ALJ/BDP/fs

Decision 89 11 058 NOV 2 2 1989

ORIGINAL

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)
Application of PACIFIC GAS AND ELECTRIC COMPANY for authority, among other things, to increase its rates and charges for electric and gas service. (Electric and Gas) (U 39 M)	Application 85-12-050 (Filed December 27, 1985)

Craig Buchsbaum, Attorney at Law, for Pacific Gas and Electric Company, applicant.

Thomas Gregory Hankley, Attorney at Law, for San Diego Gas & Electric Company; Stacy Henry, for Contel of California, Inc.; Kenneth K. Okel and Kathleen S. Blunt, Attorneys at Law, for GTE California Incorporated; Jordana L. Singer, Peter N. Osborn, and Roy Rawlings, Attorneys at Law, for Southern California Gas Company; and James L. Wurtz, Attorney at Law, for Pacific Bell; respondents.

Octavio Lee, for California Board of Equalization; Frank A. McNulty, and Carol B. Henningson, Attorneys at Law, for Southern California Edison Company; John W. Witt, City Attorney, by William S. Shaffran and Leslie J. Girard, Deputy City Attorneys, for the City of San Diego; David A. Simpson, Attorney at Law, for Armour, St. John, Wilcox, Goodin & Schlotz and California Building Industry Association; Hathaway Watson, III, Attorney at Law, for AT&T Communications of California, Inc.; and Karen Edson, for herself; interested parties.

James S. Rood, Attorney at Law, Terry R. Mowrey, Gil Infante, and Benny Tan, for Division of Ratepayer Advocates and Cherrie A. Conner, for Commission Advisory and Compliance Division.

O P I N I O N

Summary

In this proceeding, the Commission has reviewed its ratemaking procedures with regard to two separate, but interrelated issues which result from the fact that there is a one-year lag in the timing of the federal income tax deduction for California Corporate Franchise Tax (CCFT).

First, according to the utilities, there is a cashflow (or working cash) issue because the utilities are not eligible to deduct CCFT expense in the year incurred. The utilities contend that they receive the cash benefit from the deduction of CCFT expense reflected in their results of operations one year later than is assumed in our usual ratemaking federal income tax expense calculation. The utilities argue that they should be compensated for their cost of financing this lag which results in a continuing carrying cost.

The Commission denies the utilities' request for a working cash adjustment. However, since the prior year's CCFT number is now available from Commission adopted records, the Commission finds that a change in method to flow-through for the treatment of the CCFT deduction would alleviate the utilities' concerns over the timing of the benefit of the CCFT deduction. Therefore, the prior year CCFT number should be used in future ratemaking calculations of federal income tax expense.

Second, the utilities contend that when the federal income tax rate changes, present ratemaking makes an erroneous assumption regarding the value of the CCFT deduction. For example, in the federal income tax expense calculation for 1987, the utilities' test year results of operations would assume that the deduction of 1987 CCFT expense will be realized at a 40% federal income tax rate applicable to 1987 when, in fact, this deduction will be only realized at a 34% federal income tax rate applicable

to 1988 due to the one-year lag in the ability to deduct these taxes. Thus, the utilities request that they be allowed recovery for the reduced value of the deduction for 1987 CCFT expense, which is deductible in 1988 at the lower 34% rate. This is the tax rate change issue discussed below.

The Commission finds that current ratemaking should be revised to more accurately compensate the utilities for the loss in value of the CCFT deduction resulting from a tax rate reduction. The Commission adopts the Division of Ratepayer Advocates' (DRA) proposal for the flow-through treatment of the CCFT deduction. The flow-through method allows the CCFT deduction to carry the same value as is realized for federal income tax purposes and alleviates the utilities' concerns.

Since Pacific Gas and Electric Company's (PG&E) 1987 test year general rate case was kept open to resolve these issues, the Commission agrees that the federal income tax calculation for test year 1987 and subsequent attrition years may be restated using the prior year's CCFT deduction and rates may be adjusted for the change in the CCFT deduction. Other utilities may similarly restate their results of operations and be made whole for any resulting revenue shortfall in all cases where the Commission has provided for such adjustment by prior Commission decision.

Procedural Summary

A prehearing conference was held on March 31, 1988. Evidentiary hearings were held during the week of April 18, 1988. Concurrent opening briefs were filed on June 20, 1988 and reply briefs on August 15, 1988. Briefs were filed by DRA and City of San Diego (San Diego) and jointly by AT&T Communications of California, Inc., GTE California Incorporated (GTEC), Pacific Bell, PG&E, San Diego Gas & Electric Company (SDG&E), Southern California Edison Company (Edison), and Southern California Gas Company (SoCalGas) or (utilities).

Working Cash

Background

Prior to its 1987 general rate case, PG&E had not separately reflected in working cash the timing of the federal income tax deductions for CCFT and property taxes. However, in its 1987 general rate case Application (A.) 85-12-050, PG&E made two changes to working cash to reflect the timing of these deductions in payment of federal income taxes.

First, in accordance with the position adopted by DRA, PG&E moved the timing of the property tax deduction to April 15th of the test year, reflecting the fact that the Internal Revenue Code allows property taxes to be deducted in computing the first quarter's estimated tax installment, which is due April 15th.

Second, PG&E moved the timing of the deduction for CCFT to April 15th of the year following the test year, to reflect the fact that the test year CCFT is not deductible until the first quarter's federal income tax payment for the following year.

The Commission, in PG&E's 1987 general rate case decision, D.86-12-095, adopted the first working cash change. However, the Commission declined to adopt the second change based on the record. The Commission stated:

> "The Evaluation and Compliance Division shall conduct a workshop to explore the adjustment to Working Cash Allowance proposed by PG&E. The other energy utilities that have included a similar adjustment in their pending general rate case filings should participate in the workshop.... The Workshop shall precede further hearings on this issue which will be decided in PG&E's General Rate Case." (D.86-12-095, p. 236.)

Workshops to address working cash adjustments related to the CCFT deduction were subsequently held on April 25, May 18, and August 27, 1987.

Position of Utilities

The utilities point out that the Commission includes in rates CCFT expense for the test year based upon a computation of test year taxable income. Although most (90%) of the CCFT for the test year is paid in the test year, a portion of the CCFT is not paid until the following year. Current ratemaking makes a working cash adjustment to reflect the cashflow benefit the utility receives from delaying payment of a portion (10%) of the CCFT expense into the following year.

The utilities argue that in the ratemaking federal income tax computation, the current year's CCFT is treated as being currently deductible, even though the CCFT is not deductible until the following year. The utilities contend that they should be compensated for carrying costs associated with the lag in deducting the current year's CCFT, in the same way that ratepayers now receive the benefit derived by the utility in delaying payment to the State of a portion of the CCFT.

The utilities' argument is based on the ratemaking treatment currently given the 10% portion of the test year CCFT expense which is paid in the following year. Because the utility pays the CCFT expense later than is assumed in the results of operations, and the utility has the use of funds attributable to the delay of the 10% payment, the resultant cashflow benefit is reflected in a reduced working cash requirement (rate base decrease).

The utilities believe that the same principle is involved, only in the case of the lag in the CCFT deduction for federal income tax the utility receives the cashflow benefit from the deduction later than is assumed for ratemaking in the results of operations. Specifically, although the results of operations uses the current year's CCFT as a deduction for ratemaking, this deduction (or cashflow benefit) is not available to the utility until the first quarter's federal income tax payment for the

following year. The utilities believe that the delay in the cashflow benefit of the CCFT deduction results in a carrying cost to the utility which should be reflected as an additional working cash requirement (rate base increase).

Lastly, the utilities contend that there are two instances in PG&E's general rate case for test year 1987 where the Commission adopted working cash computations which had been developed to reflect the timing of tax deductions.

First, the timing of the property tax deduction was moved to April 15th of the test year (rather than reflecting a spread of such deduction over the test year). This acceleration of the timing of the property tax deduction to match the tax computation resulted in a significant working cash (rate base) reduction for PG&E in its 1987 general rate case.

Second, in the same proceeding, the Commission reflected the timing of the CCFT deduction, but did so incorrectly. The Commission treated the test year CCFT as deductible on April 15th of the test year even though it clearly is not deductible until April 15th of the following year.

According to the utilities, these two examples--CCFT and property taxes--demonstrate that the Commission does reflect the timing of tax deductions in working cash computations.

Position of City of San Diego (San Diego)

San Diego notes that prior to 1965, the CCFT component was collected from the ratepayers one year in advance. No CCFT was paid by the utilities in the year it was collected, so the ratepayers were advancing the funds for CCFT one year ahead of the time the utilities had to pay the CCFT to California.

San Diego further notes that in 1965 California desired to accelerate the payment of CCFT. A transition period of eight years (1965-1972) was put in place that required the utilities to pay out cash to California for CCFT a year in advance of the time those taxes could be reflected as a reduction for federal income

tax purposes. During the eight-year transition the tax payment acceleration was gradually implemented. This required the utilities to pay nine years of CCFT in eight years.

Also, San Diego agrees that under the current state law the utilities are required to pay at least 90% of CCFT liability in the year prior to the year in which the tax is imposed, but under federal law cannot use the CCFT deduction for their federal income tax filing until the year the tax is imposed. Therefore, San Diego agrees that there is a timing difference.

With regard to how this timing difference should be treated for ratemaking purposes, San Diego supports the testimony of DRA witness Tan:

> "Q4 If there is a TTD (tax timing difference), how should it be treated for ratemaking.
>
> "A4 Typically TTDs have been afforded a "flow-through" treatment by the Commission. This can be compared with other TTDs such as ad valorem taxes, cost of removal, payroll taxes, Investment Tax Credit, etc.:
>
> It is interesting to note that in the case of the tax rate change from 48 to 46% the Commission amortized the deferred taxes over a specific time period. In the case of rate change from 46 to 34% the Commission was required by federal tax law to amortize the deferred taxes over the remaining life of the plant, to eliminate TTD that would have caused a permanent rate base impact.
>
> "Q5 Where and when is the proper place to solve TTDs?
>
> "A5 TTDs should be addressed in the calculation of income taxes at the time of the tax law change. TTDs should not be made a permanent rate base item through a working cash allowance or as deferred tax. The TTD in this case should have been addressed between 1965 and 1971 when the State accelerated the collection of CCFT payments. PG&E has stated that "This

> permanent capital [commitment] occurred as the result of California's desire in 1965 to accelerate the payment of taxes" (Exhibit 201, page 1-4). DRA believes the present ratepayers should not pay for something that PG&E should have requested twenty years ago." (Exhibit 208, p. 3.)

Further, San Diego points out that this timing difference is not a new issue. It was discussed and resolved in Order Instituting Investigation (OII) 24. The Commission said:

> "J. Differences between state and local taxes claimed by utilities for ratemaking purposes and those used on income tax returns (e.g., State Corporation Franchise Taxes).
>
> "The state income tax deduction for federal tax purposes is the amount of tax paid in the prior year. The state tax deduction computed for ratemaking purposes has been based on the current test-year. In the case of ad valorem taxes, a utility may deduct in the current year the full amount of ad valorem taxes due on property held as of March 1st, even though one-half of the amount is not payable until the following year. For ratemaking purposes utilities record the ad valorem taxes actually payable in the current year. These practices result in some differences between taxes paid and test-year income tax expense for ratemaking purposes.
>
> "Although several alternative methods of making these calculations are discussed, neither staff nor any other party recommends a change from the present practice since they believe that the present practice yields a reasonable result over time. Under these circumstances we see no basis for a change." (Emphasis added.) (D.84-05-036, p. 33b and Ex. 209, p. 3.)

San Diego argues that the utilities are trying to readdress an OII 24 issue calling it instead a working cash issue. They should not be allowed to do this according to San Diego.

San Diego concludes that, if a flow-through tax treatment is adopted for the CCFT deduction, then the tax timing difference does not become an issue. San Diego believes that such ratemaking treatment is just and reasonable.

DRA Position

DRA agrees that there is a tax timing difference. According to DRA, this tax timing difference should have been addressed in the calculation of income taxes for ratemaking when the tax law changed. It should have been addressed between 1965 and 1971 when California accelerated the collection of CCFT payments. It should not now be made a permanent rate base item through a working cash allowance or be treated as a deferred tax.

DRA recommends adoption of the flow-through method for the ratemaking treatment of the CCFT deduction for the federal income tax calculation. DRA points out that the flow-through method can now be implemented by the Commission as the prior year's ratemaking CCFT number may be obtained from the test year decisions or attrition year rate filings.

DRA contends that the ratepayers are not receiving the benefit of the CCFT deduction before the utility receives the benefit. The basis for DRA's argument is that the test year CCFT dollar amount number is used as a convenient approximation for the prior year's CCFT expense in the test year federal income tax calculation. This is done to avoid preparing a complete summary of earnings for the prior year. It is for this reason that in PG&E's 1987 test year rate case, the estimated test year 1987 CCFT expense number was substituted for the 1986 CCFT amount as a deduction in the federal income tax computation.

DRA submits that adoption of a flow-through treatment for the CCFT deduction would negate any need for a working cash or

deferred tax adjustment because the CCFT deduction would be treated consistently for ratemaking and federal income tax return purposes. DRA notes that with the adoption of the Rate Case Plan by the Commission, the prior year's ratemaking CCFT number is available as a matter of record in the utility's test year decision or attrition year filing. Therefore, for most utilities, there would be no obstacle to changing to flow-through treatment. Where the prior year ratemaking CCFT number was not available then the test year CCFT number would have to be used as an approximation.

Discussion

The facts in this case are generally uncontroverted. It is the inference to be derived from these facts which has led to dispute.

The parties agree that the current year's CCFT expense number is not available as a federal income tax deduction until the following year ("CCFT deduction lag"). The parties further agree that the number representing the current year's CCFT expense is used as a deduction in calculating ratemaking federal income tax. That is, there is no adjustment made to reflect the fact that the current year's federal income tax deduction of CCFT expense is based not upon the amount of the current year's CCFT expense but on the prior year's CCFT amount.

Notwithstanding these areas of agreement, the parties disagree as to the significance to be ascribed to the fact that the amount of the current (or test) year's CCFT is reflected as a current federal income tax deduction without adjustment.

The utilities argue that the CCFT deduction being used in the federal income tax computation represents the deduction of the current year's CCFT expense. In support of their argument, they note that the number being used in the federal income tax computation is identical to the number representing the current year's CCFT expense. They further note that they have looked at previous rate cases (as has DRA) and there has never been an

adjustment to the current year's CCFT expense to determine the federal income tax deduction amount. In essence, the utilities argue that the deduction is what its calculation would indicate: test year CCFT expense is being used as the test year federal income tax deduction.

In contrast, DRA and San Diego state that the use of the same number was merely an effort to approximate the appropriate level of the CCFT deduction (which is, in fact, based on the amount of the prior year's CCFT expense). They argue that the Commission had in the past merely been using the current year's CCFT amount in the federal income tax computation because no other number was readily available. They assert that if the Commission had addressed the situation, it would have used flow-through, i.e., it would have sought to identify the proper deduction amount to be used in determining the appropriate level of federal income tax expense.

The dispute between the parties, therefore, centers on what year's CCFT deduction is being represented in the federal income tax computation. If the current year's CCFT is being used, and that is precisely what it is meant to be, then the utilities' arguments prevail. If the number being used as a CCFT deduction is merely representative of the deduction actually available to the utility (i.e., for CCFT expense of the prior year) then DRA and San Diego prevail.

Unfortunately, the ratemaking calculation procedure at issue has not been previously documented in any Commission standard practice manual, nor has the basis for the procedure been memorialized. Furthermore, since test year results of operation calculations do currently use the current year's CCFT number as a deduction, that on its face makes a case for the utilities, because there is nothing on record that contradicts the utilities' assertions.

Notwithstanding the lack of such documentation, we adopt the DRA/San Diego position that the test year CCFT number used is really an approximation for the prior year. Our conclusion is based on an understanding of what it takes to prepare a results of operations for a test year. The preparation of a results of operations for one test year is a major undertaking. The preparation of an additional results of operations for the year prior to the test year is likewise no small task. To do the work required to prepare the additional results of operations, solely for the purpose of deriving one number, arguably a more accurate CCFT number for the test year federal income tax calculation, does not make sense if the test year CCFT number is available, and it is a reasonable approximation.

We believe that our conclusion is supported by the conclusions reached in the OII 24 proceeding in 1984. The consensus was that the current (test year) number was a reasonable approximation. As pointed out by San Diego, this issue was mentioned in the OII 24 decision:

> "The state income tax deduction for federal tax purposes is the amount of tax paid in the prior year. The state tax deduction computed for ratemaking purposes has been based on the current test-year. ..." (Emphasis added, D.84-05-036, p. 33b.)

Apparently, the parties to OII 24, including the utilities, did not disagree that the practice yielded a reasonable result over time and decided that no change was necessary. Of course, the issue was not framed as a working cash issue as it has now been presented to us. But it is the same issue in a different form.

We agree with San Diego and DRA that adopting the flow-through method for the ratemaking treatment of the CCFT deduction for the federal income tax calculation would negate any need for a working cash or deferred tax adjustment. The CCFT deduction would then be treated consistently for ratemaking and federal income tax

return purposes. Adoption of this method is now feasible as the prior year's ratemaking CCFT number is available from the test year decisions or attrition year rate filings.

We now turn to the utilities' argument that in PG&E's 1987 test year decision, in the working cash calculation, we adopted the (first) timing deduction related to property taxes, but declined to adopt the (second) timing deduction related to CCFT. The utilities imply that this is an inconsistency which needs explanation.

The short answer is that we did not "adopt" a timing deduction for property taxes and did not "not adopt" a timing deduction for CCFT. We simply recognized that the utilities do not make a cash payment to the Internal Revenue Service in the first quarter.

Lastly, we agree with San Diego and DRA that commencing in 1965 the utilities should have asked for, and should have received, the incremental amounts when California accelerated the collection of CCFT. Such action would have eliminated any argument that there was a permanent capital commitment related to prepayment of CCFT. The utilities cannot now have this oversight corrected through a working cash adjustment. The utilities' request for a working cash adjustment to reflect the timing of the CCFT deduction for federal income taxes should be denied.

Tax Rate Change

The loss in the value of the CCFT deduction attributable to the reduction of the federal income tax rate was previously examined in the hearings addressing the implementation of the Tax Reform Act of 1986 (I.86-11-019).

In those proceedings, the utilities argued that they were entitled to be compensated for the loss in value of the federal income tax deduction for CCFT. Specifically, CCFT expense for 1987, which was assumed to be deductible at a 40% rate under current ratemaking procedures, actually will be deductible in 1988

at a 34% rate. The utilities requested that they be made whole for the loss in value of this deduction.

The Commission concluded in D.88-01-061 that the utilities were precluded because of retroactive ratemaking prohibitions from recovering the loss in value of the deduction for the 1986 CCFT expense, but recognized that current ratemaking (1987) did not properly reflect the utilities' costs with respect to the CCFT deduction. The Commission ordered further hearings to resolve the matter (D.88-01-061, p. 45).

Following further hearings, the positions of the parties are set forth below.

Position of Utilities

The utilities argue that they are entitled to a rate adjustment to reflect the fact that 1987 CCFT expense is deductible at a 34% federal income tax rate in 1988, not at a 39.95% federal income tax rate in 1987, as would otherwise be assumed in the 1987 federal income tax ratemaking computation.

The utilities contend that DRA's proposal to convert to a ratemaking method which uses the prior year's CCFT in the federal income tax ratemaking computation cannot be implemented without adjusting for the fact that the benefit of the prior year's deduction has already been given to ratepayers.

The utilities note that the present ratemaking/accounting method uses the current year's CCFT as a deduction in the federal income tax ratemaking calculation. Utilities agree that DRA's proposed change--which uses the CCFT for the year prior to the current year as a ratemaking federal income tax deduction--matches the ratemaking computation of federal income tax with the computation of the CCFT deduction in the real world. It is the "flow-through" method.

However, the utilities argue that the Commission must recognize that by changing the ratemaking/accounting method without adjustment, it would be impermissibly using the same deduction

twice. The utilities point out that in the decision that ordered these further hearings, the Commission specifically stated that there should be no double-dipping and that the same deduction cannot be given to ratepayers a second time (D.88-01-061, p. 21; also see Finding of Fact 13, p. 46). According to the utilities, the Commission would violate this principle if it gave the ratepayers the benefit of the deduction of 1986 CCFT expense in the 1987 federal income tax ratemaking calculation, when such deduction had already been used in the 1986 computation. Specifically, the utilities point out that the prohibition against double-dipping was applied by the Commission in a tax ratemaking context with regard to bad debts and unbilled revenues, where it worked to the ratepayers' advantage.

The utilities now ask for equitable treatment.

Position of San Diego

San Diego agrees that the problem arises because the CCFT deduction for actual federal tax purposes is the amount of CCFT paid in the prior year, whereas for ratemaking purposes the CCFT deduction has been based on the current test-year (D.84-05-036, p. 33b).

San Diego notes that DRA witness Infante recommends his Alternative 2 because he recognizes that in the real world there is a timing difference between when CCFT is paid and when CCFT is deductible for federal income tax purposes:

> "ALTERNATIVE 2:
>
> Require that test year and attrition year CCFT estimates adopted in rates be specifically defined and made available to the Commission staff responsible for putting together the FIT (federal income tax) estimates for the following attrition or test year so that there is no time lag in CCFT deductibility. The prior years estimated CCFT collected in rates would always be available as a deduction for the test or attrition year FIT calculation. This alternative would eliminate any conflict when the FIT rate changes because of a change

in FIT law. The utility would be allowed to collect in rates 100% of the test or attrition year CCFT estimate just like any other expense estimate collected in rates." (Exhibit 206, p. 12.)

San Diego further notes that if the Commission adopts Infante's recommendation to use the prior year's CCFT as a current deduction for federal income tax purposes he recommends the following procedures be followed:

"1. The rates for 1986 have already been set and collected in rates. D.83-01-061 has already established that 1986 will not be adjusted as this would constitute retroactive ratemaking.

"2. Use of the prior year CCFT as a current deduction for ratemaking FIT purposes would commence with the adopted 1987 results of operations.

"3. 1987 ratemaking FIT should be restated by removing the CCFT deduction based upon the 1987 adopted results of operations and replacing it with the CCFT deduction based upon the 1986 adopted results of operations.

"4. 1987 CCFT collected in rates would continue to be 100% of the test or attrition year estimate.

"5. 1988 ratemaking FIT would be calculated using the CCFT adopted for the 1987 results of operations.

"6. 1988 CCFT collected in rates would continue to be 100% of the test or attrition year estimate.

"7. This procedure would base the utilities ratemaking FIT expense on the methodology required to calculate FIT in the real world for tax return purposes and would eliminate any time lag as to when CCFT is paid when compared to when it is deductible for FIT purposes." (Exhibit 206, pp. 13-14.)

San Diego agrees with and endorses Infante's Alternative 2 proposal.

However, San Diego takes exception to the utilities' solution on how the ratemaking changeover should be accomplished to implement Alternative 2. San Diego argues that the utilities want to recover what they allege is a 6% loss in value for the CCFT deduction from federal income tax in 1987 and 1988 from the ratepayers. They maintain that if the Commission were to adopt Infante's flow-through approach (Alternative 2) to the CCFT 6% loss in value, that a ratemaking CCFT deduction for 1987, the year of change, for ratemaking federal income tax purposes would be zero (Exhibit 207, p. 1). They say this results from the fact that the 1986 CCFT tax liability which would normally be deductible in 1987 for federal income tax purposes has already been used as a federal income tax deduction for setting 1986 rates and cannot be used twice. San Diego contends that, since the utilities will still have the 1986 CCFT liability to use as a deduction in the real world determination of federal income tax, this argument is specious.

San Diego believes that the utilities want the Commission to overstate their federal income tax liability for 1987 and create a windfall profit for them. Use of the authorized 1986 CCFT expense collected in rates as a deduction in the determination of 1987 federal income tax would implement flow-through in 1987 and reflects what has occurred in the real world (Exhibit 207, p. 3). According to San Diego, it simply represents a change in estimating method, not the use of the 1986 ratemaking deduction twice.

DRA's Position

DRA recommends that the prior year's estimated CCFT adopted in rates should be used as a deduction for the test or attrition year federal income tax calculation. According to DRA, adoption of this recommendation would place the CCFT deduction on a flow-through method. This means that for ratemaking and tax

return purposes the CCFT deduction would be treated the same. DRA also contends that adoption of this recommendation also eliminates the time lag issue relating to the loss in value of the CCFT deduction due to a federal income tax rate change in the ratemaking calculation.

DRA does not agree with the utilities' position which looks to the identity of the CCFT dollars which are used on the federal income tax return and compares this to the identity of CCFT expense which is reflected as a deduction for ratemaking purposes. Instead, DRA believes the primary question is whether current Commission policy fairly estimates the level of CCFT that should be used as a deduction in estimating the amount of federal income tax which should be collected in rates. DRA believes that the present method produces a result which is reasonable, notwithstanding the fact that the level of the CCFT used as a deduction for federal income tax purposes will not precisely match the ratemaking estimate. Essentially, DRA's position is that the present approach yields a reasonable result because there was no reasonable way of estimating what the CCFT amount was for the year prior to the test year.

DRA believes there are two alternatives for treating the present problem arising from the fact that the deduction of CCFT expense is lagged by one year. First, the Commission could maintain present policy. However, DRA does not support this approach. Instead, DRA favors a flow-through approach which eliminates the discrepancy by substituting CCFT expense computed for the prior year in the federal income tax rate calculation.

DRA does not believe the switch to flow-through constitutes re-use of the prior year's CCFT deduction (i.e., double-dipping). The Commission used the current year's CCFT expense as a deduction in the federal income tax rate computation because there was no means of obtaining the prior year. In 1987, the utilities should use the 1986 CCFT expense estimates as a

federal income tax deduction, notwithstanding the fact that the utilities allege 1986 was already used in the 1986 rate computation. DRA notes that the utilities will have a CCFT deduction in the real world for CCFT expense, and it is unreasonable to give the ratepayers no deduction for that year. DRA argues that ratepayers should not be asked to provide in rates a level of federal income tax expense which is greater than what the utilities will actually experience in the real world.

According to DRA, to adopt a zero level of CCFT, as suggested by the utilities, as a 1987 federal income tax deduction would provide a windfall to the utilities in federal income tax expense which they would never have had to pay.

Discussion

The testimony and briefs have followed a bifurcated approach notwithstanding the interrelationship between the two issues. However, we recognize that the resolution of one issue has a bearing on the other.

As apparent from our discussion on working cash, we conclude that the time has come to adjust our ratemaking calculations with regard to the CCFT deduction so that there is a better match with the real world. We should make the transition to flow-through as recommended by DRA. But before we do so, we need to address the double-dipping issue.

The utilities note that in other circumstances which are similar we have recognized that tax timing differences exist between ratemaking and real world taxes. Specifically, in the case of unbilled revenues and bad debts (D.88-01-061), when revenue and expense numbers used in the results of operations and the federal income tax computation were the same (as is the case with CCFT expense), we used this fact to find that utilities had collected certain taxes in rates in advance of the time paid to the IRS. Thus, when Congress shifted the accounting rules regarding unbilled revenues, accelerating their taxation, we determined no rate

adjustment was appropriate because ratemaking had already reflected the taxation of these amounts.

The utilities now argue that this case presents the same fundamental issue except that here the utility has given a tax benefit to the ratepayers in advance of the time realized by the utility, whereas in the case of unbilled revenues and bad debts, we found that the utility had been collecting a tax cost in advance of the time paid to the Internal Revenue Service.

We are not persuaded by the utilities' argument that by implementing the DRA proposal for flow-through, we would be impermissibly using the same deduction twice. As we concluded in the working cash discussion, the test year CCFT figure was used in the results of operations as an approximation of the prior year CCFT expense amount because that was the figure that was readily available. Therefore, although it is the same number, the "same" deduction is not being used twice.

Also, since the utilities will have a CCFT deduction in the real world, we believe it is unreasonable to give the ratepayers zero CCFT deduction for that year. Therefore, we will not adopt the utilities' proposal for a zero CCFT deduction when we switch to flow-through commencing with test year 1987.

We will adopt DRA's Alternative 2 (Exhibit 206, pp. 13-14). Consistent with our decision to make the transition to flow-through, we conclude that the utilities should receive an adjustment to reflect the change in the federal income tax expense resulting from the use of the prior years' CCFT as a current federal income tax deduction. PG&E may file advice letter proposals restating its adopted results of operations for test year or attrition years 1987, 1988 and 1989. Other utilities may similarly file advice letter proposals in all cases where the Commission has provided for such adjustment by prior Commission decision. It is expected that there will be an increase in revenue requirement. Therefore, the utilities should include a proposal

for implementing into rates the resulting revenue requirement increase. The revenue increase may be consolidated with rate changes resulting from the utilities' next general rate increase proceedings or attrition increase filings.

Section 311 Comments

On September 25, 1989, the ALJ's proposed decision on this matter was filed with the Docket Office and mailed to all parties of record pursuant to Rule 77 of the Commission's Rules of Practice and Procedure.

Comments on the ALJ's proposed decision were filed by DRA, GTEC, Pacific Bell, PG&E, SDG&E, Edison and SoCalGas.

Reply comments were filed by DRA, GTE, and PG&E.

Having reviewed the comments of all parties, we conclude that the ALJ's proposed decision should remain unchanged, except for clarifications and technical corrections that have been adopted and included in appropriate places in this decision.

Findings of Fact

1. The parties agree that the current year's CCFT expense is not available as a federal income tax deduction until the following year ("CCFT deduction lag").

2. The parties further agree that the number representing the current year's CCFT expense is used as a deduction in calculating ratemaking federal income tax.

3. There is no ratemaking adjustment made to reflect the fact that the current year's federal income tax deduction of CCFT expense is based not upon the amount of the current year's CCFT expense but on the prior year's CCFT amount.

4. The parties disagree as to the significance to be ascribed to the fact that the amount of the current (or test) year's CCFT is reflected as a current federal income tax deduction without adjustment.

5. The utilities argue that the deduction is what its calculation would indicate: test year CCFT expense is being used as the test year federal income tax deduction.

6. DRA and San Diego argue that the use of the same number was merely an effort to approximate the appropriate level of the CCFT deduction (which is, in fact, based on the amount of the prior year's CCFT expense).

7. There is no Commission standard practice manual or other documentation on record that explains the underlying rationale for using the current test year CCFT number in the test year federal income tax calculation.

8. The Commission finds the DRA/San Diego position more persuasive. The current year's CCFT number was used because no other number was readily available and it represented a reasonable approximation of the prior year's CCFT amount.

9. The issue was raised in OII 24 and the parties did not disagree that the test year CCFT amount yielded a reasonable approximation of the prior year's CCFT amount. (D.84-05-036, p. 33b.)

10. Use of the test year CCFT number as an approximation for the prior year CCFT amount does not mean that the ratepayers have been given in the test year the benefit of the deduction of the test year's CCFT expense, when such deduction is not available to the utilities until the subsequent year.

11. Commencing with 1987, the utilities may restate their adopted results of operations for a test year or attrition year to reflect the prior year's CCFT amount, if that amount is on record in a Commission adopted summary of earnings. Any revenue requirement increase may be recovered through an advice letter filing in those cases.

Conclusions of Law

1. The Commission concludes that ratemaking should reflect the value of the CCFT deduction. Since the prior year's CCFT

ratemaking amount is now readily available from the recent Commission adopted records, flow-through treatment for the CCFT deduction shall be used in setting rates.

2. Commencing with test year 1987, the utilities should be allowed to file advice letters to recover the change in the federal income tax expense allowed for ratemaking resulting from the adoption of flow-through for the CCFT deduction. The utilities may restate their adopted test year and attrition year summaries of earnings for 1987 onwards in all cases where the Commission has adopted the prior years CCFT amount in a Commission decision. With the adoption of this method the value of the CCFT deduction is consistent with that allowed for federal income tax return purposes.

3. Since the Commission expressly ruled that PG&E's 1987 general rate case and OII 86-11-019 should remain open for resolution of issues related to the CCFT deduction (p. 237, D.86-12-095), the prohibition against retroactive ratemaking does not apply.

O R D E R

IT IS ORDERED that:

1. The utilities' request for a working cash adjustment to reflect the one-year lag in the timing of the California Corporate Franchise Tax deduction within the federal income tax calculation is denied.

2. Commencing with 1987, the utilities may recover the revenue requirement related to the change to flow-through for the CCFT deduction in estimating ratemaking federal income tax expense. The adopted flow-through method is set forth on pages 15 and 16, as "ALTERNATIVE 2" and DRA witness Infante's recommended procedures 1 through 7.

3. The utilities may file advice letters to adjust the revenue requirement as set forth in this opinion.

4. In the future, all results of operations for all utilities shall reflect the flow-through treatment for the CCFT deduction in computing federal income tax expense.

5. A.85-12-050 is closed. I.86-11-019 shall remain open for disposition of other matters pending before the Commission.

This order becomes effective 30 days from today.

Dated NOV 2 2 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.

Wesley Franklin

WESLEY FRANKLIN, Acting Executive Director

Orig.

H-4

State of California

Public Utilities Commission
San Francisco

M E M O R A N D U M

Date : November 17, 1989

To : The Commission
(Agenda Distribution List)

From : Bertram D. Patrick
Administrative Law Judge

File No.: I.86-11-019, A.85-12-050

Subject : Revised Pages 3, 12, 17, and 21-24, Agenda Item H-4, Meeting of 11/22/89

The ALJ's proposed decision remains essentially unchanged. However, this draft makes it clear that the utilities may file an advice letter for a revenue increase or decrease going back to test year 1987. The ALJ's proposed decision did not specifically address the question of a revenue decrease. It stated that the utilities may file for an increase.

BDP:fs

to 1988 due to the one-year lag in the ability to deduct these taxes. Thus, the utilities request that they be allowed recovery for the reduced value of the deduction for 1987 CCFT expense, which is deductible in 1988 at the lower 34% rate. This is the tax rate change issue discussed below.

The Commission finds that current ratemaking methodology does not compensate the utilities for the loss in value of the CCFT deduction resulting from a tax rate reduction. The Commission adopts the Division of Ratepayer Advocates' (DRA) proposal for the flow-through treatment of the CCFT deduction. The flow-through method allows the CCFT deduction to carry the same value as is realized for federal income tax purposes and alleviates the utilities' concerns.

Since Pacific Gas and Electric Company's (PG&E) 1987 test year general rate case was kept open to resolve these issues, the Commission agrees that the federal income tax calculation for test year 1987 and subsequent attrition years should be restated using the prior year's CCFT deduction and rates should be adjusted for the change in the CCFT deduction. Other utilities may similarly restate their results of operations and be made whole for any resulting revenue shortfall in all cases where the Commission has provided for such adjustment by prior Commission decision.

Procedural Summary

A prehearing conference was held on March 31, 1988. Evidentiary hearings were held during the week of April 18, 1988. Concurrent opening briefs were filed on June 20, 1988 and reply briefs on August 15, 1988. Briefs were filed by DRA and City of San Diego (San Diego) and jointly by AT&T Communications of California, Inc., GTE California Incorporated, Pacific Bell, PG&E, San Diego Gas & Electric Company, Southern California Edison Company, and Southern California Gas Company (utilities).

Notwithstanding the lack of such documentation, we adopt the DRA/San Diego position that the test year CCFT number used is really an approximation for the prior year. Our conclusion is based on an understanding of what it takes to prepare a results of operations for a test year. The preparation of a results of operations for one test year is a major undertaking. The preparation of an additional results of operations for the year prior to the test year is likewise no small task. To do the work required to prepare the additional results of operations, solely for the purpose of deriving one number, arguably a more accurate CCFT number for the test year federal income tax calculation, does not make sense if the test year CCFT number is available, and it is a reasonable approximation.

We believe that our conclusion is supported by the conclusions reached in the OII 24 proceeding in 1984. The consensus was that the current (test year) number was a reasonable substitute. As pointed out by San Diego, this issue was mentioned in the OII 24 decision:

> "The state income tax deduction for federal tax purposes is the amount of tax paid in the prior year. The state tax deduction computed for ratemaking purposes has been based on the current test-year. ..." (Emphasis added, D.84-05-036, p. 33b.)

Apparently, the parties to OII 24, including the utilities, agreed that the practice yielded a reasonable result and decided that no change was necessary. Of course, the issue was not framed as a working cash issue as it has now been presented to us. But it is the same issue in a different form.

We agree with San Diego and DRA that adopting the flow-through method for the ratemaking treatment of the CCFT deduction for the federal income tax calculation would negate any need for a working cash or deferred tax adjustment. The CCFT deduction would then be treated consistently for ratemaking and federal income tax

San Diego agrees with and endorses Infante's Alternative 2 proposal.

However, San Diego takes exception to the utilities' solution on how the ratemaking changeover should be accomplished to implement Alternative 2. San Diego argues that the utilities want to recover what they allege is a 6% loss in value for the CCFT deduction from federal income tax in 1987 and 1988 from the ratepayers. They maintain that if the Commission were to adopt Infante's flow-through approach (Alternative 2) to the CCFT 6% loss in value, that a ratemaking CCFT deduction for 1987, the year of change, for ratemaking federal income tax purposes would be zero (Exhibit 207, p. 1). They say this results from the fact that the 1986 CCFT tax liability which would normally be deductible in 1987 for federal income tax purposes has already been used as a federal income tax deduction for setting 1986 rates and cannot be used twice. San Diego contends that, since the utilities will still have the 1986 CCFT liability to use as a deduction in the real world determination of federal income tax, this argument is specious.

San Diego believes that the utilities want the Commission to overstate their federal income tax liability for 1987 and create a windfall profit for them. Use of the authorized 1986 CCFT expense collected in rates as a deduction in the determination of 1987 federal income tax would implement flow-through in 1987 and reflects what has occurred in the real world (Exhibit 207, p. 3). According to San Diego, it simply represents a change in estimating methodology, not the use of the 1986 ratemaking deduction twice.

DRA's Position

DRA recommends that the prior year's estimated CCFT adopted in rates should be used as a deduction for the test or attrition year federal income tax calculation. According to DRA, adoption of this recommendation would place the CCFT deduction on a flow-through methodology. This means that for ratemaking and tax

for implementing into rates the resulting revenue requirement increase. The revenue increase may be consolidated with rate changes resulting from the utilities' next general rate increase proceedings or attrition increase filings.

Although in this case the proposed adjustment serves to increase rates, we place the utilities on notice that this adjustment will not be a "one-way street." Should federal income tax rates be increased in the future, an appropriate downward rate adjustment--using the same principles applied here--will be required.

Findings of Fact

1. The parties agree that the current year's CCFT expense is not available as a federal income tax deduction until the following year ("CCFT deduction lag").

2. The parties further agree that the number representing the current year's CCFT expense is used as a deduction in calculating ratemaking federal income tax.

3. There is no ratemaking adjustment made to reflect the fact that the current year's federal income tax deduction of CCFT expense is based not upon the amount of the current year's CCFT expense but on the prior year's CCFT amount.

4. The parties disagree as to the significance to be ascribed to the fact that the amount of the current (or test) year's CCFT is reflected as a current federal income tax deduction without adjustment.

5. The utilities argue that the deduction is what its calculation would indicate: test year CCFT expense is being used as the test year federal income tax deduction.

6. DRA and San Diego argue that the use of the same number was merely an effort to approximate the appropriate level of the CCFT deduction (which is, in fact, based on the amount of the prior year's CCFT expense).

7. There is no Commission standard practice manual or other documentation on record that explains the underlying rationale for using the current test year CCFT number in the test year federal income tax calculation.

8. The Commission finds the DRA/San Diego position more persuasive. The current year's CCFT number was used because no other number was readily available and it represented a reasonable approximation of the prior year's CCFT amount.

9. The issue was raised in OII 24 and the parties agreed that the test year CCFT amount yielded a reasonable approximation of the prior year's CCFT amount. (D.84-05-036, p. 33b.)

10. Use of the test year CCFT number as an approximation for the prior year CCFT amount does not mean that the ratepayers have been given in the test year the benefit of the deduction of the test year's CCFT expense, when such deduction is not available to the utilities until the subsequent year.

11. Commencing with 1987, the utilities may restate their adopted results of operations for a test year or attrition year to reflect the prior year's CCFT amount, if that amount is on record in a Commission adopted summary of earnings. Any revenue requirement increase may be recovered through an advice letter filing in those cases.

Conclusions of Law

1. The Commission concludes that ratemaking should reflect the value of the CCFT deduction. Since the prior year's CCFT ratemaking amount is now readily available from the recent Commission adopted records, flow-through treatment for the CCFT deduction shall be used in setting rates.

2. Commencing with test year 1987, the utilities should be allowed to file advice letters to recover the change in the federal income tax expense allowed for ratemaking resulting from the adoption of flow-through for the CCFT deduction. The utilities may restate their adopted test year and attrition year summaries of

earnings for 1987 onwards in all cases where the Commission has adopted the prior years CCFT amount in a Commission decision. With the adoption of this methodology the value of the CCFT deduction is consistent with that allowed for federal income tax return purposes.

3. Since the Commission expressly ruled that PG&E's 1987 general rate case and OII 86-11-019 should remain open for resolution of issues related to the CCFT deduction (p. 237, D.86-12-095), the prohibition against retroactive ratemaking does not apply.

ORDER

IT IS ORDERED that:

1. The utilities' request for a working cash adjustment to reflect the one-year lag in the timing of the California Corporate Franchise Tax deduction within the federal income tax calculation is denied.

2. Commencing with 1987, the utilities may recover the revenue requirement related to the change to flow-through for the CCFT deduction in estimating ratemaking federal income tax expense. The adopted flow-through methodology is set forth on pages 15 and 16, as "ALTERNATIVE 2" and DRA witness Infante's recommended procedures 1 through 7.

3. The utilities may file advice letters to recover the increased revenue requirement as set forth in this opinion.

4. In the future, all results of operations for all utilities shall reflect the flow-through treatment for the CCFT deduction in computing federal income tax expense.

5. I.86-11-019 and A.85-12-050 are closed.
This order becomes effective 30 days from today.
Dated _____, at San Francisco, California.