ALJ/RAB/rmn

Item 2
Agenda 5/26/89

Decision 89 05 065 MAY 26 1989 (Mailed 4/18/89)

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.	ORIGINAL I.86-11-019 Petition for Modification (Filed November 2, 1988)
Petition of California Water Service Company (U 60 W) and San Jose Water Company (U 168 W) for modification of Decision 88-01-061.	

Messrs. McCutchen, Doyle, Brown & Enersen, by A. Crawford Greene, Attorney at Law, for California Water Service Company and San Jose Water Company, petitioners.
Messrs. Cooper, White & Cooper, by E. Garth Black and Mark P. Schreiber, Attorneys at Law, for Citizens Utilities Company of California; Craig Buchbaum, Attorney at Law, for Pacific Gas and Electric Company; and Joseph F. Young, for Southern California Water Company; interested parties.
Timothy E. Treacy, Attorney at Law, Gilbert Infante, and Larry Hirsch, for the Division of Ratepayer Advocates.

O P I N I O N

California Water Service Company and San Jose Water Company (CWS/SJW) submit this Petition for Modification of Decision (D.) 88-01-061, dated January 28, 1988. CWS/SJW requests that D.88-01-061 be modified in the following respects: The decision should be clarified to show (1) how rate base adjustments to the second test year are to be made when the water utility's last rate case decision adopted two full test years and (2) under what

circumstances a utility could include in rates the additional tax payments it incurred on its 1986 end-of-year unbilled revenue. Public hearing was held before Administrative Law Judge Robert Barnett on March 1, 1989.

1. **Investment Tax Credit and Deferred Tax Reserve**

The tax law prior to Tax Reform Act of 1986 (TRA-86) permitted a deduction for Investment Tax Credit (ITC), which was normalized by deducting ITC from rate base. When TRA-86 eliminated ITC, those utilities which had an ITC rate base reduction were left with an undervalued rate base. D.88-01-061 was an attempt to ameliorate the effects of this tax change.

Ordering Paragraph 3 of D.88-01-061 states in part:

> "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."

CWS/SJW are concerned with water utilities whose last rate case used a pre-1986 test year. CWS/SJW assert that to apply TRA-86 appropriately in establishing the revenue requirement for a pre-1986 test year utility at either the 1987 or 1988 tax rates, it has to be assumed that the change in the tax laws was in existence at the time rates were established in a utility's last rate case, and that the adopted summary of earnings would incorporate all pertinent changes in the tax laws. This is accomplished by adjusting the unamortized ITC reserve to reflect the elimination of two years of ITC when calculating the 1987 revenue requirement at the 1987 tax rate of 40% and adjusting for three years of ITC at the 1988 tax rate of 34%. Concurrently, the Deferred Tax Reserve (DTR) would be adjusted for one year of reduced tax depreciation at the 1987 tax rate and two years of reduced tax depreciation at the

1988 tax rate. CWS/SJW assert that for utilities with a 1985 or earlier test year the Commission has misapplied TRA-86 by only adjusting the last test year rather than two or three years.

CWS/SJW's position is wrong for two reasons:

1. They participated in the proceedings which resulted in D.88-01-061 and this petition is nothing more than an attack on a decision that has become final. No new facts are adduced and no new legal argument is made. CWS/SJW should not be permitted to collaterally attack D.88-01-061.

2. Nevertheless, we have reviewed D.88-01-061 in light of CWS/SJW's argument and conclude that it was decided correctly. TRA-86 eliminated ITC beginning January 1, 1986 and affected DTR beginning January 1, 1987. TRA-86 had no effect on a pre-1986 test year. The Commission, by allowing an adjustment for a pre-1986 test year, renders a benefit to the utility to which it would otherwise not be entitled. Those utilities which received two-year adjustments received them because they had two years of ITC in rates which were set in post-1985 test years.

2. Unbilled Revenues - Utilities on Meter Read Basis

"Unbilled revenues" are defined as revenues produced by sales for the period between the last meter reading in December and the end of the year, but not billed by the utility until the following year. For taxable years before January 1, 1987, utilities were permitted to report revenues for income tax purposes based on sales for a 12-month period which ran from the last meter reading of the preceding tax year to the last meter reading of the current tax year. This method of tax accounting is known as the "cycle meter reading method". Under this method, petitioners reported revenues on meter readings made after the last reading of the year (taken about December 15) as if service was rendered in the following tax year; thus, recognition of revenues for service provided during this period was deferred for tax purposes. With the passage of the Tax Reform Act (TRA), the use of the cycle meter

reading method is no longer allowed and deferred recognition of unbilled revenues is not permitted (Internal Revenue Code Sec. 451(f)). Beginning in 1987, petitioners incurred tax liability based on revenues for the calendar year in which service was provided. As for the tax liability associated with the unbilled revenues for the last days of 1986, the TRA allows those taxes to be paid rateably over a period not longer than four years (IRC Sec. 481).

In its discussion of unbilled revenues in D.88-01-061, the Commission stated:

> "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 advice letter filing we will be ordering in this decision."

Petitioners allege that although energy and communication utilities may have been establishing general rate case revenue requirements on an as-delivered basis, this is true of few, if any, water utilities. Both CWS and SJW, as do all other water utilities to the best of their knowledge, maintain their statistical sales data on a meter read basis. If a meter is read on January 2, all sales from that billing are recorded as January sales even though most of the service was furnished in December. Test year sales estimates made from this historical data, therefore, reflect sales from mid-December of the previous year to mid-December of the current year (for a utility that bills monthly) even though the

resulting estimates are assumed to be calendar year sales for ratemaking purposes.

In addition, petitioners say, many water utilities such as CWS maintained their books and paid their taxes on the meter-read basis. When TRA-86 became effective, these utilities were hit with an additional tax payment on their unbilled revenues existing at the end of 1986, which is to be paid over the four-year period 1987-1990. In the case of CWS, unbilled revenue at the end of 1986 was approximately $3.8 million.

On pages 17 and 18 of D.88-01-061, the Commission stated:

> "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."

In addition, the Commission included the following finding in its decision:

> "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."

Petitioners assert that the staff now takes the position that water utilities that paid the additional tax on the 1986 unbilled revenue are not entitled to recover the added tax expense on the grounds that revenues are set on sales estimates for a 12-month calendar year and, therefore, rates reflect taxes to be paid on calendar year revenues, not meter read revenues.

Petitioners argue that DRA's position has two deficiencies. First, the so-called calendar year sales are actually mid-December to mid-December sales which are arbitrarily moved into the calendar year for ratemaking purposes. Then because the Commission also realizes test year sales are not calendar year sales, when the rate increase goes into effect on January 1, the utility is required to prorate the rate increase on January's bills so that the customer will not be charged January rates for December service. This means that if actual results turn out exactly the same as adopted figures, the utility will collect less revenue than adopted, pay less taxes than adopted, and not earn its authorized rate of return. Petitioners fail to see how a utility in this manner has been compensated for its additional tax payments.

Petitioners claim that CWS must pay over $1.5 million in taxes over four years which is in addition to the income taxes it must pay on its 12-month operations each year. If income taxes are a legitimate operating expense recoverable in rates, then this additional cost should be reflected in CWS's water rates.

Referring to the Commission Finding 11 as set forth above, if CWS's situation does not fit the criteria the Commission had in mind at the time the finding was made, petitioners ask that the Commission clarify the order to explain what conditions and criteria would entitle a utility the right to recover the additional taxes.

Petitioners assert that SJW adopted, for financial and tax purposes and not for ratemaking purposes, the unbilled revenue method of accounting more than 43 years ago. SJW has, therefore, included unbilled revenue in income for financial and tax reporting purposes for more than 43 years. For ratemaking purposes, however, SJW, like other water utilities, has always used the meter read billing cycle method in determining its taxable revenue. Neither the unbilled revenue nor the taxes on the unbilled revenue have ever been included in SJW's income for ratemaking purposes.

Petitioners conclude that, like other water utilities, as of December 31, 1986, SJW has a tax cost incurred on unbilled revenue which has never been recovered from the ratepayers. It is, therefore, only equitable that SJW be treated consistently and uniformly by the Commission and be allowed to recover the tax liability that it has incurred but not been reimbursed for.

Discussion

The treatment of unbilled revenue resulting from TRA-86 changes was thoroughly reviewed by the Federal Energy Regulatory Commission (FERC) in Re Metropolitan Edison Company, Docket No. ER87-34-001, Opinion No. 304, July 13, 1988, which held against the utility. Our discussion of the issue draws heavily from the FERC opinion.

On the basis of the Commission's test year ratemaking principles, we cannot find that petitioners' proposed rate increase to recover taxes associated with unbilled revenues is just and reasonable. Under Commission ratemaking procedures for developing cost of service, all test year expenses and revenues, including an allowance for income taxes associated with such revenues, are synchronized. That is, for the service estimated to be rendered by the utility to its customers during the test period, all costs are included in the development of the rates the utility will be permitted to charge those customers. An allowance for the income tax period revenues is included in such costs. When petitioners provide a unit of service to a customer, the rate applied to such service includes an allowance for the income taxes petitioners must pay on the revenues for such services. Consequently, even if the number of days in the test period differs from the number of days in the billing cycle or the number of days in the taxable year for tax purposes, the utility is still made whole, because for each day of service it collects the allowable income tax component associated with that day of service. Thus, under test period ratemaking procedures, the timing of the actual payment of taxes by

petitioners does not influence the development of the cost of service, including the income tax allowance, or the actual recovery of the taxes through rates. The "unbilled revenues" phenomenon at issue in this proceeding affects only the recognition of revenues for IRS purposes, and does not affect the utility's ability to recover the taxes associated with unbilled revenues through rates.

To accept petitioners' proposal would allow a double recovery of income tax expense. Under test year ratemaking, for every cubic foot of water that petitioners have projected to be taken by their customers, they will recover the associated costs, return on equity, and income taxes. Petitioners should not be allowed to recover another component for income taxes that are already synchronized in the ratemaking process.

CWS/SJW cite Pennsylvania P.U. Comm. v Philadelphia Suburban Water Co. (PSWC) (1988) 96 PUR 4th 158, in support of their position. We have reviewed that case and decline to follow it; apparently the Commission in setting rates had subtracted unbilled revenues from PSWC's ratemaking test year revenues. That is not the case with CWS/SJW.

There are no issues of fact to be determined. The Commission concludes that petitioners have not shown good cause to modify D.88-01-061.

Petitioners filed comments to the ALJ's Proposed Decision which merely restated arguments previously made. We see no reason to modify this decision.

O R D E R

IT IS ORDERED that the petition of California Water Service Company and San Jose Water Company filed November 2, 1988 to modify D.88-01-061 is denied.

This order is effective today.

Dated MAY 26 1989, at San Francisco, California.

G. MITCHELL WILK
President
FREDERICK R. DUDA
STANLEY W. HULETT
JOHN B. OHANIAN
PATRICIA M. ECKERT
Commissioners

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

Victor Weisser, Executive Director

petitioners does not influence the development of the cost of service, including the income tax allowance, or the actual recovery of the taxes through rates. The "unbilled revenues" phenomenon at issue in this proceeding affects only the recognition of revenues for IRS purposes, and does not affect the utility's ability to recover the taxes associated with unbilled revenues through rates.

To accept petitioners' proposal would allow a double recovery of income tax expense. Under test year ratemaking, for every cubic foot of water that petitioners have projected to be taken by their customers, they will recover the associated costs, return on equity, and income taxes. Petitioners should not be allowed to recover another component for income taxes that are already synchronized in the ratemaking process.

CWS/SJW cite Pennsylvania P.U. Comm. v Philadelphia Suburban Water Co. (PSWC) (1988) 96 PUR 4th 158, in support of their position. We have reviewed that case and decline to follow it; apparently the Commission in setting rates had subtracted unbilled revenues from PSWC's ratemaking test year revenues. That is not the case with CWS/SJW.

There are no issues of fact to be determined. The Commission concludes that petitioners have not shown good cause to modify D.88-01-061.