Federal income tax purposes.

Exhibit 28, sponsored by DRA indicates that the Commission has calculated the AFUDC rate on an after-tax basis which recognized the current income tax deductibility of the interest component of the AFUDC rate. TRA 86 requires that interest during construction be capitalized for Federal Income Tax purposes and that debt interest be capitalized on 100% of the construction costs. This has the effect of decreasing the amount of annual interest expense that can be used to calculate the test year and attrition year income tax expense. Exhibit 28 states that there are three options that could be used to account for this increased tax expense:

> <u>Option 1</u> - Flow-through the increased tax expense directly to the revenue requirement. The AFUDC rate is not affected.
>
> <u>Option 2</u> - Add the increased income tax expense to the AFUDC rate. The AFUDC rate is increased.
>
> <u>Option 3</u> - Use income tax normalization to account for the increased income tax expense. The AFUDC rate is not affected, except that a gross rate for borrowed funds is used in calculating the AFUDC rate. There would be a revenue requirement effect in that the rate base would be higher under the tax normalization option.

DRA's analysis is that Option 1, flow-through, is unacceptable since it represents a complete reversal of the original concept which underlay the Commission's decision to adopt an after-tax AFUDC rate; that is, current rates should not be impacted by the level of construction.

The choice then lies between Option 2 and 3. While Option 2 does not result in any current revenue requirement increase, it would affect ad valorem taxes since the Board of Equalization ignores the reserve for deferred income taxes and taxes capitalized AFUDC for determining the tax basis of public utility property. Option 3, tax normalization provides the opportunity to avoid some incremental ad valorem taxes. In addition, the level of AFUDC accruals under Option 2 may prove to be a problem if the cost of capital rises substantially in the future.

DRA recommends the use of the gross rate for borrowed funds in calculating the AFUDC rate and Option 3, Income Tax Normalization, to account for the increase in test year and attrition year federal income tax expense. DRA further points out that Exhibit 28 is directed only at ratemaking issues that arise from changes in the federal income tax law. California state income tax provisions, as they affect the AFUDC rate and test year and attrition year ratemaking, have not been altered and will remain the same.[1] Therefore, a difference in ratemaking treatment will exist with respect to Federal and California state tax treatments.

<u>Discussion</u>

Since there was general agreement on the above, we will adopt the DRA's recommendations except for water utilities with respect to research and experimentation credit, capitalization of interest under TEFRA, and AFUDC methodology.

In the case of water utilities which have minimal amounts of construction work in progress and charge AFUDC in only rare instances, any increase in tax expense resulting from the use of different interest rates for ratemaking vs. income tax purposes is de minimis. We will authorize water utilities to use the same interest rate for capitalizing interest for ratemaking purposes as for income tax purposes thereby negating any need for the use of Option 3. We will, of course, apply the procedures adopted for gas, electric and telephone utilities to water utilities in those special instances were AFUDC has been approved for a water utility.

IV. Other Issues

A. Deduction of California Corporate Franchise Tax (CCFT)

Deduction of CCFT for federal income tax purposes was the most controversial issue in Phase 2. The utilities state that the reduction in the federal tax rate decreases the value of the CCFT

1 On September 25, 1987, S.B. 572, The California Bank and Corporation Tax Fairness, Simplification and Conformity Act of 1987 was signed into law by the Governor.

deduction causing an increase in revenue requirements. The utilities contend that TRA 86 reduces the federal tax rate and causes the increase in revenue requirements which should be considered in this OII. In addition there is a further working cash issue which is being considered in the workshops in the PG&E general rate case. The utilities generally agree that this latter issue should not be covered in this OII, although PG&E subsequently changed its position because of later developments which will be discussed in subsequent paragraphs.

In opposition, DRA contends that under current Commission test year ratemaking policy, the 1987 test or attrition year ratemaking taxable income does not change because of the change in the Federal income tax rate. Only the Federal income tax expense changes. In a recalculation of 1987 Federal income tax expense, the amount to be collected in rates will be lower due to the drop in the Federal income tax rate from 46% to 39.95%. The policy of using the CCFT estimated on 1987 ratemaking California taxable income as a current deduction for Federal income tax purposes remains the same.

DRA recommends that utilities be authorized to compute their 1987 Federal income tax allowances collected in rates to reflect the change in the Federal income tax rate from 46% to 39.95%. No adjustment to reflect the situation where actual CCFT is deductible for Federal income tax purposes one year after it has been paid should be made. DRA states that this recommendation is consistent with the current Commission policy of using the test or attrition year CCFT expense as a test or attrition year deduction to determine Federal income tax.

DRA further states that there is no similar impact for 1988 test or attrition years because 1988 rates have not yet been set. TRA 86 reduces the 1988 and subsequent years corporate tax rate to 34%. The CCFT deduction for Federal income tax purposes in 1988 and subsequent years will impact the Federal income tax allowance collected in rates at the 34% rate. No adjustment to 1988 Federal income tax similar to the recommendation for 1987 Federal income tax is necessary.

On a ratemaking basis the DRA uses the test or attrition year CCFT adopted as the Federal income tax deduction even though it will not be deductible in the real world until the following year. The impact of this timing difference on working cash is a current issue in the workshops on working cash in PG&E's 1987 test year general rate case. DRA believes that the timing of CCFT as a deduction for Federal income tax purposes and its working cash impact is a separate and distinct issue from the adjustment to 1987 and 1988 rates to reflect lower Federal income tax statutory tax rates. DRA concludes that any proposal to change the current Commission policy regarding when CCFT should be used as an Federal income tax deduction for ratemaking purposes is not an issue for consideration in this OII and should be excluded from this proceeding.

The Federal Executive Agencies (FEA) states in its brief that under TRA 86, the reduction in the corporate tax rate, affects only the amount of the tax deduction for CCFT and not the treatment of this item itself for tax or regulatory purposes. FEA's purpose in addressing the CCFT deduction in this proceeding is merely to ensure that any change in the amount of this deduction occasioned by the reduction in the corporate tax rate under the provision, of TRA 86 is considered along with the effects of the change in the tax rate itself.

PG&E during the hearings agreed that the problem associated with the CCFT deduction deferral, creating carrying costs for which utilities should be compensated should not be addressed in this OII. Since the hearings PG&E changed its position and states in its brief that it now believes it is entitled in this OII to both its carrying costs associated with the deferral in the CCFT deduction as well as an adjustment to reflect the tax rate deduction. The reason for this change was an IRS letter ruling, dated July 8, 1987, which authorized PG&E to change from the accrual to cash method of accounting for CCFT on its Federal tax return retroactive to 1985. The effect of this accounting change was to correct the problem of the lagged CCFT deduction under pre-TRA 86 law. PG&E requests that the Commission take official notice of this IRS ruling.

PG&E argues that it would have been entitled to continue to deduct CCFT on a current basis in 1987 as well, but for TRA 86. Specifically, Section 801 of TRA 86 added IRC Section 448 which required taxpayers, such as PG&E, who were using a hybrid cash method of accounting, to switch to the pure accrual method. The effect of this change in TRA 86 is to require PG&E to deduct 1987 CCFT in 1988, not in 1987. PG&E argues that the resulting increase in costs is directly attributable to TRA 86 and should be treated identically to the lag in vacation pay deduction. The increased tax costs can be treated as a debit deferred tax includable in rate base or by reflecting the lag in deduction as a working cash item.

Discussion

There are two ratemaking issues associated with this CCFT reduction. First, there is the problem associated with the ratemaking assumption that the test year estimate of CCFT is deductible on the utility's test year computation of Federal income taxes although they are not actually deductible until the following year. Second, in the context of a tax rate change, there is the problem of attributing the proper tax rate to the deduction of a particular year's CCFT expense.

Prior to the filing of PG&E's brief there was general agreement that the first issue relating to the cost associated with a one-year delay in the the CCFT was appropriately addressed outside the OII, although Pacific Bell argued that this issue should be considered in the OII since all parties to the OII were not necessarily parties in the PG&E proceedings. Now PG&E argues that even this issue comes under the OII because the IRS ruling received after the conclusion of hearings authorized the cash method of recognizing CCFT as a deduction in computing Federal income taxes but which TRA 86 denies by requiring the pure accrual system rather than the hybrid cash method authorized by the IRS ruling for PG&E for 1985 and 1986.

DRA while admitting that a reduction in the Federal income tax rate may result in the utilities not recovering the full tax benefit of the CCFT assumed in the test year, did not recommend that this issue be considered in this proceeding since it would result in a change in Commission policy, which is to estimate CCFT based on the test year and use that as a deduction in computing Federal income tax for the test year. DRA further believes that this is not the appropriate forum to consider such change in policy. DRA's witness further testified that absent a change in Commission policy he would be consistent in his recommendation regardless of whether the Federal income tax rate was going up or down.

In the opening paragraph of the OII we said: "The regulatory implications of certain provisions of the Tax Act require that this Commission fully analyze its current policies and procedures regarding the determination of reasonable allowances for income tax expenses." This language clearly indicates that it would be appropriate for the Commission to consider the impact of the reduction in the Federal income tax rate on the CCFT deduction for the 1987 test or attrition year, even if a change in policy is required. In particular, our policy has been that ratepayers pay, as closely as possible, dollar for dollar for reasonably incurred taxes. We are as concerned about implementing this policy as we are about adjusting for the changes in TRA 86. Even DRA indicates that there may be some inherent undercollection by the utilities given the existing procedure. If so, we would wish to correct this imbalance.

Because this is an important policy issue and there is still some confusion as to exactly how many dollars are involved, and because this issue has an impact on the working cash allowance, it is reasonable that further hearing be held on this issue. These hearings will be scheduled by ruling of the ALJ. In these hearings those participants in I. 86-11-019 who filed exhibits and testimony on the CCFT issue should take another look at the loss in value of the CCFT deduction and define a procedure that will allow for timely recovery of these tax dollars, as they are incurred. The hearings will exclude the 1986 deduction. Making up any loss in the 1986 CCFT deduction would involve retroactive ratemaking.

With respect to the working cash issue associated with the ratemaking treatment of the CCFT deduction and the timing of that deduction for income tax purposes, we believe that issue should be resolved in the PG&E 1987 test-year rate case matter, if for no other reason than the parties generally agreed that it should be resolved outside of this OII and therefore the record in this OII is inadequate on that issue.

B. Alternative Minimum Tax (AMT)

Prior to TRA 86, utilities were subject to an add-on tax whenever an amount equal to 15 percent of certain "preference" items exceeded the regular tax liability. Generally this provision did not affect utilities' tax liabilities. TRA 86 added a new alternative minimum tax (AMT) which increased the number of preferences as well as the minimum tax rate, making it more likely to be imposed. Based on testimony in the record, it appears that utilities would be subject to significant AMT only under adverse circumstances such as large balancing account under-collections. In addition, utilities generally would not be able to forecast such events in future test years.

TRA 86 will require that the tax base for the AMT be the corporation's regular taxable income. Tax preferences would be added and after certain adjustments, the resulting AMT income would be reduced by an exemption amount ($40,000). This taxable income amount would be subject to a 20% tax rate, resulting in the tentative minimum tax. The exemption amount would be reduced by 25% (but not less than zero) of the AMT income that exceed $150,000. Therefore, for corporations with an AMT taxable income of $310,000 or more, the exemption would be zero. A corporation's tax liability would be the greater of its regular income tax liability or the tentative minimum tax.

The question which could not be resolved by any of the participants in the workshop process was whether or not an adopted results of operations in a rate case setting would trigger the AMT.

DRA recommends that this issue be decided on a case by case basis with a definitive showing by the utility involved that an AMT will be required. This showing would be based upon the estimated results of operations for the test or attrition year. For those cases where rates have already been set for 1987 attrition years, and to the extent that a determination as to whether an AMT will be required can not be made for 1988 test years currently in progress, the utilities affected should be provided the opportunity to come before this Commission when and if an AMT appears to be required to request recovery of any gross revenue requirement short fall which the AMT may have created.

Pacific Bell recommends that rather than deferring this issue, the utilities be permitted to ratebase the AMT as a negative deferred tax until the AMT is recovered or utilized by means of the AMT credit. Without affecting the Commission's right to deny any recovery of a particular AMT incurred in the future, Pacific Bell recommends that the Commission should adopt as a general proposition that AMT should be rate based. In addition, Pacific Bell states that the IRS is considering normalization requirements for the new AMT. Therefore it is not possible to know if there will be normalization problems with a rate basing or deferred tax recovery mechanism. Because of this uncertainty, Pacific Bell recommends that the Commission order on this issue should provide for a modification of a rate basing or deferral treatment if IRS regulations require current expensing and recovery of AMT.

SDG&E has proposed that should the utility unexpectedly become subject to AMT the use of a memorandum account mechanism would enable it to make a presentation for recovery before the Commission. Such mechanism would avoid any problems with retroactive ratemaking. FEA's witness Larkin opposes the use of such mechanism to enable the utility to reconcile this item if the utility's test year or attrition year projections of this item are incorrect. The witness testified that utilities should be able to project the alternative minimum tax liability with the same degree of certainty with which they project any other test year ratemaking item.

PG&E in its brief supports including excess AMT liabilities (to the extent they exceed regular taxes otherwise payable) in rate base through a debiting of deferred taxes thus enabling the utilities to recover any carrying costs associated with the AMT obligations. PG&E admits that the ratemaking treatment of AMT is a complex subject and that in certain cases where the AMT is incurred as a result of non-utility operations, it may not be appropriate to include the AMT in rate base. Further under PG&E's proposal, excess AMT liabilities could be included in rate base for prior years even though the AMT incurrred for those years is less than the regular tax estimated for ratemaking purposes. Nevertheless PG&E believes that inclusion of excess AMT liabilities in rate base generally is the proper rate treatment.

If the Commission is unwilling to adopt the debit deferred tax approach, PG&E recommends that the matter should be left open so that utilities are not precluded from recovering the costs of the AMT should it be unexpectedly incurred.

Discussion

While it generally is not expected that AMT liability will affect utilities, there may be occasions when it may become applicable. The testimony of the various parties indicates that this is a complex issue which may be subject to further IRS interpretations and rulings before it becomes clear as to what ratemaking treatment would be permissible. Rather than committing the Commission to any specific recovery at this time, we believe that DRA's recommendation to decide this issue on a case by case basis is reasonable. A definitive showing by the utility involved that an AMT will be required or that the AMT created a revenue requirement shortfall which it seeks to recover will have to be made. In authorizing the use of the memorandum account mechanism, we place the utilities on notice that recovery of revenue requirement deficiencies is not automatic but dependent upon a complete showing justifying why recovery should be granted. The use of the memorandum account mechanism avoids any retroactive ratemaking problems and at the same time does not prejudge whether recovery will or will not be granted.

C. Unbilled Revenues

Under prior law, the meter reading billing cycle method of accounting was a proper method of accounting for revenues for Federal income tax purposes provided it was also used for accounting and financial reporting purposes. Under the meter reading billing cycle method of accounting, revenues are recognized when the bills are sent out to the customers and not when the customers actually received the service. TRA 86, however requires that public utilities report as taxable income revenues related to services rendered after the last billing date to the end of the year (on an estimated basis if it cannot be actually determined).

DRA recommends that to the extent that the unbilled revenue method was used for tax and ratemaking, the affected utilities are entitled to recovery over four years the difference which will occur in 1987 due to the mandated conversion from the unbilled revenue method to the revenue earned for service provided method for FIT purposes. DRA further recommends that this issue should be resolved on a case by case method. Each utility should be directed to provide a complete showing on this issue in its response to the Commission decision supporting any unbilled revenue adjustment.

Discussion

This issue was not controversial since utilities generally have been establishing general rate case revenue requirements on an as-delivered basis. This results in reflecting unbilled revenues in base rates, including the taxes estimated thereon. In the case of PG&E and SDG&E it was necessary to conform financial accounting to the revised income tax accounting and to the ratemaking procedures already in place. None of the other utilities made any comments or objected to the DRA proposal. To the extent that any utilities are affected by the change in TRA 86 unbilled revenue reporting requirement, they should be required to make a complete showing on this issue in their compliance advice letter filing we will be ordering in this decision.

D. Vacation Pay

TRA 86 modified the provisions of IRC Section 463 which provided for the current deduction of accruals for vacation pay earned during the tax year but not taken by employees before the end of the tax year. Such deductions under TRA 86 are limited to vacation pay which has been earned but not taken by year end and which must be taken within 8-1/2 months of the following year rather than within twelve months of the following year as was previously allowed. Therefore, under TRA 86 there is 3-1/2 month decrease in the amount of accrual which can be deducted under the old tax law.

DRA recommends that to the extent the method used on the utility's tax return differs from the method used for ratemaking purposes, the difference should be reflected as an adjustment in the Federal income tax deduction and credit table used to calculate test or attrition year FIT expense. DRA further recommends that this issue should be resolved on a case by case basis with any affected utility being required to make a complete showing in its response to the Commission decision supporting any vacation pay accrual adjustment.

PG&E argues that the flow through method DRA advocates would reflect in rates the increased tax costs from this law change as they occur. PG&E supports the deferred tax accounting method whereby the utilities will be able to recover the carrying costs of the increased tax expense. Furthermore under the deferred tax accounting method current ratepayers will be getting the tax benefits of the full vacation pay accrual included in the cost of service whereas under flow-through the tax benefits associated with the deferred portion of the vacation pay would benefit future ratepayers. Other advantages of deferred tax accounting were stated to be minimization of the effect of estimation errors for vacation pay in ratemaking, and a lower revenue requirement for 1987 which however will result in somewhat higher revenue requirements in future years. Mr. Larkin, the FEA witness also supported the deferred tax accounting concept.

PG&E further argues that there is no policy which precludes the Commission from using deferred tax accounting. In circumstances where deferred tax accounting would result in a debit (i.e. where flow-through would result in an increased income tax expense), the Commission should authorize the utilities an option to use this methodology. Should the Commission not authorize deferred tax accounting, PG&E states that certain adjustments must be made to ensure that vacation pay already taken into account as a deduction for ratemaking purposes should not be considered a second time as an eligible tax deduction for ratemaking purposes.

Discussion

The only utility offering deferred tax accounting for vacation pay differences between ratemaking vacation pay allowances and that deductible for tax purposes was PG&E. However, PG&E didn't argue that we mandate deferred tax accounting, but that we afford the utilities the option to use this methodology. As proposed by DRA, the ratepayers would pay not only the amount in question for the tax ($20 million), but the additional gross-up to cover the tax on these revenues. We will allow PG&E's proposed treatment in order to minimize financial impact in 1988.

This treatment represents a loosening of our normal treatment, which allows deferred tax accounting only where mandated by the IRS. Consequently, there may be detrimental impacts that we have not foreseen. If any problems do arise, we expect DRA or CACD to make these problems known, so that they may be considered in a subsequent proceeding. If we find that the detrimental aspects outweigh the benefits, we may require expensing of this account in the future.

E. Bad Debt Reserve

Under TRA 86, the reserve method of computing bad debt expense as a deduction for Federal income tax purposes was eliminated and the direct write-off method required. If a utility has used a bad debt reserve method in the past, the bad debt reserve must be taken into income over four years. To the extent that a utility's test year bad debt expense was based on the reserve method, the utility has passed through in rates the benefit of the higher deduction to ratepayers in the Federal income tax calculation.

DRA recommends that in a situation where the utility used the reserve method for tax and ratemaking, the utility should be able to collect in rates the additional Federal income tax expense which this change will generate in 1987 through 1990. If a direct write-off method was used, no additional FIT expense is appropriate because the ratepayer never received the benefit of a reserve method deduction. DRA recommends that the this issue be resolved on a case to case basis, with each utility affected by this issue to provide a complete showing supporting any bad debt reserve adjustment in its response to the Commission's decision in this OII.

<u>Discussion</u>

There was general agreement with the position set forth by DRA on this issue depending on whether a reserve method or a direct write-off method was used in determining bad debt expense for ratemaking and tax purposes. We will require each utility affected by this issue to provide a complete showing in its compliance advice letter filing and any subsequent rate case supporting any bad debt reserve adjustment. There will of course be no double dipping. If the deduction has been taken for ratemaking purposes previously, it cannot be used again.

F. <u>ITC - 1986 Plant Additions</u>

Repeal of ITC and ratemaking impacts are a stipulated issue. A further aspect of this issue is that rates which were set for the 1986 test year or attrition year included an ITC component as a reduction to ratebase under IRC Section 46(f)(1), or as a credit against Federal income tax under IRC Section 46(f)(2) based upon 1986 plant addition estimates. TRA 86 repealed ITC for 1986 and subsequent years plant additions except for certain transition property. A question was raised whether or not utilities in the above situation should be eligible to recover the gross revenue requirement shortfall which occurred when ITC for 1986 plant additions was used in determining the reasonable amount of Federal income tax expense to allow in rates for 1986.

DRA recommends that no recovery be granted for any gross revenue requirement shortfall that may have occurred in 1986 due to this issue. DRA believes that it would constitute retroactive ratemaking if utilities are granted recovery of revenue requirement shortfalls due to the use of ITC for 1986 plant additions in determining the reasonable amount of Federal income tax to collect in rates for 1986 based on the existing tax laws (before TRA 86 became law).

SoCal Gas argues that it should be permitted to offset against any refund ordered in this OII an amount sufficient to recover the increased tax expense actually incurred in 1986 due to the retroactive repeal of ITC to January 1, 1986. A further rationale for authorizing a rate adjustment to reflect repeal of the ITC retroactive to 1986 is the new normalization requirements contained in TRA 86 Section 211(b). Section 211(b) provides that all credits for open taxable years as of the time a final inconsistent determination is rendered must be recaptured if the amount of ITC flowed through in utility rates is in excess of that permitted under the normalization requirements. SoCal Gas believes that in light of the potential penalty for noncompliance, prudent regulatory treatment of this exposure at this time is to provide the utilities recovery in this OII in the full amount of the potential undercollection for 1986. CUCC and Roseville Telephone expressed a similar concern.

<u>Discussion</u>

We generally concur with DRA that our actions with respect to ITC in 1986 do not violate the normalization requirements since those rates were established on the basis of the most current knowledge of tax laws at that time. However, should it be determined that our action or lack of action with respect to 1986 ITC result in the invocation of the penalty clause, we will consider a filing from the affected utility or utilities to explore remedial measures. To avoid any questions of retroactive ratemaking we will allow utilities to book any increase tax liabilities in a memorandum account pending further Commission action.

G. Capitalization of Inventory Overheads

For 1987 and subsequent years TRA 86 requires that inventory overheads must be capitalized rather than expensed for income tax purposes. The capitalization requirements are extremely complex, and have the greatest impact on the gas utilities. In effect, the ending inventory as of December 31, 1986 must be restated to reflect what the ending balance would have been if overheads had been capitalized for all prior inventory years. This change has a material impact on FIT expense because the overhead deduction will no longer be available. Inventory costs will be higher due to the addition of the overheads. The amount of change will vary among the various gas utilities depending upon inventory valuation method used.

DRA states that at this time, because of the complexity of the overhead capitalization requirements, the impact on 1987 will have to be an estimate that will have to be trued up as the specific requirements are understood and applied. The change in inventory valuation will have a material effect only in 1987 since subsequent years' inventories will have complied with TRA 86 provisions. DRA recommends that the utilities take an aggressive position with the IRS and capitalize only those overheads which are without doubt required under TRA 86. If there are doubts that TRA 86 requires capitalization of certain overhead items, they should be continued to be deducted currently. DRA further recommends that if, in the future, an IRS audit determines that sufficient overheads were not capitalized, then the utility should be provided the opportunity to come before the Commission to request recovery of any shortfall in gross revenue requirement plus interest and penalties which has occurred due to the under-capitalization of overheads.

DRA further recommends that since 1987 tax liabilities associated with this change appears difficult to determine because of the need to restate the December 31, 1986 inventory balance, an amended compliance filing in January or February of 1988 be made to true up the inventory capitalization impact. Once the 1987 inventory capitalization issue is resolved the 1988 and subsequent estimates should be as close as they could be.

Both PG&E and SoCal Gas support the DRA position. SoCal Gas further states that should the IRS determine additional costs must be capitalized, such additional tax payments should be recorded in a deferred tax account and included in ratebase pending final disposition.

Discussion

Both PG&E and SoCal Gas are in agreement with the DRA position provided that they be permitted an opportunity to recover any additional tax payments and penalties should the IRS upon audit determine that the methodology used in undertaking an aggressive position with regard to various disputed overhead items resulted in the undercapitalization of overheads. We will adopt the DRA recommendations on this issue to the extent we will provide any affected utilities an opportunity to come before the Commission to seek recovery of any shortfalls resulting from taking an aggressive position with the IRS on this issue. Any recovery is contingent on the utility making an appropriate showing demonstrating that it has taken an aggressive position with the IRS in defense of its position. For reasons stated previously we will authorize the use of the memorandum account mechanism for this item.

In addition the necessity to restate the inventory as of December 31, 1986 to reflect what the ending balance would have been had overheads been capitalized for all prior inventory years makes the determination of the impact of overhead capitalization requirements difficult to determine for 1987 especially for gas utilities. We will permit the use of an initial estimate to be trued up by an amended filing with any difference recorded in an appropriate balancing account.

H. Capitalization of Removal Costs

Removal costs are incurred in the process of removing old plant facilities which have ended their useful life and replacing them with new plant facilities. These costs have been treated as currently deductible for ratemaking tax purposes for 1980 and prior flow-through property and normalized in the calculation of book depreciation rates (straight line) for 1981 and subsequent years plant additions. Removal costs up through the passage of TRA 86 have been deductible currently for all plant in service on utility Federal income tax returns.

During the workshop process the question was raised as to whether removal costs for 1980 and prior year plant would continue to be treated as currently deductible for ratemaking and FIT return purposes under TRA 86 provisions or would require capitalization (similar to the inventory overhead issue). The law is not clear on its intent in this area.

DRA recommends that removal costs for 1980 and prior plant continue to be treated as currently deductible for both ratemaking and Federal income tax return purposes. If, on audit, the IRS makes a determination that the cost of removal must be capitalized for 1980 and prior plant which is removed and replaced by new facilities, then the utilities should be provided with the opportunity to come before the Commission to request recovery of any gross revenue requirement shortfalls plus interest and penalties which may have occurred due to the IRS determination. Post 1980 plant addition removal costs are capitalized and therefore are not affected by TRA 86.

PG&E and SoCal Gas both concur with DRA's proposal provided the utilities are given an opportunity to recover the additional tax in the event these costs are required to be capitalized. SoCal Gas states that it understands that removal costs under TRA 86 are the same for both pre-1981 and post 1980 property. Therefore, SoCal Gas requests that the order in this proceeding provide that if removal costs are required to be capitalized, the utility should be allowed to make a showing before the Commission to recover the additional tax payments whether related to pre-1981 or post-1980 property.

Discussion

The utilities have generally concurred with DRA's recommendations with respect to removal costs either in total or with certain qualifications or by making no comments. We will adopt the DRA proposal and will permit utilities to make a showing before this Commission to recover any additional tax payments, penalties and interest should it be determined by the IRS that such removal costs are required to be capitalized. There apparently is a difference in opinion between SoCal Gas and DRA as to whether post 1980 property removal costs are already being capitalized and therefore are unaffected by TRA 86 in this respect. Our order will enable utilities an opportunity to seek recovery of any gross revenue requirement shortfalls plus penalties and interest, if in fact post 1980 property removal costs were not being capitalized. The use of the memorandum account mechanism is authorized under this situation.

I. CCFT Conformity

PG&E, SCE, SDG&E and GenTel state that several bills are pending in the state legislature which would require state tax laws to conform in many respects to TRA 86. The utilities argue that to the extent state conformity legislation affects the utilities' state income tax expense, the utilities should be entitled to revise revenue requirements(up or down) to reflect the state tax law change. PG&E recommends that the Phase 2 decision order utilities to file an advice letter adjusting 1987, 1988, and/or 1989 revenue requirements based on any state tax law change affecting state income tax expense for those years. The advice letter should incorporate the ratemaking principles adopted in the decision resulting from this OII. DRA did not comment on this issue.

Discussion

On Friday, September 25, 1987, Governor Deukmejian signed a new state tax law S.B. 572, The California Bank and Corporation Tax Fairness, Simplification and Conformity Act of 1987. At this time we are unable to determine how close such act brings state tax laws into conformity with TRA 86. We believe that the utilities' proposal to permit the filing of an advice letter adjusting 1987 and 1988 revenue requirements based on any state tax law change affecting income tax expense for those years is reasonable and should be adopted. The calculations adjusting CCFT should be consistent with the methodology adopted in this decision for TRA 86 revenue requirement effects.

J. Working Cash

SCE, SDG&E, SCG, and AT&T state that changes in the tax law will cause a change in the amount of taxes in cost of service and related changes to rate base. The utilities argue that the Commission should recognize the impacts of the tax changes on working cash in this proceeding in the same manner as such recognition would be given in a general rate proceeding. The change in the working cash requirement is a direct result of changes caused by TRA 86 and the Superfund Tax which must be given proper ratemaking recognition in order that the utilities do not incur adverse economic impacts.

DRA takes the position that the working cash impact of TRA 86 provisions can not be defined at this time because ratemaking tax policy is still being considered in this OII. DRA recommends that the Commission decision in this OII require affected utilities to include in their compliance presentations a detailed working cash calculation based upon their last adopted results of operations.

<u>Discussion</u>

This issue is apparently noncontroversial. We will require the affected utilities to include in their compliance presentations a detailed working cash calculation based upon their last adopted results of operations and the ratemaking tax policies adopted in this decision.

K. <u>Special/Added Facility Charge (SFC) Rates</u>

The Cogeneration Service Bureau submitted testimony and argued that the order in this OII should require not only the updating of SFC rates to reflect TRA 86 changes but also a general updating of the methodology for determining SFC rates. Although Cogeneration Service Bureau is aware that updating the methodology of SFC rates may be narrowly construed to be outside of the scope of this OII, it believes such action would be a terrible disservice to customers and QFs that pay SFC charges. Cogeneration Service Bureau argues that tariff revisions for SFC rates filed under electric and gas Tariff Rule 2 should be made in proposal form within two months of the effective date of this decision, that workshops be held to review the calculations and assumptions used, and finally that utilities address the methodological changes that occurred with PG&E's electric SFC rates under C.84-10-037 and resolution of differences attempted in the workshops.

PG&E states that it plans to file advice letters upon issuance of the Phase 2 decision. PG&E opposes Cogeneration Service Bureau's proposal for retroactive adjustments because of administrative costs involved and because adjustments to cost-of-ownership rates for other cost factors have never been made retroactively and adoption of such proposal would establish a bad precedent. PG&E requests that the decision recommend a revised advice letter filing and the rejection of the review of SDC rate methodology as being clearly outside the scope of the OII.

SCE moved to strike Cogeneration Service Bureau's testimony. While ALJ Barnett agreed that Cogeneration Service

Bureau's request was outside the scope of this OII he accepted the testimony by stipulation since Cogeneration Service Bureau was not present at the hearing since they were scheduled to testify on the following day.

Discussion

The scope of the OII is necessarily limited to the impact of TRA 86 on utility revenue requirements. We will therefore reject Cogeneration Service Bureau's request for workshops on SFC methodology in connection with this proceeding as being outside the scope of this OII. We will, however require the affected utilities to file revised advice letters to be effective prospectively to reflect the changes resulting from TRA 86. Such filings should be made within 60 days after the effective date of this order.

L. Implementation of the Effects of TRA 86 in Rates

DRA recommends that all TRA 86 provisions which impact the calculation of 1987 ratemaking Federal income tax expense for 1987 test or attrition years be reflected to the extent possible in 1987 rates. If the Commission decision on this OII is not issued with a time frame which permits the adjustment of 1987 rates to reflect the adopted ratemaking treatment of TRA 86, the TRA 86 impact on 1987 rates should be reflected as soon as possible in 1988 rates.

DRA recommends that the Commission decision in this OII should require that all utilities base their calculations of the impact of TRA 86 on 1987 adopted test or attrition year results of operations. If a 1987 adopted results of operations is not available, the most recent adopted results of operations should be used.

The impact on gross revenue requirements should be incorporated into rates in the following manner according to DRA:

> Gas and Electric Utilities--reflect the 1987 impact in their 1988 attrition filing. In the event that the Commission decision is not issued within a time frame which permits the inclusion of the 1987 impact of TRA 86 in the

> 1988 attrition filings, then DRA recommends that the impact be reflected in the GAC/SAM balancing accounts for gas utilities and the ECAC balancing accounts for electric utilities.
>
> Telephone Utilities--reflect the impact in the surcharge component of their rate structure.
>
> Water Utilities--reflect the impact using a surcharge methodology as a component of their rate structure.

DRA further takes the position that the revenue requirement decrease developed based on the methodologies adopted in this decision be used to decrease rates in 1988. Staff is against crediting such amounts to a balancing account or to true up the difference between actual taxes paid and what the Commission adopted and implemented at the outset of 1988. DRA further argues that although proposals have been made by Pacific Bell and Arthur Andersen & Co. to defer or otherwise reserve any refund of reduction in revenue requirements occasioned by TRA 86 on a variety of pretexts, it rejects these proposals and urges that such reductions be passed on to ratepayers in a timely fashion. DRA further states that utilities are searching for means to reduce costs to meet competitive challenges and threats of bypass. The timely reductions of rates would assist the utilities in accomplishing these goals.

Pacific Bell requests the Commission to temporarily hold the revenue requirement decrease in a balancing account. This would result in preserving the benefits of tax reform for the ratepayers and also provide the Commission with flexibilility to decide when revenue requirements are to be adjusted and thereby provide rate stability. Pacific Bell further argues that a balancing account would also provide an effective way of dealing with various uncertainties arising under TRA 86 where there is need for IRC clarification in several areas. A balancing account approach is not novel and has been used by the Commission on various occasions including the "Tax Initiative Account" in conjunction with property tax savings of Proposition 13. Pacific Bell also argues that there are many other imminent developments impacting revenue requirements for telecommunication utilities which suggest the adoption of a balancing account. Pacific Bell concludes that use of a balancing account to implement the impacts of TRA 86 would be the most reasonable, flexible and efficient approach. Continental Tel. supports the use of a balancing account for similar reasons.

Arthur Andersen recommends that the net savings resulting from TRA 86 be deferred and used to reduce the large ratepayer receivable created from flow-through of income tax benefits in prior years. Arthur Andersen argues that the FASB is expected to issue its new statement for "Accounting for Income Taxes in 1987". It is anticipated that this statement will require recording all accumulated deferred taxes on the balance sheet of each utility, whether previously provided in rates or flowed through to the ratepayer. Arthur Andersen estimated that the presently unrecorded deferred tax liability that will have to be recorded on the books of the five largest utilities in California is estimated to be in excess of $4.2 billion. Other reasons stated for deferring the tax savings are rate stabilization, the potential effect of competition in the form of bypass of utility services and the ratemaking objective of intergenerational equity.

SDG&E recommends that the Commission issue a generic decision in this phase which decides in principal each of the issues addressed by the parties. Each utility should be required to file by advice letter the specific implementation of the decision for that utility. SDG&E recommends that the 1987 overcollection resulting from TRA 86 be returned to ratepayers as soon as possible by a one-time bill refund or bill credit as early in 1988 as possible.

GenTel recommends that any adjustment to its 1987 revenue requirement be based on the 1987 data included in GenTel's 1988 test year Report on the Results of Operations. GenTel states that use of the last general rate order figures would not be appropriate since it would give a very skewed result. AT&T stated that adjustments to AT&T's rates by an adjustment to its billing surcharge would be the preferred mechanism. SCE recommends that any refunds ordered in this OII be incorporated in its ERAM balancing account and other balancing account as appropriate. SCE does not endorse DRA's alternative recommendation to incorporate the rate adjustment in the ECAC balancing account since ECAC is for energy expenses and revenues and ERAM is the balancing account where income taxes are reflected in base rates. Similarly, MAAC and IMAAC reflect the revenue requirement associated with nuclear units.

While SCG agrees with DRA that it submit an implementation filing based on its 1987 attrition year results of operations, it disagrees with DRA's recommendation that the revenue requirement impact of this OII be reflected in SCG's SAM balancing account. The reason set forth by SCG is that the Commission is in the process in OII 86-06-005 of eliminating the SAM balancing account as it applies to certain non-core customer classes. At issue in OII 86-06-005 is the manner in which the SAM balancing account should be allocated to different customer classes. The revenue requirement changes resulting from this tax OII may be allocated in a different manner than SCG's traditional SAM balances.

The smaller independent telephone companies state that the effects of TRA 86 on intrastate results of operation and revenue requirements are de minimus. The majority of the smaller independent's revenues are derived from toll and access charge sources, and since these revenues are adjusted through the settlement process, the revenue change due to TRA 86 are minimized.

The smaller independents believe that the minor tax changes due to TRA 86 should be handled in each company's next rate proceeding. If the Commission decides to adjust smaller company rates, the adjustments for TRA 86 should be included with adjustments for other generic OII proceedings for inside wiring and the USOA rewrite. The smaller independent telephone companies believe that DRA's recommendation regarding implementation are intended to cover those utilities which are materially affected by TRA 86. For the smaller independents a separate surcharge component makes no sense since it would cost more to implement than the actual revenue impacts themselves.

Pacific Power's witness, Anne Eakin, testified that the Commission in D.86-12-097 found that an increase of $7.289 million would be required for Pacific Power to earn a fair and reasonable return of 10.64% for test year 1987. However, to mitigate the impact of rates on its customers, the company requested, and the Commission granted, an increase of only $1.975 million. Pacific Power states that because it is collecting $5.314 million less than its justifiable revenue requirement, the company proposes to deduct the impact of TRA 86 from the adopted costs of service, which yielded a supportable revenue increase of $7.289 million. This results in the reduction of the shortfall from $5.314 million to $3.969 million. Thus Pacific Power takes the position that there would not and should not be an effect on tariffed rates because the TRA 86 adjustments does not cause adopted revenue levels to result in a rate of return which exceeds the 10.64% authorized for 1987. Appendix A to Exhibit 40 shows that after giving effect to TRA 86, the company would still be constrained to a return of 8.98%, significantly lower than the authorized return of 10.64%. Pacific further argues that while it may be appropriate to reduce the rates of other utilities, Pacific Power's rates should not be adjusted. The company further proposes to incorporate the 1988 impact of TRA 86 with its 1988 attrition filing in the fall of 1987. The basis for the 1988 attrition calculation would be the basis authorized in D.86-12-097 adjusted for the 1987 and 1988 impacts of TRA 86 as set forth in the decision on this OII.

Table 1 is a comparison of the utility estimates of the dollar impact of TRA 86 on 1987 and 1988 rates (only seven companies provided 1988 estimates). The estimated total revenue requirement impact for the 18 utilities shown on the table is a $243,878,000 decrease for 1987. These figures represent each utility's estimate of the impact of TRA 86 on 1987 and 1988 results of operations based upon their recommendation for implimentatation of TRA 86 provisions and not necessarily as adopted in this decision. These estimates will have to be evaluated and revised based upon the requirements adopted in this decision.

Table 1

OII 86-11-019, Tax Reform Act of 1986

COMPARISON OF HEARING PARTICIPANTS ESTIMATES OF THE $ IMPACT ON 1987 & 1988 RATES

Revenue Requirement impact
Increase (Decrease) in Thousands

Utility	1987 Impact	1988 Impact	Reference
Pacific Gas & Electric Co.	(942,3[illegible])	Not Provided	Exhibit 31, Page 37
Southern Calif. Edison Co.	(44,4[illegible])	Not Provided	Exhibit 29, Table II
San Diego Gas & Elec. Co.	(29,960)	Not Provided	Exh. 47, Page 1-1 to 2-3
Southern Calif. Gas Corp.	(15,286)	Not Provided	Exh. 30, CLC-F-1, Page 2
Pacific Bell	(95,000)	(270,000)	1 Page Exhibit 26
General Telephone Co.	10,[illegible]	Not Provided	Exh. 44, General Exh. 1
Continental Telephone Co.	(1,[illegible])	(5,228)	Exh. 37, SE-1, 1 & 6 of 6
Pacific Power & Light Co.	(1,400)	Not Provided	Exhibit 41, 1st page
CP National Corp. - Telephone	(171)	(191)	Exh. 33, RCM-1, Page 1 of 3
Tuolumne Telephone Co.	(45)	(72)	Same as Above
Roseville Telephone Co.	(592)	(1,306)	Exhibit 32, Schedule II
Sierra & Mariposa Tele. Co.'s	(69)	Not Provided	Exh 35, Append B, Pg 1of2
Kerman Telephone Co.	(12)	Not Provided	Exh 35, Append C, Pg 1of2
Other Small Telephone Co.'s	(15)	Not Provided	Exhibit 35
Ponderosa & Siskiyou Telephone	(54)	Not Provided	Exh 34, Attch I & II
AT&T	(4,800)	Not Provided	Exh 42, Attch A, Pg 1 of 4
Citizens Utilities - Telephone	381	(934)	Exh 43, Attachment A
Citizens Utilities - Water	505	(141)	Exh 43, Attachment B
Total Revenue Requirement Impact of TRA 86	($243,878)	Complete Data is Not Available	

The revenue requirement increases or decreases shown above represents each utility's estimate of the impact of TRA 86 on 1987 and 1988 results of operations based upon their recommendations for implementation of TRA 86 provisions. These estimates will be evaluated and revised based upon decision requirements.

Discussion

Although DRA recommends that TRA 86 provisions which impact the calculation of 1987 ratemaking FIT expense for 1987 test or attrition years be reflected in 1987 rates, it is now obvious that the earliest such adjustments could be made would be in 1988 rates. SCE has objected to the use of ECAC and SCG has objected to the use of GAC/SAM balancing accounts. We concur with SCE that ERAM and other appropriate balancing account should be used instead of ECAC to record the effect of revenue requirement adjustments resulting from this investigation. For gas utilities we will require the use of the GAC/CAM balancing accounts.

Consistent with our treatment of the gas and electric utilities, we will require water utilities to reflect the revenue requirement impact of TRA 86 for 1987 and 1988 in a special surcharge account. We will however exempt small water companies as well as other small utilities with ratemaking taxable incomes under $25,000 in the last adopted test or attrition year results of operations from filing advice letters for any revenue requirement adjustments for 1987 resulting from TRA 86 since the effect should be insignificant because the tax rate for small businesses remains at 15% for taxable income under $25,000. For the next $25,000 of taxable income TRA 86 tax rate is 15% compared to 18% under the prior law and the next $25,000 is taxed at 25% compared to 34% under the old rates, etc. There are some tax savings for 1987 for taxable income above $25,000, although not to the full extent of the rate change since TRA 86 rates did not go into effect until July 1, 1987. We will therefore require utilities with ratemaking taxable income above $25,000 to make the advice letter compliance filing.

For water utilities required to make the advice letter filing, we will authorize the establishment of a special surcharge account in which will be recorded 1987 and 1988 revenue requirement impact due to TRA 86 including interest from January 1, 1987 to the effective date of the surcharge filing. Additional interest will accrue from the effective date of the surcharge filing until December 31, 1988 on the portion of the balance of the special surcharge account attributable to the period prior to the effective date of the surcharge account.

Pacific Bell and several other companies including Arthur Anderson have recommended that any revenue requirement adjustments resulting from TRA 86 be deferred in a balancing account to be used as the Commission believes appropriate. Consistent with D.87-12-063 in I.87-02-023, Uniform System of Accounts for telephone company rewrite (USOA), we will authorize balancing account treatment of the revenue requirement effects of TRA 86 and S.B. 572. Such balancing account will terminate no later than January 1, 1989 in connection with our investigation into regulatory flexibility instituted November 25, 1987 (I.87-11-033), and will bear interest at the 90-day commercial paper rate. This treatment will be authorized for AT&T, Pacific Bell, GenTel, Citizens, ConTel and Roseville Telephone Company.

SDG&E believes that each utility should be required to file by advice letter the specific implementation of this Phase 2 decision. SDG&E recommends that the 1987 overcollection resulting from TRA 86 be returned to ratepayers as soon as possible by a one-time bill refund or bill credit as early in 1988 as possible. We are in favor of returning the 1987 overcollections as soon as possible. However the basic DRA proposal assumes that the overcollection be returned over the one year period, in order not to create any cash flow problems if the magnitude of the overcollections is substantial. Rather than permitting each utility to have an option of making an immediate one time refund or credit, we believe it would lead to less confusion if all utilities which are required to refund the 1987 overcollections in 1988 are required to do so on a consistent basis.

The next question we should address is whether all utilities should be required to return the 1987 overcollections in 1988 or whether an exception should be made in the case of the small independent telephone companies. Since a substantial portion of the small independent telephone companies revenues are from toll sources which are automatically adjusted through the settlement process, the impact of TRA 86 is not substantial on their intrastate results of operations or revenue requirements. We are of the opinion that the smaller independent telephone companies' argument that no rate adjustment should be made at this time because the effect of TRA 86 changes are de minimus has merit. We will except the Smaller Independents from the filing requirements in this order and require the tax act impacts be addressed in their next general rate case or General Order (G.O.) 96 filing as appropriate.

Pacific Power states that by foregoing a 1988 attrition filing, it will fully compensate its customers for all benefits of TRA 86. Based on the Commission's review of Pacific's past rate orders, the Commission believes this may be the case. However, to insure that customers are protected, Pacific Power should make an informal filing with the Commission Staff to demonstrate that the amount of money it could have supported in a 1988 attrition filing is at least equal to, if not greater than the benefits of TRA 86.

In summary, all utilities except those specifically excluded will be required to make a compliance filing in the form of calculations reflecting a 1987 revenue requirement adjustment in conformance with the methodology adopted in this decision. We are requiring the utilities to refund the full 1987 overcollection in 1988 under the assumption such overcollection is not taxable in 1987. Should the IRS upon audit disagree with the methodology used in taking an aggressive position with regard to the non-taxability of 1987 refundable revenues, we will provide affected utilities an opportunity to come before the Commission to seek recovery of any shortfalls resulting from this issue.

The utilities should base their calculations on 1987 adopted test or attrition year results of operations. If a 1987 adopted results of operations is not available, the most recent adopted results of operations should be used. The changes due to TRA 86 should also be reflected in subsequent attrition adjustment years to the extent applicable. Any utility exempted from our filing requirement for 1987 effects would not be precluded from making a filing if they believe an adjustment is warranted.

The impact on gross revenue requirements for 1987 should be incorporated into rates through the ERAM/GAC/CAM balancing accounts, for energy utilities, in the temporary TRA balancing account for telephone companies to be distributed as the Commission further orders and the surcharge methodology as a component of their rate structure for water utilities. By spreading the adjustment over the year 1988 any cash flow problems relating to refunding the excess revenue requirements for 1987 become minimized.

To the extent the 1988 attrition filings or 1988 general rate case filings do not conform to the tax rate changes adopted in this decision, utilities shall include in their advice letter filings the necessary adjustments to conform to this decision. Utilities not having any attrition or test year 1988 filing will be required to file tariffs revising 1988 tariffs to conform their ratemaking income tax expense to this decision. Any difference in revenue requirements for the period January 1, 1988 to the date revised tariffs go into effect are also collected subject to refund and applicable interest. Such amounts will be incorporated into rates in the same manner as 1987 revenue requirement adjustments.

The working cash impact of TRA 86 provisions are dependent upon the ratemaking tax policies being considered in this decision. The affected utilities should include in their Advice Letter and/or compliance filing presentations a detailed working cash calculation reflecting the working cash impact.

V. Comments on Proposed Decision

A. General

As provided in Section 311 of the Public Utilities Code, ALJ Tomita prepared a Proposed Decision which was filed with the Commission and served on all parties on November 24, 1987. Rules 77.1 through 77.5 of this Commission's Rules of Practice and Procedure permit parties to file comments on such Proposed Decision within 20 days of its date of mailing. Comments were received from DRA, Pacific Bell, PG&E, Pacific Power, SCE, SCG and the smaller independent telephone companies. In addition comments were received from GenTel, California Water Service Company (CWSC) and San Jose Water (SJWC) with a motion to file late-filed comments which will be accepted. Reply to comments were filed by Pacific Bell, PG&E, SCE and SGC. The comments and replies to comments were carefully considered. The comments discussing clarification of specific matters, to the extent adopted were included in the appropriate places in the decision. Material changes to the decision are discussed below.

B. Pacific Bell's Comments

Pacific Bell commented that the ALJ's proposed decision requires the telephone companies to reflect any revenue requirement effect of TRA 86 by means of a surcharge whereas the ALJ in the USOA (Uniform System of Accounts) investigation proposed that the revenue requirement increase in that proceeding be placed in a balancing account together with revenue requirement changes resulting from TRA 86 and other rate matters. Pacific Bell further suggests that it would be willing to return the 1987 effect of TRA 86 to ratepayers as a one time refund or as a surcredit over 1988 but that the 1988 effect should be placed in a memorandum account. The rationale offered for this difference in treatment is that the other revenue requirement impacting developments listed by the ALJ in the USOAR decision only come into play after 1987. We agree with Pacific Bell's comments and therefore we will direct Pacific Bell and General Telephone to implement an intrastate billing surcharge/surcredit on a bill-and-keep basis based on their 1987 adopted billing base (1987 attrition) to reflect their 1987 revenue requirement effect for TRA 86 and SB 572.

We will not implement an intrastate billing surcharge/surcredit for Citizens, Continental Telephone or Roseville. We believe that for the purposes of rate stability it would be more effective to place the entire revenue requirement adjustment into a memorandum account for AT&T, Citizens, Continental Tel and Roseville Telephone. Such memorandum account will be for a limited period of time, not to exceed one year, and will bear interest at the 90-day commercial paper rate consistent with other memorandum accounts. During this time we expect to remove the memorandum account in our coordinated Rate Design Proceeding for Pacific Bell as set forth in Appendix A of I.87-11-033.

C. <u>Comments of Pacific Power</u>

Pacific Power commented that its customers are already enjoying all of the benefits of TRA 86. Furthermore Pacific Power states that prior to the issuance of the proposed decision in the current proceeding, the company decided not to seek an attrition increase in order to maintain stable prices even though the Commission's decision in the last general rate case encouraged the company to file attrition increases in 1988 and 1989. Should the company be required to adjust rates downward for TRA 86, the company will likely file an offsetting attrition increase in order to avoid a further reduction in the company's rate of return. We will adopt alternate 3 recommended by the company which will require the company to make an informal filing to the CACD to demonstrate that the amount of money it could have supported in a 1988 attrition filing is at least equal to, if not greater than, the benefits of TRA 86. If the company's showing is inadequate, it must either reduce its rates or make a formal attrition filing before the Commission.

D. Comments of Smaller Independent Telephone Companies

The Smaller Independents argue that they have demonstrated that the tax effect of TRA 86 was so small that no adjustment to their local rate structure was justified. The toll and access charge revenues of the Smaller Independents will be adjusted automatically through the settlement process. Smaller Independents believe that the Commission understands this position; however the proposed remedy set forth in the proposed decision to exempt Smaller Independents by exempting companies with ratemaking taxable income of $25,000 or less in their last adopted results of operations will not accomplish the intended results since the ratemaking taxable income includes toll and access charge revenues and thus pierces the threshold taxable income of $25,000 of which 75-80% would automatically be adjusted through the settlement procedure. The Smaller Independents argue that the cost involved in performing calculations, filing advice letters and adjusting rate schedules will exceed the amount of rate reduction ultimately determined to be applicable. Therefore, the Smaller Independents request that the proposed decision be modified to recognize their unique circumstance and exclude them from further participation in this proceeding. In view of the minimal revenue impact on the Smaller Independents, we will exempt them from the filing requirements of this decision and require that the impacts associated with TRA 86 and S.B. 572 be addressed in their next general rate case or General Order (GO) 96 filing as appropriate.

E. Comments of CWSC and SJWC

CWSC and SJWC comment that water utilities in general have very minimal amounts in construction work in progress and that the income tax effect on the differential in interest rates applied to these small amounts of construction is de minimus but that the potential accounting requirements are staggering. CSWC and SJWC recommend that water utilities be allowed to use the same interest rate for capitalizing interest on construction for ratemaking purposes as for income tax purposes on all construction on which no AFUDC rate has been authorized. We find the proposal reasonable and will adopt such proposal for water utilities.

CWSC and SJWC also commented that ordering paragraph No. 1 raises some implementation problems in spreading the 1987 revenue impact over less than a full calendar year since water sales do not occur equally throughout the year and water utility rate decisions do not provide monthly sales data. CWSC and SJWC propose that: (a) the amount of the revenue refundable from January 1, 1987 to the effective date of the new tariff be accounted for separately from the amount of the refund attributable to the period from the effective date of the new tariff to December 31, 1988; (b) The post-surcharge date amount will not bear interest since with the surcharge credit in effect, it will never be collected from the ratepayer; (c) The pre-surcharge amount shall include compounded interest to the tariff date; (d) The principal amount of the revenue refundable shall be allocated on a straight-line basis between pre- and post-surcharge periods. That is to say all 1987 revenue refundable will be pre-surcharge while only a portion of 1988 will be pre-surcharge (i.e., if tariff date is April 1, 1988, then March 12 of 1988 revenue refundable will be pre-surcharge); (e) Compounded interest shall be calculated on the assumption that the pre-surcharge revenue refund was received on a straight-line basis; (f) Compound interest continues to accrue on the pre-surcharge balance attributable to the amount of the balance related to the period from January 1, 1987 to the effective date of the surcharge.

For purposes of crediting the surcharge refunded to the pre- and post-surcharge account, the revenue refunded each month shall be allocated on the basis that the two accounts bear to each other at the tariff date. Because the refund calculation requires some estimate of 1988 interest rates and a straight-line revenue assumption, there will be some error in the total refund estimate. CWSC and SJWC propose that the resulting difference be added to the utility's Balancing Account at January 1, 1989 and be adjusted accordingly in the next general rate case or advice letter, whichever occurs first. The proposals appear to be reasonable and will be adopted with the modification that the amount in the Balancing Account at January 1, 1989 will be adjusted accordingly in the next general rate case or offset rate case, whichever occurs first. Any problems associated with interest computations can be resolved with CACD.

Findings of Fact

1. TRA 86 provides for a reduction in Federal Income Tax rates as well as many other changes that affect ratemaking income tax expenses for public utilities.

2. All other TRA 86 issues other than contributions in aid of construction were addressed in this phase of the OII.

3. The parties agreed to stipulate to seven issues shown in Appendix A and recommended that the Commission accept the stipulations and order ratemaking treatment consistent with the stipulations.

4. There was general agreement to DRA's position regarding the research and experimentation credit reduction from 25% to 20% in 1986 through 1988; to continue to defer the issue of capitalization of interest under TEFRA-IRC Section 189 until Treasury Regulations relating to questions are issued; and to use a gross of tax interest rate in calculating the AFUDC rate and Option

3-income tax normalization to account for the increased income tax expense occasioned by TRA 86 provisions requiring the capitalization of interest during construction for income tax purposes. DRA's position is reasonable except for water utilities for whom we will authorize the use of the same interest rate for capitalizing interest for ratemaking purposes as is used for tax purposes except in those instances where an AFUDC rate has been authorized.

5. When the magnitude of the changes in Federal Income Tax rates are significant, it is reasonable to review the Commission's ratemaking policy that assumes that test year estimated CCFT deductions will be deductible for Federal Income Tax purposes in the test year when in fact it cannot be deducted until the following year.

6. Due to the complexity of the CCFT issue, further hearings will be held on this subject. These hearings will be held as directed by the ALJ.

7. It is not reasonable to adjust the loss in value of the CCFT deduction for 1986, since that would require us to revise the assumptions made in setting rates for 1986 - rates which were not made subject to refund by the OII.

8. The working cash issue relating to the CCFT deduction for Federal Income Tax purposes is properly addressed in PG&E's 1987 test year rate case and is outside the scope of this OII.

9. PG&E's change in position to include the working cash problem relating to the CCFT deduction is too late, since the parties generally agreed that it should be handled in PG&E's 1987 general rate case workshops, thus the record in this proceeding on that issue is deficient.

10. The provisions of TRA 86 with respect to AMT for utilities and the ratemaking implications involved are complex and may be subject to further IRS interpretations and rulings before it becomes clear what ratemaking treatment would be permissible.

Rather than committing ourselves to any specific treatment for recovery of AMT expense we will adopt as reasonable DRA's recommendation to handle this issue on a case by case basis, with the affected utility permitted to make a showing for recovery of such AMT expense. We will also authorize the use of memorandum account mechanism in order to avoid any retroactive ratemaking problems should the Commission agree that the requested AMT recovery sought was appropriate.

11. To the extent that any utility is affected by the unbilled revenue method required by TRA 86, it is appropriate for such utility to make a complete showing justifying its request for revenue requirement adjustment on this issue.

12. DRA's proposal to treat the difference on the deductibility of accrued vacation pay for federal income tax purposes and ratemaking purposes as an adjustment in the Federal income tax deduction and credit table used to calculate test or attrition year FIT expense is reasonable.

12a. PG&E's proposal to treat the difference on the deductibility of accrued vacation pay for federal income tax purposes as a deferred tax and rate base it is reasonable.

13. It is unreasonable to reuse a vacation pay deduction or a bad debt expense deduction a second time, if it has already been used as a deduction for ratemaking purposes.

14. There was general agreement with DRA's position on the treatment of bad debt expense resulting from the elimination of the reserve method of computing bad debt expense in TRA 86. A utility that used the reserve method for tax and ratemaking should be allowed to collect in rates the additional federal income taxes that this change will generate in 1987 through 1990. We will therefore require any utility affected by this issue to make a complete showing supporting any bad debt reserve adjustment.

15. We concur with DRA's position that our actions with respect to ITC for 1986 plant additions do not violate the

normalization requirements since those rates were established on the basis of the most current knowledge of the tax laws at that time. However, should it be determined that our actions with respect to 1986 ITC result in the invocation of the penalty clause, we will consider a filing from the affected utility or utilities to consider taking possible remedial measures.

16. The overhead capitalization requirements of TRA 86 are extremely complex. Both PG&E and SoCal Gas agree with DRA's position to take an aggressive position with the IRS and not capitalize those overhead items which are subject to question, provided the utilities are permitted to record additional tax payments in a deferred tax account and ratebased should the IRS determine that the methodology used in taking an aggressive position resulted in the undercapitalization of overhead expenses. Rather than using deferred tax account we will authorize the use of the memorandum account mechanism to record any additional tax liability resulting from the undercapitalization of overhead expenses.

17. Because of the complexity of the overhead capitalization requirements, and the need to restate the December 31, 1986 inventories it is reasonable to permit the utilities to true-up the revenue requirement adjustment for 1987 in the appropriate base rate balancing account.

18. TRA 36 provisions require the capitalization of removal costs. There is uncertainty whether removal costs for 1980 and prior year plant will continue to be treated as currently deductible for ratemaking and FIT return purposes. The utilities generally agree with DRA's recommendation to continue to treat removal costs on such property as currently deductible for both ratemaking and tax purposes, provided they are permitted recovery of tax shortfalls, penalties and interest if the IRS rules otherwise. Because of the uncertainties relating to capitalization of removal costs, it is reasonable for utilities to take the

aggressive stance recommended by DRA and recover tax shortfalls, penalties and interest should the IRS rule against such position and will authorize the use of a memorandum account to record such amounts.

19. To the extent applicable we will allow utilities to reflect the effects of S.B. 572, The California Bank and Corporation Tax Fairness, Simplification and Conformity Act of 1987 as it affects 1987 and 1988 revenue requirements based on tax law changes affecting state income tax expense in a manner consistent with the methodology adopted in this decision for TRA 86 revenue requirement effects.

20. The tax law change will impact working cash and revenue requirements for 1987 and 1988. Affected utilities will be required to include in their advice letter filings a detailed presentation of working cash calculation based upon their last adopted results of operations.

21. The Cogeneration Service Bureau's request for an updating of SFC rates to reflect TRA 86 changes is reasonable; however, its request for general updating of the methodology for determining SFC rates is outside the scope of this OII.

22. Based on the utilities' estimate of the impact of TRA 86 on 1987 revenue requirements, there is an estimated total reduction in revenue requirements of approximately $244 million dollars.

23. The impact of TRA 86 and SB 572 should be calculated on the basis of the last adopted test year or attrition year results of operations. Water utilities with test years older than 1987 should consult with the Water Utilities Branch before filing.

24. Since it is too late to adjust 1987 rates for the revenue requirement adjustments resulting from the changes in the tax laws, the adjustments should be reflected as early as possible in 1988 rates.

25. Arthur Andersen's proposal to defer the net tax savings from TRA 86 is based upon conjecture that utilities will have to

record all accumulated deferred taxes on the balance sheet whether previously provided in rates or flowed through.

26. While there may be benefits which may result from the deferring of tax savings they are not sufficient for us to depart from our policy of returning to today's ratepayers any overpayments of income tax occasioned by changes in the tax laws.

27. There is benefit to the utilities in passing through the tax savings to ratepayers by reducing rates and therefore enabling them to reduce expenses and better meet the competitive challenges and threats of bypass.

28. To the extent any adjustments are made to balancing accounts, the proper balancing accounts are base rate balancing accounts rather than energy cost balancing accounts.

29. The revenue requirement effect of TRA 86 on small utilities with ratemaking taxable income under $25,000 is probably minimal since the tax rate on the first $25,000 of taxable income under the new law remains the same.

30. Pacific Power should furnish an informal 1988 attrition filing to the CACD within 30 days after this order is mailed. If such information demonstrates that by foregoing a 1988 attrition filing, Pacific Power will have passed all benefits of TRA 86 to its customers, no further action will be needed. If Pacific Power's showing is inadequate, it must either reduce its rates or make a formal attrition filing before the Commission within 45 days after its informal filing is rejected by the Commission.

31. In PG&E's 1987 General Rate Case, PG&E reflected an $85.3 million rate decrease as an initial estimate of the revenue requirement decrease for 1987 attributable to TRA 86.

32. In using OII 86-11-019 the Commission ordered that as of January 1, 1987, all rates and charges then in effect shall be collected subject to refund including interest in order to account for any changes that might result from this investigation.

33. Utilities who have filed 1988 attrition year or test year filings using income tax expenses inconsistent with this decision, shall include in their advice letter filings adjustments necessary to correct any discrepancies. Other utilities not having attrition filings and not specifically exempted in this order shall file revised tariffs to reflect the change in tax laws consistent with this order.

34. Congress is currently considering legislation which would increase taxes on corporations, including utilities. If such legislation is adopted, it is likely to have ratemaking impacts.

35. The revenue requirement effects of TRA 86 on the Smaller Independents is small because the bulk of their revenues are from toll and access charges which will be adjusted automatically through the settlement process.

36. Utilities exempted from the filing requirements of this order should address the impact of TRA 86 and S.B. 572 in their next general rate case or GO 96 filing as appropriate.

37. The implementation procedures proposed by CSWC and SJWC for water utilities are reasonable and are adopted with the modification noted under Comments to Proposed Decision.

38. Considering the revenue requirement changes resulting from the USOA investigation, the inside wiring investigation, Pacific Bell's 1988 attrition, General Telephone's final decision in its general rate case, and the pending investigation into rate flexibility (I.87-11-033), it is reasonable to authorize the use of a temporary memorandum account to record the revenue requirement effects of TRA 86 and S.B. 572 for the larger telephone companies. Such memorandum account will bear interest at the 90-day commercial paper rate and will be disposed of as directed by the Commission.

38a. For Pacific Bell and General Telephone, it is reasonable to authorize a billing surcharge/surcredit to refund the 1987 effect of TRA 86 as a one-time refund in calendar year 1988. Placing the 1988 effect of TRA 86 and the entire revenue requirement adjustment for AT&T, Citizens, Continental and Roseville into a memorandum account is reasonable.

39. Since water utilities have minimal amounts of construction work in progress, it is reasonable to authorize those water utilities with no authorized AFUDC rate to use the same interest rate for capitalizing interest for ratemaking purposes as for income tax purposes and thereby eliminating complex accounting requirements.

Conclusions of Law

1. All public utilities subject to this OII, other than those specifically exempted in this decision should be required to file calculations to reflect the revenue requirement effects of TRA 86 on 1987 ratemaking income tax expense and on 1988 ratemaking income tax expense to the date when tariffs are revised to reflect the revenue requirement effects of the tax changes. Such calculations should be based on adopted test year or attrition year results of operations using the methodology adopted in this decision.

2. Small utilities subject to this OII with ratemaking taxable income of $25,000 or less in their last adopted test year or attrition year should be exempted from the filing requirements of this decision since the tax rate for taxable income of $25,000 or less remains at 15% and the effects of the other provisions will be de minimus. Similarly the Smaller Independents should be exempted from the filing requirements of this decision, since the bulk of the TRA 86 effects will be adjusted automatically through the settlement process for toll and access charges and the net effect of TRA 86 on the local operations is small.

3. Utilities should be authorized to include in their compliance filings the effect of S.B. 572, The California Bank and Corporation Tax Fairness, Simplification and Conformity Act of 1987

as it affects 1987 and 1988 revenue requirements in a manner consistent with the methodology adopted in this decision for TRA 86 revenue requirement effects.

4. All utilities should reflect in their attrition filings for 1988 and 1989 the impact of TRA 86 and S.B. 572 to the extent applicable based on the methodology adopted in this decision.

5. PG&E's revenue requirement adjustment for 1987 income tax expense (whether a refund or collection) shall reflect the difference between a calculated revenue requirement change based on the ratemaking procedures adopted in this decision and the $85.3 million reduction attributable to TRA 86 reflected in rates in PG&E's 1987 General Rate Case. PG&E's revenue requirement adjustment for 1988 income tax expense (whether a refund or collection) shall reflect the difference between a calculated revenue requirement change based on the ratemaking procedures adopted in this decision and the further $86.3 million reduction attributable to TRA 86 reflected in rates in PG&E's 1988 attrition rate case.

6. The stipulations entered into by the parties on Appendix A are reasonable and should be adopted as part of this decision in determining the impact of TRA 86 on utility income tax expense for ratemaking purposes and to be used by utilities in calculating the impact of federal income tax law changes on 1987 and 1988 revenue requirements.

7. Utilities will have an opportunity to recover future tax liability associated with any unintended violation of normalization of ITC requirements as a result of this order upon an appropriate showing in a future rate proceeding and will be authorized to record such liability in a memorandum account.

8. Utilities will be permitted to record in memorandum accounts additional taxes and penalties resulting from the ratemaking treatment adopted in this decision on those specific issues discussed in this decision. Utilities will be permitted to

seek future recovery of such amounts based upon a complete showing justifying such recovery.

9. The adjustments ordered herein do not constitute retroactive ratemaking, since moneys collected from January 1, 1987 were made subject to refund to account for any changes that might result from this investigation. Moreover, this is not a general rate proceeding.

10. The effective date of this order is the date of signature to permit revenue requirement adjustments related to the tax acts to go into effect as early as possible in 1988.

11. Utility rates for 1988 shall be calculated subject to refund or adjustment to reflect any federal tax legislation which is adopted for that year. Utilities shall file adjustments to their rates which reflect such legislation through the advice letter process, using principles consistent with those adopted in this decision.

12. Utilities exempted from the filing requirements of this decision should be required to reflect the revenue requirement effects of tax law changes in their next general rate case or offset rate case filing.

O R D E R

IT IS ORDERED that:

1. Respondents shall file calculations with supporting workpapers proposing a 1987 revenue requirement adjustment for TRA 86 and S.B. 572 effects in conformance with the methodology adopted in this decision. The calculations shall be based on 1987 adopted test or attrition year 1987 results of operations and if a 1987 adopted results of operations is not available then the most recent adopted results of operations shall be used. Respondents shall make such compliance filing within 60 days after the effective date of this decision. The impact of the revenue requirement

adjustment, including interest, shall be recorded in the GAC/CAM balancing account for gas utilities and in the ERAM and other appropriate balancing account for electric utilities.

1a. Pacific Bell and General Telephone shall, within 15 days after the effective date of this decision, make an Advice Letter filing to implement an intrastate billing surcharge/surcredit based on their 1987 adopted billing base to reflect the 1987 revenue requirement adjustment for TRA 86 and SB 572 effects in conformance with the methodology adopted in this decision. The intrastate billing surcharge/surcredit shall be on a bill-and-keep basis and shall reflect interest accrued at the current 90-day commercial paper rate from January 1, 1987 to the effective date of the tariff. The billing surcharge/surcredit shall become effective 5 days after the tariff filing and shall remain in effect until January 1, 1989 unless further ordered by the Commission. Telephone utilities not otherwise exempted shall reflect the revenue requirement impact, including interest, at the 90-day commercial paper rate in a TRA 86 balancing account and dispose of such balance as the Commission further orders.

2. Respondents shall calculate federal income tax expense for ratemaking purposes for 1988 using the methodology adopted in this decision and similarly calculate California Corporation Franchise Tax expense for ratemaking purposes to the extent applicable and file advice letters adjusting their tariffs to reflect the revenue requirement effects of the tax changes. The calculations shall be based on the last adopted results of operations as adjusted by any adopted attrition mechanism. Respondents shall make such filing within 60 days after the effective date of this decision or, in those instances where a 1988 general rate order or attrition award is pending, 60 days after the effective date of such order or award. For energy utilities any revenue requirement adjustments, including interest at the 90-day commercial paper rate from January 1, 1988 to the effective date

when base rate tariffs are revised, shall be recorded in the ERAM, GAC, SAM balancing account. Telephone companies, not otherwise exempted, shall reflect any revenue requirement adjustment, including interest to the extent applicable, in a TRA 86 memorandum account and dispose of such balance as the Commission further orders.

3. Respondent water utilities shall calculate federal income tax expense for both 1987 and 1988 using the methodology adopted in this decision and similarly calculate California Corporation Franchise Tax expense for ratemaking purposes to the extent possible. The calculations shall be based on the last adopted results of operations. The impact of the revenue requirement adjustment for both 1987 and 1988, including interest on that portion of the revenue adjustment relating to the period prior to the date the surcharge rate (or credit) becomes effective, shall be recorded in a special surcharge account. Within 60 days after the date of this decision, respondent water utilities shall file an advice letter for the purpose of establishing a surcharge rate to reflect an amortization of the total revenue requirement adjustment including interest recorded in the surcharge account over the remainder of 1988. The surcharge rate will be shown as a percentage which will apply on total customer water bills exclusive of Safe Drinking Bond Act loan surcharges and exclusive of CPUC Reimbursement Fees. The surcharge will be effective on the date of filing.

4. Utilities with ratemaking taxable income of $25,000 or less are exempted from making this compliance advice letter filing relating to 1987 or 1988. Any utility exempted from this advice letter filing is not precluded from making such filing, if the utility believes that an adjustment is warranted.

5. Utilities are permitted to keep memorandum accounts for additional income taxes, penalties and interest for those specific issues discussed in the decision which could not be resolved.

Utilities will be permitted to request recovery of such amounts based on a full showing justifying such recovery.

6. Gas, electric, telephone utilities and water utilities with an authorized AFUDC rate shall use a gross of tax interest rate in calculating the AFUDC or IDC rate and Option 3 - income tax normalization to account for the increased income tax expense occasioned by TRA 86 provisions requiring the capitalization of interest during construction for income tax purposes. Water utilities with no authorized AFUDC rate may use the same interest rate for capitalizing interest for ratemaking purposes as for income tax purposes.

7. Utilities affected by TRA 86 provisions resulting from the elimination of the reserve method of computing bad debt expense shall make a complete showing supporting any bad debt reserve adjustment in their compliance advice letter filing or any general rate case filing.

8. Utilities shall include in their compliance filing a detailed presentation of working cash calculations based upon their last adopted results of operations.

9. Utilities are permitted to true up the revenue requirement adjustment for 1987 for overhead capitalization requirements in an appropriate base rate balancing account. Such true up must be made by March 31, 1988.

10. Utilities exempted from the filing requirements of this decision shall address the revenue requirement effects of the tax law changes in their next general rate case or offset rate case filing, as appropriate.

11. Utilities with Special/Added Facility Charge (SFC) rates filed under electric and gas tariff Rule 2 shall file revised advice letters to reflect the changes resulting from TRA 86 and S.B. 572. Such filings should be made within 60 days after the effective date of this order.

12. Pacific Power & Light Company (Pacific Power) shall file an informal 1988 attrition filing with the Commission Advisory and Compliance Division within 30 days after this order is mailed. If such information demonstrates that by foregoing a 1988 attrition filing, Pacific Power will have passed all benefits of TRA 86 and S.B. 572 to its customers, no further action will be needed. If Pacific Power's showing is inadequate, it must either reduce its rates or make a formal attrition filing before the Commission within 45 days after its informal filing is rejected by the Commission.

13. Pacific Gas & Electric Company's (PG&E) revenue requirement adjustment for 1987 income tax expense (whether a refund or collection) shall reflect the difference between a calculated revenue requirement change based on the ratemaking procedures adopted in this decision and the $85.3 million reduction attributable to TRA 86 reflected in rates in PG&E's 1987 General Rate Case. Similarly, PG&E's revenue requirement adjustment for 1988 income tax expense shall reflect the difference between a calculated revenue requirement changed based on the ratemaking procedures adopted in this decision and the further $86.3 million reduction attributable to TRA 86 reflected in rates in PG&E's 1988 attrition rate case.

14. Utilities rates from and after January 1, 1987 are subject to refund and adjustment, with interest, to account for the changes and possible changes to revenue requirements authorized herein; those changes made as a result of the advice letter filings, memorandum accounts and balancing account entries mentioned in Ordering Paragraphs 1-13. Interest should be computed

at the average 3-month commercial paper rate as published in the Federal Reserve Bulletin.

This order is effective today.

Dated January 28, 1988, at San Francisco, California.

STANLEY W. HULETT
President
DONALD VIAL
FREDERICK R. DUDA
G. MITCHELL WILK
JOHN B. OHANIAN
Commissioners

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

Victor Weisser, Executive Director

PB

APPENDIX A

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

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.	I. 86-11-019

STIPULATIONS

To narrow the issues, the parties participating in the workshops conducted in this Investigation developed the following Stipulations:

STIPULATION NO. 1: REDUCTION IN CORPORATE TAX RATE

Law Prior to Tax Reform Act of 1986

Section 11 of the Internal Revenue Code (the "Code") imposed a tax for each taxable year on the taxable income of every corporation. Except for the impact of the phase-out rule described below, the rate of tax on taxable income in excess of $100,000 was 46%. Taxable income of less than $100,000 was subjected to graduated tax rates ranging from 15% to 40%, but the benefits of these lower rates were phased out for corporations with taxable income in excess of $1,000,000. This phase-out resulted in a flat 46% tax rate for large corporations.

Tax Reform Act of 1986 (the "Act")

Section 601 of the Act amended section 11 of the Code (now designated the Internal Revenue Code of 1986) to impose a tax on corporations at a rate of 34%. Lower graduated rates continue to apply to taxable income less than $75,000. Phase-out of the lower graduated rates begins at a taxable income level of $100,000, effectively imposing a flat 34% tax on large corporations.

The decrease in the corporate income tax rate from 46% to 34% is effective for taxable years beginning on or after July 1, 1987 (Act Section 601(b)). For taxable years that include the effective date of the change in tax rates (e.g., a calendar year), section 15 of the Code provides for a "blending" of the different tax rates in effect during the tax year of the taxpayer.

For ratemaking purposes, the above-described changes result in a federal income tax rate for 1987 of 39.95%. The rate for 1988 and subsequent years will be 34%.

STIPULATION NO. 2: FLOWBACK OF EXCESS DEFERRED TAXES RESULTING FROM THE CORPORATE TAX RATE REDUCTION

Law Prior to Tax Reform Act of 1986

Taxpayers are permitted deductions for the "exhaustion, wear and tear" on both "property used in the trade or business," or "property held for the production of income." (Section 167(a) of the Code). Depreciation deductions are governed by section 167 (Depreciation) and section 168 (Accelerated Cost Recovery System) and the regulations thereunder.

Generally, these Code sections and related regulations and rulings of the Internal Revenue Service govern: (1) the period over which property may be depreciated for tax purposes, (2) the depreciation method that may be used, and (3) the tax treatment relative to salvage proceeds, costs incurred to retire/remove property, and remaining unrecovered costs at the time property is removed from service. In addition, these Code sections and related regulations/rulings also provide for the proper accounting, in the case of public utility property, for depreciation related timing differences. Public utilities must "normalize" depreciation related timing differences (Code Sections 167(l) and 168(e)(3)). Such timing differences arise because the tax deduction for depreciation expense will, in many instances, exceed depreciation expense recorded in the public utility's regulated books of account in the earlier years of a depreciable asset's life and will subsequently reverse in the later years of the asset's life when book depreciation expense exceeds the tax depreciation deduction. Failure to properly normalize these timing differences (including, but not limited to, the effects of differences in lives, depreciation method, salvage proceeds and cost of removal) will result in the loss of eligibility to claim depreciation deductions under the accelerated provisions of Code Sections 167 and 168.

The "normalization method of accounting" for public utility property generally requires that the utility:

(1) Use the same depreciable lives and method of depreciation to compute both its tax expense and its depreciation expense in establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account;

(2) Make adjustments to a reserve (commonly referred to as a deferred tax reserve) to reflect the deferral of taxes that result from depreciation related timing differences that arise when the utility claims tax depreciation deductions under the provisions of Sections 167 and 168 of the Code (i.e., accelerated tax depreciation) and identical amounts of depreciation expense are not taken into account for ratemaking purposes; and,

(3) Use consistent estimates and projections in the ratemaking process for determination of tax expense, book depreciation expense, the deferred tax reserve, and rate base.

The California Public Utilities Commission ("CPUC") applies the "normalization method of accounting" (Decision 84-05-036, May 2, 1984). The present issue is the need to assure continued application of the "normalization method of accounting" given the existence of amounts currently included in the deferred tax reserve (deferred generally at a tax rate of 46%) that will reverse at the lower corporate tax rates imposed by the Tax Reform Act of 1986, thereby creating an "excess" of deferred taxes. A company that deferred these taxes at a tax rate lower than its tax rate under the Tax Reform Act could have a "deficit" in deferred taxes, instead of an excess, thereby causing an increase in future revenue requirements.

Tax Reform Act of 1986

Section 203 of the Act provides general transitional rules necessary to implement the Act's revisions to the Code. Section 203(e) specifically addresses "normalization requirements" with respect to the excess deferred tax reserve as follows:

"(e) Normalization Requirements -

(1) In General - A normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of Section 167 or 168 of the Internal Revenue Code of 1986 if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method.

(2) Definitions. - For purposes of this subsection -

(A) Excess tax reserve. - The term "excess tax reserve" means the excess of -

(i) the reserve for deferred taxes (as described in Section 167(1)(3)(G)(ii) or 168(e)(3)(B)(ii) of the Internal Revenue Code of 1954 as in effect on the day before the date of the enactment of this Act), over

(ii) the amount which would be the balance in such reserve if the amount of such reserve were determined by assuming that the corporate rate reductions provided in this Act were in effect for all prior periods.

(B) Average rate assumption method. - The average rate assumption method is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its regulated books of account which gave rise to the reserve for deferred taxes. Under such method, if timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying -

(i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by

(ii) the amount of the timing differences which reverse during such period."

For ratemaking purposes, section 203(e) requires that the excess tax reserve be reduced over the remaining lives of the depreciable property that gave rise to the excess. In implementing the average rate assumption method ("ARAM"), use of individual vintage account property records is required, as opposed to a method that aggregates all property lives, and bases the reduction in the excess deferred tax reserve on such an aggregate life. However, if vintage records are not available, it would be appropriate to use a method other than ARAM, as long as such other method meets the normalization requirements.

In addition, for ratemaking purposes, section 203(e)(2)(B) of the Act requires that a reversal of a timing difference must occur for a particular vintage account before a reduction to the excess deferred tax reserve associated with that account is permitted.

To the extent that a reversal of timing differences has not occurred for a particular vintage account, additions to the deferred tax reserve will continue to be made at the applicable statutory rate.

STIPULATION NO. 3: REPEAL OF THE INVESTMENT TAX CREDIT

Law Prior to Tax Reform Act of 1986

Section 38 of the Code provided for the allowance of a general business credit against taxes payable. The general business credit included "... the investment credit determined under Section 46(a)" (Code Section 38(b)(2)). The amount of investment credit was determined under Section 46(b) and, prior to repeal, was 10 percent of "qualified investment" as determined under Section 46(c).

The Code also provides for "recapture" of investment credit in those cases where property that had previously qualified for the credit was "disposed of" (i.e., retired from service) prior to the expiration of various minimum time periods (Section 47(a)(5)).

Section 46(f) of the Code provides, in the case of "public utility property," for normalization of investment credit.

Tax Reform Act of 1986

The Act repealed the regular investment tax credit for property placed in service after December 31, 1985 (Act Section 211(a)). However, various rules were included in the Act which permit taxpayers to claim investment credit in years after 1985 on certain "transition property."

Transition property is defined as property acquired or constructed pursuant to a contract that was binding on the taxpayer prior to January 1, 1986. The limited relief provided by the transitional rules with respect to any given property depends on the type of property. Assuming that the acquisition or construction of the property otherwise meets the binding contract rules, the property must be placed in service on or before the following dates to qualify as transition property and, therefore, qualify for the investment credit (Act Section 203):

(1) July 1, 1986 for property with a class life of less than 5 years;

(2) January 1, 1987 for property with a class life of at least 5 years but less than 7 years;

(3) January 1, 1989 for property with a class life of at least 7 years but less than 20 years; and

(4) January 1, 1991 for property with a class life of 20 years or greater and certain real property.

Several other provisions of the Act apply to transition property and limit the total investment credit benefit on this property. First, the amount of ITC is reduced by 35% for property placed in service after 1986 (Act Section 211(c)). This provision is effective July 1, 1987, so for calendar year taxpayers the 1987 reduction is 17.5%. Second, the depreciable basis of ITC transition property must be reduced by 100% of the ITC claimed on the property (after the above-noted reduction, if applicable). Taxpayers are not permitted to elect a reduced investment credit in lieu of the basis reduction (Act Section 211(d)).

For ratemaking purposes, the Act continued the requirement to normalize investment credits, even though the credit has been repealed. If the provisions of Section 46(f) are not met for taxable years beginning after December 31, 1985, the affected utility would have to repay the greater of: (1) all credits claimed for open years, or (2) the amount of the utility's unamortized investment credits.

The repeal of ITC will cause an increase in revenue requirements. For new plant not qualifying as transition property, utilities operating under paragraph 1 of subsection 46(f) of the Code will no longer be able to reduce rate base under the provisions of that paragraph. For new plant not qualifying as transition property, utilities operating under paragraph 2 of subsection 46(f) of the Code will no longer be able to reduce cost of service under the provisions of that paragraph.

STIPULATION NO. 4: MODIFICATION OF THE ACCELERATED COST RECOVERY SYSTEM

Law Prior to Tax Reform Act of 1986

The Economic Recovery Tax Act of 1981 (ERTA) added Code Section 168 which allowed a "depreciation" deduction for "recovery property." This new depreciation system, called the "Accelerated Cost Recovery System" (ACRS), generally provided for significantly shorter depreciation or "recovery" periods (i.e., tax lives) than under the Asset Depreciation Range (ADR) system.

ACRS applied to recovery property placed in service after December 31, 1980. The depreciation deduction or recovery allowance was based on various percentages of the property's basis as specified in a table contained in section 168(b). The depreciation method used to develop the recovery allowance was essentially the 150% declining balance method with a switch to the straight-line method at the time that maximized the deduction. Real property was also covered by ACRS and originally was "recovered" or depreciated over 15 years using tables based on the declining balance method. Subsequent amendments increased the recovery period for real property, first to 18 years and then to 19 years.

Numerous other rules were enacted by ERTA in connection with ACRS, including optional straight-line elections and calculation of gain or loss upon disposition of recovery property.

Tax Reform Act of 1986

The Act revises the ACRS rules that have been in effect since 1981. The new depreciation system, referred to as modified ACRS or "MACRS", retains many of ACRS' original concepts, but also adds new classes of property, shifts some property between classes, and replaces the 150% declining balance method for some classes of property with the 200% declining balance method.

The new MACRS provisions will generally apply to property placed in service after 1986. However, the Act includes various transition rules that permit certain types of property to be depreciated under the prior ACRS depreciation system. To qualify for such treatment, the "transition property" must be placed in service by specified dates (depending on the type of property) and have been acquired, built or rebuilt pursuant to a written contract that was binding on March 1, 1986.

A special election is available to apply MACRS to property placed in service after July 31, 1986. Such property would otherwise be subject to the ACRS rules under prior law. However, the election cannot be made with respect to "transition property" that is eligible for investment credit.

Normalization requirements, identical to those contained under the prior law's ACRS provisions, have been retained for MACRS (Code Section 168(i)(9)).

For ratemaking purposes, MACRS will cause increases or decreases in revenue requirements, depending on whether MACRS results in decreases or increases to the deferred tax reserve, since the deferred tax reserve is subtracted from rate base.

STIPULATION NO. 5: CAPITALIZATION OF CONSTRUCTION PERIOD OVERHEAD EXPENSES

Law Prior to Tax Reform Act of 1986

Section 189 of the Code, "Amortization of Real Property Construction Period Interest and Taxes," required capitalization of interest and property taxes incurred during the construction of real property. Amounts so capitalized can be amortized over a 10-year period. Prior law did not require various indirect costs (i.e., payroll taxes, pension costs, and general overheads) to be capitalized although taxpayers who self-construct assets are required to capitalize direct costs (e.g., materials and direct labor costs). The general rules governing capitalization were found in Section 263 of the Code and the regulations thereunder.

Tax Reform Act of 1986

The Act repealed Section 189 of the Code and added new Section 263A, "Capitalization and Inclusion in Inventory Costs of Certain Expenses." The general requirements of Section 263A, referred to as "uniform capitalization rules" in the related Committee Reports, are stated as follows in subsections (a) and (b):

> "(a) Nondeductibility of Certain Direct and Indirect Costs. -
>
> (1) In General. - In the case of any property to which this section applies, any costs described in paragraph (2) -
>
> (A) in the case of property which is inventory in the hands of the taxpayer, shall be included in inventory costs, and
>
> (B) in the case of any other property, shall be capitalized.
>
> (2) Allocable costs. - The costs described in this paragraph with respect to any property are -
>
> (A) the direct costs of such property, and
>
> (B) such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property.
>
> (b) Property to which Section Applies. - Except as otherwise provided in this section, this section shall apply to -
>
> (1) Property produced by taxpayer. - Real or tangible personal property produced by the taxpayer...."

Costs incurred after December 31, 1986 will generally be subjected to the new uniform capitalization rules of section 263A. The statute also provides that regulations be prescribed to carry out the purpose of the new rules. The Committee Reports

(Conference Agreement) provide for patterning the uniform capitalization rules after the provisions contained in the regulations applicable to extended long-term contracts. The following items, which have been deductible currently for tax purposes, must be capitalized under the new law, to the extent they are directly or indirectly associated with real or tangible personal property constructed by the utility:

(1) Pension and benefit costs;
(2) Payroll taxes;
(3) Sales and use taxes;
(4) Ad valorem taxes;
(5) Rental costs for equipment/facilities used in the performance of the long-term contract;
(6) Indirect materials and supplies;
(7) Depreciation on equipment/facilities used in the performance of the contract; and
(8) Administrative and general salary expense.

STIPULATION NO. 6: SUPERFUND TAX

The new alternative minimum tax (AMT) provisions of the Act form the basis for calculation of the superfund tax. The superfund or "environmental" tax is imposed on all corporations under the provisions of H.R. 2005, the Superfund Amendments and Reauthorization Act of 1986. The superfund tax and other taxes imposed by this legislation are to be used for toxic waste cleanup and related activities.

The amount of the environmental tax is equal to 0.12% of a corporation's alternative minimum taxable income (AMTI) as computed under the new AMT provisions in the Act. Every corporation must pay the tax on AMTI in excess of $2 million, even though a corporation does not have an AMT liability (i.e., the corporation's regular tax exceeds its AMT). The tax is effective for tax years beginning after December 31, 1986.

For ratemaking purposes, the environmental or superfund tax will increase tax expense in an amount equal to the tax. In addition, the net-to-gross multiplier should be adjusted to include the environmental or superfund tax, because increases or decreases in gross revenue requirements will directly affect AMTI and the amount of environmental or superfund tax liability.

STIPULATION NO. 7: BUSINESS MEALS AND ENTERTAINMENT EXPENSES

Subject to certain exceptions, for tax years after 1986 the Act limits the amount allowable as a deduction for business meal and entertainment expenses to 80% of such expenses.

To the extent such expenses are allowable for ratemaking purposes, the federal income tax attributable to the 20% tax deduction disallowance is an additional current tax expense for ratemaking purposes. The impact on revenue requirements will be the additional tax expense multiplied by the net-to-gross multiplier.

* * *

(END OF APPENDIX A)