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ORIGINAL

Decision No. 86595

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SOUTHERN CALIFORNIA GAS COMPANY for a General Increase in its Gas Rates.	Application No. 55345 (Filed November 26, 1974)

(See Decision No. 85354 for appearances.)

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O P I N I O N

Southern California Gas Company's (SoCal) application seeks authority for a general increase of $151,450,000 in its gas rates, designed by SoCal to yield a 10.25 percent rate of return on its rate base. based upon a summary of earnings for test year 1976 contained in Exhibit C attached to the application. The total rate relief requested was reduced to $129.470,000 on September 4, 1975 based upon SoCal's revised estimates of revenues, expenses, rate base, cost of capital, and its estimate of a reasonable return on equity for test year 1976. Some of the factors included in the reduction of SoCal's estimated revenue requirements are the elimination of a proposed underground storage project. institution of a program to limit certain capital expenditures by methods such as deferring replacement (which could increase operating and maintenance costs of plant kept in service), and elimination of a cost of living adjustment to payroll.

SoCal's requested return on its capital structure is 10.25 percent both on the original and on the revised basis. The corresponding return on common equity increased from 15 percent in SoCal's original showing to 15.64 percent in the revised basis shown in Exhibit 3-2.

SoCal's revised exhibits, which reflect updated estimates of gas supply and heating value of the gas supply, show a decline to $118,609,000 in the total rate increase required to yield a 10.25 percent return on rate base. SoCal concedes that the average heating value of the gas supplied should be 1055 Btu per cubic foot, the revised staff estimated heating value adopted in D.85354 dated January 20, 1976 in this proceeding.

SoCal states that gas supplies have continued to decline at a significant rate and it has experienced rapidly increasing costs without offsetting revenues which have brought about a serious erosion of earnings and effectively prevented it from earning the 8.50 percent rate of return authorized in D.83160 dated July 16, 1974 in A.53797. SoCal contends that the continuing high rate of inflation projected for the future will further erode earnings and prevent it from realizing its allowed rate of return let alone the fair rate of return sought here for the future; that further rate relief calculated to deal realistically with the effect of persistent and substantial cost inflation is required; that SoCal's costs of doing business across the entire spectrum of its operations are continuing to increase; that these escalating costs include operating and maintenance costs, wage rates, employee benefits, and materials and supplies; that continuance and expansion of its research and development programs also increase its need for rate relief; that due to the reduction of available gas supplies it is necessarily committed to expansion of existing underground storage facilities and the construction of facilities in the newly acquired Honor Rancho (HR) underground storage field to meets its increased requirements for load balancing; that HR will not produce additional revenue but will add significantly to its operating costs and capital charges, which in turn will require significant amounts of additional capital from the sale of debt and common stock.

During the course of the proceeding SoCal terminated its efforts to acquire a second underground storage facility and indicated that it was exploring the possibility of leasing underground storage fields to meet its seasonal and peak load balancing demands.

Present rates as defined in the application were the rates in effect as of October 1, 1974, excluding that portion of the rates relating to gas exploration and development adjustment (GEDA) charges contained in its rates, and reflecting wholesale gas service agreements effective November 1, 1974 and December 1, 1974 for service to San Diego Gas & Electric Company (SDG&E) under Schedule G-61 and to the city of Long Beach Gas Department (LB) under Schedule G-60. This GEDA adjustment is 0.061 cents per therm or thermal unit for all consumption under all measured classes of service. Present rates, the rates contained on pages 1 and 2 of Table 20-C of Exhibit 1 and revised pages 3 and 4 of Table 20-C contained in Exhibit 1-19, as used in this decision, contain the modification to interruptible and wholesale schedules adopted in D.84512 dated June 10, 1975 in A.53797. Any relief granted subsequent to October 1, 1974 in a purchase gas adjustment (PGA) proceeding or in a GEDA proceeding would be additive to the rate relief authorized herein.

Offset rate relief granted in D.83881 dated December 17, 1974 in A.55117 overlaps a portion of the total rate relief requested herein. D.85354 authorized a partial general rate increase, subject to refund, of $39,363,000[1/] which is a portion of the total increase authorized herein, above present rates. This amount includes the revenue effect of the rates authorized in D.83881 in 1976.

1/ D.85397 dated January 27, 1976 reduced the increase authorized in D.85354, which was $39,363,000, to $39,323,000. The reduction corrected a miscalculation in computation in D.85354. D.86118 dated July 13, 1976 ordered the filing of reduced rates and ordered the filing of refunds with interest equivalent to a 0.25 percent reduction in rate of return from the effective date of D.85354. The $39,323,000 increases to $51,597,000 for the sales adopted herein.

A prehearing conference was held in this proceeding on February 20, 1975 to ascertain the identity of parties and the scope of their anticipated participation in the subsequent hearings. After due notice including publishing and posting of notice, and the mailing of bill inserts, seven days of hearing were scheduled in this proceeding for the testimony of public witnesses, including a night hearing, as compared to two days of public witness testimony in SoCal's last general rate increase application. Statements[2/] or testimony were presented by 34 public witnesses in the city of Los Angeles, by nine public witnesses in the city of Santa Ana, by 20 public witnesses in the city of San Bernardino, by seven public witnesses in the city of Palm Springs, and by 11 public witnesses in the city of Santa Barbara. No public witnesses appeared in the city of Bakersfield.

SoCal briefly outlined the basis of its request. The staff and LA indicated the scope of their intended participation to the public. The general thrust of the public witness testimony and statements, and of the extensive correspondence received by the Commission, relates to the difficulty of the public in making ends meet during this period of rapid inflation, in general, and of paying rapidly increasing utility bills including gas bills, in particular. The special problems of the poor, the aged, of persons on fixed income and of unemployed customers were described in detail. This Commission and the Legislature have been responsive toward mitigating some of these problems through the establishment of lifeline rates.

2/ Excludes statements made by SoCal, by the Commission staff (staff), and by the city of Los Angeles (LA).

The Commission and the Legislature have also been responsive to the need for conservation of our energy resources. To the extent that there is curtailment of usage due to conservation, such as residential conservation, the limited supply of gas available for distribution by SoCal can be used to a greater extent to supply demands of lower priority, interruptible customers which would otherwise be curtailed and to lengthen the time before curtailment of residential customers.

A total of 70 days of hearings were held in this matter before Examiner Jerry Levander from April 21, 1975 to December 9, 1975. This matter was submitted on December 9, 1975 subject to receipt of concurrent opening briefs on January 22, 1976 and concurrent closing briefs on February 5, 1976, and the receipt of late-filed Exhibits 91 by SoCal and 92 by the staff showing updated gas supply estimates and revised expense and revenue estimates flowing from the revised gas supplies. The late-filed exhibits were due on the same day as the opening briefs filed in this proceeding. SoCal did not make a timely filing of Exhibit 91. SoCal's reply brief alleges that the staff could have put Exhibit 92 in evidence during the course of the proceedings which could have been subject to cross-examination; that there are errors in the staff's showing which would make it unfair for this Commission to rely on Exhibit 92 to any extent; that the staff did not give adequate consideration to the overstated (by 38 M^2cfd) past estimates of Transwestern Pipeline Company (TW) and to the lower level of 1976 deliveries which would result from the permanent El Paso Natural Gas Company (EP) curtailment plan going into effect. However, SoCal still did not file Exhibit 91 to provide the Commission with its updated estimates.

New questions were raised in SoCal's closing brief. The examiner, in his capacity as presiding officer, issued a ruling by letter dated February 27, 1976 directing the production of evidence by SoCal. This letter states in part:

> "Applicant did not file late-filed Exhibit 91 on the January 22, 1976 due date which was also the filing date for concurrent opening briefs, or on February 5, 1976 the date for filing concurrent reply briefs. The issue of revised gas supply estimates and of the related revenue effects of changed gas supply estimates was argued on pages 24 through 29 of applicant's reply brief.
>
> "Southern California Gas Company is directed to file Exhibit 91 with this Commission on or before March 22, 1976 with copies to the parties who filed briefs on January 22, 1976. The exhibit shall contain:
>
> (a) an explanation of whether applicant's estimates rely on a pro forma treatment utilizing the permanent El Paso curtailment plan for all of test year 1976; a composite of the interim curtailment plan and of the permanent curtailment plan or on another type of treatment;
>
> (b) applicant's estimates of gas supply by source for test year 1976 under each of the assumptions in (a);
>
> (c) summaries of earnings based on the assumptions in (a) with an explanation of changes from applicant's estimates in Exhibit 69; ..."

Exhibit 91 was received on March 23, 1976. The exhibit contains SoCal's revised estimate of its gas supply and of the effect on its test year operations caused by the changed gas supply estimate. Exhibit 91 was not responsive to the alternate treatments requested in the above quoted ruling. SoCal filed these alternatives as Exhibit 91-1 on April 9, 1976.

SoCal's utility affiliate, Pacific Lighting Service Company (PLS) supplies gas to SoCal on a cost of service basis which has been approved by this Commission. All of the expenses and return for PLS are included as a part of SoCal's revenue requirements. SoCal is seeking the same rate of return for PLS as for itself.

SoCal, through witnesses, presented testimony and exhibits in support of the requested increase for itself and for PLS. The total PLS revenue requirement is a portion of SoCal's production expenses. The staff's witnesses presented a comprehensive showing as to all aspects of the proposed rate relief. LA requested a copy of all written staff data requests and of SoCal's written responses thereto so as to expedite its cross-examination of all of SoCal's witnesses and of the staff's witnesses. The examiner directed SoCal to make these written data requests and written responses thereto available to a city representative for inspection and provided for SoCal and LA to make appropriate arrangements for the reproduction of any of the requested material. SoCal was further directed to answer all staff data requests fully and responsively in compliance with Sections 581 and 582 of the Public Utilities Code. LA participated extensively in the cross-examination of witnesses in this proceeding. It produced evidence only on rate of return. The California Manufacturers Association (CMA) sponsored evidence on rate spread. The city of Long Beach (LB) presented evidence on modification of its rate design through lowering the demand charge and consolidating commodity block rates (both of these objectives were met in D.85354 as modified by D.85397), and requested a lower relative increase in its rates than proposed by SoCal and by staff, but not solely at the expense of SDG&E. LB asked the Commission to recognize SoCal's obligation to deliver the annual contract volume to it as set forth in its showing, seeks a finding that there was a deficiency of gas deliveries by SoCal to it, requests that the Commission order SoCal to compensate LB in an amount to be determined by negotiation between the parties, and that this amount be used as a credit against then current billings from SoCal. The Western Mobilehome Association (WMA) presented evidence in support of rate relief to the mobilehome park operators served by SoCal to restore a differential between master metered and submetered rates to enable the park operators to recover costs of their providing submetered gas service. Several of the electric utilities testified as to their igniter requirements, which was the subject of D.85410 dated February 3, 1976. This decision reflects the modified igniter requirements SoCal was ordered to file in D.85767 dated May 4, 1976. Many parties other than described above also presented their positions on various issues and participated in the cross-examination of witnesses.

Gas Supply Shortage

The gas supply shortage discussed in D.83160, mimeo pages 6 and 7, is continuing. SoCal's original estimate shows sales of 1,015,695 M^2cf for 1972, 896,077 M^2cf for 1973, 802,219 M^2cf for 1974 estimated, 751,033 M^2cf for 1975 estimated, and 669,135 M^2cf for 1976 estimated. Actual sales for 1974 and 1975 were 807,823 M^2cf and 804,937 M^2cf, respectively. SoCal's gas purchases were 837,949 M^2cf in 1974 and 823,118 M^2cf in 1975. SoCal injected 1,376 M^2cf of its 1975 supply as cushion gas (nonrecoverable gas to establish a minimum field operating pressure) in the new HR field. There are fluctuations of purchases versus sales from year to year depending on variations in compressor station use, in unaccounted for gas, and in net injection or withdrawal from storage. In 1976 SoCal anticipates making a net injection of 21,500 M^2cf into HR.

SoCal's revised estimate of 720,536 M^2cf of gas sales for ratemaking purposes (see Exhibit 91) assumes revised delivery estimates based on the permanent EP curtailment plan being in effect for all of 1976, a 38 M^2cfd downward adjustment to TW's revised (through August 1976) estimate of gas supplies, plus deliveries from California sources. SoCal's as expected sales estimate of 725,851 M^2cf assumes the EP interim curtailment plan will be in effect through April 30, 1976 and the permanent EP curtailment plan, per EP's Federal Power Commission (FPC) filing, will be in effect for the remainder of the year. SoCal's revised estimate is higher than its original estimate in this proceeding, but as noted in D.85354 "the augmented supply estimates of SoCal's pipeline suppliers would slow but not arrest the decline in SoCal's gas supply."

Based upon its original estimate of gas supply SoCal anticipates the possibility of firm curtailment during a cold winter in 1978 or in the winter of 1979 absent a reduction in firm demand caused by conservation on the part of its customers.

SoCal is buying approximately 9,500 M^2cf of California gas supplies in the test year with an option to take deliveries within a three-year period. SoCal is deferring this take so as to have this additional gas available to avoid possible firm curtailment in 1978 or in 1979, in the event that no additional supplies of gas or that no curtailment of usage occurs by that time. This is a prudent action on its part.

SoCal placed on the record the efforts of its parent Pacific Lighting Corporation (PLC) and certain affiliates to seek out, procure, and deliver additional supplies of gas to it. We will not outline this information in detail; however, it should be noted that the potential capital requirements of these various projects appear to be far in excess of the total investment in utility plant by SoCal and PLS. The terms and conditions under which SoCal's parent and affiliates can secure new gas supplies for SoCal is dependent to some degree upon the financial health of SoCal. These activities have been made necessary by the inability of SoCal's traditional suppliers to meet their contractual obligations for gas deliveries, let alone to meet increased demands.

The conservation efforts proposed to be implemented by SoCal will be discussed in detail in the results of operation portion of this decision. SoCal is proposing to have its marketing division engage in an expanded program to promote gas conservation in order to reduce the possibility of firm, high priority, curtailment. The immediate effect of gas conservation carried out by SoCal's customers is to make available additional volumes of gas to low priority[3/] industrial customers, which would otherwise be curtailed. The availability of additional interruptible gas supplies would have both economic and environmental effects within SoCal's service area.

Honor Rancho Storage Field

SoCal has acquired title and/or surface and underground storage rights to HR for use as an underground storage reservoir to meet its seasonal and peak loading requirements. SoCal is constructing or reconstructing wells and compressor facilities and treatment facilities to facilitate the injection and removal of gas from this field together with associated oil products. Various components of the construction program will be put on line during the course of test year 1976. SoCal proposes to include the full cost of this plant as if it were in service as of January 1, 1976 without inclusion of any allowance for interest during construction. The staff has weighted plant additions in HR on an as-expected basis and has capitalized interest during construction. The staff treatment of HR

3/ See D.85189 dated December 2, 1975 in C.9642, which established new gas curtailment priorities.

adopted the rationale in D.83160 (see mimeo pages 7 and 8). The respective amounts in utility plant for HR are $72,243,000 in SoCal's estimate and $38,015,000 on the staff basis, a difference of $34,228,000. There are associated differences in: the reserve for depreciation of general plant of $570,000; in production expense; in ad valorem taxes; in income taxes; and in depreciation expense associated with SoCal's pro forma treatment of this plant.

The policy witness for SoCal and PLS, Mr. Hill, SoCal's Vice President of Regulatory Affairs, testified that there were no circumstances that he was aware of which would justify reversal of treatment of HR by the Commission (TR 473). SoCal's argument in support of its treatment of HR is that the diminishing supply does not permit the same opportunity for additional volumetric sales as existed previously, that there is a reduced margin experienced in additional firm sales due to lifeline rates, and that the magnitude of its investment is greater at HR than at Aliso.

We are not convinced by SoCal's argument and adopt the as-expected treatment for the test year. We will authorize SoCal to file an advice letter rate increase to offset inclusion of the full costs of acquisition, construction, and operation of HR for periods subsequent to December 31, 1976. We approved offset relief in D.83881 to reflect the complete utilization of Aliso in SoCal's operations, to offset a wage increase, to amortize a synthetic natural gas peaking project, and to offset the expiration of an amortized tax credit.

The other unresolved issues raised in this proceeding will be discussed under the subjects designated in center headings in the following sequence:

A. Results of Operation
B. Rate of Return
C. Rate Spread
D. Modifications to Purchase Gas Adjustment Clause

A. RESULTS OF OPERATION

Both SoCal and the staff presented results of operation studies for SoCal and PLS for test year 1976 which included all elements related to revenues, including customer growth, use per firm customer, and declining interruptible sales in the revenue mix. During the course of the proceeding, a number of important revisions were made by SoCal and the staff in their respective estimates, some of which were included in Exhibit 69, a comparative results of operation. Subsequent modifications based upon new information have been incorporated in Table 1 on page 15. Table 1 contains the latest comparison of SoCal and staff estimates of SoCal's results of operation for test year 1976 and the adopted amounts, all at present rates (as previously defined), which do not incorporate the reductions ordered in D.86118.

SoCal revised its Exhibit 69 showing in Exhibit 91 to incorporate later data on gas supply and on the average heating value of its supply. SoCal carried the changes associated with the new gas supply through summary of earnings calculations.

The adjustments to the staff's Exhibit 69 showing are increases in gas supplies and revenues (modified from Exhibit 86) and the associated increase in gas costs contained in Exhibit 92-1, and the changes discussed in D.85354, namely, the increase in average gas heating value from 1053 Btu per cubic foot to 1055 Btu per cubic foot, an increase in SoCal's operating expenses of $187,000, an increase in SoCal's rate base of $1,942,000, an increase in SoCal's JDIC income tax deductions by $266,000, and decreased revenues of $165,000 to reflect changes in estimated igniter gas deliveries.

State and federal income taxes, franchise taxes, uncollectibles (no change of uncollectibles is associated with changed interruptible or wholesale deliveries) and the rate of return will all be affected[4/] by the above-mentioned modifications of the staff estimates contained in Exhibit 69. These changes have been incorporated in Table 1. We have set out in Table 1-A on page 15-A the results of operation under present and authorized rates.

4/ Use of the staff methodology would also result in a change in the working cash component of rate base. This modification of the staff estimate was not incorporated in Table 1.

TABLE 1

Southern California Gas Company

RESULTS OF OPERATION UNDER PRESENT RATES a/

Test Year 1976

Item	SoCal Exhibit 91	Commission Staff	SoCal Exceeds Staff	Adopted
		(Dollars in Thousands)		
Operating Revenues	$824,572	$850,066 c/d/	$(25,494)	$841,192
Operation & Maintenance Exp.				
Production	489,739	504,518 c/	(14,779)	505,032
Storage	8,739	8,108	631	8,276
Transmission	12,637	12,236	401	12,637
Distribution	73,419	72,832	587	73,187
Customer Accounts	45,632	43,565 e/	2,067	43,561
Sales	7,244	3,767 b/d/	3,477	7,244
Admin. & General	80,431	71,413 b/d/	9,018	74,797
Subtotal O&M Exp.	717,841	716,439	1,402	724,734
Wage Inc. Adj.	-	(12,027)	12,027	(3,626)
Postage Inc. Adj.	-	907 f/	(907)	907
Total O&M Exp.	717,841	705,319	12,522	722,015
Taxes				
Taxes Other Than Income	31,137 b/	29,227 b/d/	1,910	29,711
Federal Income	(11,112) b/	7,572 b/d/	(18,684)	(3,286)
State Income	(555) b/	3,121	(4,006)	624
Total Taxes	19,140	39,920	(20,780)	27,049
Depreciation	41,390	40,297	1,093	40,314
Total Oper. Exp.	778,371	785,536 b/	(7,165)	789,378
Return	46,201	64,530 b/	(18,329)	51,814
Rate Base				
Working Cash	38,000	16,171 d/	21,829	18,037
Remainder	942,095	902,885 d/	39,210	903,896
Total	980,095	919,056 b/	61,039	921,933
Rate of Return	4.71%	7.02%	(2.31)%	5.62%

(Red Figure)

a/ See mimeo. page 3. Does not incorporate reductions in D.86118.
b/ Calculated.
c/ See Exhibit 92-1.
d/ Includes changes from Exhibit 69 referred to in D.85354.
e/ Includes increases in uncollectibles related to heating values.
f/ Staff recommends use of postage rates in effect.

TABLE 1-A

Southern California Gas Company

RESULTS OF OPERATION UNDER PRESENT AND PROPOSED RATES

Test Year 1976

Item	Adopted	Authorized Increase	Authorized
	(Dollars in Thousands)		
Operating Revenues	$841,192	$64,490 a/	$905,682
Operation & Maintenance Expense			
Production	505,032	1,411 b/	506,443
Storage	8,276	-	8,276
Transmission	12,637	-	12,637
Distribution	73,187	-	73,187
Customer Accounts	43,561	323 c/	43,884
Sales	7,244	-	7,244
Administrative & General	74,797	1,122 c/	75,919
Subtotal O&M Exp.	724,734	2,856	727,590
Wage Inc. Adj.	(3,626)	-	(3,626)
Postage Inc. Adj.	907	-	907
Total O&M Exp.	722,015	2,856	724,871
Taxes			
Taxes Other Than Income	29,711	-	29,711
Federal Income	(3,286)	26,922 d/	23,636
State Income	624	5,547 d/	6,171
Total Taxes	27,049	32,469	59,518
Depreciation	40,314	-	40,314
Total Oper. Exp.	789,378	35,325	824,703
Return	51,814	29,165	80,979
Rate Base			
Working Cash	18,037	(1,772) e/	16,265
Remainder	903,896	-	903,896
Total	921,933	(1,772)	920,161
Rate of Return	5.62%	-	8.80%

(Red Figure)

a/ Authorized increase to achieve 8.80% rate of return.
b/ Increased purchased gas price for gas purchases from PLS.
c/ Result of $64,490,000 increase in operating revenues.
d/ Effect of increased operating revenues.
e/ Reduction in working cash at 8.80% rate of return.

Operating Revenues

The major differences in the estimates of operating revenues at present rates are based upon use per firm meter, and differing estimates of the gas supply.

In past general rate proceedings differences in estimates of firm general service usage per customer were of much greater relevance in estimating revenues than they will be in the future. Past estimates reflected declining block rate structures within a customer class, lower unit rates charged for lower priority usage, and air conditioning discounts. This is still a major factor in the comparison of revenues at present rates. In the past SoCal's earnings would decrease markedly in a hot year and would improve dramatically in a cold year due to these differences in unit pricing within a class and between customer classes. That portion of the total gas supply not sold to firm (high priority) customers was sold at lower rates to meet interruptible customer requirements. Our adoption of lower unit lifeline rates and the flattening of commodity charges in the rates adopted herein will dramatically affect the swing in revenues occasioned by sales to either higher or lower priority customers depending on changes in usage per firm customer and on the largely temperature-induced variations in high priority usage.

When interruptible unit rates equal nonlifeline unit rates, SoCal will experience greater earnings in a hot year than in a cold year because larger amounts of gas, sold at higher unit rates, would be available to meet interruptible requirements on SoCal. The differential in revenues would be the result of marginal shifting of consumption either below or above the designated lifeline quantities.

The primary determinant on both net and gross revenues at authorized rates will be the quantity of gas actually received by SoCal from its suppliers, particularly its out-of-state suppliers, TW and EP. Under the declining block structure which characterized SoCal's earlier rate structures differences in actual deliveries from projected deliveries represented unit price sales made close to and sometimes below the cost of the gas to SoCal. The revenue differences at present rates due to the different estimates of gas supplies will be of a greater order of magnitude compared to revenue differences at authorized rates, which are based primarily on staff rate design criteria.

SoCal contends that for the period from September 1975 to January 1976 TW's deliveries were 38 M^2cfd below TW's estimates. The staff shows that actual EP deliveries for 1974 were approximately 185 M^2cfd above EP's estimates and that 1975 deliveries will be approximately 188 M^2cfd above EP's estimate. The staff's estimate incorporates anticipated additions to reserves available to SoCal's suppliers which will increase the supply to SoCal during the test year.

The effect of our adopting a gas supply estimate above actual deliveries for the test year would be to excessively lower commodity rates and to overestimate sales. SoCal's revenues would then be insufficient to meet the authorized revenue requirement. On the other side of the coin, if we adopt a gas supply estimate which is on the low side of actual deliveries the unit commodity cost per Mcf will be greater than necessary to meet the total company revenue requirement which would result in an excessive level of earnings.

SoCal's Exhibit 91, filed several months after the staff's Exhibit 92, reflects the higher level of California and offshore gas purchases contained in its earlier estimate compared to the staff estimate.5/ SoCal could have revised its estimate in conformity with the above-mentioned letter ruling of February 27, 1976 if justified by changed circumstances.

5/ SoCal's estimate is approximately 4.3 M^3cf above the staff estimate.

The permanent EP curtailment plan is not yet in effect, consequently, SoCal has been receiving larger quantities of gas from EP than it has estimated. The adopted estimate of gas supply is supported by SoCal's gas receipts through May 1976. It is reasonable to adopt the staff estimate of TW and EP gas purchases in Exhibit 92 for ratemaking purposes adjusted to a 365-day year and SoCal's California and offshore estimates.

As noted in the foregoing discussion the quantities of gas which SoCal might be expected to receive from its suppliers are of critical importance in establishing growth in revenues for SoCal. Pacific Gas and Electric Company (PG&E) faces a similar situation. It would be desirable for the utilities and the staff to explore methods of refining supplier estimates, or of getting better estimates of gas supply. This could involve one or more of the following procedures: (a) securing an FPC order directing the pipeline companies to make available the work papers supporting their estimates to their customers; (b) securing an FPC order requiring the filing of estimates such as are contained in FPC Form 16 on a monthly basis; (c) securing an FPC order requiring pipeline companies under its jurisdiction to file revised estimates when either a predetermined quantity or a predetermined percentage change in the estimates has occurred.

Certain gas usages are temperature sensitive to some degree, particularly gas used for space heating purposes. Both SoCal and staff estimates reflect adjustments of usage to average temperature conditions. In A.53797 we analyzed the staff's estimate which utilized a 30-year base for temperature adjustments and SoCal's estimate which utilized a 20-year base for temperature adjustments and we adopted the staff base period. However, we stated "SoCal may wish to present additional information on this subject in a future rate proceeding..." (see mimeo. page 12 of D.83160). SoCal witness Wilson stated that "The Commission in D.83160 determined that the 30-year base period was proper for ratemaking purposes..."; that SoCal is using annual updates on a 20-year basis for internal planning purposes; that the use per customer would be 131.3 Mcf per customer in 1976 using a 20-year average (through 1975) temperature base compared to his original 1976 estimate of 134.2 Mcf per customer using a 30-year average temperature base (through 1970). The impact of the changing composition of population served by SoCal, of the energy crisis, and of conservation efforts have resulted in a shifting of methodology in determining estimated use per customer. It would have assisted the record had SoCal elected to provide additional information in this area of correlation of use with differing average temperature bases. This Commission and other agencies should have available to them the best possible demand estimates to evaluate the requirements of SoCal's customers and the available gas supply. Use of this information would be of assistance in evaluating the efficacy of conservation programs.

SoCal's Manager of Gas Requirements, Gas Balances, and Rate Design, Mr. Wilson, established an average growth rate in use per firm customer over a five-year period 1969 to 1973. Data applicable for 1974 was not utilized because of the sharp decline in use per customer associated with the energy crisis. The average annual growth rate was added onto estimated use in the last quarter of 1974 and trended through 1976.

Mr. Wilson's revised estimate reduces his estimate of use per customer from 134.2 Mcf per customer in 1976 to 129.5 Mcf per customer by incorporation of an estimate of voluntary reduction in gas consumption by SoCal's customers prepared by Mr. Shea, SoCal's Vice President of Consumer Services, who is in charge of SoCal's marketing and customer services. Mr. Wilson testified that during the 14-month period from October 1973 to December 1974 use-per-meter declined by approximately 12 Mcf, or almost 8.5 percent, principally as a result of the energy crisis and consequent conservation efforts; and that a reduction of 3.1 Mcf per meter or about 2.3 percent over the 18-month period that the new conservation program would be in effect through the end of the test year would be achieved.

A staff witness Mr. Jones, a senior utilities engineer, made two estimates of use per customer. Both estimates utilized a 30-year base, ending with 1970, for establishing average temperature conditions. The starting point of Mr. Jones' initial estimate was higher than that of Mr. Wilson because it began at a point where there was a rebound in use per customer as compared to the starting point of Mr. Wilson, which was near the bottom of a dip in use per customer. He utilized a relationship of use during the first two months of 1968 to 1973 inclusive to the total years' use in arriving at an end-of-year figure for 1975, added the trended growth in use per customer from December 1967 to October 1973 of 1.8 Mcf per year to arrive at his 1976 estimate of 137.1 Mcf per customer.

Mr. Jones revised his estimate after reviewing recorded data through May 1975 because of changed customer use patterns. His revised estimate of 136.3 Mcf is based upon the summation of individual monthly trends. Mr. Jones testified that he had not utilized any reduction attributable to the voluntary load curtailment program prepared by Mr. Shea because there was no viable data to support a quantification of conservation efforts, but that the conservation efforts of SoCal's customers from November 1973 to December 1974 were reflected in his estimate; that conservation, price elasticity, and the downtrend in the economy are working to decrease use; and that the belief by the general public that there is no actual energy shortage, or that the shortage is abating, or that the "energy shortage" was a rip-off tends to increase use.

LA argues that we should adopt a heating value per cubic foot of gas in excess of 1057 Btu because SoCal and the staff have erred on the low side in estimating heating values in the past; that we adopted a staff estimated heating value of 1056 Btu in D.85113 dated November 18, 1975 in A.55899; that the staff did not adequately justify the reduction in its use per customer estimate; that SoCal dreamed up the reduction in use per customer rather than reduce its requested rate increase; that the original $900,000 estimate of income from SoCal's energy conserving insulation program should be included in operating income rather than as a below the line item as proposed by SoCal; that SoCal lowered its estimate of insulation revenues when a staff associate utilities engineer, Mr. Copeland, suggested that the Commission include insulation income for ratemaking purposes; and that the staff's use of supplier estimates in Exhibit 92-1 in computing revenues reflects the conservative estimates of TW and EP.

The city of San Diego (SD) discounted SoCal's estimated reduction in use per meter through conservation and supported the staff estimate.

In D.85113 we discussed variables affecting heating values which apply in this proceeding, and adopted the staff estimate of heating values through April 1, 1976. The revised staff estimate of heating values, based on trending the latest information then available, is reasonable. The potential revenue attributable to deliveries of the adopted gas sales volume necessarily encompasses the heating value of gas since the unit sales price is a price per therm measured by multiplying gas volumes, the heating value of gas, and an altitude adjustment.

SoCal makes arrangements for insulation of older buildings with approved outside contractors. SoCal often finances this insulation and its insulation revenues are interest charges received by it for deferred payment of insulation contracts. SoCal's original $910,000 estimate assumed a higher proportion of such deferred payments than have occurred. We agree such income after operating expenses should be treated as other operating revenues, but in the reduced amount of $568,000 estimated by Mr. Shea, using an expanded work force of 25 insulation sale representatives.

The continued exposure of the public to messages of need for conservation of gas from the public sector, including this Commission, and the private sector, including the expanded conservation effort on SoCal's part, should result in a decline in use to meet and, perhaps, exceed the reduction in use per customer envisioned by Messrs. Wilson and Shea.[6/]

6/ The 12-month-ending temperature adjusted use per customer using a 30-year average temperature base filed by SoCal in C.9642 shows a change in use per customer from 132.9 Mcf in July 1975, to 133.1 Mcf in September 1975, followed by a decline to 129.5 Mcf in April 1976. The corresponding reductions in use per firm customer were less for both PG&E and for SDG&E compared to SoCal. The temperature sensitive load in PG&E's service area is greater than that in the SoCal area, which in turn is greater than in the SDG&E service area.

The staff's revised TW and EP supply estimates in Exhibit 92, SoCal's California and offshore supply estimates, SoCal's estimate of firm general service sales and gas engine sales, and the updated igniter requirements filed in Advice Letter 981 have been incorporated in the adopted results.

The gas sales volumes and related revenues by class as estimated by SoCal, by the Commission staff, and as adopted are shown on the following tabulations. The revenue differences for other revenues also reflect differences in interruptible exchange deliveries.

Gas Sales by Classes of Service
Test Year 1976

Class of Service	SoCal (Exh. 91)	Staff	Adopted
		(Sales in M^2cf)	
Firm General Service	440,776	463,923	440,776
Gas Engine	7,142	7,142	7,142
Regular Interruptible	190,933	195,767a/	198,365
Steam Plants	4,410	3,122b/	18,311
Wholesale	77,275	70,621	79,772
Total Sales	720,536	740,575	744,366

Revenues by Classes of Service
Test Year 1976

Class of Service	SoCal (Exh. 91)	Staff	Adopted
		(Dollars in Thousands)	
Firm General Service	$604,383	$629,338	$604,383
Gas Engine	6,343	6,343	6,343
Regular Interruptible	151,724	157,459a/	157,085
Steam Plants	2,845	2,000	11,813
Wholesale	57,489	53,161	59,093
Subtotal	$822,784	$848,301	$838,717
Other Operating Revenues	1,788c/	1,765c/d/	2,475c/e/
Total Revenues	$824,572	$850,066	$841,192

a/ Exhibit 92-1 shows an increase in sales volumes, compared to Exhibit 86, of 53,379 M^2cf and a revenue increase of $42,127,000 all of which were assigned to regular interruptible sales.

b/ Total igniter requirements per D.85410 which includes 461 M^2cf for SDG&E.

c/ Includes $392,000 for sale of oil recovered at HR.

d/ See Exhibit 69.

e/ Includes $568,000 for insulation sales revenues.

Operating Expenses

a. Wage and Employee Benefit Adjustments

SoCal's 1976 expense estimate includes a prospective April 1, 1976 wage and salary increase of 11 percent treated on a pro forma full year basis together with related employee benefits and payroll tax increases. SoCal originally proposed a cost-of-living escalator of up to three percent for all of its employees which was tied to a trigger point in a cost-of-living index. The threshold level for this cost-of-living adjustment was not reached and SoCal's modified estimate does not provide for any increase in wages and salaries attributable to increases in the cost-of-living. This 11 percent increase above 1975 levels is equal to the percentage increase SoCal agreed to pay its union employees in December 1974.

The staff estimate contains an 11 percent wage increase adjustment based on expense payroll included in the staff estimates because at the close of the hearings no contract or offer had been made which would affect increased wage levels for the test year. The staff argues that the generosity of the 11 percent increase, which was effective in 1975, would dictate that SoCal should drive a hard bargain in its negotiations for the 1976-1977 contract; that if the Commission were to allow for a projected wage increase which could only be described as most generous on top of last year's increase that management would be stripped of its most useful tool in labor negotiations; that in light of the difficult economic problems recently faced by SoCal's ratepayers, exacerbated by the substantial cost of gas increases, SoCal management might consider foregoing wage increases such as the 11 percent plus received in 1975; that SoCal has included an 11 percent wage increase for management and nonunion employees as well as for union employees; and that if SoCal signs an unreasonable labor contract prior to the issuance of a decision in this case, the staff would not sit idly by while an increase in that amount to all employees is reflected in rates.

LA argues that if the 1975 union increase of 11 percent was reasonable, there was no evidence to justify the identical increase for nonunion personnel nor was there evidence that SoCal did in fact increase its nonunion wages by 11 percent; that these have been difficult economic times and that companies such as Bethlehem Steel Corporation recently announced that it was cutting its nonunion salaries because of a bad year; that there is no justification for the ratepayers to bear all such costs; that no wage increase in 1976 should be recognized; and there should be a further reduction due to excessive allowances claimed for nonunion employees in 1975.

By letter dated March 9, 1976, SoCal advised the Commission that it has made a firm wage offer in its current labor negotiations of 8½ percent plus increased company contributions toward medical plan benefits; that its offer was submitted to represented employees for ratification; that it expected that the wage increase plus related benefits would become effective on April 1, 1976; and that its estimate of the cost of this increase in wages and benefits would be about $14,100,000 on an annualized basis. By letter dated April 1, 1976, SoCal advised the Commission that the Utility Workers Union of America and the International Chemical Workers Union had accepted its offer.

SoCal has not carried its burden of proof in showing why rates should be designed to provide management the same percentage increase as its union employees. For rate fixing purposes in 1976, operating expenses should include the 8 1/2 percent increase in wages and salaries plus related benefits for non-management employees and 6 1/2 percent for management salaries plus related benefits.

SoCal's estimated 1976 payroll expense is $37,534,000 for management employees and $91,893,000 for non-management employees incorporating an annualized 11 percent increase of $12,826,000 over the 1975 levels. SoCal's payroll increase of 8 1/2 percent totals $9,911,000. The two percent lower adjustment to management payroll would reduce the latter figure by $676,000, for full year exclusive of any other adjustment to operating expenses.

In the recent PG&E rate decision, Decision No. 84902 dated September 16, 1975 in Application No. 54279, this Commission disallowed executive salaries in excess of $100,000 a year for the reason that "salaries considerably lower than this are sufficient to motivate and provide incentive to the many other dedicated executives in PG&E's organization. Salary levels in the top management ranks of the public sector likewise seldom approach, let alone exceed, the $100,000 mark."

In a later PG&E rate decision, Decision No. 86281 dated August 24, 1976 in Application No. 55509, we stated "In Decision No. 84902 dated September 16, 1975 the Commission disallowed executive salaries to the extent they exceeded $100,000 per year. Based on this recent decision the staff estimates are $88,000 less than PG&E's. PG&E made an extensive, uncontroverted presentation in support of the reasonableness of the salaries it pays executives. We are convinced by applicant's showing and arguments and will not adopt the staff's adjustment of executive salaries."

In this SoCal decision the record shows that there is only one executive earning over $100,000 a year, the Chairman of the Board ($111,870.94). The issue of excessive executive salaries was not directly presented in the SoCal hearings. We will not, therefore, disallow any portion of that salary as excessive, but we place SoCal on notice that in its next rate case it must be prepared to justify the reasonableness of the salaries it pays executives and if it does not do so the Commission will reduce executive salaries to at least a maximum of $100,000.

b. Postage Expense

The staff did not give recognition to the recent postage increase because it was not in effect while the hearings were in progress. During the briefing period the increase authorized was being litigated. The staff agreed that any increase which became final should be incorporated in SoCal's operating expenses. The adjustment of $907,000 added to the staff estimate in Table 1 and included in adopted expenses gives recognition to a two cents per bill increase in SoCal's postage expense, which incorporates the bulk mailing discounts. SoCal's estimate contains increased postage expense of $1,742,000.

c. Inflation Factor

SoCal utilizes a so-called bottom-up method of estimating in which many line organizations prepare their estimates of expenses for a future period based upon past experience, anticipated changes in a particular function, and known changes in the cost of doing business for a future period. These estimates are reviewed by several supervisory levels to test their reasonableness and their conformity with the overall policy goals of the organization.

In the event that a change in one of the factors of the estimate is not known, SoCal prescribed an eight percent increase to account for the inflationary impact of such a change. It contends that failure to incorporate such changes would result in the production of a revenue requirement which does not meet its needs in actual practice, which in turn results in a lower than authorized rate of return. The 1976 estimate was prepared by SoCal's management personnel who utilized the 1975 bottom-up estimates as a starting point of their test year projections. There was not total consistency in the method followed by all of its witnesses. SoCal neglected to summarize the extent of the 1975 increases and a great deal of time was spent on the record in ascertaining the exact methodology followed by SoCal's witnesses. This problem was compounded by errors in the allocation of certain expenses and the unfamiliarity of certain witnesses with the data utilized in making their estimates or allocations they supplied to other witnesses.

The Commission staff witnesses generally utilized trending procedures for estimating certain nonlabor related expenses where known changes were not available at the time of the preparation of the staff exhibits.

SoCal contends that inflation is a fact of life which must be recognized by regulatory bodies in the determination of revenue requirements. The staff contends that while the eight percent was recited as the general inflation figure, it was revealed on cross-examination that it could not be determined how much of an inflation factor was built into the 1975 estimates; that SoCal's witnesses often did not know the amount reflected in 1975 or 1976 estimates; that there was a 25 percent inflation factor used (for a certain expense) in 1975 which was used on a compounded basis in 1976; that the cost guidelines were not consistently followed; and that the inflation factor was similar to the contingent wage adjustment which SoCal expected to occur in 1975 and represents SoCal's best guess of what will happen in the future. The staff contends that the inclusion of the inflation factor was ill-conceived and not supported, and served only to confuse the record and to invalidate SoCal's estimates. SD concurred with the latter statement of the staff and recommends that the Commission eliminate the inflation factor from all expense estimates.

SoCal contends that the staff straightline extrapolations or trending are representative as historical trends but their exclusive use as indicators of current economic conditions is misleading.

SoCal's inflation factor and the staff's trending of non-labor expense changes are different methodologies seeking the same result, namely, arriving at a reasonable estimate of expenses in the test year. The confusion, however, on the part of SoCal's witnesses, the inconsistencies in following the cost guidelines, and the changed conditions which were not adequately explained, all delayed the hearing. It is not realistic to expect that the level of expenses, which was being experienced in the latter part of 1974 when this application was being prepared, will prevail in test year 1976 given the present level of inflation. We recognize that the extent of inflation has declined markedly since the peak experienced, but present increases in the cost of goods and services are still high and must be recognized. There are applications of the staff trending methodology which are valid indicators and other cases where such trending produces misleading results. Informed judgment is essential in evaluating whatever estimating tool is utilized. The expenses which we adopt herein will reflect the amounts we deem to be just and reasonable for the test year. We are not adopting any overall inflation methodology but are adopting an item-by-item adjustment.

d. Production Expenses

Production expenses account for over 68 percent of the adopted 1976 O&M expenses and 60 percent of the total operating revenues of SoCal at present rates. Consistent with our revenue determination, SoCal's production expenses will be the sum of its cost of purchasing gas from EP contained in Exhibit 92 and the cost of service from PLS at the 8.5 percent rate of return authorized in D.83160. The gas purchase expense of PLS was increased by $13,000 over that shown in Exhibit 92 to reflect the reduction in exchange deliveries which would flow from the updated igniter gas deliveries. The remaining elements of PLS's costs which flow through to SoCal are discussed in our analysis of PLS's operations.

e. Storage and Transmission Expenses

We adopt the staff's $463,000 adjustment to SoCal's storage expense estimate to reflect the as-expected basis for operation of HR rather than the pro forma estimate used by SoCal.

SoCal's estimate of storage and transmission expense represents the modifications of its operations resulting from curtailment of deliveries. SoCal changed its staffing practices at several compressor stations based upon its evaluation of manpower required to provide normal service, to provide continued service in the event of a transmission line break, and to utilize storage in transmission lines to meet peak system demands. The staff approach of trending and adjusting 1972 to 1974 expenses and of determining the ratio of supervisory and engineering expenses to total labor, modified for new operations, would be a valid criteria for carrying out the same type of function in the same manner as in the past. This methodology does not adequately consider changes in SoCal's operations. These staffing requirements are not directly related to the volumes of gas purchased by SoCal or PLS.

The adopted results reflect the staff HR adjustment and the payroll adjustment related to the wage increase, the latter being incorporated in the total wage adjustment. The total wage adjustment also includes changes in the remaining expense categories.

There were discussions on the record about the possibility of the sale of gas transmission facilities by SoCal and/or PLS to Standard Oil Company of Ohio (Sohio). A Sohio subsidiary, Sohio Transportation Company of California, filed A.56445. This subsidiary may seek to acquire gas transmission facilities from SoCal or PLS to transport liquid hydrocarbon products.

Prior to selling major transmission facilities SoCal (and possibly PLS) should file an application demonstrating that such facilities will not be required for SoCal's present and future operations. The application should show the proposed method of booking plant retirements and the revenue requirement related to the affected plant.

f. Distribution Expenses

SoCal's estimate is based on expected operations which include increased maintenance expenses resulting from the use of improved leak protection equipment which will continue for several years until its entire system is checked out.

The staff's estimate used trending methodology adjusted to reduce leak detection expenses using more efficient equipment, and adjusted to spread certain increased maintenance programs over five years. Mr. Copeland distinguished between when to use trended estimates (e.g., Account 880, the keeping of maps and records) and when to depart from trends in estimating additional expenses utilizing new equipment and new procedures to meet safety requirements. He differentiated between increases in SoCal's workload for lesser leak repairs but not for blowing leak repairs because the older leak detecting equipment would have picked up the larger Class I leaks, and noted an omission of SoCal's which would decrease expenses.

SoCal points out that Class I leaks relate to potential hazards as well as to blowing leaks.

Differences in the meter and regulator maintenance expenses are due to SoCal's estimate being based on the anticipated workload for 1976 compared to the staff's estimate considering expense on a typical year basis.

Cathodic protection together with the use of plastic pipe to replace steel distribution lines will decrease the frequency of leaks in the system. Certain portions of SoCal's system are checked for leaks annually, other portions at intervals of up to five years. A reasonable amount for ratemaking for Accounts 887 and 892 lies between the two estimates. We are reducing SoCal's estimate by $160,000. We will adopt SoCal's estimate for maintenance of meters and house regulators giving consideration to the timing of repairs of various classes of meters, to the spreading of meter repair work to avoid excessive workload variations in its shop, and to the frequency of filings for general rate relief. The remaining staff adjustments are reasonable.

g. Customer Account Expenses

Aside from our prior discussion of postage and wages, the remaining differences of $343,000 and of $165,000 relate to the differences between the as-expected approach of SoCal and the staff trending, and to estimated use per firm customer which affects uncollectibles.

Mr. Copeland testified that there was very little fluctuation in direct labor expense on a per customer basis adjusted to comparative wage levels from year to year, but that customer account expenses other than direct labor have fluctuated without any apparent pattern and that a typical year based on trending would be the appropriate way to establish an estimate. He testified that the employment of 16 additional employees at a payroll cost of $214,000 to process payment checks more expeditiously was not incorporated in his estimate because he was informed that as a result of the work of these employees, SoCal would save banking charges of $450,000 since they performed encoding functions which are now handled by SoCal's banks; that SoCal could not point out where the reduction in bank charges appeared in its estimates in these accounts; and that he considered that the additional expense of these employees versus the reduction of interest charges would be a wash and hence did not adjust the account.

We adopt the staff's $343,000 adjustment, a $907,000 postage adjustment, and SoCal's estimate of uncollectibles adjusted due to the increase in the heating values of gas.

h. Sales Expenses

SoCal's sales expense estimate of $7,244,000, equal to one percent of its estimated operating and maintenance expenses, is one of the more controversial elements in this proceeding.

SoCal contends that the Commission must support its voluntary load reduction plan because the plan is responsive to our mandates to conserve natural gas; that the $7,244,000 is needed to reduce firm usage by 14,285 M^2cf, or 3.13 percent in 1976; that SoCal and its customers are faced with the possibility of firm curtailment in 1978 if it is a cold year or during an average temperature year in 1979, unless such firm load reduction occurs, due to delays in bringing in new gas supplies; that it is necessary to have plans if firm curtailment becomes necessary; that this reduction in firm demand is needed to keep the southern California economy viable; and that its voluntary load reduction plan, a creative conservation effort, was well under way at the time conservation admonitions were included in D.84729, D.84902, and D.84121. In addition, its program satisfies the Federal Energy Administration's UCAN Program requirements published on October 24, 1975. SoCal contends that the cost of its program divided by its estimated savings in firm usage equals 51 cents per Mcf which is cost effective when compared to the staff's estimated gas purchase price of 70 cents per Mcf; that this conservation has helped it to postpone the need for another underground storage facility which accounts for significant savings in test year 1976; that cost benefit comparisons should be to practical energy alternatives such as the fuel oil equivalent of approximately $2.50 per Mcf or almost five times as much as the gas made available as a result of its conservation programs, or of new supplies of gas from Alaska, or from synthetic coal gas, which could be two or three times as expensive as current supplies.

SoCal's witness, Mr. Shea, estimated that the conservation goal could be met at the level of expense requested; that the studies underlying the estimate were the results of the work of an experienced staff that has been highly successful in promoting load by SoCal over many years; that SoCal has a higher degree of saturation of gas usage for cooking, heating, water heating, and clothes drying than other utilities in the country; that this expertise and long history of success when turned to producing a conservation program should produce equal success; that the staff used outdated comparisons with the level of conservation programs for PG&E and Southern California Edison Company (Edison); that both Edison and PG&E have sharply increased their forecast of expenses for conservation programs; that SoCal's conservation program will directly reflect the level of expenditures authorized in this proceeding.

SoCal points out that staff witness Copeland agreed that if its conservation programs achieve a 3.13 percent reduction in firm usage in 1976, its estimated expense would be a good investment.

Mr. Shea testified that his original sales estimate focused on the objectives of promoting conservation of energy and of supplying information to SoCal's customers on the efficiency of gas appliances and that the revised program eliminated the latter program and increased the conservation budget; that SoCal revised its estimates because subsequent to the preparation of the original estimate the company became aware of a further deterioration in the gas supply situation because the Pan Alberta project was aborted and it became apparent that other gas supply projects were not going to be carried out to meet the expected delivery dates to southern California; that elements in SoCal's planning were cutting down load to push back the possibility of firm curtailment, continuing with efforts to bring in new supplies, and planning how to carry out firm curtailment if it became necessary to do so; that he was aware of and discounted public criticism concerning the ratepayer's bearing the burden of paying for SoCal's advertising expenses but he was more impressed by the fact that they did not represent a high percentage of

SoCal's customers; that the expanded home insulation program expenses were anticipated to be below the line; that SoCal was helping to train equipment supplier salesmen and the general public to more efficiently utilize equipment; that SoCal was giving awards in recognition of improved gas efficiency and was disseminating research information about more efficient types of equipment; that SoCal was subsidizing manufacturers and the promotion of new, more efficient types of gas using equipment and pilotless equipment[7/] to reduce usage; that subsidies were necessary because manufacturers would not voluntarily go into the research or installation of such facilities due to the extreme competitiveness of the market; that a continuation of SoCal's conservation program would increase firm conservation to 25,330 M^2cf in 1977 by carrying forward current programs and eliminating pilot usage on appliances; that new housing is required to have insulation installed; that there are approximately 1.1 million older homes which could be insulated within SoCal's service area both through its own program and those of other companies, the largest of which are those being carried out by Sears, Roebuck and Co. and Montgomery Ward and Co.; that for a typical home of 1,100 to 1,300 square feet, the cost would range from $185 to $225 and that savings of approximately 13.8 Mcf per year per house could be obtained, representing approximately 20 percent of the gas being supplied to the house; that the cost of such insulation could be amortized through gas savings in approximately 11 to 12 years at current rates; and that significant gas conservation could be realized by using automatic controls on thermostats which reduce temperatures when not needed for comfort control, by an overall reduction in heating temperatures, by increase in cooling temperatures, and by water control devices on new types of showerheads to reduce the amount of hot water required.

7/ Senate Bill 1521 mandates pilotless new equipment in 1977.

Mr. Copeland's testimony points out that the amount estimated by SoCal is equal to the $8,746,000 authorized in D.83160 with increases for wages and materials, reduced by transfers to other more appropriate accounts. Mr. Copeland's original estimate was $3,435,000 less than SoCal's estimate, excluding a $173,000 wage adjustment. Mr. Copeland testified that his estimate allows SoCal a reasonable allowance to inform the public of energy conservation needs, reasons for the rate hike, changes in billing practices and in meter reading schedules, of procedures to follow in case of emergencies; that the intent of the staff estimate is to exclude expenses used for solicitation of new customers or of maintaining SoCal's market status; that the dwindling supply of gas from present sources is of grave concern; and that the utility be discouraged from actively soliciting new customers until new sources of supply are found which will guarantee existing and potential customers with an adequate gas supply.

The staff argues that Mr. Shea's estimate was exactly the same as the amount disallowed by Mr. Copeland and was submitted as a voluntary load reduction plan; that the plan itself was elicited through cross-examination of Mr. Shea; that SoCal failed to submit any evidence to support its contentions; that the claimed reduction of 3.13 percent in firm load from advertising is based upon a midpoint between two curves shown in Exhibit 64 which would not be achieved until July 1, 1978; that one of the curves depicted is a product saturation curve for five household appliances; that Mr. Copeland testified that there was no relationship between a past sales program for household appliances and an energy reduction compaign; that Mr. Shea's testimony that constant reiteration of conservation messages was necessary to achieve its goal and the failure to utilize repetitive communications would dilute the entire program was not supported by a survey, Exhibit 23, performed by SoCal's consultant, the Marylander Marketing Research, Inc. (MMR); that the MMR study indicates that the opposite is true for saturation in advertising; and that Mr. Shea contends that he did not rely on the MMR study.

LA argues that SoCal's program is neither fiscally prudent nor related to conservation; that the conservation unit was formerly responsible for encouraging the profligate use of gas. LA suggests that if SoCal was interested in conservation, it would immediately end preferential air conditioning rates,[8/] would stop promoting gas air conditioning through advertisements on their trucks, and would stop free-footage allowances for swimming pools.[9/] LA objected to SoCal's conservation advertising of $3,030,000 including $340,000 to manufacturers, distributors, and dealers and $407,000 for American Gas Association (AGA) publicity.[10/]

The preliminary MMR study points out that the thrust of SoCal's advertising campaign was aimed at areas where the potential gas savings were marginal and indicated that SoCal's message was recognized and responded to by its better educated and more affluent customers. Neither the MMR study nor any of the witnesses could quantify the effect on demand of SoCal's advertising program.

The areas of greatest potential reduction in firm demand are in space and water heating and in eliminating pilot lights. Space heating represents approximately half of the residential load and ceiling insulation of older buildings could reduce the space heating

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8/ D.85354 terminated air conditioning discounts.

9/ SoCal also gives free-footage allowances for space heating, cooking, water heating, air conditioning equipment, garbage incinerators, gas refrigerators (which are not currently marketed) and clothes dryers.

10/ Expenses included in Administrative and General Expenses.

load by approximately 20 percent. Reduction in heating temperature settings and increased cooling temperature settings, retrofitting of appliances to eliminate pilot lights, and reduction in the temperature of hot water could result in major reductions in gas usage which would be reflected in customer bills.

Some of the criticisms of SoCal's program raised by the staff and IA are valid. There is a fine line between promotion and conservation. Facets of SoCal's program cross into promotional activities, and this may be necessary. There should be a revamping of conservation activities to reach all segments of SoCal's customers. SoCal should try limited experiments using different methods to reach its customers, possibly through direct contacts rather than through additional advertising, and should measure the effectiveness of its programs. The expenses for an augmented home insulation program should be a part of sales expenses.

SoCal should report in detail its activities in sales expenses and conservation programs contained in administrative and general expenses as a part of the reporting mechanism in C.9884. The Commission's Conservation Team should review these reports and advise SoCal and this Commission of its objections to any aspect of the program. The cost benefit expressed as dollars per M^2cf of reduced usage should be shown for all program elements. The free-footage incentives for nonessential gas uses which were not mentioned in the lifeline legislation, i.e., for clothes dryers, air conditioning equipment, garbage incineration, swimming pool heaters, and gas refrigerators will be eliminated. We will make the same kind of adjustment for other gas and electric utilities at the earliest opportunity.

It appears that SoCal is meeting its 1976 average firm usage goals. We will adopt $7,244,000 for SoCal's sales expenses to assist SoCal in meeting and exceeding its conservation goal and to meet the other informational requirements described by Mr. Copeland. We expect the changes in emphasis described above both in sales and in administrative general expenses. SoCal should phase out industrial or cooperative advertising support when specific improvements are required by law, e.g., for the insulation of new buildings, but it should continue to promote insulation of existing buildings. This amount includes $2,500,000 for advertising expenses.

Our staff analysis of the SoCal conservation program filed on March 31, 1976 indicates that a substantial redirection in conservation programs is being accomplished. SoCal is placed on notice that the Commission expects a continued expansion of efforts in conservation. Concurrently, any efforts to advise the public relative to SoCal's supply plans should be undertaken in such a manner so as not to confuse the public about the need to conserve and detract from conservation efforts. Payments to the AGA should be examined and conservation expenditures carefully accounted for separately. AGA expenditures are hereinafter discussed and appropriately adjusted.

In subsequent proceedings, a more detailed analysis will be undertaken and SoCal's rate of return will be adjusted, upward or downward, as the evidence indicates. In connection with the filing of its 1977 conservation programs, SoCal shall clearly detail its various conservation advertising expenses.

SoCal shall perform follow-up studies to determine the effectiveness of its conservation programs and shall inform the Commission of the results. Included shall be an assessment of the degree and effectiveness of efforts to distribute information and to market conservation hardware, with estimates of cost effectiveness and resulting energy savings. Justification shall be provided for relative emphasis among media for information transfer, among efforts directed toward behavior change as compared with hardware, and among various hardware options promoted.

SoCal should also take the initiative to develop and bring before the Commission programs of incentives, including but not limited to subsidies, low-interest loans and modified rates, for inducing conservation-oriented behavior and investment by end users.

The Energy Conservation Team shall review these programs and advise the Commission of any action which would be appropriate.

i. Administrative and General (A&G) Expenses

In addition to the effect on pensions and benefits associated with the wage increase there is a $636,000 difference between SoCal and the staff resulting from SoCal's adopting the aggregate cost method for funding its pension fund. The staff contends that SoCal should have continued utilizing the modified aggregate cost funding method, which has been used since 1954, and that the additional cost of SoCal's switching its funding method should be disallowed. SoCal contends that it could not afford to wait and see if the Internal Revenue Service (IRS) would disallow the modified aggregate cost funding method which could lead to a disqualification of its pension plan because it is required to use a recognized actuarial technique, one of which is the aggregate cost method; that the change was made effective January 1, 1975 and was an ongoing cost being currently experienced by SoCal; that SoCal changed its funding method as a result of the 1974 Pension Reform Act; and that the new funding method is specifically approved in the Act.

The authorized A&G expense includes pension funds and benefits related to authorized wage levels. We do not concur with the staff adjustment of $636,000. SoCal has adequate reason to be concerned with the validity of its continuing to use its old funding method under the Pension Reform Act of 1974.

SoCal witnesses were unfamiliar with much of the detail and methods used in preparing their original estimates and testimony on portions of A&G expenses. They subsequently prepared revised or additional exhibits to reflect changed circumstances, to more adequately explain the basis of their estimates, and to correct errors in the original estimates.

The staff witness relied primarily on verbal information requests and was unable to determine the basis of the company's estimates in several important areas. He was not familiar with some of the underlying allocations between accounts. He testified about protracted delays in SoCal's supplying answers and of lack of specific answers to his requests in several areas.

Written data requests and answers would have limited the argument on whether the problem was SoCal's failure to supply information or was due to the witness' lack of understanding.

On mimeo. pages 20 and 21 of D.83160 there is a discussion of SoCal's public relations programs, of its legislative advocacy, of its expenditures for social objectives, and of California Assembly Resolution HR 56 dated May 22, 1972 urging this Commission to maintain downward pressure on the overall level of advertising expenditures, to examine and to require the utility to demonstrate, within guidelines, substantial benefits to the ratepayers for allowed expenses. We stated that SoCal has the burden of proof in justifying any portion of its request for a rate increase; that it should be explicit in explaining the need for each of its public relations programs and of showing benefits for the ratepayer as well as for the enhancement of its corporate image; and that Commission staff estimates should be based upon greater familiarity with specific programs. We authorized $650,000 for advertising concerning gas safety and the gas supply situation and suggested that an information program focusing on the cost impact of reduced gas supplies might have a salutary effect on SoCal's energy conservation program. In analyzing this record we find that neither SoCal nor the staff adequately considered these admonitions.

SoCal requests that $2,987,000 of public relations department expenses and $991,000 of institutional advertising should be charged to operating expenses and borne by the ratepayer. With respect to institutional advertising, we are of the opinion that these expenses should more properly be borne by the investors than ratepayers. Our policy is clearly set forth in D.84902 of September 16, 1975 on Pacific Gas and Electric Company's A.52279, 52280, and 52281.

With regard to public relations, SoCal's witness, Mr. Riffel, prepared an estimate of $2,987,000, almost double that authorized in 1974. SoCal has actually gone so far as to request over one and one-half times the public relations funds allowed PG&E in its last rate case when SoCal's revenues are only 45 percent as great. The staff, relying principally on levels previously authorized, recommended $1,895,000.

LA contends that the rationale for SoCal's public relations activities, primarily the increase in institutional advertising, was Mr. Riffel's testimony that SoCal as well as being in the gas business was in the information business. LA alleges that SoCal has not justified any public relations expense and that no allowance should be permitted; that the staff erred in making any allowance for SoCal; and that the staff has been taken in by the claim that public relations is related to energy supply acquisitions which include high-priced public relations consultants engaged in endeavors all over the world.

We note that some of SoCal's proposed public relations activities bear a strong resemblance to the institutional advertising costs that we have eliminated as a part of the allowed cost of service. We also note that certain of SoCal's proposed expenses in this area are similar to those disallowed PG&E in D.86281, and we have therefore eliminated scholarships and facility and supply site tours.

We concur with LA's assessment that SoCal has not fully justified its public relations expenses and their benefit to the ratepayer. Given the size of the company and our limited information on its programs, we cannot make a finding of reasonableness for any amount exceeding $780,000.

In future proceedings involving this and other utilities, we shall expect the utility to justify, and our staff to verify, public relations costs in detail and to supply for the record information on each aspect of the utility's public relations programs so that we may make judgments regarding the reasonableness of each activity and of appropriate allowances. Failure by the utility to fully detail and justify its programs may result in disallowance of all public relations expenditures.

SoCal estimated $4,502,000 for research and development (R&D) projects in 1976. The staff's estimate of $2,087,000[11] is $2,415,000 below SoCal's estimate. In D.83160 mimeo. pages 23 through 25 and 75 through 77 we pointed out that R&D activities are a discretionary area; that SoCal's customers and society would benefit from having more efficient, more pollution-free gas consuming appliances and processes; that to the extent that more efficient appliances are developed and marketed, more efficient uses of gas energy are realized, there will be savings of gas; that with such savings the requirements for expensive new sources of gas supply would be lessened and the average cost of gas in the SoCal gas pool might be reduced; that SoCal's interruptible customers would benefit to the extent that firm gas savings were utilized to meet interruptible loads; and that this factor should be considered in rate design. We noted objections to some of the new R&D projects devoted to developing new uses for natural gas rather than for conservation and we ordered SoCal to keep the staff fully informed, in advance, of

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11/ The staff witness increased his estimate by $100,000 above that shown in Exhibit 69.

contemplated new R&D projects and of updated information on current R&D projects. SoCal has complied with that order and the staff reviewed the filings.

The staff argues that SoCal should analyze Commission decisions encouraging R&D programs; that we encourage innovative R&D programs, not a continuation of projects which are archaic both in need and design; that SoCal's witness, Mr. Davis, stated that he sees the goal of SoCal's R&D program to be the same as the R&D program of the American Gas Association (AGA); that review of the present AGA program in Reference Item U shows that one of the main, if not the overriding, purpose of the AGA program is penetration and maintenance of market; that SoCal sought to clothe all of its R&D activities in the rhetoric of conservation and pollution abatement; that Mr. Shea discontinued the CONCERN program as a sales activity but that $125,000 allocated to a similar R&D program was continued under a new name; and that the staff witness analyzed the projects individually and tested them utilizing the following tests:

(a). Is the project for basic development of a principle which will reduce gas consumption or reduce pollution?

(b) Does the project help develop new sources of gas supply?

(c) Does the project result in better instrumentation or operation thereby reducing operating costs?

(d) At a time when there is not sufficient gas available in the near future for its customers, no program should be undertaken which would result in additional gas usage.

(e) Any program undertaken must be cost effective.

Mr. Davis described the SoCal R&D projects listed in Exhibit 20, indicated when the results of the project might be marketed, listed cosponsors of various projects, described the energy savings to be achieved from the various residential, commercial, and industrial projects, and the pollution abatement sought from some of the programs. He indicated that many of these programs would not get off the ground if SoCal did not back them. In the area of instrumentation development, he described research which had various potential uses in SoCal's operations and the development of instrumentation for coal gasification plant controls.

SoCal's operations improvement projects include development of a silent pavement breaker which would benefit both equipment operators and the public in general, a leak pinpointer, a pipe locator permitting closer and more accurate location of buried pipes, and investigation of emergency shut-down systems. The improved leak detection and pipe location tools could bring about savings in excavation costs needed to make repairs by SoCal and other utilities. SoCal is continuing its research in coal gasification and in development of low Btu fuel which would have industrial applications.

The staff witness did not agree that some of the projects would result in energy savings. He testified that SoCal was developing products where there would be no gas available, or that interruptions of gas service would be unacceptable if the product development was successful due to declining gas supplies, or that some projects would promote usage in new areas.

The adopted results reflect a $250,000 reduction in SoCal's estimate for R&D expenditures for the test year. The reductions are in the areas of additional expenses above the authorized amortization for the Target fuel cell, elimination of research for intermediate power generation, and a cutback in new air conditioning applications. We have eliminated the air conditioning discount from SoCal's rates. Development of new equipment which reduces gas use for the replacement air conditioning market should continue to be pursued. SoCal should discontinue any promotional activities to encourage the development of new air conditioning loads. It would be preferable to utilize natural ventilation combined with insulation wherever possible rather than promoting air conditioning applications.

SoCal has budgeted $1,025,000 for applied industrial R&D projects. In addition, it has budgeted $500,000 for research in low Btu fuel for industrial applications; it has budgeted $350,000 for HYGAS coal gasification which will benefit industrial customers; and it has budgeted $500,000 for instrumentation development, a portion of which will be for coal gasification. SoCal should continue to evaluate the potential of developing fuel from marsh vegetation and the capturing of gas from organic waste disposal sites. SoCal should consider future projects suggested by the staff evaluation of its conservation program in C.9642 in planning future R&D programs.

SoCal should continue to supply the staff with data on existing and proposed R&D projects on January 15th of each year and should indicate whether the activities would assist in its conservation efforts, in environmental improvement, in pollution control, and in improving its operations. The data should include information regarding the engineering feasibility, cost-benefit ratio, and other potential benefits for each new project. The staff should evaluate the R&D projects and prepare a memorandum to the Commission with its preliminary recommendation on the reasonableness of the R&D projects for ratemaking purposes. Staff evaluation of the reasonableness of the R&D projects should be judged by the guidelines listed below:

1. The project should support the R&D objectives of SoCal and the Commission. SoCal must comply with the then existing environmental regulations.
2. The project should lead to environmental improvement and/or increased safety.
3. The project should support the Commission's conservation objectives and promote conservation by efficient resource use, and by reducing and/or shifting system load.
4. The project should help to develop new resources and/or processes and to advance supply technology.
5. The project should help to improve operating efficiency.
6. SoCal's priority setting process should minimize expense on those concepts which have a low probability of success.

SoCal should provide the staff with an update each June 15th. The report should include the expenditures incurred for each project and any changes made to the original R&D programs included in the January 15th filing.

SoCal's estimate includes $70,000 for AGA dues, $407,000 for AGA advertising, $341,000 for AGA research and communications, $21,000 for Pacific Coast Gas Association (PCGA) dues, $21,000 for National Petroleum Council dues, $15,000 for Merchants and Manufacturers Association dues, and payments to taxpayers associations and to nonutility related organizations.

Staff financial witnesses were critical of SoCal for not using the most economical, reasonable air transportation available and for faulty recordkeeping, e.g., salaries of employees engaged in GEDA activities, not on SoCal's payroll, were reported in General Order No. 77-H filings but their expenses were not.

The staff recommends that where a PLC subsidiary is financed by rates established by this Commission that the expenses associated with their activities be reported. We concur.

The staff engineering witness recommends disallowance of $80,000 contributed to nonutility related organizations, of expenditures for legislative advocacy, and $149,000 of the AGA contribution. He was unable to determine whether a portion of the $340,000 AGA contribution purportedly for research and development included communications expenditures. He recommended the AGA disallowance based on either past historical allocations or on the ground that a substantial portion of AGA's research and development programs was aimed at increasing the gas industry's position in the market or in creating new markets.

SoCal contends that the AGA and PCGA provide a forum through working committees, conferences, and conventions where each segment of the industry can contribute to the knowledge of the others; that through mutual sharing of information SoCal's operations would be more efficient and its ratepayers would benefit from improved service and performance of its employees; that its employees wish to provide themselves with periodic refresher courses on current utility problems but that such courses are not available through schools but only through the workshops and conferences of AGA and PCGA; and that the potential benefits to SoCal and its customers far outweigh the costs. SoCal also argues that its use of a private plane is necessary for its executives to reach remote places and to effectively utilize their valuable time; that it uses commuter air lines for California flights; and that its executives needed the space in first-class flights to work on long flights.

LA argues for total disallowance of all R&D, public relations, and organization membership expenses; of expenditures for clubs, for sporting events, for a Disneyland party for employees, for travel expenses in excess of the daily allowance allowed state employees, and for first-class air travel; for the use of a private plane by SoCal; for the expenses associated with the attendance of 32 SoCal employees and one of their consultants at a PCGA convention in Hawaii; and for amounts spent for legislative advocacy. We have considered this argument in our reduction of SoCal's A&G expenses.

There is validity to SoCal's argument concerning the functions of the AGA and PCGA. However, an examination of Reference Items U and V indicates that a substantial portion of the AGA's activities are for developing new markets and of expanding gas usage. AGA research is also directed at conservation goals, development of more efficient gas using equipment, pollution controls, exploration activities, and developing new sources of fuels. The record clearly demonstrates that recordkeeping activities separating utility and nonutility related functions need improvement, i.e., there are instances where there is no salary allocation commensurate with the defraying of travel expenses for nonutility related activities. We also concur with the staff financial examiner's recommendation that scheduled first-class air travel not be utilized at the ratepayers' expense, except those flights of more than three hours' duration. It is reasonable to reduce SoCal's estimates by $350,000 related to AGA and PCGA expenditures, the amounts contributed to nonutility and noncharitable organizations, and the reduction in other miscellaneous expenses described above.

SoCal's estimate for outside services for 1976 was $3,256,000 which includes charges by PLC of $1,840,000 for legal services and $1,400,000 for tax audit and gas supply finance services.[12/] PLC allocates expenses of its personnel who are engaged in work for SoCal, for its own operations, and for its other subsidiaries. The 1976 allocation to SoCal was 75 percent of the estimated expenditures of the legal department, the tax department, and the audit department, and 80 percent of gas supply finance charges. The

12/ A $300,000 duplication in expenses which should have been eliminated was not made by SoCal in Exhibit 69.

staff engineer recommended a $1,000,000 adjustment to $2,256,000 for these allocations. A staff financial witness recommended that 50 percent of the PLC billings or $1,628,000 be disallowed. SoCal's witness did not make any analysis of the services assertedly performed by PLC for SoCal or attempt to determine whether the charge was reasonable. A staff financial witness discovered that SoCal had been charging all vacation and nonbillable hours of PLC's legal department to SoCal and after discussion with PLC attorney's, was informed that future allocations would be made on a pro rata work activity basis. The staff witness testified that legal expenses for projects such as Western LNG, Pacific Alaska LNG, the coal gasification project, the Gas Arctic project, and Indonesia LNG, were charged to SoCal and that these expenses should be charged to the affiliates responsible for the projects. The staff witness reviewed time sheet allocations from SoCal's legal department and prepared Exhibit 63, the time sheets of PLC attorneys and law clerks for December 1974. No time sheets were kept by the other PLC departments allocating charges to SoCal.

The $3,256,000 sought by SoCal for outside services includes allocations from PLC of $2,710,000 and $546,000 for fees to outside consultants. The state of the record does not support the billings from PLC; and for purposes of this decision, we will adopt the recommendation of the Finance and Accounts Division that 50 percent of these billings be disallowed. We are reducing the $3,256,000 of SoCal's estimate for outside services by 50 percent of the billings from PLC, which reduction is $1,355,000, to allow only that portion of time spent on utility business in expenses.

The burden of proof of proving the reasonableness of affiliated transactions rests squarely on SoCal. It has not borne that burden in this proceeding. If SoCal desires to continue this type of working relationship with its parent, adequate time, payroll, and expense records should be kept for all of the services performed where allocations are made to SoCal or PLS or to entities financed by rates established by this Commission, e.g., the GEDA adjustment. These records should not only specify service to SoCal but should indicate the nature and identity of the work performed (e.g., legal services for settlement of particular vehicular accident claims, or for right-of-way acquisitions).

The staff's estimate of A&G salaries and office supplies and expenses is $1,408,000 lower than that of SoCal's estimate. The staff noted large increases which were not explained in the record. The staff witness also compared executive salaries to other utilities and found the percentage of higher paid employees is higher for SoCal than other utilities in California.

We have reviewed these items and will adopt a $634,000 adjustment downward for A&G salaries and for office supplies and expenses.

A&G expense transferred credits are capitalized. The adopted plant in service estimate incorporates most of the staff adjustments. The estimated staff A&G expense transferred credit is reasonable.

Taxes Other than Income

Adopted ad valorem taxes reflect the staff as-expected treatment of HR, the staff treatment of capitalization of ad valorem taxes on nonoperative construction work in progress, and an adjustment to capitalized payroll and benefits consistent with the adjustment to payroll and benefits expenses.

SoCal's estimate of its average 1975-1976 ad valorem tax assessment rate of $12.35 exceeds the staff's estimate by $0.20. The 1975-1976 rate used in the adopted tax computation is $12.23. SoCal's estimate of an ad valorem tax rate of $12.76 for the 1976-1977 tax year does not give adequate consideration to the tax limitation provisions of Senate Bill 90. The corresponding staff estimate of $12.30 appears to be overly conservative. The average rate utilized herein for SoCal's 1976-1977 ad valorem taxes is $12.60.

Adopted payroll taxes reflect the use of the higher estimated staff estimate for state unemployment insurance and inclusion of payroll taxes based upon the payroll levels incorporated in the adopted amounts shown in Table 1.

Income Taxes

Differences in operating revenues, operating expenses, payroll taxes, and in the plant base for the computation of ad valorem taxes all effect the income tax estimate.

Both SoCal and the staff used accelerated depreciation following the double declining balance method or the 150 percent declining balance method based upon Internal Revenue Service (IRS) guidelines, including the lower limits or shorter lives available under the asset depreciation range system for eligible properties in estimating income tax depreciation, and include an allowance for a five-year amortization of $1,619,000 in California Corporation Franchise Taxes (CCFT) less Federal Income Tax (FIT) effects through 1976. SoCal was authorized to switch from paying CCFT on taxable income for a prior year to a current basis. An ad valorem tax amortization previously authorized was fully extinguished at the end of 1974 and is not reflected in either of the estimates or in the adopted results. This methodology is reasonable.

The differences between the company and staff estimates for the optional repair allowance (ORA) flow from the staff using a three-year average compared to SoCal's use of its test year estimate. The staff brief stated that the ORA treatment followed in D.84569 dated June 17, 1975 in A.55676 should be followed. We will adopt SoCal's flow-through estimate for the ORA.

However, the $5,100,000 deduction in gross revenue impact computed for D.84569 in the A.55676 PGA was made for calendar year 1975 and since SoCal's rates were reduced correspondingly, it is now necessary to restore that deduction so that SoCal is not continually penalized by that amount. For that reason, $5,100,000 is added to the revenue requirement authorized here, for rate design purposes.

The staff did not include any amount for amortization of TARGET (fuel cell) payments. We are putting SoCal on notice that additional commitments for the TARGET program will not be recognized for ratemaking purposes, absent a compelling showing based on changed circumstances to justify continuation of this program. However, since we authorized the amortization of earlier expenditures for TARGET to achieve a normalized level for such expenditures, it would not be appropriate to disallow the authorized amount during the amortization period which includes the test year.

The methodology followed by the staff in deriving the tax deduction for long-term interest was consistent with that adopted in D.83160. We will adopt this staff approach modified to reflect updated interest rates for new long-term debt issues, which are discussed in the rate of return section of this decision. The short-term interest deduction assumes a 7.25 percent rate (the June 7, 1976 rate) and reflects adjustments to short-term borrowing resulting from SoCal's accelerated processing of its receipts.

In a supplement to our recent PG&E rate decision we expressed our concern over the reasonableness of taxes. (D.86360 dated September 1, 1976 in A.55509.) We have this same concern in regard to SoCal and expect SoCal and the staff to explore this tax field in detail in SoCal's next rate case in which taxes are an issue.

Investment Tax Credit (ITC)

PLC filed with IRS, on behalf of SoCal, its election to flow through the six percent additional ITC permitted by the Tax Reduction Act of 1975 (TRA) ratably over the useful life of the qualified property as a reduction in its cost of service of $295,000 annually. SoCal estimates its ITC, including its use of Option II in the TRA, will be $3,270,000 for 1976. The revised staff estimate of SoCal's ITC tax deduction is $4,339,000.[13/] The staff used a five-year average flow-through. The staff also proposes a $3,832,000 rate base reduction, 80 percent of the additional six percent credit which was not flowed through at the end of 1976.

Both SoCal and the staff are using a five-year average flow-through of the four percent ITC authorized by prior legislation and of the ten percent ITC on transmission and storage facilities presently authorized.

SoCal contends that the staff treatment results in a faster than ratable flow-through which would result in its loss of the additional credit to SoCal under Section 46(f) of the Internal Revenue Code; that authorization of revenues on the staff basis would be based on a hypothetical level of income not realized due to the loss of the extra ITC; that a rate base reduction would result in a reduction of the revenues it needs and is entitled to; that these effects would impact negatively on its cash flow; that the staff witness indicated that SoCal would lose the credit if his treatment was followed; and that the Commission must act prudently to avoid SoCal's loss of the additional credit.

13/ See Exhibit 89.

The staff argues that since the staff method was followed in D.85354 at the request of SoCal, SoCal's rates were set on a basis other than Option II; that for purposes of calculating tax expense in setting rates D.85354 is a final order within the meaning of the TRA; that Congress cannot regulate activities reserved to the states; that SoCal was imprudent in sponsoring the ITC legislation; and that it risked losing its eligibility in electing Option II and in restricting the Commission's ability to meet SoCal's needs. The staff concluded that SoCal's imprudence, coupled with the acknowledged reduction in risk and financing requirements, might also be considered in determining rate of return.

LA argues that proper ratemaking treatment of ITC will not result in a disallowance of benefits to SoCal; that even if SoCal loses the benefits of ITC such loss will be caused by the imprudence of SoCal and must be borne by it not by its ratepayers; that SoCal proposes a $295,000 reduction in rates whereas its actual revenue requirements decrease by $7,026,000; and that the Commission should adopt the $7,026,000 reduction or set rates on a normalization basis including a $295,000 reduction in revenue requirements and rate of return reduction of 0.35 percent, due to SoCal's imprudence in failing to elect flow-through and in giving consideration to the following statements filed in SoCal's brief in A.55444: "The cash flow generated by the ratable flow-through method will reduce SoCal's external financing requirements and will have an actual and favorable effect on SoCal's cost of money." And "SoCal's election will have a positive impact on its bond ratings and cost of debt and equity capital."

Several of the parties referred to their arguments on the ITC issue in C.9915, the investigation on the Commission's own motion into the ITC provisions of the 1975 TRA and to arguments filed in A.55676 and related matters. We disposed of the 1975 treatment of ITC in D.85627 dated March 30, 1976 where we reduced SoCal's rate of return by 0.25 percent.

LA further argues that the staff estimate of SoCal's total ITC income tax savings of $11,548,000 should be recognized in full for ratemaking purposes; that the five-year (1972-1976) averaging method used for calculating the ITC under the 1971 tax law and for transmission facilities under the TRA is not reasonable or justified; and that if a five-year average is used, it should include both past and future years, e.g., for SoCal's test year 1972 the years 1971 to 1975 were used.

SD joined in LA's recommendation and characterized the choice of Option II as a forced contribution of capital by the ratepayer to the utility company[14/] citing <u>City and County of San Francisco v Public Utilities Commission</u>, (1971) 6 Cal 3d 119 at 129.

The staff witness testified that there were large year-to-year variations in new plant additions. There was a large increase in plant expenditures in 1976 compared to prior years. A major portion of the 1976 plant additions are related to the construction of facilities necessary to operate HR. SoCal witnesses testified that in the future SoCal planned to lease rather than purchase additional gas storage fields.

14/ SD's reply brief in A.55676, et al., refers to ratepayer contribution to SDG&E.

The timing and cost impact of the storage leasing policy is not readily discernible at this time. It should result in a lower level of plant expenditures.

The five-year averaging method for the classes of plant agreed to by SoCal and the staff is reasonable for test year 1976. We will utilize ratable flow-through for the additional six percent ITC on distribution plant in computing SoCal's FIT. The above-mentioned arguments will be considered in our determination of the reasonable rate of return for SoCal and PLS. We will not adopt a rate base adjustment related to the ITC.

The differential in the additional ITC on distribution and miscellaneous plant between ratable flow-through used in calculating adopted taxes and full flow-through is $3,204,000. The revenue requirement for this tax differential is $6,884,000.

Reacquisition of Debt

SoCal and PLS realized gains through reacquisition of their debt at discounted market prices for sinking fund purposes. The utilities did not pay any income tax on these gains as they utilized the provision of the Internal Revenue Code allowing an offset of the gain (IDI), against depreciable property, which in turn reduces the depreciable property basis for computing income tax depreciation. SoCal and the staff treated the gain as a below the line transfer to surplus, but did not increase tax expense. This issue was before the Commission in the recent PG&E rate case (D.86281) where we recognized the anticipated gain on reacquired bonds in 1976 as deferred income and interest-free capital to be amortized over the remaining life of the individual bond issues affected by sinking fund retirements. We adopt the same methodology in this proceeding. A further discussion of this issue is contained in the rate of return portion of this decision.

Depreciation Expense

SoCal originally proposed changed lives and revised assumptions in calculating depreciation expense based upon a study of its properties made by a consulting firm. This study resulted in a decrease in the weighted average plant life and an increase in depreciation expense. SoCal considered a reduction in lives due to lesser economic life caused by reduced gas supplies. The staff disagreed with the latter contention and recommended that distribution main lives be decreased from SoCal's earlier 44-year estimate to 42 years rather than to the 40 years proposed by SoCal, agreed with SoCal's reduction of service life for services from 33 to 30 years, and recommended that salvage values be increased for certain classes of plant. The staff witness used his judgment in estimating changed distribution facility lives giving consideration to the increasing proportion of plastic pipe, with a shorter life than steel pipe, being used by SoCal. SoCal agreed to these changes. Distribution mains and services account for over half of SoCal's plant investment.

LA contends that the staff witnesses' judgment absent a mathematical study is invalid; that SoCal's capital reduction program will increase plant lives; and that no change in depreciation rates is warranted.

The evidence supports the use of the staff's estimated plant lives applied to the depreciable plant in the adopted rate base in calculating depreciation expense.

Rate Base

The adopted rate base incorporates the HR and capitalized wage adjustments, and the staff transfer of A&G expenses to capital.

Other staff rate base adjustments reduce plant in service by $1,410,000. A staff engineer adopted the recommendations of a staff accounting witness who recommended that: (a) $776,000 in gains from the sale of operating facilities should be used to offset the investment in a new centralized facility; three items of property be transferred from operating to nonoperating property, including a $72,000 property used as a rod and gun club by approximately ten percent of SoCal's employees, an $88,000 facility, and a $117,000 property; (c) transfer of compressor station spare parts from plant to materials and supplies; and (d) disallowance of interest during construction of contract retention fees that represent construction costs not yet supplied by SoCal.

The staff accountant did not quarrel with SoCal's accounting treatment in (a) but distinguishes between flowing a nonoperational gain to shareholders when an operating system is disposed of through sale or condemnation and the replacement of like facilities. He testified that SoCal reduced the tax basis of the new facility rather than report a gain. SoCal argues that reduction of the gain was arbitrary; that the staff witness testified that the transaction would require a Commission resolution or a change in the Uniform System of Accounts; that the rod and gun club was SoCal's largest employee activity organization; that its investment was for the health and welfare of its employees and is properly includable in rate base; that the staff witness was not aware that the $88,000 facility is still being used; and that it concurs with the remaining staff recommendations.

All of the staff adjustments except for the deletion of the still operative property are reasonable. Therefore, we adopt a $1,322,000 plant adjustment and an increase of $244,000 in material and supplies.

The net revenues derived from the adopted summary of earnings at present rates, shown in Table 1, of $45,292,000 yield a rate of return on the adopted rate base of 4.91 percent which is unjust and unreasonable. SoCal's net revenues at proposed rates would be $117,253,000 and would yield a rate of return of 12.33 percent which is excessive.

Pacific Lighting Service Company Results of Operation

The adopted treatment of differences in estimates for PLS' cost of service parallels the treatment afforded SoCal for similar issues. Table 2 shows SoCal's and the staff's estimates of PLS' cost of service and the adopted cost of service at the 8.50 percent rate of return authorized in D.83160.

Adopted production expense is based on the staff's TW estimate and SoCal's estimate of California and offshore purchases. Exchange deliveries are affected by the higher adopted level of igniter gas deliveries.

A&G expenses (consisting of franchise taxes charged to PLS) reflect adopted sales at the 8.50 percent rate of return authorized in D.83160.

SoCal's estimate of ad valorem tax rates for PLS are $11.45 for 1975-1976 and $11.92 for 1976-1977. The corresponding staff estimates are $11.30 and $11.67. We have used rates of $11.40 and $11.83.

Rate Base

The staff adjustment of $95,000 in plant for interest during construction is reasonable.

SoCal estimated PLS' working cash allowance in rate base at the $878,000 amount authorized in D.83160. The corresponding staff estimate of $442,000 is based on a staff lead-lag study. The adopted working cash allowance of $432,000 is based on the staff lead-lag study applied to the adopted results. PLS' working cash allowance should reflect changed conditions. The end of year earnings filing

Table 2

PACIFIC LIGHTING SERVICE COMPANY

Results of Operations Under Present Rates
Test Year 1976

Item	SoCal Exh. 69 & 91	Staff Exh. 69 & 92-1	Adopted
	(Dollars in Thousands)		
Operating Revenues	$185,690	$188,927	$191,036
Operating Expenses			
Production	$151,687	$153,523	$155,521
Admin. & General	155	145	153
Taxes Other than Income	5,110	4,887	5,000
Income Taxes	2,536	4,215	4,206
Depreciation	6,941	6,941	6,941
Total	$166,429	$169,711	$171,821
Net Income	$ 19,261	$ 19,216	$ 19,215
Rate Base			
Plant in Service	$260,012	$259,917	$259,917
Working Cash	878	442	431
Other	(34,293)	(34,293)	(34,283)
Total	$226,597	$226,066	$226,065
Rate of Return	8.50%	8.50%	8.50%

( ) Red Figure

for PLS should contain an adjustment to reflect a recomputation of working cash based upon a lead-lag study and recorded experience for the year.

A staff financial witness testified that PLS' rate base erroneously included interest bearing projects (LNG ships, land transactions, and miscellaneous work orders) between January 1972 and April 1974 which increased PLS and cost of service to SoCal by $390,065. Since this transaction has no effect on the ratepayer, there is no compelling reason to correct it at this time; however, future transactions of this nature should be reviewed.

The adopted gross operating revenues for PLS which are incorporated in SoCal's production expenses are $191,036,000 at the 8.50 percent rate of return authorized in D.83160, and $194,097,000 at the 8.8 percent rate of return authorized herein.

B. RATE OF RETURN

In determining the appropriate rate of return in this proceeding, the Commission must balance the interests of SoCal's customers and those of the investors furnishing the funds necessary to meet the public utility service needs of SoCal and PLS. The financial requirements for the integrated operations of SoCal and PLS, designed to meet the needs of SoCal's customers, are appropriately treated as a single entity, PLU.

We strive to give the customers the lowest rate practicable and at the same time to provide SoCal with the funds necessary to construct the PLU system and to provide SoCal's customers with reasonable service.

All of the common stock of SoCal and PLS is owned by PLC. SoCal, the Commission staff, and LA ascribed PLC's preferred stock to the PLU capital structure. The funds derived from the preferred issues have been utilized for the same utility purposes SoCal or PLS could have utilized had they issued preferred stock in their own names.

SoCal and PLS are constitutionally entitled to an opportunity to recover their operating costs and to earn a reasonable return on that portion of the PLU system which is lawfully devoted to public use. The rate of return on rate base provides for the payment of interest on debt, dividends on preferred stock, and earnings on common equity. A company's earnings level should be sufficient to permit it to attract capital on reasonable terms and to adequately compensate its investors. After considering all of the evidence, the Commission concludes that a rate of return of 8.8 percent is fair and reasonable for SoCal and PLS. We will now proceed to consider the evidence which assisted us in arriving at the rate of return we judge to be fair and reasonable.

Testimony and exhibits concerning the fair rate of return for the PLU system were presented for SoCal by witness Jensen who recommended a 10.25 percent rate of return and by rebuttal witness French[15/] who testified that the 10.25 percent rate of return approximates a fair rate of return from the investor's viewpoint and that the Commission should authorize a rate of return of not less than 9.6 percent in order that PLU be assured of being able to continue to furnish adequate service and to undertake necessary expansion without jeopardizing its financial standing; by Commission staff witness Scheibe who recommended a rate of return between 8.85 and 9.15 percent; and by witness Kroman for the city of Los Angeles who recommended a rate of return of 8.90 percent or of 8.75 percent if IDI gains were used to reduce debt expense.[16/]

15/ SoCal states that its decision to present Mr. French, a market expert from Argus Research Corporation (Argus), was reinforced by the Commission's criticism of the lack of market price evidence in D.84902 (PG&E).

16/ He recommended a reduction in rate of return if the Commission utilized SoCal's ratable flow-through treatment of its additional ITC to give recognition to PLU's increased cash flow, decreased outside financing, and increased interest coverage.

SoCal contends that the rate of return for itself and for PLS must be at a level which will enable them to maintain their credit ratings, to attract capital on favorable terms so that the PLU systems can be expanded to meet the energy needs of SoCal's customers, and to provide investors with an adequate return. SoCal points out that there is no significant difference between the PLU capital structure developed by it, by the Commission staff, and by LA; but that significant differences exist between the embedded costs of debt and in the rate of earnings to be allowed on common equity. SoCal states that long-term debt assumptions should be based on estimated debt costs at the time a decision is reached in this proceeding which reflects differences in terms, average life of the various issues, the total cost to the issuer, and the type of utility.

Testimony of Mr. Jensen

Mr. Jensen cites Supreme Court decisions establishing the principle that rates should be sufficient to permit the company to earn a return on its property equivalent to returns generally being earned by other similarly situated companies. He states that rates should be adequate to allow earnings which will maintain the financial integrity of PLU and enable PLU to maintain its credit and attract capital; that in evaluating these principles it is necessary to consider each company whose rates are under review in the light of prevailing economic conditions in general and in the region where that company is located; that factors such as comparative risk, inflation, cost of capital, regulatory lag, conservation, service area, quality of service, and size are all important and have been considered in his recommendation; that he has made an extensive comparative analysis of various utilities relative to returns of equity and total capital, market value to book value relationships, institutional holdings, operating ratios, and size; and that he investigated returns for 30 industrial groups, money market movements of selected short-term rates, capital market rates for Aa and A rated utility bonds (on a newly issued and on a distributed basis), and credit rating changes.

Mr. Jensen compared PLU to 15 natural gas distribution companies, 15 integrated natural gas holding company systems, 10 straight electric utility companies, and major California utilities. He considered the change in emphasis from SoCal's competition with electric utilities to the current emphasis on conservation.

Mr. Jensen concluded that on the basis of size and comparability of operations that the most meaningful comparisons are between PLU, the five largest natural gas distribution companies, and ten electric companies, which are tabulated below:

Item	Five Largest Gas Distribution Companies		Ten Electric Companies		Pacific Lighting Utility System	
	1967-71		1967-71		1967-71	
Capital Ratios						
Debt	54.1%		55.5%		49.7%	
Preferred Stock	2.6		8.7		12.7	
Common Equity	43.3		35.8		37.6	
	1968-74	1974	1968-74	1974	1968-74	1974
Comparative Earnings						
Debt	5.6%	6.8%	5.8%	7.1%	5.5%	6.5%
Preferred Stock	4.0	5.0	5.2	6.3	5.1	5.5
Common Equity	14.1	13.0	12.5	11.4	9.3	9.4
Total Capital	9.0%	9.2%	8.1%	8.4%	6.9%	7.3%
Times Interest Earned						
Pre-tax	4.3%	3.5%	3.6%	2.4%	3.6%	2.9%
After-tax	3.1	2.6	2.6	2.0	2.7	2.5

Mr. Jensen testified that compared to industry group averages utilities rank near the bottom on return on total capital and on return on common equity; that over the foreseeable future utilities will require unprecedented amounts of new capital and will be in direct competition with all industrial sectors for the investor's dollar; that in the past there was a trade-off in that utilities had lower risks and greater predictability of operations than industry but that more recently the utility industry has experienced considerable supply problems; that while supply cost increases have been mitigated somewhat by fuel adjustment and purchased gas adjustment clauses these merely offset some cost elements but do nothing to improve the overall supply availability; that increased costs of capital and of operation caused by inflation and regulatory delays have contributed to instability in earnings; and thus the trade-off that investors formerly accepted is no longer viable and investment is likely to continue to go to other sectors unless utility earnings and outlook are improved.

He testified that institutional investors are not overly enthusiastic about PLC; that future sales of PLC stock are likely to result in dilution of stockholder equity and that if this situation continued future financing plans of PLC's subsidiaries could be in jeopardy; that PLU has not been able to achieve the level of earnings contemplated in Commission rate orders; that investors have generally not recognized the merit of regulatory support of supply programs, such as GEDA; and that one of the rating services has derated SoCal's bond rating from AA to A.

The record shows that the recent earnings of PLC's nonutility operations have been negligible. This fact could influence the investment choice of some institutional and of some noninstitutional investors. SoCal's earnings stability should be improved by the rate spread and PGA revisions adopted in this decision which should serve to lessen the risk assumed by investors in securities of PLU and of PLC.

Since 1970, the PLU financing mix has shifted from predominantly internal financing (depreciation accruals) to predominantly external financing. PLU's debt ratio increased from 43.5 percent in 1967 to a 55.2 percent peak (with PLC preferred stock allocated to PLU) in 1973. Mr. Jensen estimates a debt ratio of 51.7 percent at the end of 1976 and a 35:65 ratio of new internal to external financing, excluding any consideration of ITC.

Increases in the weighted average cost of debt and the amount of debt have exerted upward pressure on PLU's revenue requirements. These increases coupled with past increases in PLU's debt ratios have decreased the times interest coverage on its debt. Mr. Jensen seeks to reverse the decline in times interest earned from the 2.43 times interest coverage set forth in D.83160 to 2.71 for 1976.

PLU's earned times interest coverage is higher for the five-year period from 1970 to 1974 inclusive than the coverages of the ten largest gas and ten combination gas and electric company groups used by Mr. Scheibe. Table 20-U of Mr. Jensen's Exhibit 3-3 shows that PLU's pre-tax times interest coverage of 2.9 is higher than the coverage of ten electric companies (2.4 times) and below that of the five largest gas distribution companies, of the 15 largest gas distribution companies, and of the ten combination companies (3.5 times, 3.3 times, and 3.6 times, respectively).

Mr. Jensen estimated that in 1975 PLU would issue $60,000,000 of new debentures ($35,000,000 had been issued at the time he testified), make a $13,000,000 sinking fund deposit, increase common equity by $15,000,000, and decrease short-term debt by $38.3 million; and that in 1976 PLU would issue $80,000,000 of new mortgage bonds, make a $13,000,000 in sinking fund deposit, and decrease short-term debt by $24.7 million (see second revision of Table 22 in Exhibit 3-2).

Table 3 contains the capital ratios, cost rates, and weighted cost used in the rate of return determinations for PLU adopted in D.77975 for test year 1970, in D.80430 for test year 1972, in D.83160 for test year 1974, and SoCal's revised estimate for 1976. The table also includes times interest earned data.

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TABLE 3

PACIFIC LIGHTING UTILITY SYSTEM

Rate of Earnings on Capital

Item	Capital Ratios	Cost Rates	Return Components
Requested - Test Year 1976			
Debt:			
Long Term	50.9%	7.32%	3.72%
Short Term	.8	7.75	.06
Total	51.7	7.32	3.78
Preferred Stock	10.7	5.47	.59
Common Equity	37.6	15.64	5.88
Total Capital	100.0		10.25
Times Interest Earned			2.71
Decision No. 83160 - Test Year 1974			
Debt:			
Long Term	50.0	6.50	3.25
Short Term	2.5	10.00	.25
Total	52.5	6.67	3.50
Preferred Stock	12.5	5.47	.68
Common Equity	35.0	12.35	4.32
Total Capital	100.0		8.50
Times Interest Earned			2.43
Decision No. 80430 - Test Year 1972			
Debt:			
Long Term	46.2	5.82	2.69
Short Term	3.8	5.50	.21
Total	50.0	5.80	2.90
Preferred Stock	10.7	4.83	.52
Common Equity	39.3	11.65	4.58
Total Capital	100.0		8.00
Times Interest Earned			2.76
Decision No. 77975 - Test Year 1970			
Debt:			
Long Term	50.0	4.56	2.73
Short Term	-	-	-
Total	50.0	4.56	2.73
Preferred Stock	12.0	4.83	.58
Common Equity	38.0	11.68	4.44
Total Capital	100.0		7.75
Times Interest Earned			2.84

The Chairman of the Board of PLC, Mr. Miller, reviewed D.83160 during the period that SoCal was assembling its showing for this proceeding and concluded that under the circumstances it was imperative that SoCal seek a substantially higher level of return than had been sought or obtained including a 15 percent return on equity. Mr. Miller was concerned at the downward drift in PLC's stock price below book value and he felt that a better return was needed to make PLC's stock more attractive to meet the large capital requirements that its gas supply projects will need (TR 362 ff).

Prior to that review rates of return in the range of 13 to 15 percent were being considered by SoCal. Based on PLU's original capital structure, a return of 15 percent on equity together with the other elements resulted in an overall rate of return request of 10.25. SoCal's new financing requirements and cost of embedded debt declined due to the cancellation of its plans to acquire a second storage facility in 1976, due to the capital limitation program, and due to changes in the bond market. There was also a sharp decline in the prime rate during this period. Mr. Jensen anticipated that SoCal would have an additional $5.7 million available through the additional ITC at the end of 1976 as result of the TRA. SoCal revised its new financing requirements downward but kept its requested rate of return of 10.25 constant. This resulted in successive increases in its estimated return on common equity to 15.58 percent and to 15.64 percent.

Mr. Jensen justified the increase in the common equity return as a recognition of statements by Commissioners that it would be appropriate to give recognition to SoCal's conservation efforts in establishing its rate of return.

Under SoCal's rate proposal, the results of conservation in firm usage would be additional sales to interruptible customers at lower commodity rates. The rate authorized herein, giving consideration to lower residential lifeline rates and to the increase in level of research and development activities which are focused at providing additional quantities of gas to interruptible customers, will narrow the differential in unit rates and gain public support to promote conservation.

Testimony of Mr. Scheibe

Mr. Scheibe's study of the cost of capital and rate of return showed changes in interest rates and debt issues; changes in PLU's capital structure and financing; earnings rates on average total capital and on average net plant investment; revenues, expenses, and net income; per customer net investment, revenues, expenses, and net operating income; and nominal interest paid by major California utilities. He compared PLU to ten gas companies,[17/] ten combination gas and electric companies,[18/] and PG&E.

Mr. Scheibe testified that rate of return is an expression of the capital cost of a utility including debt, preferred, and common equity; that the final determination of a rate of return is on

17/ Both on a combined basis and on a split basis showing five gas holding companies and five gas distributing companies.

18/ Both on a combined basis and on a split basis showing the five largest and the next five largest companies.

the basis of judgment, not on the basis of any formula, or on any averaging of comparative earnings; that his recommendation for an individual utility gives consideration to the requirements of that utility and to its customers; that there are three major primary areas in a rate case and a major secondary area; that the primary areas are rate base, revenues and expenses, and rate of return, and the secondary area is rate spread; that in view of the continuing inflationary trends which are high even though they have subsided from their peaks it is difficult to hold down rates even with the most stringent allowances in the above-mentioned primary areas and there is a need to determine in greater detail that each customer group receives fair treatment.

Mr. Scheibe recommended a range in the overall rate of return between 8.85 percent and 9.15 percent resulting in a rate on common equity between 12.15 percent to 12.94 percent. His recommendation at the lower end of the common equity range is 0.2 percent below that authorized in D.83160, the return on common equity at the top of his range is 4.8 percent above that last authorized. He noted the higher equity ratio in this proceeding compared to 1974. His recommended allowance for debt cost of 7.15 percent is 10.34 percent higher than the allowance in D.83160. He gave consideration to 15 statistical factors and 15 nonstatistical factors in making his recommendation on return on common equity. He testified that PLU has not been having any difficulty in meeting its indenture coverage due in part to its maintenance of a balanced capital structure on an overall utility basis; that while coverage to maintain a bond rating is important it must be considered a secondary factor because if the trade-off in cost to the ratepayer becomes too great, a rigid coverage requirement cannot be maintained, and maintenance of a rigid debt coverage may not be necessary as the rating agencies themselves say that security ratings are not a precise science because there are so many variables; that the range of return should give an interest coverage of 2.4 to 2.5 times after taxes and approximately 3 to 3.1 times before taxes; that the need for funds for gas utilities has been less than for combination utilities but is still substantial, that SoCal's slower relative customer growth places it in a relatively better financial position; that while SoCal is concerned with huge exploration and development programs for new gas supplies, there have been no absolute determinations of the manner in which such costs will be handled but that all proposals indicate that the company's customers will be required to finance such programs to a great extent; that while risk increases because of gas supply requirements it will be covered by additional payments from SoCal's customers and therefore no additional return requirement is appropriate for exploration costs.

Mr. Scheibe testified that attrition affecting SoCal's equity earnings is caused by the addition of plant at higher cost per unit of additional revenues, the increase of expenses at a faster rate than corresponding revenues, and the increase of fixed charges, primarily interest costs, which may be partially offset (between rate hearings) by tax savings; that the rate of return is an allowance for the capital needs of a company for debt, preferred, and common equity and should not be a catch-all for every possible adjustment; that expected near-term rapid changes in expenses or plant, the so-called operational attrition, either absolutely known or reasonably assured, should be handled by means of specifically stated attrition allowances or offsets or by use of a sufficiently advanced rate year;[19/] but that such attrition should not be justification for excessive allowances to avoid future rate cases.

19/ The January 1, 1977 offset authorized herein offsets the remaining revenue requirement for HR.

Mr. Scheibe testified that he had always given consideration to below-the-line income in his rate of return recommendations, including income resulting from the discount on reacquired bonds, e.g. he discussed IDI in three earlier rate cases commencing in 1970 involving the PLU group; that other income includes all such income not merely IDI; that the other major source of below-the-line income is the allowance during construction (ADC), or capitalized interest; that the Commission gave recognition to IDI income in D.83160 where we stated "These debt issues were authorized by the Commission and the interest payments on that debt are lawful obligations of PLS and SoCal. We will not adjust the debt expense of PLU in this decision because of the gains realized on the reacquired debt."; that he recommended a lower allowance for equity in PG&E's A.53118 than in its prior rate case and one of his relevant considerations was that while he regarded other income as less solid and more volatile than operating income, even discounting it considerably will still indicate the possibility of a utility's realizing a higher rather than a lower return; that since this income is noncash income care must be taken that it not be given the undue emphasis which, in other jurisdictions, has resulted in some utilities being in a cash poor position and a loss of bond ratings; that the amount of PLU's IDI income is not of a magnitude to make this a likely possibility; that an alternate treatment of IDI would be to spread the discount over the average remaining life of the issue or spreading it over the life of theoretical replacement bonds; that had he made such an adjustment it would have been no greater, if as great, as the consideration he gave to other income in his rate of return recommendation; that another alternative would be to treat the discounts as a reduction in rate base; that the effect on earnings of a rate base adjustment would be approximately one-twelfth of the rate base adjustment and even if these earnings were discounted drastically, his consideration would be greater than to be derived by a rate base reduction; that rate of return rather than a rate base adjustment would be appropriate because the plant investment would not change; and that in the event an adjustment is made to the debt interest rate (as was done by Mr. Kroman) or to rate base that his equity return should be adjusted upward by at least enough to offset the deduction in the interest rate or in rate base, and that this consideration of other income applies to all income not simply to IDI.

In making his recommendation, Mr. Scheibe gave consideration to the state of the economy, to the high level of unemployment, and of the need to moderate the recovery and avoid another boom and bust period through the exercise of restraint in price and wage actions. He was influenced by and quoted Arthur Burns, Chairman of the Federal Reserve Board, by Mr. Rees, Director of the Council on Wage and Price Stability, and by a statement of President Ford that "It is essential, particularly at this time, that all segments of the economy, industry, and labor exercise restraint in their wage and price actions." He testified that these are compelling reasons for conservative earnings recommendations in utility rate cases; that he was not primarily concerned with the market; that the Commission could not influence the market any more than King Canute could influence the tides; that while many utilities are selling below book value, over half of the industrials are also selling below book value and the Commission cannot base its decision on market prices or attempt to set a rate of return high enough to attempt to bring a utility's market price up to book value; that PLC's market price was affected adversely by its nonutility earnings; and that it was true that utility risks have increased but industrials have also become more risky.

The staff brief notes that Mr. Jensen admitted that SoCal has had no problem whatever with indenture restrictions because of interest coverage. The staff argues that SoCal's decline in interest coverage has been no greater than that of comparable companies and thus it is in no worse competitive condition than it was five years ago; that the arrest in the decline of interest coverage is a positive factor in evaluating PLU's financial condition; that the utility's contribution to PLC's financial condition was far better than that of the nonutility activities.

Mr. Scheibe testified that he did not give any consideration to the effect of the increase in ITC from four to ten percent in his rate of return determination because he thought that the current magnitude of the additional credit is minor and should not affect the allowance on rate of return, but that the amount of additional ITC could become a significant factor in the future.

SoCal estimates the total PLU capitalization at $1,229,400,000 at the end of 1976 including approximately $626,100,000 in long-term debt and $9,600,000 in short-term debt. Mr. Scheibe estimates that the PLU long-term debt would equal $631,108,000 representing 51.5 percent of PLU's capitalization at the end of 1976. This would equate to a total capitalization of approximately $1,225,000,000. SoCal's revised estimates of additional ITC amounts to $2,060,000 in 1975 and $3,270,000,000 in 1976. Thus SoCal's need for new capital through the end of 1976 is reduced by approximately $5.1 million, approximately 0.4 percent of PLU's capitalization, because of the availability of additional ITC not yet flowed through to its customers. We will give this reduction in SoCal's financing requirements consideration in establishing the adopted rate of return.

The following tabulation shows Mr. Scheibe's determination of PLU's capitalization and earnings requirement on common within his recommended range of rate of return of 8.85 percent to 9.15 percent:

Item	Capital Ratios	Rates	Earnings Requirement - Common: 12.15%	12.41%	12.68%	12.94%
			Weighted Cost Totals			
Long-term Debt	51.5%	7.15%	3.68%	3.68%	3.68%	3.68%
Preferred Stock	10.8	5.47	.59	.59	.59	.59
Common Equity	37.7		4.58	4.68	4.78	4.88
Totals	100.0%		8.85%	8.95%	9.05%	9.15%

Testimony of Mr. Kroman

Mr. Kroman reviewed Mr. Jensen's testimony and exhibits and concluded that Mr. Jensen's approach resulted in an invalid conclusion in regard to the return on common equity.

He testified that SoCal overstated its estimated embedded interest cost by assuming a higher level of interest rates for new long-term debt than is supported by recent experience; that SoCal's IDI gains varied from $250,000 to $500,000 per year between 1960 and 1966 and subsequently increased to an excess of $2 million annually to $3,090,000 for 1975 estimated and $2,806,000 for 1976 estimated; that if the $2,806,000 is deducted from PLU's interest charges, the adjusted embedded cost of debt would be reduced from 7.26 percent to 6.81 percent; that if the IDI realized from 1952 to 1976 of approximately $25,200,000 were amortized over 25 years the annual amortization would be approximately $1,007,000 and if this amount were averaged with the estimated 1976 discount of $2,806,000, the adjusted embedded cost would be 6.96 percent. He recommends utilization of the latter procedure for reducing PLU's cost of debt.

He testified that the New York Public Service Commission, the Nevada Public Service Commission, and the FPC had reduced embedded cost of debt by annual IDI savings; that a 1970 FPC decision states "...the discounts on repurchased debt under consideration here represent a savings which is virtually automatic. Columbia is required to repurchase its debentures for sinking fund purchases. So long as interest rates continue above the levels of the early 1950's, such repurchases will continue to be made at discounts each year. Unless amortization of these amounts is required, the cumulative effect will be to add sums to retained earnings, with no benefit to consumers. Yet consumers will continue to pay the cost of debt, including new debt issued at higher rates to replace that retired."

(Re: Manufacturers Light and Heat Company (1970) 84 PUR 3d 519); that the FPC has established accounting procedures for premiums, discounts, and expenses related to issuance of long-term debt and for gains and losses related to refunding and reacquisition of long-term debt to allow accounting for them on a current basis when a regulatory agency having rate jurisdiction over the utility does not require amortization of the gains and losses and applies them to embedded debt cost in determining the rate of return for rate setting purposes. He did not make a calculation based on the remaining life of reacquired PLU securities.

He contends that Mr. Jensen predicates his requested allowance for common equity at least in part upon an abnormally high interest rate and on abnormally low stock prices; that Mr. Jensen wrote in the context of a prime interest rate in the range of 12 to 12-1/2 percent; that at the time he prepared his testimony the prime rate was 7-1/2 percent and might drop further; that to the extent the Commission relied on the prime rate in setting the allowance on common equity for The Pacific Telephone and Telegraph Company in D.83162 dated September 19, 1972 in A.53587 that logic would require a significant reduction in the allowance for common equity earnings; that just as interest rates have dramatically fallen since the preparation of Mr. Jensen's testimony utility common stock prices have risen; that the chart used by Mr. Jensen in support of his equity request on Chart K and Table 24 of Exhibit 3 is based on utility common stock prices as of the end of June 1974 when the Dow Jones utility stock index stood at 68.22, virtually the lowest level since 1967; that the index has subsequently recovered to approximately 80;[20/] that Mr. Jensen developed a relatively high

20/ The index was at 85.95 at the close on June 23, 1976.

return on equity during a period of severely depressed prices and if Mr. Jensen's method is used with the Dow Jones utility average at 80, the indicated equity return falls to about 12.95 percent at a market to book ratio of 1.00. He further contends that Mr. Jensen failed to develop objective independent data on a reasonable level of interest coverage as a basis for his requested rate of return figure; that he is not suggesting that the fair rate of return should be based solely upon a predetermined level of interest coverage but if an adequate level of interest coverage is as important as Mr. Jensen suggests then an attempt should be made to establish that level for use as an independent input in the process of arriving at the figure to be used for the fair rate of return rather than working backwards from the recommended rate of return.

Mr. Kroman prepared comparisons of what he believed to be a representative cross-section of privately owned public utilities whose service areas are in the western region of the United States showing that PLU's capitalization increased by approximately half of the increase experienced by the other western utilities from 1970 to 1973 and testified that the increase in PLU's capitalization from 1973 to year end 1976 will be far below the recent experience of the western area utilities. He contends that there is an erroneous implication given in Mr. Jensen's presentation that the PLU utilities are unique in their need to obtain external financing.

Mr. Kroman contends that Mr. Jensen's principal basis for comparative earnings includes five gas distribution systems which are for the most part merely conglomerations of individual gas distribution companies, some of which have annual revenues as small as one to three percent of SoCal's revenues;[21/] that none of the

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21/ The five all operate under several regulatory jurisdictions. There was a considerable difference in return between the multiple subsidiaries of several of the companies listed.

five companies serve in the western area of the United States; and that Mr. Jensen did not present any evidence other than a general statement of other comparative factors.

Mr. Kroman testified that he attempted to determine a proper level of interest coverage independent of the rate of return; that such coverage multiplied by the appropriate weighted debt cost will provide one indication of the reasonable rate of return; that the increasing importance attached by investors, rating agencies, and regulatory bodies to the level of interest coverage requires that the problem be examined more closely than heretofore in rate of return studies; that a second approach would be to make an independent derivation of a reasonable return on common equity weighted by the percentage of common equity in the capital structure, to add the equity cost to the weighted cost of debt and the weighted cost of preferred stock to provide a rate of return which should be reasonably close to returns derived by other methods used; that if a utility's outstanding senior debt is rated Aa or A consideration should be given to attempt to prevent these ratings from falling below A because of the unusually high spread in cost between A and Baa debt issues and because of the more limited market for lower rated issues; that based on his analysis a pro forma after tax coverage of approximately 2.4 times after tax or about three times before taxes provides a rational basis for developing a fair and reasonable rate of return; that he had given recognition to an inverse relationship between return on equity and the equity ratio for PLU which Mr. Jensen had ignored, although Mr. Jensen had utilized such a relationship in an earlier proceeding; that his adjustment of the 12.35 percent allowance on equity authorized in D.83160, with a 35 percent equity ratio, to the 37.5 percent equity ratio he developed for PLU in this proceeding results in a reduction on equity to approximately 11.8 percent; that the

1973 return on average common equity of 17 western utilities adjusted to a 37.5 percent equity ratio for the year 1973 is 11.22 percent; that the median return on common equity authorized for telephone, electric, and gas utilities decisions printed in Public Utilities Reports (PUR) is 11.91 percent, adjusted to a 37.5 percent equity ratio, for companies operating in jurisdictions using original cost rate bases, and an 11.55 percent median for all companies.

Mr. Kroman testified that each million dollars of additional cash flow resulting from retained ITC would reduce SoCal's requirements for new debt on the open market at prevailing interest rates by a million dollars, and that SoCal's embedded debt cost and rate of return should be reduced by 0.0035 percentage points per million dollars of additional ITC. This adjustment would equate to approximately 0.02 percent on rate of return for approximately $5,000,000 of ITC retained at the end of 1976.

Mr. Kroman also called the Commission's attention to several risk reducing factors in that SoCal's claims of favorable impact on its bond ratings, cost of debt and equity capital, and interest coverage resulting from its retention of ITC would work toward a lower rate of return. Mr. Kroman stated that while he was unable to quantify the favorable impacts, and did not consider them in his rate of return recommendation, these effects logically require a reduction in the rate of return requirement. We have considered these risk reducing factors in our determination of a reasonable rate of return for SoCal.

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The summation of Mr. Kroman's recommendation for an 8.75 percent rate of return deducting IDI from the cost of embedded debt is tabulated below together with times interest data:

Item	Capital Ratios	Cost Rates	Return Components
Debt	51.0%	6.96%a/	3.55%
Preferred Stock	11.5	5.47	.63
Common Equity	37.5	12.19	4.57
Total	100.0%		8.75%
Times Interest Earned			2.46

a/ Embedded debt cost reduced by average of 25-year IDI amortization and 1976 IDI.

His corresponding recommendation on rate of return using an unadjusted embedded debt cost is tabulated below:

Item	Capital Ratios	Cost Rates	Return Components
Debt	51.0%	7.26%	3.70%
Preferred Stock	11.5	5.47	.63
Common Equity	37.5	12.19	4.57
Total	100.0%		8.90%
Times Interest Earned			2.41

Rebuttal Testimony

Mr. French partially supported the recommendation of Mr. Jensen for a 10.25 percent rate of return. He felt that adoption of Mr. Jensen's recommendation would result in a fair rate of return and that a rate of return of 9.6 percent, which would yield 14 percent on equity was the minimum necessary from an informed investor's point of view.

Mr. French testified concerning the greater risk in large electric and gas utilities compared with past periods and of the risk to the investor related to the securing of additional supplies of gas by SoCal; that if SoCal is largely unsuccessful it will experience a very substantial shrinkage in its basic business; that if it is successful, the investor faces the financial risks that accompany the financing of the projects needed to bring gas to southern California; that while projects may be financed outside of the PLU system, the ultimate credit behind most of the projects is SoCal's; that suppliers of capital going into new supply projects obviously will closely evaluate the ability of SoCal to continue to function as a healthy financial entity; that in addition to expenditures for long-term projects to secure a gas supply, SoCal has normal construction requirements which will require it to return to the financial markets annually for additional outside capital and investors recognize that this financing will be needed despite the existence of a shrinking basic gas business; that this causes them to increase their return requirements for investing in PLU; that investors currently perceive a significant political-regulatory risk in investments in California utilities and the actions that this Commission takes in the near term will have an impact on investors' perceptions of this risk; however, the impact will not be fully reflected overnight; that investors are also somewhat apprehensive concerning possible action by the California legislature or by voters in statewide referenda which may affect their interests adversely; that irrespective of the ultimate impact of the Commission's current activities related to rate design and rate structure, the near term impact of this activity on investor risk perception is to increase it; that the fact that PLU serves a large urban service area is also a risk enhancing factor rather than a risk reducing factor as alleged by Mr. Scheibe; that investors do not generally compare PLC closely with the western regional utilities selected by Mr. Kroman because PLC is not directly comparable to this group of companies and investors do not consider them to be so (e.g., the majority of these utilities are telephone utilities and four or five electric companies whose principal energy requirements are supplied by hydropower); that he considered PLU to be comparable to large gas distribution systems and the typical large electric and gas companies and that it is to these groups of companies that investors generally look when evaluating PLU for investment purposes; that the electric utilities will generally experience rising energy sales in the coming years compared to PLU where declining sales are expected; that the most optimistic forecast one could reasonably make for SoCal would be that its energy sales slide would be halted; that the typical large utility is financing a growing business while PLU is required to finance a basic business that is shrinking; that if PLU is allowed to earn a minimum return on equity of 14 percent some improvement in market performance of its common stock[22/] would undoubtedly result; that while he would not expect it to permit the utility to issue

22/ Mr. French did not distinguish between SoCal and PLS common stock, which is owned by PLC, and PLC's own common stock.

new shares without dilution in the near term it should eventually lead to significant improvement in utility market to book ratio to enable it to at least keep its per share dilution to modest proportions upon the sale of new common stock; and that a 14 percent earnings level would enable PLU to achieve after tax times interest coverage of 2.55 which should reasonably assure PLU's ability to issue additional debt securities without risking further downgrading of its credit standing by the rating agencies or by investors in general.

Mr. Scheibe testified that he read Argus' reports to investors when possible and was impressed with them particularly because there is far less equivocation than is often found in such advice, but he pointed out total misses in Argus' predictions of an upturn in 1974 stock prices, of an increase in 1974 and 1975 housing starts, and in its recommendations for certain stocks; that Mr. French attempted to attribute the sins of PLC to PLU and pointed out some of the risk factors ignored by Mr. French, particularly the poor performance of PLC's nonutility operations; that Mr. French did not consider the reactions of the consuming public to continually escalating costs; that this Commission made a statement regarding the nature and weight to be given the recommendations of strictly investment oriented witnesses in D.67369 dated June 11, 1964 in C.7409 (Re Pacific Tel. & Tel.) i.e.,

> "...that respondent's present earnings are not excessive and should be higher; that respondent's common stock is not an attractive investment either for their own portfolios or for trust accounts under their directions; that respondent plays an important role in the economic growth of California; and that under respondent's present earnings it would be difficult to dispose of debentures at favorable rates and, should the Commission establish a lower rate of return,

> respondent would be put in the position of having to dispose of its debentures at very high rates, if indeed, it could find interested buyers in the market place. . . . We must also note that without exception these witnesses expressed the investor viewpoint as it relates to respondent's earnings and to the extent that the Commission must, in determining rate of return, equate the interest of respondent's ratepayers with those of its investors, these witnesses have contributed toward informing the Commission of the interest of respondent's investors. The common thread running through all of these witnesses' testimony is the urging that respondent should be allowed either higher earnings or that its rates should not be reduced. We can accept as self-evident that the investor interests lie in the direction of higher earnings and it certainly is respondent's prerogative to advance such interests through the urgings of these witnesses. However, the public interest goes beyond merely satisfying the investors' interests in higher earnings even though from the viewpoint of the investor such higher earnings are variously characterized as reasonable or 'optimal'."

Mr. French attacked Mr. Kroman's testimony in a number of respects. Mr. Kroman in turn submitted surrebuttal testimony, together with updated and new studies which challenged Mr. French's arguments on risk or on quality of investment in comparing the ratings of PLC to the Dow Jones 15 utilities by Moody's,[23] by the Standard and Poor's Stock Guide, and by Value Line in its Safety and Beta ratings, and by his 1973 and 1974 studies of earnings on equity which show that the median of Forbes' Industrials and of the median earnings of Fortune's 500 largest

23/ There is a minor exception in the difference between the median investment grade of Moody's 24 utilities which is between A and A- compared to PLC's A-.

industrials, 50 largest banks, 50 largest diversified - financial, 50 largest retailing, and 50 largest transportation companies are far below SoCal's request.

Mr. Kroman testified that he initially did not use 1974 data because the information was not available and that he would not base his recommendation on a year in which the economy was in the depths of a recession.

Mr. Kroman's updated PUR listings of return on common equity showed an increase in the median to 12.41 percent adjusted to a 37.5 percent equity ratio and an average return of 12.20 percent. Mr. Kroman testified that if he followed Mr. French's advice and excluded telephone companies, the average would be reduced from 12.20 percent to 12.02 percent and the median would be reduced from 12.41 percent to 12.10 percent. He concluded that these figures support his recommendation for a 12.19 percent return on equity.

Mr. Kroman testified that his most recent data showed utility times interest coverage far lower than the minimum 2.55 times interest coverage recommended by Mr. French, that PLS can maintain its A rating with an abnormally low coverage because of its cost-of-service tariff, and Mr. French did not take this into account.

Mr. French's testimony is characterized by the staff and by LA as consisting mainly of generalizations and conclusions regarding the utility industry which were not supported by any studies, or statistics, or charts. The staff points out that one of the few specifics mentioned by Mr. French, that industrials earned 15 percent on equity in 1973, differs from Mr. Jensen's figure of 12.3 percent; that Mr. French indicated that he had volumes of material with him in support of his conclusions but none of it was ever introduced into evidence; that he ignored the effect on PLC's earnings caused by its nonutility operations; that Mr. French is not a specialist in the natural gas industry nor has he been the analyst directly analyzing PLU at any time; that Mr. French had previously testified on behalf of PLC at Securities and Exchange Commission hearings in support of PLC's diversification program, which he admitted had turned out unfortunately.

Other Parties

The cities of Camarillo and SD supported LA's recommendation on rate of return but presented no evidence. SD recommends the 8.75 as being the highest which should be allowed.

Adopted Rate of Return

We again note, as we have in D.85354 that "SoCal and PLS have and will continue to require outside financing for a large proportion of their capital needs and the potential of achieving a reasonable rate of return is necessary to attract this capital at reasonable costs.

We will adopt a rate of return slightly lower than the lower end of the range recommended by Mr. Scheibe and slightly above that recommended by Mr. Kroman, and we will adjust Mr. Scheibe's recommended capital structure for the 1976 test year by transferring from retained earnings to deferred income the estimated IDI of $2,810,000. We consider these gains to be interest-free capital which shall be amortized over the remaining life of the individual bond issues affected by sinking fund retirements. Similar ratemaking treatment will be given to any such gains realized in the future.

As we observed in D.86281, there is no basis for continuing to consider these gains as non-operating income. Their realization stems from money market conditions rather than management's business acumen. Furthermore, the high interest rates responsible for the gains are part of the embedded cost of debt paid by ratepayers; therefore, the benefit of such gains should be shared by ratepayers.

Mr. Scheibe estimates that the three issues of PLU debt totaling $110,000,000 will be issued between October 1975 and October 1976. PLS issued $25,000,000 of debt in October 1975 at 9.45 percent and SoCal issued $50,000,000 of debt in May 1976 at 9.26 percent. We will assume SoCal will issue the remaining $35,000,000 at 9.26 percent in arriving at an overall cost of debt of 7.20 percent.

The adopted cost rates and capital ratios result in an overall rate of return of 8.8 percent and a return on common equity of 12 percent. The application of an 8.8 percent rate of return on the PLU rate base would provide interest coverage before taxes on income 3.23 times and after taxes of 2.37 times.

In reaching that return we are recognizing not only the reduction in SoCal's embedded debt cost because of the additional six percent ITC on distribution plant, amounting to approximately $3.3 million. We are also mindful of the benefits described by SoCal's Mr. Goodenow who stated that because of SoCal's election of Option II, cash flow would be maximized, interest coverage increased and the financial requirements in constructing facilities and acquiring gas supplies relieved.

In addition, as we noted at page 59 above, SoCal's brief in A.55444 described certain benefits which would result from its election of Option II. All of these benefits reduce SoCal's risk.

In D.86281 issued August 24, 1976, we adopted a rate of return of 9.20 percent for PG&E (a flow-through utility) equating to a 12.83 percent return on equity with an equity capital of about 37 percent. In doing so we noted that it has been our experience that investors expect higher returns on equity from flow-through utilities and that on a comparable risk basis PG&E is entitled to a higher rate of return than a company which does not flow-through its tax savings. The following table shows the adopted rate of return computation:

PACIFIC LIGHTING UTILITY
Adopted Rate of Return

Item	Captial Ratios	Cost Ratios	Return Components
Long-term Debt	51.5%	7.20%	3.71%
Preferred Stock	10.8	5.47	.59
Unamortized Gains on Reacquired Bonds	.2	-	-
Common Equity	37.5	12.0	4.50
Total	100.0%		8.8 %

C. RATE DESIGN

The staff's lifeline rate design, incorporated in the staff's Exhibits 45 and 45-2 was utilized when we authorized a partial general rate increase in D.85354. SoCal requests that its rate design be adopted in this final decision. However, SoCal indicated that if the Commission should continue the rate structure authorized in D.85354 that it concurs with the staff that 60 therms per month for lifeline use rather than 75 therms per month be adopted for general service customers.

The following tabulation summarizes SoCal's rate proposal for general natural gas service under Schedules G-1 to G-5:

Alt.-LR
A-55345 vg/dz *

Monthly Customer Charge*

Use Band	Twelve Months Use, TU	Maximum One Month Use, TU	G-1	G-2	G-3	G-4	G-5
			Per Meter Per Month				
1	0 - 500	166 or less	$ 3.80	$ 3.93	$ 4.13	$ 4.48	$ 5.92
2	501 - 2,000	167 through 666	4.19	4.59	5.07	5.79	7.61
3	2,001 - 4,000	667 through 1,332	4.91	5.92	7.05	8.54	11.08
4	4,001 - 12,000	1,333 through 4,000	6.42	8.63	11.40	14.61	18.81
5	Over - 12,000	over 4,000	10.85	15.45	20.30	26.25	33.10

Commodity Charge (Additive to Monthly Customer Charge)

Regular Use

Per thermal unit .... 11.0¢

Air Conditioning Use

Applicable to 53 thermal units per rated ton,
May through October billing periods only, per unit .... 9.3¢

*This is also the minimum charge. For "space heating only" customers, the monthly customer charge is multiplied by 2 during the six "winter" billing months November-April, and there is no monthly customer charge in the other months.

SoCal proposes establishment of service charges for general service customers in each of its five rate zones. SoCal would establish five use bands governed either by 12 months of cumulative gas use or by use in a maximum month. The proposed monthly customer service charge would increase with increased use in successive band levels. SoCal contends that the service charge would only defray customer charges and would not include any consumption. SoCal proposes a uniform commodity charge for all general service consumption of 11 cents per therm, except for a 9.3 cents per therm charge applicable to 53 therms per rated ton of air conditioning capacity during the cooling period of May through October. SoCal estimates that approximately 19 percent of its customers would be billed under band 1, the lowest use band, and 72 percent of its customers would be billed under band 2. SoCal proposes to bill new customers under use band 2 until 12 monthly billings demonstrate that the service charge should be dropped to band 1. SoCal would immediately move the customer to a higher use band if use during any month exceeded the monthly limit for band 2.

SoCal contends that its proposals would recover a higher proportion of its fixed charges in its monthly customer charges, compared to present rates, which would lessen the impact of revenue loss flowing from further curtailments of interruptible sales in future years. SoCal proposes to simplify its interruptible rate schedules, to maintain a declining block rate schedule for regular interruptible customers, and to maintain a differential commodity charge varying with the priorities of its regular interruptible customers. SoCal proposes that igniter gas service supplied for utility electric generation be sold at a premium compared to other gas service supplied to electric utilities. Igniter service has a higher priority than any other interruptible use.

All of SoCal's proposed monthly customer charges for firm general service exceed the minimum charge in SoCal's present rates, as defined herein, which includes two therms of usage, and they also exceed the lower service charges including no consumption authorized in D.85397. SoCal's proposed rates are incompatible with lifeline principles because larger residential customers would not be entitled to the lower lifeline rate for a portion of their usage and all general service customers would receive increases in lifeline rates before the required 25 percent rate differential had occurred.

The contention of SoCal and CMA that SoCal's revenues and earnings would decline to a greater extent under the staff's proposed rate design than under SoCal's declining priority related rates is correct.

D.86087 in C.9988 dated July 13, 1976 sets forth, on an interim basis, lifeline volumes necessary to supply the minimum energy needs of average residential users for cooking, water heating, and space heating, by season and by climatic zones on an individual basis, on metered units of multi-unit complexes, an on unmetered units of multi-unit complexes.

CMA argues that Commission implementation of broad social policy is improper where such action requires it to abandon its regulatory responsibilities in the establishment of just and reasonable rates; that such rates must be set and allocated to the various customer classes on the basis of cost-of-service; that the staff has incorrectly concluded that the Commission has rejected cost-of-service in the setting of rates; that the extreme peak-day method most accurately reflects cost incurrences among the various classes of customers served by SoCal; that the rates proposed by the staff for lifeline usage are not compensatory on any allocation basis; that the cost of providing 75 therms, excluding return and taxes, is greater than the billing for that service at staff proposed rates under either the base supply and load equation method, the coincident extreme peak-day method, or the annual average-day method; and that rates proposed by SoCal and the staff which fail to make any contribution to return necessitating increased rates to other customer classes in order to make up the revenue deficit not only fail to meet the test of being just and reasonable but create an unlawful discrimination affecting SoCal's other customers; that such discrimination exceeds the limits of the Commission's discretion to make economic classifications and set rates based thereon; that even if these rates were lawful they are certainly not prudent and in the best interests of SoCal or its ratepayers; that the lifeline quantity proposed by the staff is both too large and applicable to too many customers due to the failure to set up a definition of residential customers. CMA recommends that lifeline be offered on a separate schedule on a voluntary basis and that the rate for usage above lifeline have a very steep inversion similar to the structuring of SoCal's terminated G-10 schedule so that a customer would find it less expensive to purchase quantities above the lifeline amount under the normal general service schedule, and that the revenue deficit created by lifeline rates be absorbed by other than lifeline firm general service customers to better maintain existing class relationships and help focus customer attention on the cost of usage above lifeline.

CMA believes that all customers would not receive the same conservation signal under the staff proposal nor does it believe that it is particularly desirable that they receive the same signal; that the magnitude of the conservation signal received by various customer classes should be proportional to the cost of serving those classes.

CMA contends that value of service considerations are inappropriately used by staff to justify increased interruptible rates; that in D.55614 dated September 24, 1957 in PG&E's A.38668 the Commission refused to increase gas costs due to competitive factors (an increase in fuel oil costs) but spread the rate increase on a cost basis, which included an increase in the interruptible rate; that in A.38668 CMA argued that a fuel oil cost escalator is a competitive factor to enable the utility to market its gas and that the market value concept represents a ceiling on a price, not a floor; and that the Commission refused to raise the ceiling on PG&E's fuel oil escalation clause to place all of the increase on PG&E's interruptible customers.

We again note that we have never adopted any given cost allocation method for SoCal. The base supply and load equation method, which SoCal contends is the best allocation method for its operations, contains allocations of purchased gas on a demand and on a commodity basis. This merely represents a formalistic restatement of the charges included in SoCal's purchased gas expenses. SoCal's potential demands are far in excess of the quantities its suppliers can meet. They are not supplying contracted quantities. SoCal would buy quantities in excess of contract quantities if they were available from its out-of-state suppliers. There might have been a true demand cost at the time PLU executed the contracts, but at this time all purchased gas costs are in essence commodity costs with the exception of peaking gas purchased from California suppliers.

The General Services Administration (GSA) contends that the Commission's clear intent to provide a master-metered military housing with a quid pro quo in rates is evidenced by the language in D.83160 where we noted that there is a cost differential advantage to large master-meter customers supplying a number of housing units because most of their consumption is purchased at the tail block rate; that if SoCal were to own and operate a system which provides a meter for each separate housing unit, the average bill per unit would be higher; and that this differential in cost per housing unit would offset or exceed the cost of operating and maintaining a private distribution system. GSA contends that the purpose of the lifeline concept is to help the poor or small volume users and to promote conservation; that in this sense lifeline is the antithesis of cost related pricing; that lifeline is an income distribution method rather than a pricing system; that the Commission could restrict recovery of lifeline sale deficits to the residential class only or to all classes of customers; and that if the Commission restricted recovery to the residential class, it has the option of extending the basic flat lifeline charge to all lifeline billing units or could restrict that rate to those demands not surpassing the basic lifeline entitlement by disqualifying the customer for any lifeline benefits if his monthly consumption exceeded the lifeline entitlement.

GSA raises questions concerning the adequacy of the lifeline volumes and requests an in-depth study, which was carried out in C.9988. GSA recommends that the extra costs of providing residential lifeline benefits fall on large volume residential users only because spreading the surcharge over all billing could result in lowering residential bills which could frustrate conservation efforts. GSA proposes that separate schedules by customer classification be utilized in lieu of an outmoded all purpose schedule concept. GSA requests that master-metered military housing be afforded the same rate treatment proposed by staff for multi-family dwellings. GSA recommends that since interruptible sales do not satisfy the function they once performed, there is no reason to artificially restrain prices from floating to a true market or replacement cost price; that after stripping away the sophistry of allocation it is recognized that interruptible volumes do in fact use capacity, and therefore should make a certain contribution to fixed costs; and that equity as well as the economics of the gas industry dictate that interruptible volumes be priced at a true cost reflecting present market conditions.

LB - SoCal Dispute

LB showed the difference between the demand-commodity relationships under which it purchases gas at wholesale vis-a-vis SoCal's other wholesale customer, SDG&E. LB supplies a much greater proportion of its total gas deliveries with its own supplies compared to SDG&E. LB pays higher demand and total costs per Mcf than does

SDG&E. LB's witnesses testified that an analysis either on a cost-of-service basis or on a comparative basis with SDG&E shows that it is entitled to a lesser increase in rates.

LB also seeks a finding that there was a deficiency of gas deliveries by SoCal to LB as a prelude to negotiations between LB and SoCal to establish an appropriate amount of compensation.

SoCal argues that LB is attempting to interpret the SoCal-LB service agreement phrase "shall not exceed the equivalent of 42,500 Mcf per day" to mean "shall equal the equivalent of 42,500 Mcf per day" and that LB attempts to reinforce this interpretation by reference to an entirely separate section of the service agreement which provides for makeup volumes arising due to an entirely different reason, an oversupply of LB's own source of gas; that deliveries of makeup gas were made in 1971-1972 and 1972-1973 strictly on a best-efforts basis in order to treat LB equitably with SDG&E; that during those periods SoCal was delivering to SDG&E in excess of a 100 percent load factor; that in no manner do these best-effort deliveries to LB support the contention that SoCal was under an obligation to make such deliveries; that LB's argument that it was not until 1974 that SoCal stated that it was not obligated to deliver the annual contract amount refers to its letter of October 16, 1974 which was written during the time consideration was being given to the appropriateness of continuing the SDG&E "floor" in Phase II of A.53797; and that in light of SoCal's position in A.53797, which was subsequently supported by D.84512, and the worsening gas supply situation, it denied LB's request for a credit related to alleged deficient deliveries for the prior contract year. SoCal claims there is no basis for LB's claim for indemnity for failure to meet an obligation that never existed and that LB's rates should reflect the system average increase.

CMA concurs with SoCal that no reduction in a G-60 rate is justified. CMA argues that a reduction in system load factor[24/] does not necessarily indicate that a reduction in the demand charge is justified; that it is necessary to look at the cause of LB's reduced load factor, which is going down due to parity treatment of interruptible curtailment accompanied by increased firm requirements; that the demand charge which LB pays is related to its right to demand gas on peak-days to supply its firm load; that LB's right is not diminished by interruptible curtailment and consequently the charge is still justified; that LB's daily contract demand amount is much higher than its contract amount while for SDG&E the two are the same, which means that LB can demand relatively greater volumes of gas to meet its peak requirements and this is a further illustration of its lower load factor; that LB can expect to receive a higher proportion of its annual contract amount than can SDG&E; and that given the parity treatment of interruptible deliveries to LB and SDG&E this indicates that LB has a greater overall higher priority of service on its system than does SDG&E and LB's rates should reflect these differences.

LB contends that its load factor is not a function of the demand charge in the G-60 schedule and that LB's demand charges are based entirely on its level of service. LB's estimated annual load factor is 48.5 percent compared to SDG&E's 72.9 percent annual load factor.

24/ The ratio of average daily demand during a year and the contract demand.

Section II.B of the SoCal-LB service agreement provides for firm parity in the event of a gas supply shortage. This provision has never been implemented. Section II.C of the contract provides in part:

> "1. ... It is the general intent that curtailment by Buyer of gas for resale to steam plants shall be integrated with curtailment of sales of Seller and its affiliate[25] to steam plants and other large interruptible customers....
>
> "2. ... Deliveries of gas to Buyer hereunder for resale to interruptible industrial and commercial customers other than steam electric generating stations shall be integrated with delivery and curtailment of gas to similar interruptible industrial and commercial customers of Seller and its said affiliate on a volumetric basis...
>
> "3. ... Curtailment of interruptible service by Buyer hereunder shall be effective only during such time as Buyer shall be receiving some natural gas hereunder from Seller."

LB has not contended that there was a period of time during which it received no gas from SoCal. In the event that LB procures large additional increments of supply and is in a position to meet all of its demands during a portion of the year without reliance on SoCal, it would be undesirable to afford LB the opportunity to deliver volumes above that which it could deliver by reason of the interruptible parity provisions of its contract and to rely on SoCal for seasonal or peak demands. Section II.C.3 should be deleted from the contract.

The daily contract demand set forth in SoCal's gas service agreement with LB was increased from 42,500 Mcf to 72,000 Mcf

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25/ Southern Counties Gas Company which was merged with SoCal.

between December 1, 1969 and December 1, 1975. The original contract executed in 1961 provided for 50,000 Mcf per day. Section I of the current contract states in part:

> "A.26/ Daily Contract Demand and Annual Contract Quantity. The daily contract demand delivery rate shall be a maximum of 72,000 Mcf per day commencing with the first day of December 1975, and deliveries during the contract year December 1 through the succeeding November 30 ('annual contract quantity') shall not exceed the equivalent of 42,500 Mcf per day taken each day of the contract year...
>
> * * *
>
> "D. All of Seller's obligations to sell and deliver gas hereunder shall be subject to..., the available natural gas supply, and such other limitations as are set forth in this agreement. However, Seller now believes that it is in a position to make delivery of the quantities of gas called for hereunder and expects to keep itself in such position during the term hereof...
>
> * * *
>
> "F. If during the contract year December 1, 1975 through November 30, 1976, Buyer is required to reduce its receipts from Seller below its annual contract quantity in order to maintain parity of curtailment with the gas system of Seller and its affiliate, and solely to the extent that such reduction in receipts is occasioned by a temporary excess of local own source gas available to Buyer, Buyer shall have the right to take deferred delivery of such volumes in excess of its annual contract quantity at the regular commodity rate then in effect at any time mutually agreeable to the parties within the contract year following such reduction in receipts."

26/ Prior amendments had a similar text but different daily contract demands and different dates.

Cost allocation may have been a major consideration in the negotiations leading to the drafting of the SoCal-LB service agreement but the Commission was subsequently requested to and authorized increases in LB's rates to yield the same percentage increase in revenues to LB as to SoCal. Even if the original rates represented the application of an adopted cost allocation method, authorization of rate increases on an average percentage increase basis constitutes a departure from that cost allocation method. LB desired the multiple commodity rates in the past so that it could wheel gas through its system to Edison at a profit. The usefulness of this rate structure to LB went out with the decline in gas available for resale to Edison.

In the context of declining gas supplies the parallel curtailment of LB and SoCal assumes a dominant role in the service agreement. The annual contract quantity is for all practical purposes a ceiling on SoCal's commitment to supply gas to LB on a firm basis in conjunction with LB's own gas supply. SoCal is providing gas for interruptible uses under parallel curtailment provisions.

LB's annual load factor of 48.9 percent requires SoCal to provide a greater relative peaking and seasonal load to LB compared to SDG&E, with an annual load of 72.9 percent, for each Mcf of contract demand. There are expenses incurred by SoCal in meeting these demands which should be reflected in rates. LB should not receive a lesser relative increase in rates than SDG&E.

<u>Discussion</u>

The following actions taken in D.85354 and D.85397, based on the rate design criteria set forth in D.85354, are just and reasonable and should be retained in the rates authorized herein:

(1) All commodity billings should be made on a therm basis;

(2) Schedule G-10 should be terminated;

(3) There should be a single commodity rate for gas engine service;

(4) The rate forms for LB and SDG&E should be continued in effect; and

(5) Air conditioning discounts should be terminated.

The refund provision set forth in Section E.5 of the Preliminary Statement should be canceled as of the date the new rates go into effect since it applied only to the interim rates. This section states:

"<u>E.5. Refunds of Interim Rate Increases</u>

"Interim increases in rates should be subject to refund to the customers on a like basis plus 7 percent interest, to the extent that:

(1) The subsequent total relief authorized is less than $M 39,323 or

(2) If subsequent restructuring of rates results in some customers' interim rates being higher than subsequent rates."

The total <u>revenue</u> increase above present rates authorized in this application is $69,590,000 or 8.3 percent. The <u>rates</u> ✓ authorized in this decision increase SoCal's revenues by $17,993,000 above present rates, or 1.7 percent.

The rates authorized in Appendix A incorporate all changes in SoCal's rates from those at present rates to the effective date of this decision. The partial rate relief of $39,323,000 authorized in D.85397, which includes the increase authorized in D.83881, are not additive to the increase authorized herein, but are included.

The partial rate relief of $39,323,000 effectively becomes $51,597,000 when related to the volumes adopted in this decision, to zoning changes, to establishment of master-metered lifeline schedules and to changes in lifeline quantities. ($17,993,000 + $51,597,000 = $69,590,000.)

SoCal originally proposed that changes in GEDA or in its PGA made during the processing of this application would not be considered in the determination of its revenue requirement, but that any such changes be made additive to the revenue requirement at the adopted rates. However, the $5,100,000 PGA adjustment related to SoCal's prior treatment of its ORA occurred after this application was filed and is not incorporated in the Summaries of Earnings Tables 1 and 1-A. Since the application was filed, PGA procedure revisions make it impractical to now restore the $5,100,000 in the form of a PGA adjustment. The PGA revisions include elimination of lifeline quantities from PGA increases and changes in the amount of gas included in the lifeline exemption, and will be affected by our adoption of new master-metered lifeline schedules. The total revenue increase of $69,590,000 authorized in this application, and shown in Table 4, is the sum of the $64,490,000 shown in Table 1-A plus the restoration of the $5,100,000 disallowance ordered in D.84569.

We are authorizing establishment of GM and GMS schedules to permit an extension of the lifeline discount to multiple residential units. It is not appropriate to apply Section E.5.2. of SoCal's preliminary statement in this situation. Customers receiving service under GM and GMS schedules are new customers under these schedules.

SoCal proposed redefining "H" customers, changing the accumulated "H" customer billing limit from 11 to 20 therms, and making zoning changes. These changes are reasonable and should be adopted. Refunds should be made to customers in rezoned areas pursuant to Section E.5.2. of D.85397. The annual impact of rezoning changes increases SoCal's revenue requirement by $284,000.

The rates adopted herein in Appendix A will conform to the specifications of D.86087, Ordering Paragraphs 2, 3, 4, and 5.

The HR offset filing should be filed at the earliest possible time, no later than December 1, 1976 to permit an adequate review.

The staff rate design gives consideration to the lifeline concept. It contains an inverted rate structure in which consumption above the lifeline quantity is priced at higher unit commodity charges than is consumption below the lifeline quantity. The staff recommends an ultimate rate design which would equalize the commodity rates for all retail service classes with the commodity rate under the general service schedules for consumption in excess of the lifeline quantity. Table 4 contains the summary of authorized increases for test year 1976. There is no increase for consumption under the lifeline quantities. The charge to a residential customer in SoCal's Schedule G-1 Zone 1 with a consumption of 100 therms per month during the heating season would decrease from $15.81 to $15.66, a decrease of 0.9 percent. The comparable change for a residential customer with a consumption of 200 therms per month during the heating season would be from $30.01 to $29.86, a decrease of 0.5 percent.

In addition to the above changes in rate design we will adopt the lifeline rates set forth in D.86087 and we shall increase rates by increasing tail blocks only, except for wholesale customers. After increasing wholesale rates by the system average percentage increase, we shall increase the lowest tail block (interruptible or firm classes) until it is at the level of the next lowest tail block, then increase those tail blocks until they are at the level of the next lowest tail block and so forth until tail blocks are eliminated. As a practical matter, the rate increase authorized in this decision is not sufficient to eliminate all tail blocks. This procedure conforms to our rate treatment of PG&E in D.84902 dated September 16, 1975 in A.54279, and D.86281 dated August 24, 1976 in A.55509, wherein we increased tail blocks to the extent possible to equalize and/or eliminate them.

In an earlier SoCal offset rate increase proceeding we spread the increase to the wholesale customers by the system average increase per therm and to the other classes of service on a uniform cents-per-therm basis, excluding lifeline quantities. (D.86048 dated June 29, 1976 in A.56540.) In this decision we shall modify that rate design to conform to the rate design authorized for PG&E.

TABLE 4

SOUTHERN CALIFORNIA GAS COMPANY

Summary of Authorized Increases
Test Year 1976

Class of Service	Adopted Sales MMcf	Rev. Adopted Sales Present Rates M$	Authorized Increase a/ Amount M$	Authorized Increase a/ Per-cent	Authorized Increase a/ Cents Per Mcf	Avg. Rev. After Inc. Cents Per Mcf	Avg. Rev. After Inc. Cents Per Therm
General Service							
Lifeline	173,548	$316,843	$ 5,967 c/	1.9%	3.4¢	186.0¢	17.67¢
Nonlifeline	267,228	287,540	9,806	3.4	3.7	111.3	10.62
Subtotal	440,776	604,383	15,773	2.6	3.6	140.7	13.41
Gas Engine	7,142	6,343	1,646	25.9	23.0	111.9	10.60
Regular Interr.	198,365	157,085	43,600	27.8	22.0	101.2	9.59
Steam Plnt. Elect. b/	18,311	11,813	3,668	31.1	20.0	84.5	8.01
Wholesale b/	79,772	59,093	4,903	8.3	6.1	80.2	7.60
Subtotal	744,366	838,717	69,590	8.3	9.3	122.0	11.60
Other Opr. Rev.	N.A.	2,475					
Total Rev.	N.A.	841,192	69,590 d/				

a/ Includes offset restoring ORA disallowance in D.84569.

b/ Includes igniter gas.

c/ D.83881 in A.55117 awarded an offset increase effective 1/1/75 on a percentage-of-revenue basis to all classes, prior to establishment of lifeline levels. The $5,967,000 is the test year revenue effect of the increase authorized in D.83881.

d/ M$ 64,490 authorized increase - Table 1-A, plus M$ 5,100 due to restoration of PGA ORA disallowance, see text for explanation.

A.55345 Alt.-LR-dz

TABLE 5

Classification	Mth Sales Volume	M$ Rev. at Decision Rates 1/	M$ Increase at Decision Rates 2/	¢/Th Increase 1/	Percent Increase
General Service					
Lifeline	1,826,887	322,810	-	-	-
Non-Lifeline					
G-1 thru G-5					
Tail Blocks	897,645	98,298	2,449	0.273	2.49
Other	1,901,169	200,148	-	-	-
Gas Engine (G-45)	75,348	7,966	562	0.746	7.05
Regular Interruptible (G-50, 50T, & 53T)	2,092,751	199,742	15,602	0.746	7.81
Utility Electric (G-58)	193,181	15,344	1,440	0.745	9.38
Wholesale (G-60 & 61)	841,595	63,996	2,007	-	3.14
Due to Rounding Rates	-	3	(8)	-	
Total	7,828,576	908,307	22,052	-	2.43 1/ 1.94 3/

(Red Figure)

1/ Does not include GEDA and PGA increases to 10/1/76.

2/ Increased rates due to this decision only. Does not include interim increases.

3/ Based on present revenues at 8/1/76 rates including interim and all GEDA and PGA increases to 10/1/76.

D. MODIFICATIONS TO PURCHASED GAS ADJUSTMENT CLAUSE

SoCal witness Stanley testified that he deducted SoCal's ORA from taxable income in 1976; that this treatment is a full flow-through of the benefit to its ratepayers; that the Commission reduced SoCal's 1975 gas offset request in D.84569 dated June 17, 1975 in A.55676 by $5,100,000, SoCal's estimated 1975 ORA; that if the Commission does not allow it to collect the full offset, it will suffer a double deduction for the ORA. As mentioned, since rates determined herein are based on a revenue requirement increased by $5,100,000 no PGA revision is necessary.

D.86048 dated June 29, 1976 in A.56540 modified SoCal's PGA to include the following provision:

> "The semi-annual April and October revision of the PGA shall include an adjustment to offset any over- or under-collection of gas costs for the six-month period ending three months prior to the requested effective date of the new PGA."

Prior to the issuance of D.86048 SoCal had to absorb all of the downside risk relating to recovery of offset revenues in the PGA, i.e., if differences in the gas mix and pricing from that predicted occurred and there was a revenue deficiency in the authorized offset SoCal absorbed that deficiency. If there was a surplus of revenue realized from the PGA, SoCal was obligated to refund the over-collection, with interest. The new adjustment account of accumulated over- or undercollections from SoCal's PGA is in keeping with the energy cost adjustment clause adopted in D.85731 dated April 27, 1976 in C.9886, the Commission's investigation into electric utility fuel adjustment tariff provisions.

SoCal's PGA contains a provision that "PGA increases are subject to refund and reduction if...(3) the end of year temperature adjusted rate of return exceeds the authorized rate of return up to the amount of the authorized increase, ... " Exhibit 36 shows that there would be a difference in revenues of $28,939,000 at present rates between a hot year and a cold year and that this overall increase would be decreased to $16,204,000 at SoCal's proposed rates. The revenue shift between a hot and a cold year for general service schedules is $98,159,000 at present rates and $105,591,000 at SoCal's proposed rates. The major revenue shift results from changes in firm use, related to temperature differences, which results in either more or less gas being available for sale to SoCal's regular interruptible (including utility electric generation) and to its wholesale customers for their interruptible uses. Interruptible and wholesale deliveries are sold at lower unit costs than general service. This situation will continue although the differential would be reduced. If there was a colder than normal year, SoCal's revenues under its present and proposed rates would increase both on a gross and a net basis and would result in an increased rate of return. The above quoted tariff provision would provide for refunds on an average temperature year basis. SoCal is faced with the possibility that during an actual hot year its revenues would decline and its rate of return would drop below that authorized due to increased sales to interruptible and wholesale customers at lower commodity rates, and SoCal would be faced with the possibility of having to make refunds when its revenues are adjusted on an average temperature year basis.

SoCal should not have to pay refunds due to its earning a rate of return in excess of that authorized. In fact its return is below that authorized. The temperature related shift of gas from customers covered under the lifeline exemption to interruptible and wholesale customers would be relatively small compared to the shift of gas from firm customers using amounts above lifeline quantities. The magnitude of the revenue shifts and changes in rate of return related to the PGA are declining. Continuation of the temperature adjusted rate of return clause is inconsistent with our treatment of the electric utility energy cost adjustment clause and this provision should be deleted from the PGA.

Other Matters

Exhibit 94 shows SoCal's estimate of increased costs associated with recent expansion of regulatory reporting requirements related to the FPC end-use priority system, to C.9642, to reports supplied to the Energy Resources Conservation and Development Commission, and to reports to the Federal Energy Administration. These estimates were $147,000 in 1974, $509,000 in 1975, and $252,000 in 1976. SoCal anticipates that further expansion of its reporting activities may be necessary. SoCal's witness testified that many of these requests cover the same general area of inquiry but each seems to have a slight twist of its own requiring a totally different program. He expressed the desire that the involved agencies get together to avoid unnecessary overlapping in information gathering. We concur. Our staff should consult with other affected government agencies to standardize data requests in areas of mutual concern.

In the event that SoCal is successful in obtaining additional gas supplies for electric generation purposes to mitigate adverse air pollution effects these additional volumes of gas should be priced outside of the normal rate schedules on an incremental cost basis including transportation charges, taxes, and the cost of gas.

Findings of Fact

1. SoCal originally requested a general increase in rates of $151,450,000 above the rates in effect on October 1, 1974. During the course of the proceeding SoCal modified its exhibits to show that an increase of $118,609,000 would yield the 10.25 percent return on rate base requested.

2. It is reasonable to adopt the staff's TW and EP gas supply estimates and SoCal's California and offshore gas supply estimates.

3. The adopted estimates in Tables 1 and 2 of operating revenues, operating expenses, and rate bases of SoCal and PLS for 1976 test year sales of 744,366 M^2cf are appropriate to determine SoCal's gross revenue deficiency under present rates. Present rates as defined for purposes of this order are those effective as of October 1, 1974, excluding that portion of the rates relating to GEDA charges of 0.061 cents per therm, and including the November 1, 1974 G-61 and December 1, 1974 G-60 wholesale gas service agreement adjustments between SoCal, SDG&E, and LB. Except for the $5,100,000 reduction of SoCal's offset in D.84569, all other rate changes which have occurred since that date should not be utilized in the revenue

deficiency determination, including the reduction ordered in D.86118. Table I includes the expenses attributable to the HR Storage Field and SoCal's rate base, including interest during construction during test year 1976 attributable to HR, on an as expected basis.

4. An allowance of $7,244,000 for SoCal's 1976 sales expense is reasonable for conservation programs; this amount includes $2,500,000 for advertising expense. In A&G expenses, $780,000 is a reasonable allowance for public relations activities including safety information. SoCal should test the efficiency of its conservation programs and of its programs to inform the public of the cost impact of new sources of energy to maximize the impact of its programs within its budget.

5. SoCal's earnings under present rates from its operations during the 1976 test year produced a rate of return of 5.62 percent on a rate base of $921,933,000.

6. A rate of return of 8.8 percent for the PLU system is just and reasonable to arrest SoCal's erosion of earnings and to materially improve its financial performance, to enhance its ability to raise additional capital required for financing its continuing construction programs, (which are required to provide peaking and season load requirements), to provide better investor acceptance of SoCal's and PLS's securities, and to reduce the risk of derating SoCal's and PLS's securities. A corresponding return on common equity under the adjusted capital structure would be 12.0 percent. This rate of return determination is based upon imputing PLC preferred stock to PLU and the use of end-of-year capital ratios.

7. The ITC treatment adopted for computation of income taxes and in the rate of return determination is reasonable.

8. A fixed rate of return of 8.8 percent on its rate base of $225,941,000 is reasonable for PLS for application in its cost of service tariff.

9. The rates and charges authorized herein are just and reasonable and present rates and charges, insofar as they differ therefrom, are, for the future, unjust and unreasonable.

10. SoCal is entitled to an increase of $69,590,000 in gross annual revenue to raise its test year rate of return from the present 5.62 percent to the 8.8 percent found reasonable. This increase includes the restoration of the $5,100,000 deleted from SoCal's PGA increase in D.84569.

11. All classes of service, excluding service provided under lifeline, should bear a portion of the required revenue increase. Table 4 of the foregoing opinion shows the amount of increase authorized herein, by class of service. The rates authorized by this Commission, set forth in Appendix A hereto, reflect a fair and reasonable apportionment of the authorized increase to the various classes of service. The rates contained in Appendix A incorporate the net authorized changes in SoCal's rates from those included at present rates to October 1, 1976, including the effect of the partial rate relief of $39,323,000 authorized in D.85397, which includes the increase authorized in D.83881. The partial rate relief of $39,323,000 effectively becomes $51,597,000 when related to the volumes accepted herein; consequently, the additional increase authorized by this decision is reduced by $51,597,000.

12. This decision will increase revenues by approximately $17,993,000.

13. We will fully implement rates based on the lifeline criteria in D.86087 at this time.

14. New multiple residential schedules GM and GMS should be authorized to extend lifeline benefits.

15. SoCal should vigorously pursue its insulation program. Revenues received by SoCal through its insulation program should be included in other operating revenues.

16. SoCal should be authorized to make an offset filing to include the full effect of HR in its operating plant as of January 1, 1977, providing that its filing is made on or before December 1, 1976.

17. The reduction in SoCal's rates to deduct the 1975 ORA allowance should be rescinded.

18. Refunds should be made to customers in rezoned areas pursuant to Section E.5(2) of D.85397.

19. In the event that SoCal is successful in obtaining additional gas supplies for electric generation purposes to mitigate adverse air pollution effects these additional volumes of gas should be priced outside of the normal rate schedules.

20. If SoCal and/or PLS sell gas transmission facilities to Sohio, SoCal, and/or PLS should provide sufficient information to the Commission to ascertain whether or not a rate adjustment is necessary.

21. SoCal should report in detail on its conservation program as part of the reporting mechanism in C.9884. The Commission's conservation team should review those reports and advise SoCal of its objections to any aspect of the program. The cost benefit relationships should be shown for all program elements. SoCal should phase out industrial or cooperative advertising support.

22. SoCal should be guided by our comments and guidelines concerning its own R&D program and of the AGA R&D program it supports. SoCal should consider future projects suggested by the staff evaluation of its conservation program in C.9642 in planning future R&D programs. SoCal should continue to supply the staff with data on existing and proposed R&D projects and should indicate whether the activities would assist in its conservation efforts, in its environmental efforts, or in improving its operations. The staff's evaluation of these current and proposed projects should be performed and the staff should prepare a memorandum to the Commission with its preliminary recommendation of the R&D projects for ratemaking purposes. SoCal should be advised of the result of such evaluation.

23. LB should receive a system average increase in rates. Section II.C.3 should be deleted from the SoCal-LB service agreement.

24. If SoCal desires to continue to receive legal services, tax audit services, and gas supply finance services for PLC, it should keep adequate time, payroll, and expense records for all the services performed where allocations are made to SoCal or PLS, or to entities financed by rates established by this Commission, e.g., the GEDA adjustments. These records should not only specify service to SoCal but should indicate the nature and identity of the work performed.

25. The free footage incentives for nonessential gas uses which were not mentioned in the lifeline legislation, i.e., for clothes dryers, air-conditioning equipment, garbage incinerators, and gas refrigerators, should be eliminated.

26. When the activity of a PLC subsidiary is financed by rates established by this Commission expenses associated with such activity should be reported to the Commission.

The Commission concludes that the application should be granted to the extent set forth in the following order and in all other respects denied.

O R D E R

IT IS ORDERED that:

1. Southern California Gas Company (SoCal) is authorized to file the revised tariff schedules with changes in rates, charges, and conditions as set forth in Appendix A attached hereto, and concurrently to cancel its present schedules for gas service. Such filing shall comply with General Order No. 96-A. The effective date of the new and revised tariff sheets shall be one day after the date of filing. The new and revised schedules shall apply only to service rendered on and after the effective date thereof.

2. SoCal shall:

   a. Vigorously pursue its insulation program. Net revenues after expenses received by it through its insulation program shall be included in other operating revenues.

   b. Be authorized to make an offset filing to include the full effect of Honor Rancho in its operating plant as of January 1, 1977, providing that its filing is made on or before December 1, 1976.

c. Price outside of the normal rate schedules additional volumes of gas for electric generation purposes to mitigate adverse air pollution effects.

d. Provide the Commission with sufficient information to ascertain whether a rate adjustment is necessary in the event SoCal and/or Pacific Lighting Service Company sell gas transmission facilities to Sohio Transportation Company of California.

e. Report in detail on its conservation program as part of the reporting mechanism in Case No. 9884. The cost benefit relationships shall be shown for all program elements. SoCal shall phase out industrial or cooperative advertising support. The Commission's conservation team shall review those reports and advise the Commission and SoCal of its objections to any aspect of the conservation program.

f. If it desires to continue to receive legal services, tax audit services, and gas supply finance services from Pacific Lighting Corporation, keep adequate time, payroll, and expense records for all other services performed where allocations are made to SoCal or Pacific Lighting Service Company or to entities financed by rates established by this Commission, e.g., the gas exploration and development adjustment. These records shall not only specify service to SoCal but shall indicate the nature and identity of the work performed.

g. Report expenses associated with the activity of a Pacific Lighting Corporation subsidiary when such activity is financed by rates established by this Commission.

3. New multiple residential schedules GM and GMS are authorized to extend lifeline benefits.

4. The modifications to the purchased gas adjustment clause set forth in this decision are adopted.

5. SoCal shall be guided by our comments and guidelines concerning its own research and development programs and of the American Gas Association's research and development programs it supports. SoCal shall consider future projects suggested by the staff evaluation of its conservation program in Case No. 9642 in planning future research and development programs. SoCal shall continue to supply the staff with data on existing and proposed research and development projects and shall indicate whether the activities would assist in its conservation efforts, in its environmental efforts, or in improving its operations. The staff's evaluation of those current and proposed projects shall be performed and the staff shall prepare a memorandum to the Commission with its preliminary recommendation of the R&D projects for ratemaking purposes. SoCal shall also be advised of the result of such evaluation.

6. SoCal shall cancel Section E.5 of the preliminary statement in its tariffs effective the date that the rates in Appendix A are effective.

7. Refunds shall be made to customers in rezoned areas pursuant to the preliminary statement provision in (Section E.5(2)) authorized in D.85397.

8. The free footage incentives for nonessential gas uses which were not mentioned in the lifeline legislation, i.e., for clothes dryers, air-conditioning equipment, garbage incinerators, and gas refrigerators, shall be eliminated. Within thirty days of the effective date of this order SoCal shall file revised tariff pages eliminating these free footage allowances.

Alt.-LR
A.55345 dz ***

9. The city of Long Beach shall receive a system average increase in rates. Section II.C.3 shall be deleted from the SoCal-Long Beach service agreement.

The effective date of this order is the date hereof.

Dated at San Francisco, California, this 23 day of NOVEMBER, 1976.

President

Leonard Ross

Robert Batinovich

Commissioners

I am attaching a written concurrence
Leonard Ross
Robert Batinovich

I dissent
William Symons Jr

I dissent
Vernon L. Sturgeon

APPENDIX A

RATES

	G-1 Lifeline	G-1 Non-Lifeline	G-2 Lifeline	G-2 Non-Lifeline
Mo. Charge	$ 3.13226	$ 3.13226	$ 3.17870	$ 3.17870
First 30 therms	12.782¢	12.782¢	13.031¢	13.031¢
Next 45 therms	11.760¢	11.760¢	12.172¢	12.172¢
Next 925 therms	11.760¢	14.202¢	12.172¢	14.614¢
Over 1,000 therms	N.A.	13.698¢	N.A.	13.698¢

	G-3 Lifeline	G-3 Nonlifeline	G-4 Lifeline	G-4 Non-Lifeline
Mo. Charge	$ 3.21949	$ 3.21949	$ 3.30431	$ 3.30431
First 30 therms	13.562¢	13.562¢	14.463¢	14.463¢
Next 45 therms	12.599¢	12.599¢	13.112¢	13.112¢
Next 925 therms	12.599¢	15.041¢	13.112¢	15.554¢
Over 1,000 therms	N.A.	13.698¢	N.A.	13.698¢

	G-5 Lifeline	G-5 Non-Lifeline
Mo. Charge	$ 4.19873	$ 4.19873
First 30 therms	16.018¢	16.018¢
Next 45 therms	13.596¢	13.596¢
Next 925 therms	13.596¢	16.038¢
Over 1,000 therms	N.A.	13.698¢

N.A. - Not applicable as lifeline allowances do not enter the over 1,000 therms block.

	G-30 (Charge per lamp per month)
1.99 cf/hr or less	$1.88
2.00 - 2.49 cf/hr	2.27
2.50 - 2.99 cf/hr	2.71
3.00 - 3.99 cf/hr	3.19
4.00 - 4.99 cf/hr	3.77
5.00 - 7.49 cf/hr	4.57
7.50 - 10.00 cf/hr	5.70
Ea. cf/hr over 10 cf/hr	0.69

G-45, G-50, G-50T, and G-53T

All usage, per therm - 13.698¢

G-58

All usage, per million Btu - 136.98¢

	G-60	G-61
Mo. Demand Chg. per Mcf of Daily Contract Demand	$ 3.0186	$ 2.2317
Commodity Charge per unit shown	9.721¢ per therm	97.65¢ per MMBtu
Minimum annual charge for additional peaking demand	$205,000	$317,000
Additional peaking demand gas - commodity charge		117.42¢ per MMBtu

APPENDIX B

Rate as of October 1, 1976

RATES

	G-1 Lifeline	G-1 Non-Lifeline	G-2 Lifeline	G-2 Non-Lifeline
Mo. Charge	$ 3.13226	$ 3.13226	$ 3.17870	$ 3.17870
First 30 therms	12.782¢	12.782¢	13.031¢	13.031¢
Next 45 therms	11.760¢	11.760¢	12.172¢	12.172¢
Next 925 therms	---	14.202¢	---	14.614¢
Over 1,000 therms	---	13.58 ¢	---	13.58 ¢

	G-3 Lifeline	G-3 Non-Lifeline	G-4 Lifeline	G-4 Non-Lifeline
Mo. Charge	$ 3.21949	$ 3.21949	$ 3.30431	$ 3.30431
First 30 therms	13.562¢	13.562¢	14.463¢	14.463¢
Next 45 therms	12.599¢	12.599¢	13.112¢	13.112¢
Next 925 therms	---	15.041¢	---	15.554¢
Over 1,000 therms	---	13.58 ¢	---	13.58 ¢

	G-5 Lifeline	G-5 Non-Lifeline
Mo. Charge	$ 4.19873	$ 4.19873
First 30 therms	16.018¢	16.018¢
Next 45 therms	13.596¢	13.596¢
Next 925 therms	---	16.038¢
Over 1,000 therms	---	13.58 ¢

	G-30 (Charge per lamp per month)
1.99 cf/hr or less	$1.85
2.00 - 2.49 cf/hr	2.23
2.50 - 2.99 cf/hr	2.67
3.00 - 3.99 cf/hr	3.14
4.00 - 4.99 cf/hr	3.71
5.00 - 7.49 cf/hr	4.50
7.50 - 10.00 cf/hr	5.61
Ea. cf/hr over 10 cf/hr	0.68

G-45, G-50, G-50T, and G-53T

All usage, per therm - 12.894¢

G-58

All usage, per million Btu - 128.94¢

	G-60	G-61
Mo. Demand Chg. per Mcf of Daily Contract Demand	$ 2.7624	$ 2.0691
Commodity Charge per unit shown	9.565¢ per therm	96.08 ¢ per MMBtu
Minimum annual charge for additional peaking demand	$190,000	$294,000

APPENDIX C

REVENUE SUMMARY

	M$
Authorized increase - see Table 1-A	64,490
ORA restoration from PGA	5,100
Total authorized increase over 10/1/74 see Table 4	69,590
Effect of increases authorized in D.85354 and D.85397, effective 1/1/75 and 1/27/76	(51,597)
Net revenue increase of this decision	17,993

Adjustment Due To Changes In Rate Design Since 10/1/74 Necessary To Achieve The $17,993 Net Revenue Increase

	M$
Adjustment 1-restores loss due to rezoning	284
Adjustment 2-restores loss due to GMS discount	210
Adjustment 3-restores loss due to D.86087 lifeline levels	3,565
Increase for rate design purposes only	22,052

(Red Figure)

This decision ignores a central issue of gas company regulation: the accuracy of gas supply estimates and the question of how the Commission should deal with the different estimates in setting rates. The possibility that gas will become abundantly available or in short supply due to conditions outside the control of the utility or the Commission magnifies the problem. No one (the customer or the utility) is well served by whatever short-term gains occur if the adopted estimates prove to be significantly erroneous. Under present pricing formulas an erroneous estimate can involve an enormous sum of money - far more than is involved in all other issues combined.

In addition, we feel that the analysis in the original draft opinion is unsatisfactory on several crucial issues - including potential phantom taxes, promotional advertising, public relations. We have modified that draft to make adjustments for unjustified promotional expenditures and to take into account the effect of tax privileges on the risk experienced by the company and on its appropriate rate of return. The net effect of these adjustments is to reduce the revenue increase from a proposed $27.7 million to $18 million. Obviously, this belated method of opinion-writing is unsatisfactory. We are signing this only because it is less objectionable in its results than the original revision. We hope all parties will be better served in the future by a full, analytical consideration of the issues we have mentioned.

Leonard Ross

Robert Batinovich

Decision No. 86595
A.55345

COMMISSIONER VERNON L. STURGEON, Dissenting

The 8.8% rate of return and the resultant 12.00% return on equity adopted by the majority are grossly inadequate. It is apparent that they are inadequate for the simple reason that a rate of return of 8.8% in 1976 test year results in a return on equity lower than the 12.35% return adopted by this Commission in SoCal's 1974 general rate case (D.83160). Gas supply risks alone in test year 1976 are substantially greater than similar risks in year 1974. Certainly the need to attract substantial sums of capital in 1976 is crucial and will continue in that state as domestic supplies diminish. A 12.00% return on equity, not having been found adequate in 1974, cannot by any measure become adequate in 1976.

On page 96 of the decision reference is made to the recent PG&E decision which reads as follows:

> "In D.86281 issued August 24, 1976, we adopted a rate of return of 9.20 percent for PG&E (a flow-through utility) equating to a 12.83 percent return on equity with an equity capital of about 37 percent. In doing so we noted that it has been our experience that investors expect higher returns in equity from flow-through utilities and that on a comparable risk basis PG&E is entitled to a higher rate of return than a company which does not flow-through its tax savings."

That statement clearly infers that SoCal is not a flow-through utility. The fact is that it is such a utility. It is a flow-through utility with the exception of the 6% additional investment credit allowed by the Tax Reduction Act of 1975. This additional ITC amounts to $3,000,000 whereas the so-called flow-through ITC amounts to about $11,000,000.

Even if we accept arguendo the majority's reasoning that SoCal not being a flow-through utility, is less risky and therefore investors will expect a smaller return on equity, such reasoning is specious because PG&E is a combination utility whose risks are infinitely smaller.

Conclusion:

The rate of return and the return on equity adopted herein is only attained by inaccurately characterizing SoCal as a non-flow-through utility and improperly comparing its risks with those of a combination utility.

In general terms no one is served (the customer or the utility) by a rate of return and return on equity which will not provide adequate funds for debt and preferred stock and does not allow earnings for common stock equity sufficient to produce retained earnings for suitable dividends.

In the case of a gas utility the problems are compounded by reasons of the diminishing supply of domestic gas. SoCal must be allowed earnings to attract sufficient capital which it will be required to invest in high risk and expensive supply projects while meeting its regular capital needs.

An 8.8% rate of return and 12.00% return on equity cannot provide SoCal with funds sufficient to meet such requirements.

San Francisco, California
November 5, 1976

Vernon L. Sturgeon
VERNON L. STURGEON
Commissioner