

Decision 90-12-034 December 6, 1990

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**  
D. 86-11-019  
(Petition for Modification  
Filed September 7, 1990)

Application of PACIFIC GAS AND ELECTRIC COMPANY for authority, among other things, to increase its rates and charges for electric and gas service.

Application 85-12-050  
(Filed December 27, 1985)

(Electric and Gas) (U 39 M)

SUPPLEMENTAL OPINION

Summary

This decision modifies Decision (D.) 89-11-058 thereby authorizing Pacific Bell (Pacific) and GTE California Incorporated (GTEC) to use the current year's booked California Franchise Tax (CCFT) amount as a deduction in calculating federal income tax (FIT) for purposes of determining earnings levels for that year under the New Regulatory Framework (NRF) adopted in D.89-10-031. Pacific filed a Petition for Modification (Petition) of D.89-11-058 on September 7, 1990. It appeared on the California Public Utilities Commission's (Commission) Daily Calendar on September 17, 1990. No protests have been received. GTEC and the Commission's Division of Ratepayer Advocates (DRA) filed comments on October 2, 1990, and October 9, 1990, respectively. Both GTEC and DRA support

Pacific's Petition and recommend that GTEC should be granted the same authority sought by Pacific.

Background

D.89-11-058, dated November 22, 1989, adopted the "flow-through" method for the ratemaking treatment of CCFT (Ordering Paragraph 4 at p. 24), effective December 22, 1989. The flow-through method uses the prior year's CCFT as a deduction in computing FIT expense for ratemaking purposes. According to the decision, the prior year's CCFT is to be based on an adopted test year or attrition year CCFT estimate. A utility subject to traditional ratemaking would implement D.89-11-058 by substituting the prior year's adopted CCFT for the current year's CCFT in the ratemaking FIT calculation.

Both Pacific and GTEC are no longer subject to traditional cost of service regulation for intrastate operations. D.89-10-031, dated October 12, 1989, discontinued rate cases and attrition proceedings for Pacific and GTEC and replaced them with an incentive-based regulatory framework, effective January 1, 1990. The NRF includes a price cap indexing mechanism and the sharing of earnings above a benchmark rate of return. The price cap indexing mechanism is used to annually adjust rates based upon a formula that considers overall inflation and a 4.5% productivity factor. Under the adopted sharing mechanism, earnings above a benchmark rate of return, 13%, are divided equally between the utility and its ratepayers. The sharing mechanism requires earned rates of return to be based on recorded intrastate results that reflect the Commission's ratemaking adjustments.

Pacific's Request

Pacific's Petition requests that the Commission modify D.89-11-058 to authorize it to use the current year's booked CCFT to calculate FIT for purposes of determining earnings levels under

the incentive-based regulatory framework adopted in D.89-10-031. Pacific requests that it be authorized to use the current year's CCFT unless or until such time as a return to the traditional rate case/attrition process is effected.

Pacific states that with the adoption of the NRF, the role played by traditional cost of service elements, such as FIT, has changed. Year-to-year changes in FIT ratemaking expense no longer necessarily result in rate adjustments and there is no adopted test year or attrition year CCFT. Instead, FIT expense affects the calculation of the utilities' rates of return for sharing purposes.

Pacific believes that reported earnings under the NRF should reflect the revenues and expenses for the period covered by the report. Pacific states that consistent with this principle, the current year's CCFT should be used to calculate FIT for purposes of determining earnings levels for that year. This approach matches expenses with the revenue such expenses helped to generate. For external reporting purposes Pacific now uses the current year's CCFT as a deduction in computing FIT expense. These reported results comply with Generally Accepted Accounting Principles (GAAP).

Pacific further commented, that under D.89-11-058 it would be required to replace the actual booked FIT expense used for external reporting purposes with a surrogate FIT calculation developed using the prior year's CCFT. This substitution of the current year's CCFT with the prior year's CCFT could distort sharing calculations in years where there has been a significant year-to-year change in tax rates or regulated income. Further, under the NRF, there is no adopted test year or attrition year CCFT estimate for the prior year to use in calculating FIT expense, as required by D.89-11-058. Therefore, Pacific believes that D.89-11-058 is inconsistent with the NRF adopted in D.89-10-031. Pacific also states that the calculation of a surrogate FIT expense

under the NRF would present administrative difficulties for the utilities and would unnecessarily complicate ratemaking.

In response to Pacific's Petition, DRA states that it believes that the best interest of Pacific and its ratepayers will be served by granting the modification requested. DRA recommends that in granting Pacific's Petition, the Commission should also exclude GTEC from the requirements of D.89-11-058. Since both Pacific and GTEC are now under the NRF adopted by D.89-10-031, it would be inconsistent to exclude Pacific from the requirements while requiring GTEC to conform to them. DRA also recommends that should the modification be granted, neither Pacific nor GTEC should be permitted to request from the Commission authority to reflect in rates any changes in revenue requirements that may occur due to the exclusion from the requirements of D.89-11-058. DRA believes this prohibition should apply not only to the time frame during which the NRF remains in force, but also in the situation where the Commission returns to traditional cost of service ratemaking.

GTEC, in response to Pacific's Petition, agrees with Pacific that the adoption of the use of the flow-through of the CCFT in the calculation of test year FIT expense was designed for cost of service regulation. GTEC states that the price cap mechanism established in the new incentive-based regulatory framework does not employ any tax calculation but instead applies an index to billed revenues to determine the change in prices. The sharing mechanism requires reporting earnings as shown on the Local Exchange Company's (LEC) books. Therefore, there is no advantage to adjusting book results following the methodology prescribed in D.89-11-058. GTEC recommends that any modification of D.89-11-058 in line with Pacific's Petition should be applicable not only to Pacific but to all telecommunications utilities subject to the NRF. This will ensure the Commission that the affected LEC's will determine and report taxes for monitoring and reporting of sharable earnings under the NRF in a consistent manner.

Discussion

The NRF adopted in D.89-10-031 does not lend itself to the adoption of the flow-through method for the ratemaking treatment of CCFT adopted in D.89-11-058. Under NRF there is no adopted test year or attrition year CCFT estimate for the prior year's CCFT to use in the calculation of FIT expense. Also, under NRF the utilities use earned rates of return based on recorded intrastate results to calculate sharable earnings. Pacific's as well as GTEC's recorded results comply with GAAP, thereby using the current year's CCFT in calculating FIT expense. We agree with Pacific that the replacement of the recorded FIT expense with a surrogate FIT calculation developed using the prior year's CCFT could distort the sharing calculation and could present administrative difficulties for the utilities.

Both DRA and GTEC agree that utilities subject to the NRF should be treated consistently. On page 74 of D.89-11-031 it states that variations in the regulatory framework should be allowed only if there is a compelling justification. There is no reason to treat GTEC differently from Pacific in this instance. Therefore, it is reasonable to modify D.89-11-058 to authorize Pacific and GTEC to use the current year's CCFT as a deduction in computing FIT expense for reporting purposes and for purposes of calculating sharable earnings under the new regulatory framework. Because of the above reasons Pacific's Petition should be granted to the extent provided in this order.

DRA recommends that neither Pacific nor GTEC should be allowed to reflect in rates any changes in revenue requirements that may occur due to the exemption of the requirements of D.89-11-058. DRA believes this prohibition should apply not only during the time frame that NRF remains in effect, but also in the event that the Commission returns to traditional cost of service ratemaking. We find that DRA's request is reasonable. Neither Pacific nor GTEC should be allowed to file for recovery of revenue

requirement differences resulting from the two methods (flow-through of the CCFT deduction authorized in D.89-11-058 and the use of the current year's CCFT in calculating FIT expenses) at any time while the NRF remains in effect and including the event where the Commission returns to traditional cost of service ratemaking.

Findings of Fact

1. In D.89-11-058, effective December 22, 1989, the Commission ordered all utilities to reflect in their results of operations the flow-through treatment for the CCFT deduction in computing federal income tax expense.
2. In D.89-10-031 the Commission replaced traditional cost of service regulation with a new incentive-based regulatory framework for Pacific and GTEC beginning January 1, 1990.
3. Pacific's Petition, filed September 7, 1990, requests modification of D.89-11-058 to authorize Pacific to use the current year's booked CCFT amount as a deduction in calculating FIT for purposes of determining earnings levels under the NRF.
4. No protests were received. GTEC and DRA filed comments on October 2, 1990, and October 9, 1990, respectively, supporting Pacific's Petition.
5. There is no reason to treat Pacific and GTEC differently for calculation of FIT expenses under NRF.
6. Under NRF there is no adopted test year or attrition year CCFT estimate for the prior year's CCFT to use in the calculation of FIT expenses as ordered in D.89-11-058.
7. Under NRF the sharing mechanism requires earned rates of return to be based on recorded intrastate results that reflect the Commission's ratemaking adjustments.
8. Pacific's and GTEC's recorded results reflect the current year's CCFT expense in computing the recorded FIT expense.
9. Calculation and use of a surrogate FIT expense for that recorded on the utilities books may present administrative

difficulties for the utilities and may unnecessarily complicate the ratemaking process.

10. It is appropriate for Pacific and GTEC to use the current year's booked CCFT as a deduction when calculating the recorded FIT for purposes of determining earnings levels under the NRF.

Conclusions of Law

1. There is no reason to treat Pacific differently from GTEC under the NRF. D.89-11-058 should be modified to authorize Pacific and GTEC to use the current year's booked CCFT as a deduction when calculating the recorded FIT for purposes of determining earnings levels under the NRF. Pacific and GTEC should be authorized to use this method until such time as a return to traditional cost of service regulation is effected.

2. Neither Pacific nor GTEC should be allowed to file for recovery of revenue requirement differences resulting from the two methods, flow-through of the CCFT deduction authorized in D.89-11-058 and the use of the current year's CCFT in calculating FIT expenses, at any time while the NRF remains in effect and including the situation where the Commission returns to traditional cost of service ratemaking.

3. In order to provide timely implementation of the changes adopted in this decision, this order is effective today.

SUPPLEMENTAL ORDER

1. Findings of Fact 12 through 18 are added to D.89-11-058 as follows:

12. In D.89-10-031 the Commission replaced traditional cost of service regulation with a new incentive-based regulatory

framework for Pacific Bell and GTEC beginning January 1, 1990.

13. There is no reason to treat Pacific and GTEC differently for calculation of FIT expenses under NRF.
14. Under NRF there is no adopted test year or attrition year CCFT estimate for the prior year's CCFT to use in the calculation of FIT expenses.
15. Under NRF the sharing mechanism requires earned rates of return to be based on recorded intrastate results that reflect the Commission's ratemaking adjustments.
16. Pacific's and GTEC's recorded results reflect the current year's CCFT expense in computing the recorded FIT expense.
17. Calculation and use of a surrogate FIT expense to that recorded on the utilities' books may present administrative difficulties for the utilities and may unnecessarily complicate the ratemaking process.
18. It is appropriate for Pacific and GTEC to use the current year's booked CCFT as a deduction when calculating the recorded FIT for purposes of determining earnings levels under the NRF.

2. Conclusions of Law 4 through 5 are added to D.89-11-058 as follows:

4. Pacific and GTEC should use the current year's booked CCFT as a deduction when calculating the recorded FIT for purposes of determining earnings levels under the NRF. Pacific and GTEC should use this method until such time as a return to traditional cost of service regulation is effected.
5. Neither Pacific nor GTEC should be allowed to file for recovery of revenue requirement differences resulting from the two methods, flow-through of the CCFT deduction



authorized in D.89-11-058 and the use of the current year's CCFT in calculating FIT expenses, at any time while the NRF remains in effect and including the event where the Commission returns to traditional cost of service ratemaking.

3. Ordering Paragraph 4 of D.89-11-058 is modified to reads as follows:

4. In the future, all results of operations for all utilities, except Pacific Bell and GTE California Incorporated, shall reflect the flow-through treatment for the California Corporate Franchise Tax deduction in computing federal income tax expense. Pacific Bell and GTE California Incorporated shall use the current year's booked California Corporate Franchise Tax as a deduction when calculating the recorded federal income tax for purposes of determining earnings under the new regulatory framework adopted in D.89-10-031. Pacific Bell and GTE California Incorporated shall use this method until such time as a return to traditional cost of service regulation is effected.

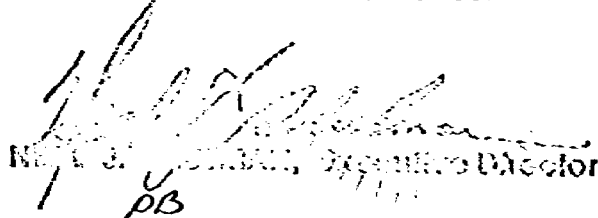
4. Ordering Paragraph 4a is added to D.89-11-058 as follows:

4a. Pacific Bell and GTE California Incorporated shall not recover in rates any revenue requirement differences which may result from the exemption of the flow-through treatment for the California Corporate Franchise Tax deduction in computing federal income tax expense while under the new regulatory framework. Pacific Bell and GTE California Incorporated shall not recover in rates any revenue requirement differences which may result from the exemption of the flow-through treatment for the California Corporate Franchise Tax deduction when or if the Commission returns to traditional cost of service regulation.

5. To the extent not otherwise granted by this order, Pacific Bell's Petition for Modification of D.89-11-058 is granted. This order is effective today. Dated December 6, 1990, 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

  
John B. Ohanian, Executive Director  
PB