

Decision 82 12 046

DEC .. 8 1982

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of )  
THE PACIFIC TELEPHONE AND TELEGRAPH )  
COMPANY, a corporation, for author- )  
ity to increase certain intrastate )  
rates and charges applicable to )  
telephone services furnished within )  
the State of California. )

Application 59849  
(Filed August 1, 1980;  
amended August 28, 1980  
and October 14, 1980)

In the Matter of the Application of )  
THE PACIFIC TELEPHONE AND TELEGRAPH )  
COMPANY, a corporation, for author- )  
ity to increase certain intrastate )  
rates and charges applicable to )  
telephone services furnished within )  
the State of California. )

Application 59269  
(Filed November 13, 1979;  
amended November 15, 1979)

Re Advice Letter (PT&T) No. 13640 )  
to reprice certain telephone )  
terminal equipment and Resolution )  
No. T-10292 granting approval of )  
said changes. )

Application 59858  
(Filed August 1, 1980)

In the Matter of Advice Letter )  
Filing No. 13641 of THE PACIFIC )  
TELEPHONE AND TELEGRAPH COMPANY )  
for authority to increase certain )  
rates for key telephone service by )  
\$30.1 million. )

Application 59888  
(Filed August 19, 1980)

Investigation on the Commission's  
own motion into the rates, tolls,  
rules, charges, operations, costs,  
separations, inter-company settle-  
ments, contracts, service, and  
facilities of THE PACIFIC TELEPHONE  
AND TELEGRAPH COMPANY, a California  
corporation; and of all the tele-  
phone corporations listed in  
Appendix A, attached hereto.

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OII 63  
(Filed December 18, 1979)

Investigation on the Commission's  
own motion into the rates, tolls,  
rules, charges, operations, costs,  
separations, inter-company settle-  
ments, contracts, service, and  
facilities of THE PACIFIC TELEPHONE  
AND TELEGRAPH COMPANY, a California  
corporation; and of all the tele-  
phone corporations listed in  
Appendix A, attached hereto.

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OII 81  
(Filed August 19, 1980)

Investigation on the Commission's  
own motion into the Matter of  
Revision of the Accounting for  
Station Connections and related  
Ratemaking Effects and the Economic  
Consequences of Customer-owned  
Premise Wiring.

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OII 84  
(Filed December 2, 1980)

(See Decisions 93367, 93728, and 82-08-01  
for appearances)

FIFTH INTERIM OPINION  
DECISION ON THE EFFECT OF THE  
ECONOMIC RECOVERY TAX ACT OF 1981  
ON THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

Background

On August 4, 1981 the Commission issued Decision (D.) 93367 in the general rate phase of these proceedings. That decision set rates for The Pacific Telephone and Telegraph Company (Pacific) based on adopted results of operations for the test year 1981. On August 13, 1981 President Reagan signed the Economic Recovery Tax Act of 1981 (ERTA). Among the provisions of ERTA is the Accelerated Cost Recovery System (ACRS) which enables a company, for income tax purposes, to recover the cost of its plant faster than it was able under the prior system of accelerated depreciation. However, ERTA mandates that all utilities use normalization accounting for ratemaking purposes in order to claim the benefits of ACRS.<sup>1</sup> The ACRS provisions of ERTA are retroactive to January 1, 1981, making the faster recovery, and hence the tax benefits, available for plant placed in service after December 31, 1980. The effects of ERTA on the revenue requirements of utilities under Commission jurisdiction was explored by the Commission in Order Instituting Investigation (OII) 24. However, the specific adjustments to a utility's revenue requirement were referred back to appropriate rate proceedings of the various utilities.

The effect of ERTA on Pacific's 1981 results of operations was not included in D.93367, which was an interim decision with further hearings scheduled after August 13, 1981 on several matters. On October 22, 1981, the Commission staff (staff) filed a petition to

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<sup>1</sup> There are two Internal Revenue Code provisions covering normalization, one in § 167 and one in § 168. (See Appendix A.)

enlarge the continued proceedings to receive evidence on ERTA's effect on Pacific. The staff alleged that the record in OII 24 showed that substantial revenue requirement reductions would be experienced by Pacific as a result of ERTA. Following arguments on the staff petition on October 28 by the parties, and a supplemental written response by Pacific October 29, the assigned administrative law judge (ALJ) granted the staff's petition on November 30. By D.93850 dated December 5, 1981 the Commission concurred with the ALJ's ruling of November 30 and, in addition, made the revenues of Pacific beginning January 1, 1982 subject to refund pending determination of the ratemaking effects of ERTA. In its decision the Commission ordered taking of evidence on the revenue impacts resulting from ERTA on the test year 1981 and subsequent years and, also, evidence on the effects any increase in cash flow resulting from ERTA would have on the rate of return for the years involved. Hearing on the matter was held June 16, 1982 with optional concurrent briefs due July 2. Pacific and the staff filed briefs and the City of San Francisco (San Francisco) was allowed to make an oral statement in lieu of brief on June 25. The matter is now ready for decision.

Staff Evidence

Nettie C. Fabian, a financial examiner from the Commission's Revenue Requirements Division, testified for the staff and presented a report. Fabian testified that ERTA will increase the allowable depreciation that Pacific can take for income tax purposes in 1981 by \$92.1 million. She stated that her estimate includes the effect of D.93728 dated November 13, 1981, which dealt with changes in the method of accounting for Pacific's switch from capitalizing to expensing inside wiring (station connections) and which was the subject of OII 84, a proceeding now consolidated with this record.

Because Pacific's rates are set on a normalized tax basis, pending resolution of litigation now in progress,<sup>2</sup> the increased ACRS depreciation does not affect Pacific's results of operations with the exception of the deferred tax reserve. Under normalization, the net change in income taxes resulting from accelerated depreciation which exceeds depreciation used for ratemaking purposes is noted in a reserve account and deducted from Pacific's rate base before rate of return is applied to determine revenue requirement. Applying the corporate tax rate of 46% to the \$92.1 million for 1981 results in a reduction of Pacific's tax bill of \$42.4 million for the year 1981 which is, in effect, a deferral of taxes. For ratemaking purposes under normalization, the average of the deferred taxes over the year 1981 is deducted from Pacific's rate base which has been calculated using regular or normal depreciation. That reduction in rate base, which for 1981 averages an additional \$19.6 million because of ERTA, affects the revenue requirement of Pacific because now Pacific can earn its authorized rate of return with less net income. Specifically, the reduction in net income is Pacific's D.93367 authorized rate of return of 12.91% times the \$19.6 million or \$2.5 million. That is after taxes, however, and must be increased by the net-to-gross multiplier (1.896 in D.93367) to determine the reduction in gross revenue requirement, i.e. how much less must be collected from the ratepayers. In this case that amounts to \$4.8 million according to Fabian. That figure is for total Pacific operations in California; the intrastate portion, over which this Commission has jurisdiction, is about 75% of total operations or \$3.6 million. Thus Fabian recommends a reduction in Pacific's California intrastate revenue requirement as authorized by D.93367 of \$3.6 million retroactive to January 1, 1982. That is the date D.93850 made Pacific's revenues subject to refund pending a determination of the effects of ERTA.

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<sup>2</sup> See D.93367, mimeo pp.201-205 and Appendix G.

Because the Commission in D.93850 ordered evidence presented for subsequent years, Fabian presented data for 1982 and 1983 corresponding to 1981. Table I is a reproduction of Fabian's Table I in Exhibit 464. It shows that for 1982 the gross revenue requirement for Pacific's total California operations would be \$19.3 million less than that adopted by the Commission in D.93367 and for 1983 \$45.1 million less.

The figure for 1982 reflects 1982 ACRS depreciation for 1981 and 1982 additions to plant, and the figure for 1983, ACRS depreciation in 1983 for 1981, 1982, and 1983 additions. The intrastate adjustment would again be about 75% of the California total or \$14.5 million for 1982 and \$33.8 million for 1983.

In her direct testimony contained in Exhibit 464 Fabian recommended that the above reductions in revenue requirement be reflected in the final decision in this proceeding. But under cross-examination by Pacific's counsel, she recommended that only the 1981 adjustment be made in this proceeding and the 1982 and 1983 adjustments be considered in OII 24.

TABLE I

The Pacific Telephone and Telegraph Company

ESTIMATED CHANGE IN REVENUE REQUIREMENT DUE TO THE EFFECTS  
OF THE ECONOMIC RECOVERY TAX ACT OF 1981  
Staff's Witness Fabian

Item	Total California		
	1981	1982	1983
<u>Cost of Service</u>			
Additional ACRS Depreciation	\$92,115	\$170,996	\$297,548
Statutory Tax Rate	x46%	x46%	x46%
Current Taxes Payable	(42,373)	(78,658)	(136,872)
Deferred Taxes Payable	42,373	78,658	136,872
Ratemaking Tax Expense	\$ -	\$ -	\$ -
<u>Rate of Return</u>			
Average Reserve for Deferred Taxes	\$19,629	\$ 78,811	\$184,436
Rate Base	(19,629)	(78,811)	(184,436)
D.93367 Adopted Rate of Return	x12.91%	x12.91%	x12.91%
D.93367 Adopted Net-to-Gross-Multiplier	x1.896%	x1.896%	x1.896%
Gross Revenue Requirement	\$(4,805)	\$(19,291)	\$(45,145)

(Red Figure)

Pacific's Evidence and Position

Donald A. Dahl, division staff manager for classifications and taxes, testified for Pacific. Dahl stated that as far as 1981 is concerned, Pacific reviewed the staff workpapers supporting Fabian's analysis and recommendation and is generally in agreement with both the data and method used to determine the \$3.6 million California intrastate adjustment. Dahl agrees that the adjustment should be retroactive to January 1, 1982 with refunds and rate adjustments as appropriate. He claims the adjustments would be proper because they are based on results of operations adopted by the Commission in D.93367 for the test year 1981. The adjustment would merely revise the adopted results and therefore be consistent with the normalization accounting requirements of ERTA.

Dahl believes adjustments for 1981 or 1982 based on the staff estimates shown on Table I would make Pacific ineligible for the ACRS benefits provided by ERTA. He claims this is because adjustments to Pacific's revenue requirement due to ERTA can only be made in concert with other elements of cost of service and rate base related to the deferred tax reserve. Dahl maintains that the incremental effects of ERTA in 1982 and 1983 are directly dependent on additions to plant in the rate base during 1981, 1982, and 1983. His estimate of the 1982 and 1983 California total operation reduction in revenue requirement is \$23.7 million for 1982 and \$56.9 million for 1983, the detail of which is shown on Table II. This compares with Fabian's \$19.3 million and \$45.1 million, the differences being due to different estimates of the plant additions, and hence depreciation and tax credits, for 1982 and 1983. As referenced in the footnote on Table II, Dahl's Exhibit included all elements necessary to meet the normalization requirements of ERTA.



TABLE II

## THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY - TOTAL CALIFORNIA OPERATIONS

## IMPACT OF ECONOMIC RECOVERY TAX ACT OF 1981 ON REVENUE REQUIREMENTS

FOR YEARS 1982 and 1983\*

Pacific's Witness Dahl

Revenue Requirement Item (\$Millions)	1982†			1983‡		
	INCL. ERTA	EXCL. ERTA	DIFF.	INCL. ERTA	EXCL. ERTA	DIFF.
1. Plant in Service (A/C 100.1) - Avg.	\$2,215.7	\$2,215.7	\$ -	\$2,397.3	\$2,397.3	\$ -
2. Depreciation Reserve (A/C 171) - Avg.	409.2	409.2	-	444.3	444.3	-
3. Deferred Tax Reserve (A/C 176.1) - Avg.	574.1	476.9	97.2	585.4	352.7	232.7
4. Net Change in Rate Base (L1-L2-L3)	1,232.4	1,329.6	( 97.2)	1,367.6	1,600.3	( 232.7)
5. D.93367 Rate of Return	12.91%	12.91%		12.91%	12.91%	
6. Net revenue requirement resulting from changes to rate base (L4xL5)	159.1	171.6	( 12.5)	176.6	206.6	( 30.0)
7. Depreciation Expense (A/C 608)	(6.1)	(6.1)	-	103.9	103.9	-
8. Federal Income Tax Expense	235.9	235.9	-	228.8	228.8	-
9. Net revenue requirement (L6+L7+L8)	388.9	401.4	( 12.5)	509.3	539.3	( 30.0)
10. D.93367 Net-to-Gross Multiplier	1.896	1.896		1.896	1.896	
11. Gross Revenue Requirements (L8xL9)	\$ 737.4	\$ 761.1	(\$23.7)	\$ 965.6	\$ 1022.5	(\$ 56.9)

† Incremental change from prior year (1982 vs. Adopted results in D.93367; 1983 vs. 1982)

\* Includes the revenue requirements impact of all elements which affect the level of the reserve for deferred taxes in order to insure that Pacific remains eligible for accelerated depreciation (ACRS) under ERTA.

Assumptions: (1) Illustrative data based on construction and book depreciation levels in July 1981, 6 year plan (excludes the impact of EIG and Remaining Life/Attainable Life).

(2) Any impact of bifurcation (CI-II), divestiture, and sale of customer premises equipment are not included.

(3) Includes the impact of Expensing Station Connections. This is the reason for the incremental decline in depreciation expense in 1982 vs. 1981 adopted results.

A-59849 et al. /ALJ/jn

In commenting on the effects from increased cash flow on rate of return as required by the Commission in D.93850, Dahl stated any increases in cash flow would be minimal. He testified that the maximum increase in average daily cash flow for the 1981 test period was only \$3.5 million. Relative to Pacific's 1981 net new external financing requirements, ERTA reduced those requirements approximately one percent.

In its brief Pacific argues that any adjustments based on 1982 or 1983 estimates raise the identical eligibility question to the Average Annual Adjustment (AAA) method still at issue concerning previous accelerated depreciation options.<sup>3</sup> That is, if the reserve amount used to reduce the 1981 adopted rate base is larger than the 1981 test year reserve amount, Pacific's eligibility is in jeopardy because normalization is not used as required by ERTA. Pacific cites Internal Revenue Service (IRS) Regulations § 1.167(l)-1(h)(6)(i), (ii) which, in part, provides that "a taxpayer does not use normalization...if, for ratemaking purposes, the amount of the reserve for deferred taxes...exceeds the...reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking." Pacific argues that the overlay of the 1982 and 1983 ERTA effects on Pacific's 1981 adopted results of operations would be similar to the AAA method and Pacific would be ineligible for the benefits of ACRS.

San Francisco's Position

San Francisco argues there are only two issues for the Commission to decide. First, for regulatory and ratemaking purposes can the Commission look at incremental changes outside the test year,

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<sup>3</sup> Ibid.

and, if so, how can it look at them; second, if the Commission can look at isolated ratemaking changes, then, given the Commission's normalization policy for Pacific, how can it do so and be consistent with its policy of using full normalization subject to refund.

San Francisco claims Pacific's position seems to be that the Commission can look at only the test year 1981, but if it does look to years beyond the test year, then the Commission must look at all the issues, not just the isolated ones. San Francisco believes Pacific is wrong as a matter of law and as a matter of Commission practice. On the matter of law it cites City of Los Angeles v PUC (1975) 15 C 3d 680. In that Decision the court concluded that the Commission possessed the power to implement an annual rate adjustment scheme for changing federal tax expenses and remanded the cases at issue to the Commission for reconsideration. San Francisco also cites Southern California Edison Co. v PUC (1978) 20 C 3d 813 and the Commission's handling of Proposition 13 in support of its contention that any savings from reduced taxes that properly can be passed on to consumers are due the consumers. Those antecedents, San Francisco contends, give the Commission the power to consider the effects of ERTA beyond the test year 1981. All that is required is for the Commission to comply with its policy, and, in this case, the law, that full normalization must be considered in assessing the incremental changes. This, says San Francisco, is what both the Pacific and staff witnesses have done in preparing their estimates of the impact of ERTA as shown on Tables I and II.

#### Discussion

Only three of the numerous parties in these proceedings participated to any extent on the ERTA issue, Pacific, staff, and San Francisco. Pacific fears that if any adjustment is made beyond the

test year 1981, Pacific will lose its eligibility for ACRS at a tremendous cost to both its ratepayers and stockholders. Staff's witness recommends an adjustment for 1981 and consideration in the OII 24 proceeding of 1982 and 1983 adjustments; the Commission's Legal Division (legal staff) recommends adjustments for 1981, 1982, and 1983 equal to those calculated by the staff witness. San Francisco recommends adjustments for the three years equal to those calculated by Pacific's witness, and an adjustment in rate of return for the increase in cash flow. The 1981 and 1982 adjustments would be made effective January 1, 1982 and the additional amount for 1983 on January 1, 1983.

First, we note the OII 24 proceeding remains general in nature and we do not intend to take up specific utility rate adjustments there. The record does not show what staff witness Fabian's recommendation is for 1982 and 1983; however, the position of the legal staff is to adjust Pacific's revenue requirement for both 1982 and 1983 by the amounts shown on Table I adjusted to intrastate levels.

Based on the record it can be conceded that: (1) both the Pacific and staff witnesses, using normalization accounting, have correctly calculated the credit to the tax reserve for the years 1981, 1982, and 1983 although their final figures differ because of different investment assumptions, and (2) the Commission has the power to consider incremental changes in a utility's results of operations outside that utility's ratemaking test year and has done so in the past.

Those concessions aside, there is merit in Pacific's argument that any adjustments based on 1982 and 1983 ACRS would have an effect on Pacific's eligibility similar to the AAA treatment now in abeyance pending litigation with the IRS. However, it appears that the 1982 and 1983 adjustments San Francisco and our legal staff recommend are more like the Annual Adjustment (AA) method for

treatment of investment tax credit (ITC) discussed in D.87838 dated September 13, 1977 in A.53587 et al. than AAA. (See Appendix B.) That treatment involves a post-test year annual adjustment of test year revenue requirements for changes brought about only because of income tax considerations. The income tax considerations in turn hinge on estimates made for the year in which the adjustment would apply plus any previous years including the test year. That procedure is almost exactly what is proposed by San Francisco and the legal staff. However, without results of operations for 1982 and 1983 which take into account all ratemaking factors, for example, an attrition year estimate, it must be rejected because whether the adjustments are like AAA or AA or some combination, we still face the risks we faced in D.91337, dated February 13, 1980 in A.51774 et al. of causing Pacific to be ineligible for substantial reductions in income tax liability. In D.91337 the Commission stated it did not agree with the IRS that the AAA/AA methods fail to meet the test of normalization under the Internal Revenue Code and we affirm that position here. In order to protect Pacific and its customers the Commission decided in D.91337 to set Pacific's rates after 1979 based on full normalization subject to refund; this puts a cap on Pacific's potential tax liability, which at that time was estimated to be over \$1 billion, pending the outcome of the litigation with the IRS on use of the AAA/AA normalization methods.

One further test can be made to ensure that what we have decided is fair to the consumers and Pacific. We can consider what we would have ordered if ERTA had been in effect at the time we signed D.93367 on August 4, 1981. That order undoubtedly would have included only the \$3.6 million adjustment proposed by Pacific. This is because one must concede that ACRS is no more than an acceleration of pre-ERTA accelerated depreciation. And, without ERTA in mind, the Commission anticipated no order adjusting the revenue requirement on

January 1, 1982 for the estimated average change in the tax reserve account occurring in 1982 as a result of changes in the pre-ERTA factors affecting the tax reserve account. Nor was an adjustment contemplated for 1983; nor did any party suggest such adjustments.

So we come back to the position we took in D.91337, await the outcome of the AAA/AA litigation with the IRS and, in the meantime, set Pacific's rates based on full normalization subject to refund.

On the issue of adjusting Pacific's rate of return for the increase in cash flow because of ERTA, we will not make an adjustment. We take this position because of a concern that adjusting the return for 1982 and 1983 may tinker with normalization in such a way that Pacific's eligibility would be in jeopardy. In any event, the effect would be very small as testified to by Dahl. Also, the improvement in cash flow in this case would most likely affect only short-term borrowings which were not included in the financing components used to determine Pacific's currently authorized 12.91% rate of return. (D.93367, mimeo p. 147.)

Amount and Timing of the Adjustment

We have before us several matters in these proceedings that may require various revenue requirement adjustments effective at various times including some refunds. Among these are Pacific's request for an additional \$69.9 million for certain adjustments to its depreciation rates, a reduction in revenue requirement of \$12.8 million agreed to by Pacific resulting from a stipulation authorized by D.82-05-044, the effect of that stipulation on the Commission's decisions on inside wiring accounting treatment in OII 84, and stranded investment considerations covered by Ordering Paragraphs 16.a. and c. of D.93367. What we do with some of those issues may

affect the estimates of Fabian and Dahl contained in this phase of the record. Therefore, we indicate at this time that, although we intend to issue decisions on each of the issues noted above, we will issue a single decision dealing with all refunds and changes in revenue requirement. We will do this for the convenience it obviously affords Pacific and, more importantly, to reduce the confusion to consumers which would result from issuing several decisions over a period of time, all changing the rates of Pacific up and down and/or providing for refunds.

Because, for the most part, the investment estimates of the staff were adopted in D.93367 in determining revenue requirement for Pacific, when the time comes we will adopt the staff estimate on Table I for this phase of the proceedings adjusted for any effects of the issues noted above. Assuming no adjustments were made, Pacific's revenue requirement beginning January 1, 1982 would be reduced by \$3.6 million with an appropriate refund calculated to the effective date of the rate reductions.

Findings of Fact

1. On August 13, 1981 President Reagan signed into law ERTA, a tax act which enables Pacific to recover for income tax purposes investment in plant made after 1980 at an accelerated rate over previous depreciation allowances.

2. Interim D.93367 issued by the Commission on August 4, 1981 did not take into account the effect of ERTA on Pacific's revenue requirement for the test year 1981.

3. By D.93850 dated December 5, 1981 the Commission opened these proceedings to take evidence on the effects of ERTA on Pacific's revenue requirement for 1981 and subsequent years including any change in the rate of return granted by D.93367, and ordered the revenues of Pacific beginning January 1, 1982 subject to refund pending determination of the ratemaking effects of ERTA.

4. A public hearing was held at which time all interested parties were given an opportunity to appear and be heard on the effects of ERTA on Pacific's revenue requirement for 1981 and subsequent years.

5. Witnesses for Pacific and the staff presented evidence showing their estimates of the effect of ERTA on Pacific's revenue requirement for 1981, 1982, and 1983.

6. In making their estimates, the witnesses for Pacific and the staff used normalization accounting as that term is defined in the IRS Code.

7. Beginning with D.91337, for test years subsequent to 1979 the Commission has set Pacific's rates on full normalization subject to refund pending the outcome of litigation with the IRS concerning the modified normalization methods known as AAA and AA required by D.87838.



8. Any adjustments to Pacific's revenue requirement found reasonable in D.93367 for the test year 1981 based on estimates for years subsequent to 1981 would be similar to the AAA and/or AA normalization methods and could jeopardize Pacific's eligibility for the ACRS depreciation allowances provided by ERTA.

9. It is fair to consumers and Pacific to continue the Commission policy noted in Finding 7.

10. Assuming no adjustments are required as a result of other decisions in other phases of these proceedings, the effect of ERTA on Pacific's revenue requirement after taking into account normalization accounting as required by the IRS Code is a reduction in the revenue requirement authorized for the test year 1981 by D.93367 of \$3.6 million beginning January 1, 1982.

11. In addition to Finding 10 and pursuant to D.93850, all revenues collected by Pacific which are subject to ERTA shall continue to be collected subject to refund from January 1, 1982, onward until (a) the adjustments for the year 1981 are disposed of by Commission Order, and (b) the tax litigation surrounding the AAA/AA normalization methods is resolved removing the risk of ineligibility for ACRS depreciation allowances provided by ERTA for revenues collected for the years 1982, 1983, and onward.

12. The Commission will be issuing other decisions in these proceedings which may affect Pacific's revenue requirement and it will be more expedient for Pacific and its customers if the Commission combines the adjustments found reasonable in this decision with those decisions.

#### Conclusions of Law

1. A rate refund and an adjustment to the revenue requirement found reasonable for Pacific in D.93367 should be ordered as a result of the effects of ERTA.

2. The refund and adjustment referred to in Conclusion of Law 1 should be deferred until other refunds and/or adjustments to Pacific's revenue requirement, the determinations of which are pending in these proceedings, are ordered.

3. Rates should continue to be collected subject to refund as set forth in D.93850 until the adjustments referred to in Conclusions of Law 1 and 2 are disposed of by Commission Order, and the litigation surrounding the AAA/AA normalization methods is resolved removing the risk of ineligibility for ACRS depreciation allowances provided by ERTA. At that time the Commission will determine whether an adjustment to the revenue requirements for the years 1982 onward should be ordered as a result of the effects of ERTA.

FIFTH INTERIM ORDER

IT IS ORDERED that:

1. The Pacific Telephone and Telegraph Company (Pacific) shall refund to its customers and reduce its rates by amounts to be specified and at a time to be set by further order of the Commission.

2. A.59849 et al. are continued.

3. Pursuant to D.93850, all revenues collected by Pacific in 1981 which are subject to ERTA shall continue to be subject to refund until such time as the order referred to in Ordering Paragraph 1 is issued.

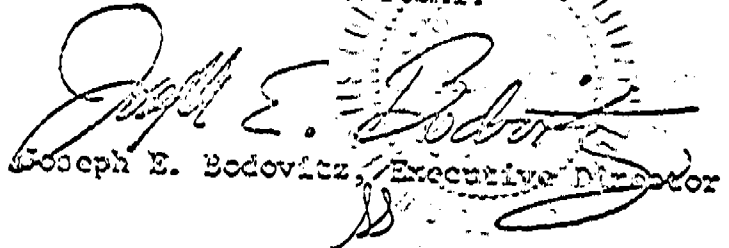
4. All revenues collected by Pacific in 1982 and thereafter, which are subject to ERTA, shall continue to be subject to refund until the litigation surrounding the AAA/AA normalization methods is resolved removing all risk of ineligibility for ACRS depreciation allowances provided by ERTA. At that time the Commission shall determine whether an adjustment to the revenue requirements for the years 1982 onward should be ordered as a result of the effects of ERTA.

This order becomes effective 30 days from today.

Dated December 8, 1982 . at San Francisco, California.

JOHN E. BRYSON  
President  
RICHARD D. GRAVELLE  
LEONARD M. GRIMES, JR.  
VICTOR CALVO  
PRISCILLA C. GREW  
Commissioners

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

  
Joseph E. Bodovitz, Executive Director

APPENDIX A

Excerpts From the Internal Revenue Code

Section 167(1)

(G) Normalization method of accounting.—In order to use a normalization method of accounting with respect to any public utility property—

(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation.

Section 168(e)

(3) Special rule for certain public utility property.—

(A) In general.—The term “recovery property” does not include public utility property (within the meaning of section 167(f)(3)(A)) if the taxpayer does not use a normalization method of accounting.

(B) Use of normalization method defined.—For purposes of subparagraph (A), in order to use a normalization method of accounting with respect to any public utility property—

(i) the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes; and

(ii) if the amount allowable as a deduction under this section with respect to such property differs from the amount that would be allowable as a deduction under section 167 (determined without regard to section 167(f)) using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under subparagraph (B)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

APPENDIX B  
Page 1

The Commission description of the AAA and AA methods as contained in D.87838 CPUC 82 549, 562, 563, 566.

AAA-Average Annual Adjustment

" . . . We believe it fairer to use a variation of the annual adjustment proposed, which we will call the 'averaged annual adjustment'".

\* \* \*

" . . . General's opening brief, page 16, describes the methodology, as follows: ' . . . the deferred tax reserve is averaged three years into the future in the same fashion as pro forma normalization, and in addition, federal income tax expense is also averaged for the same three-year period by which test period tax expense and rate base is adjusted. The necessary correlation of the reserve and tax expense provided in the cited Treasury Regulation is thereby achieved (Exhibit 3, page 16).' This is exactly the methodology for the averaged annual adjustment."

\* \* \*

"...we will hold constant all items of cost-of-service not directly dependent on the increase in deferred tax reserve. The computation starts with the test year figures. Using the latest available estimates, we will compute the reduction in net revenues resulting from the increased deferred tax reserve in each of the next three years, compute the resulting decrease in tax expense in each corresponding year, then average the deferred tax reserve and federal tax expense for the four-year period. These averaged annual adjustment figures for deferred tax reserve and federal tax expense will then be used in the current test years for the pending rate cases."

APPENDIX B  
Page 2

AA-Annual Adjustment

"...we are adopting for the purposes of ITC and eligibility thereunder the only method that appears to encompass all the factors we desire, the annual adjustment. Sometime prior to the first day of each year after (and including) the test year, we shall recalculate the ITC for the coming year on the basis of the best estimates then available and shall adjust the rates accordingly at the beginning of the year to provide for the full year-to-year growth in the annual amount of ratable flow-through..."

(END OF APPENDIX B)

8. Any adjustments to Pacific's revenue requirement found reasonable in D.93367 for the test year 1981 based on estimates for years subsequent to 1981 would be similar to the AAA and/or AA normalization methods and could jeopardize Pacific's eligibility for the ACRS depreciation allowances provided by ERTA.

9. It is fair to consumers and Pacific to continue the Commission policy noted in Finding 7.

10. Assuming no adjustments are required as a result of other decisions in other phases of these proceedings, the effect of ERTA on Pacific's revenue requirement after taking into account normalization accounting as required by the IRS Code is a reduction in the revenue requirement authorized for the test year 1981 by D.93367 of \$3.6 million beginning January 1, 1982.

11. No adjustment in Pacific's rate of return as authorized by D.93367 is required as a result of the effects of ERTA.

12. The Commission will be issuing other decisions in these proceedings which may affect Pacific's revenue requirement and it will be more expedient for Pacific and its customers if the Commission combines the adjustments found reasonable in this decision with those decisions.

#### Conclusions of Law

1. A rate refund and an adjustment to the revenue requirement found reasonable for Pacific in D.93367 should be ordered as a result of the effects of ERTA.

2. The refund and adjustment referred to in Conclusion of Law 1 should be deferred until other refunds and/or adjustments to Pacific's revenue requirement, the determinations of which are pending in these proceedings, are ordered.

FIFTH INTERIM ORDER

IT IS ORDERED that:

1. The Pacific Telephone and Telegraph Company shall refund to its customers and reduce its rates by amounts to be specified and at a time to be set by further order of the Commission.

2. A.59849 et al. are continued.

This order becomes effective 30 days from today.

Dated DEC 8 1982, at San Francisco, California.

JOHN E. BRYSON  
President  
RICHARD D. GRAVELLE  
LEONARD M. GRIMES, JR.  
VICTOR CALVO  
PRISCILLA C. GREW  
Commissioners