

Decision 90 05 083 MAY 22 1990

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of General Telephone)
Company of California, a California)
Corporation (U 1002 C), for authority)
to increase and/or restructure)
intrastate rates and charges for)
telephone services.)

Application 87-01-002
(Filed January 5, 1987)

And Related Matter.)

I.87-02-025
(Filed February 11, 1987)

FINAL OPINION

Introduction

In March of 1988, during the evidentiary phase of this test year 1988 general rate case of General Telephone Company of California, Inc. (GTEC), the Commission's Division of Ratepayer Advocates (DRA) became concerned that the reduction of GTEC's income tax liability resulting from the tax deduction of the premium GTEC paid to refinance its long-term debt was not being passed on to GTEC's ratepayers. DRA sought an order to show cause regarding GTEC's failure to flow through tax savings. GTEC opposed the motion.

The August 1988 Decision (D.) 88-08-061 in this rate case proceeding reserved the question of how GTEC should flow through those tax benefits to its ratepayers for further hearing. The decision also required GTEC to track the tax benefits of its debt refinancing in a memorandum account subject to refund while the Commission reviewed how those benefits should be accounted for prospectively in ratemaking.

In February of 1989, GTEC filed a pleading seeking to eliminate the requirement of a memorandum account and thereby ensure that the tax benefits accruing in the interim would be

retained by the company. That pleading will be disposed of in this decision.

The flow through of tax benefits was also an issue in the 1989 Financial Attrition proceeding for the energy utilities (Application (A.) 88-07-023, et al.). In the resultant decision, D.88-12-094, the Commission found that additional proceedings were needed to devise a method to quantify and pass through the analogous tax benefits from debt refinancing by the energy utilities. As opposed to its earlier decision on GTEC, the Commission did not require the energy utilities to set up a memorandum account to accumulate the difference in tax liability pending its final decision.

At the first pre-hearing conference in this matter, the assigned administrative law judge (ALJ) directed GTEC and DRA to attend Commission Advisory and Compliance Division's (CACD) workshop, convened in response to D.88-12-094, on the generic issue of how the tax benefits should be passed on to ratepayers. It was expected that workshop results would guide the parties toward a resolution of GTEC's ratemaking issues, and progress toward settlement would be reviewed at a subsequent pre-hearing conference. Those workshops were held on March 23 and April 19, 1989. Six methods for accounting and passing through the tax benefits were examined. One particular methodology was agreed upon by all the parties to those workshops.

At the subsequent pre-hearing conference on May 10, 1989, GTEC and DRA submitted a proposed settlement pursuant to Article 13.5 of the Commission's Rules of Practice and Procedure. The proposal set forth the workshop methodology and proposed that it be applied in this case. The proposed settlement does not resolve GTEC's application to remove the memorandum account. In fact, on May 10, 1989, DRA supplemented its opposition to GTEC's petition to delete the memorandum account. It noted that under the stipulated method, \$2.568 million will have accumulated in

the memorandum account. DRA recommended that the balance be returned to GTEC's ratepayers via a surcredit on access and intraLATA service over a six-month period.

Copies of the parties' "Joint Motion by Division of Ratepayer Advocates and GTE California for Adoption of Proposed Settlement Agreement" and "Proposed Settlement of Issues Regarding the Proper Ratemaking Treatment of the Tax Benefits Associated with Bond Repurchase Premiums" were served on all parties to this proceeding on May 10, 1989. No party has filed any comment on the proposed settlement.

The Adopted Ratemaking Treatment

The ratemaking method proposed in the GTEC-DRA settlement in this case is the same as the one approved in D.89-11-068, the 1990 Financial Attrition proceeding, for use by the energy utilities. It is known as the "DRA's Amended PG&E Method 2" and will be referred to as the "workshop method." This method nets the tax benefit from the bond call premiums and unamortized discounts and expenses (BP&UDE) associated with the early retirement of debt before calculating net proceeds of the refinancing.

The net of tax BP&UDE is amortized, by the straightline method, over the remaining life of the replacement issue (or the original issue if there is not a replacement issue). Net proceeds increase each year by the amortization of the net of tax BP&UDE. The net of tax BP&UDE is net-to-grossed by that year's authorized net-to-gross multiplier only when calculating the increase to the interest expense, which is used to calculate the effective cost of debt, compensating for the fact that the BP&UDE is only deductible for tax purposes in the year of the retirement. Capital structures are not to be adjusted for the adoption of this ratemaking treatment.

DRA filed testimony in support of the settlement. DRA endorses the workshop method because it nets the tax benefit from

the BP&UDE before increasing the cost of debt to recover the BP&UDE. This ensures that GTEC will only recover the net of tax BP&UDE.

Consistent with other parties to the CACD workshop, GTEC and DRA agreed that the workshop method should be implemented beginning January 1, 1990. This would reduce rates on a going-forward basis. The parties anticipated that GTEC would be subject to a new regulatory framework, where rates are no longer set on a Commission-approved cost of service basis. Thus, they recommend that a steady revenue requirement adjustment stream be used to flow the amounts calculated back to ratepayers based on an average annuity. This yearly decrease to the revenue requirement is \$2,443,000 per year for 23 years. The parties stipulated that this reduction to revenue requirement should become effective January 1, 1990.

Given the industry-wide review of this issue during the CACD-chaired workshops and the consistency of GTEC and DRA's recommendation with the consensus result of the workshop, it is reasonable to adopt the workshop method, effective January 1, 1990, to flow the tax benefits to GTEC's ratepayers.

Memorandum Account Treatment of Benefits Accrued

Since September 28, 1988, the effective date of D.88-08-061, the tax benefits arising from GTEC's bond refinancing have been booked into a memorandum account, subject to refund. GTEC argued that the memorandum account should be deleted because energy utilities were not required to book their tax benefits in memorandum accounts, subject to refund, pending final decision on the method for calculating and passing through the tax benefit.

The ALJ did not act on GTEC's application because the Commission had not issued its final order on the proper treatment of tax benefits by the energy utilities. That order, D.88-11-068, confirmed that the energy utilities were to flow tax

benefits through prospectively in rates from January 1, 1990. Tax benefits that admittedly existed before the Commission's decision ordering the CACD to convene the workshops would not be flowed through in rates.

DRA notes that \$2.568 million has accrued in the memorandum account GTEC was ordered to establish September 27, 1988, assuming use of the workshop method to calculate tax benefits. While a memorandum account was required in GTEC's general rate case (D.88-08-061), no memorandum accounts were required of the energy utilities, even though this issue was raised in their attrition proceeding. Instead, the energy utilities were ordered to address the methodology for calculating tax benefits and flowing them through to ratepayers. GTEC had volunteered to participate in the workshop, even before it was ordered to by the ALJ.

GTEC's use of the workshop method pursuant to its settlement with DRA is advantageous to ratepayers. Four major methodologies were dissected at the workshops. This scrutiny of the adopted methodology and other variants eliminates the possibility of later misunderstandings when the annual benefit is calculated. The settlement with DRA also avoids a contested proceeding, which may have resulted in adoption of a methodology for GTEC that was less favorable to ratepayers.

For these reasons, we believe it equitable to treat GTEC the same as the energy utilities with respect to tax benefits accruing before January 1, 1990.

Amounts booked to the memorandum account ordered in D.88-08-061, that is, the tax benefits accruing during the period of September 28, 1988 to January 1, 1990 as calculated under the workshop method, are not required to be flowed through to GTEC's ratepayers. The memorandum account should be discontinued and its balance should be zeroed out. We need not address GTEC's petition to eliminate the memorandum account because we have

determined that the balance should be retained by GTEC's shareholders rather than its ratepayers.

Conclusion

The proposed settlement between GTEC and DRA adopting the workshop method of calculating the income tax benefits of the cost of refinancing long-term debt is in the public interest and should be approved. GTEC shall revise its surcharges on all services to spread a \$2.443 million annual decrease in surcharge revenues evenly among access, local exchange, and toll services. The \$2.443 million decrease shall remain in effect for 23 years, commencing with January 1, 1990. In order to calculate the change in surcharge, GTEC shall use the 1989 Billing Base, adopted in D.89-12-048 and adjusted for actual 1989 receipts. GTEC should propose the appropriate change to the surcharge in an advice letter filing with CACD. After the 23-year period has run, GTEC may make an appropriate filing to increase its revenues by \$2.443 million per year. GTEC shall discontinue the memorandum account ordered by Paragraph 8 of D.88-08-061 and zero out the balance contained in that account.

Findings of Fact

1. D.88-08-061 recognized that certain tax benefits realized by GTEC as a result of refinancing its long-term bonds were not being passed on to ratepayers.

2. Those tax benefits consisted of the decrease in income tax liability due to the deductibility of the bond call premiums and unamortized discounts and expenses associated with the early retirement of debt. GTEC was already recovering the cost of paying those premiums and other expenses of refinancing in its rates.

3. Ordering Paragraph 8 of D.88-08-061 required GTEC to establish a memorandum account into which it shall book the difference between currently authorized rates and rates it would be collecting if it revised its accounting for refinancings to follow the net of tax method. The memorandum account amount would be

collected subject to refund based on the outcome of hearings to be held to address the reasonable method for passing through the tax benefits to GTEC ratepayers.

4. On February 2, 1989, GTEC filed a Petition to Modify Ordering Paragraph 8 of D.88-08-061 to eliminate the memorandum account.

5. GTEC and DRA participated in workshops chaired by CACD to formulate a generic method for calculating and flowing through the tax benefits from analogous energy utility refinancing of long-term debt to energy utility ratepayers.

6. The workshop participants agreed that the modified version of the Pacific Gas and Electric Model 2 presented by DRA at the April 19, 1989 workshop (the workshop method) was a reasonable means of accomplishing the tax benefits flow-through.

7. On May 10, 1989, GTEC and DRA filed their "Proposed Settlement of Issues Regarding the Proper Ratemaking Treatment of the Tax Benefits Associated with Bond Repurchase Premiums (settlement proposal)," wherein they agreed that the workshop method set forth the reasonable ratemaking treatment of the tax benefits associated with bond repurchase premiums and expenses. GTEC and DRA stipulated to a reduction to revenue requirement of \$2.443 million per year for 23 years effective January 1, 1990.

8. In D.89-11-068, the workshop method was adopted for all of the energy utilities (except for Sierra Pacific Power Company, which was not a party to the financial attrition proceeding), effective January 1, 1990. The utilities were not required to flow through the tax benefits they had received prior to January 1, 1990.

9. GTEC and DRA anticipated that the Commission would decide in D.89-11-031 that cost of service-based annual revenue requirements should no longer be adopted for GTEC under its new regulatory framework for local exchange carriers. In their settlement proposal, they recommended flowing through the tax

benefits in the form of an annuity. That annuity would change the company's authorized revenue requirement effective January 1, 1990 and be rolled into rates via an advice letter or in conjunction with any revenue "true up" or supplemental rate design ordered by the Commission in the course of the new regulatory framework proceeding.

10. GTEC and DRA have explained in their settlement proposal that the workshop model produces an annual revenue requirement that changes each year as the expense of refinancing is amortized. GTEC and DRA have calculated that an annual annuity of (\$2.443) million per year for 23 years would produce the same result as the accepted workshop model.

11. Copies of the "Joint Motion by Division of Ratepayer Advocates and GTE California for Adoption of Proposed Settlement Agreement" and the "Proposed Settlement of Issues Regarding the Proper Rate-making Treatment of the Tax Benefits Associated with Bond Repurchase Premium" were served on all parties to this proceeding on May 10, 1989.

12. There have been no protests to the settlement proposal.

Conclusions of Law

1. There is no reason to treat GTEC differently from the other utilities for whom the Commission has adopted the workshop method.

2. GTEC should use the workshop method for calculating and passing through to ratepayers the tax benefits of bond refinancing in rates effective January 1, 1990, as stipulated by GTEC and DRA in the settlement proposal.

3. GTEC should not be required to flow through to its ratepayers any of the tax benefits that have been booked to the memorandum account required by Ordering Paragraph 8 of D.88-08-061.

4. The proposed settlement is reasonable in light of the whole record, consistent with law, and in the public interest.

5. The application of GTEC to Modify Ordering Paragraph 8 of D.88-08-061, filed on February 2, 1990, is moot.

FINAL ORDER

IT IS ORDERED that:

1. The "Proposed Settlement of Issues Regarding the Proper Ratemaking Treatment of the Tax Benefits Associated with Bond Repurchase Premiums" filed by GTEC and DRA on May 10, 1989 is approved.

2. General Telephone Company Company of California, Inc. (GTEC) shall use the DRA's Modified version of the Pacific Gas and Electric Model 2 as presented at the April 19, 1989 workshop ordered by D.88-12-094 to calculate and flow through the tax benefits resulting from its bond refinancing as recognized by D.88-08-061.

3. GTEC shall adjust each of its surcharges to recover a total of \$2.443 million less per year for 23 years, commencing with January 1, 1990. The reduction shall be spread among all of the surcharges. GTEC shall use the billing base-adopted in D.89-12-048, adjusted for actual 1989 receipts, to make the appropriate changes to the surcharges.

4. GTEC should be required to file an advice letter, within 10 days of this order, to implement the reduction to the surcharges as discussed in Ordering Paragraph 3 above, with tariff revisions to go into effect 30 days after the advice letter is filed. The amount of the reduction relating to the period from January 1, 1990 until the tariff revisions go into effect should be reflected as a one time reduction to the surcharges as discussed in Ordering Paragraph 3 above. The advice letter will specify that the \$2.443 million reduction shall be in effect for 23 years, commencing with January 1, 1990. General may elect to book the annual reduction to the memorandum account authorized in D.89-12-048 (the Alternative

Regulatory Framework Phase II true-up decision for Pacific Bell and GTEC) until such time as that memorandum account is zeroed out. ✓

5. GTEC shall discontinue the memorandum account required by Ordering Paragraph 8 of D.88-08-061 and shall zero out all balances in that account. ✓

6. GTEC's application to Modify Ordering Paragraph 8 of D.88-08-061 is dismissed.

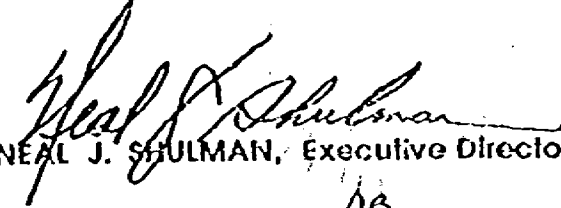
This order is effective today.

Dated MAY 22 1990, at San Francisco, California.

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

Commissioner Frederick R. Duda,
being necessarily absent, did
not participate.

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


NEAL J. SHULMAN, Executive Director
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