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Decision No. 87838 SEP 13 1977

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.	Application No. 53587 (Filed September 19, 1972)
In the matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.	Application No. 51774 (Filed March 17, 1970)
In the Matter of the Application of The Pacific Telephone and Telegraph Company, a corporation, for telephone service rate increases to offset increased wage, salary and associated expenses.	Application No. 55214 (Filed September 30, 1974; amended December 13, 1974)
Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of The Pacific Telephone and Telegraph Company.	Case No. 9503 (Filed January 30, 1973)
Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of the telephone operations of the Pacific Telephone and Telegraph Company.	Case No. 9802 (Filed November 26, 1974)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs, separations, inter-company settlements, contracts, service, and facilities of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a California corporation; and of all the telephone corporations listed in Appendix A, attached hereto.	Case No. 9832 (Filed November 26, 1974)
In the Matter of the Application of General Telephone Company of California, a corporation, for authority to increase its rates and charges for telephone service.	Application No. 51904 (Filed May 15, 1970; amended July 17, 1970)
In the Matter of the Application of General Telephone Company of California, a corporation, for authority to increase its rates and charges for telephone service.	Application No. 53935 (Filed March 28, 1973)
Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of General Telephone Company of California.	Case No. 9100 (Filed August 4, 1970)
Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of the telephone operations of all the telephone corporations listed in Appendix A, attached hereto.	Case No. 9504 (Filed January 30, 1973)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs, separations, practices, contracts, service, and facilities of GENERAL TELEPHONE COMPANY OF CALIFORNIA, a California corporation; and of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a California corporation; and of all the telephone corporations listed in Appendix A, attached hereto.	Case No. 9578 (Filed July 3, 1973)

(Appearances are listed in Appendix A.)

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OPINION

This is the latest, and hopefully the final, proceeding on the long and tortuous road involving the regulatory rate treatment of accelerated tax depreciation (which includes asset depreciation range, class life system, salvage value, and repair allowance) and the Job Development Investment Credit, now called the Investment Tax Credit (ITC), for two major California telephone utilities, The Pacific Telephone and Telegraph Company (Pacific), and General Telephone Company of California (General). This proceeding results directly from the remand by the California Supreme Court in City of Los Angeles v Public Utilities Commission (1975) 15 C 3d 680, which annulled that portion of the rate increase granted Pacific in D.83162 dated July 23, 1974 which related to accelerated tax depreciation and ITC. (All other matters decided in D.83162 were affirmed by the court.) This annulment also applied to General because in D.83778 dated November 26, 1974 General's accelerated tax depreciation and ITC were treated by this Commission in the same manner as was Pacific's in D.83162.

At the time the above decision was filed by the court, there was under submission another rate increase proceeding for Pacific, A.55214, in which we issued D.85287 on December 30, 1975. D.85287 granted a rate increase subject to refund to provide for any adjustment in the rates that might be required as a result of the hearings in the instant proceeding. In addition, at the time this matter was remanded by the court two rate increase applications, A.55492 for Pacific and A.55383 for General, were pending. The accelerated depreciation and ITC issues in those proceedings were removed for final determination in this proceeding.

In the remanded matters this Commission had set rates based on the normalization method of accounting,[1] which involves the computation of rates based on the same method of depreciation, both for depreciation expense and federal income tax expense, while the federal income taxes are actually paid on the basis of a different amount of (accelerated) depreciation expense. Since accelerated depreciation substantially increases the allowable expenses to the utility, the taxable income, and therefore the federal income tax expense of the utility, is substantially below what it would have been had taxes been paid on the rate-making (straight-line) depreciation basis. The difference between the amount of taxes computed on a straight-line depreciation basis and an accelerated depreciation basis is reflected in a reserve account called the deferred tax reserve. This amount, on an average basis, is deducted from rate base so that the authorized rate of return is not earned on this sum. The

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1/ Internal Revenue Code (IRC) Section 167(l)(3)(G), which reads as follows:

> "(G) Normalization method of accounting.--In order to use a normalization method of accounting with respect to any public utility property--
> (i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and
> (ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

deferred tax reserve accumulates from year to year disproportionately to revenues, expenses, and rate base as long as the overall plant additions by the utility continue to grow. To this extent, the taxes set aside in the deferred tax reserve shall never be paid and amount to an actual tax saving, rather than only a deferral. (ITC is defined as a tax credit, thus is a direct tax saving and not a deferral.)

In the remand of D.83162 the Supreme Court held, inter alia, that this Commission has the power to implement an alternative method, e.g., an annual adjustment, of tax expense treatment for accelerated depreciation and ITC. This annual adjustment method was discussed but not used in arriving at the treatment set forth in D.83162. The Supreme Court ordered this Commission to give consideration to this method, as well as other alternatives, including the possibility of a commensurate adjustment in the rate of return, and to provide for refunds, if appropriate.

Hearings on this remand were held between March 1, 1976 and July 9, 1976 before Commissioner Robert Batinovich and Examiner Phillip E. Blecher. The matter was submitted on the latter date subject to the filing of briefs.

The Proposed Report of the examiner was issued on January 19, 1977. Exceptions to the Proposed Report were timely filed by Pacific, General, City of Los Angeles (LA), and Toward Utility Rate Normalization (TURN). These exceptions shall be discussed where appropriate.[2]

2/ All transcript corrections requested after the date of submission by Pacific, General, and LA have been adopted.

Review

D.83162, 83778, and 85287 have exhaustively reviewed and discussed this tax expense issue from its inception. We shall not reiterate that discussion, but shall attempt to confine the review of evidence and discussion of the issues to those old matters still pertinent here, as well as the new matters not previously raised. However, we think a brief recounting of three California Supreme Court decisions relating to this issue is warranted.

Case 1: City and County of San Francisco v Public Utilities Commission, et al. (1971) 6 C 3d 119. This case annulled D.77984, which had provided that Pacific could use accelerated depreciation with the normalization method of accounting as defined in IRC Section 167, because this Commission failed to consider lawful alternatives in the calculation of federal income tax expense. On page 130 the court said: "Because these methods involve fictitious allowances for tax expense and because they provide results which in the light of current federal income tax law are either harsh on the utility or the ratepayers, the Commission may also consider alternative approaches which strike a balance between these two extremes." This statement was quoted with approval in Case 3, infra. Since there has been no substantive change in the applicable federal tax statutes, this quotation is as appropriate today as when made.

Case 2: City of Los Angeles v Public Utilities Commission (1972) 7 C 3d 331. A general rate increase for Pacific was annulled partly because the Commission computed taxes on the basis of normalization.

Case 3: City of Los Angeles v Public Utilities Commission (1975) 15 C 3d 680. This is the case which remanded D.83162, et al., for these proceedings. The court stated on page 684 that the Commission took the action in D.83162 in spite of the court having annulled its previous decision in this matter for failure to consider lawful alternatives in the calculation of federal income tax expense (Case 1). The court further said that the Commission set a rate which in its own words would create a windfall for the telephone companies to the detriment to the ratepayers.

Pursuant to the remand in Case 1 the Commission entered D.80347 dated August 8, 1972 which directed further hearings into the tax expense problems. These further hearings had not yet been held at the time of the decision in Case 2. In D.80347 we said on page 3: "For the purpose of this opinion only we will compute Pacific's federal tax expense on the basis of accelerated depreciation with flow-through." D.80347 thus ordered a substantial refund amounting to about $176 million, including interest, based on the flow-through method of computation of the federal tax expense. D.80347 also set rates which were in effect through the effective date of D.83162 rates, which was August 17, 1974. The hearings held pursuant to Case 1 were consolidated with A.53587 and resulted in D.83162 where this Commission again adopted the normalization basis for computing federal tax expense, which resulted in Case 3.

In D.74917 dated November 6, 1968, prior to the enactment of the Tax Reform Act of 1969 (TRA) effective January 1, 1970, we determined that Pacific was imprudent in not electing the accelerated depreciation option. For ratemaking purposes we imputed accelerated depreciation with full flow-through, though Pacific was paying taxes on a straight-line basis. This procedure was approved in Case 1. TRA allowed utilities to take accelerated depreciation even though they had not taken it before 1969 only if the cost of service (which includes federal income tax expense) was computed on a normalization basis. After the enactment of TRA both Pacific and General reversed their long-standing opposition to accelerated depreciation and elected it on a normalization basis. This election has resulted in the instant proceedings in which we are attempting to comply with the mandate from our Supreme Court to reach an equitable determination of this problem.

Pacific and General argue that accelerated depreciation is allowable only if normalization accounting is used because neither is eligible under IRC Section 167.1 for flow-through accounting. If normalization is not used, then the companies must revert to straight-line depreciation and the benefits of accelerated depreciation will be lost to both the utilities and the ratepayers. We have previously agreed with this position, as has the court in Case 1, though this result is due only to the intransigence of Pacific and General in not opting for accelerated depreciation when they had the opportunity. While this Commission deplores the actions of Pacific and General, we are again compelled to agree with their interpretation of the tax law. To impute flow-through now in attempting to redress the balance between the utilities and ratepayers, we would ultimately cause the ratepayers substantially higher rates and poorer service

while seriously damaging the financial position of the companies. This horrendous result has been created by Congress through the options allowed the utilities in the tax laws, which have the effect of allowing the regulatee to regulate the regulator.

Thus, we are forced to again consider the question of maintaining eligibility for accelerated depreciation on a normalized basis. The primary reference for this purpose is Treasury Regulation 1.167(l)-(1)(h)(6).[3/] It delineates when the normalization method of accounting is not used, and concomitantly, when it is used. If these criteria are not met, then accelerated depreciation in its entirety will be disallowed creating a huge tax liability for Pacific and General, which will be met with an equally huge deferred tax reserve account, which is paper only, as the monies credited to the deferred tax reserve have already been spent.

3/ This regulation, as far as pertinent, reads as follows:

> "(6) Exclusion of normalization reserve from rate base. (i) Notwithstanding the provisions of subparagraph (1) of this paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking."

The same proposition prevails for ITC. Since ITC became effective in December 1971, General and Pacific have elected ratable (service-life) flow-through (Option 2).[4/] This means that the amount of plant investment in the taxable year shall be apportioned on its expected service life for ratemaking purposes.

Neither Pacific nor General was eligible for ITC Option 3[5/] (see Case 1, page 130), which allows full flow-through of the tax saving in the year in which the benefit occurred.

4/ IRC Section 46(f)(2), which reads as follows:

> "(2) Special rule for ratable flow-through.--If the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary or his delegate, paragraph (1) shall not apply, but no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer--
>
> "(A) Cost of service reduction.--If the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit allowable by section 38 (determined without regard to this subsection), or
>
> "(B) Rate base reduction.--If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection)."

5/ IRC Section 46(f)(3), which reads as follows:

> "(3) Special rule for immediate flow-through in certain cases.--In the case of property to which section 167( )(2)(C) applies, if the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary or his delegate, paragraphs (1) and (2) shall not apply to such property."

Thus, ITC for Pacific and General will be disallowed in its entirety if the taxpayers' cost-of-service for ratemaking purposes is reduced by more than a ratable portion of the credit allowed or if the base to which the taxpayers' rate of return for ratemaking purposes is applied is reduced by more than a ratable portion of the credit.

Assumptions

This discussion and ensuing decision reflect the assumptions set forth below:

(1) Tax Reduction Act became effective on January 1, 1970.

(2) As a result of Case 1 and D.80347, Pacific's rates from January 1, 1970 to August 17, 1974 have been promulgated on a flow-through basis. Since these rates are final they cannot now be amended by any action of this Commission. Therefore (a) any action taken in respect to Pacific's rates will apply from August 17, 1974 until the effective date of the rates set in D.85287, which is January 5, 1976; (b) the rates set in D.85287 are subject to refund and any action taken in this decision shall adjust those rates accordingly; and (c) any action taken here shall apply prospectively to the rates to be set in pending A.55492 of Pacific.

(3) General's rates for test year 1970 in D.79367 (effective December 12, 1971) and thereafter have been subject to refund. Therefore (a) any action taken on accelerated depreciation here shall apply to the rates collected by General from December 12, 1971; (b) although ITC was not in existence in test year 1970 used in D.79367, any action taken on ITC shall apply from December 12, 1971, as General has been taking ITC since it has been available; and (c) any action taken here on ITC and accelerated depreciation shall apply prospectively to the rates to be set in pending A.55383 of General.

(4) Neither Pacific nor General has the option to elect accelerated depreciation on a flow-through basis under IRC Section 167, et seq. (Case 1.)

(5) Both Pacific and General must use a normalization method of accounting to maintain eligibility for accelerated depreciation under IRC Section 167, et. seq.

(6) Neither Pacific nor General has the option to elect ITC on a flow-through basis (Option 3) under IRC Section 46, et seq.

(7) Normalization accounting for accelerated depreciation reduces financial risk and increases cash flow compared to the flow-through treatment for accelerated depreciation.

(8) Both Pacific and General were guilty of imprudent management in their original determination to pay federal income taxes on a straight-line depreciation basis. (Cases 1 and 3.)

(9) The quantification of a rate of return reduction because of the increased cash flow and decreased risk and vulnerability of normalization accounting is difficult and judgmental.

The Evidence

Various alternative methods presented at the hearings may be summarized as follows:

General's Proposals

1. Three-Year Reserve and Tax Adjustment Method. This is a variation of a previously proposed three-year pro forma method which, it was argued, was disqualified under Treasury Regulation 1.167(ℓ)-(1)(h)(6) because it used a deferred tax reserve balance that exceeded the amount of such deferred tax reserve for the period used in determining the taxpayers' tax expense. The current proposed method remedies this defect because it considers the additional tax expense for the same period as the deferred tax reserve. It is based on the assumption that the federal income tax will increase in proportion to growth after the test year. The method of computation is as follows:

> At test year the Commission should find a reasonable federal income tax (before ITC) and a reasonable normal growth rate. (General recommends using the compound growth in main stations for the three preceding years.) The test year tax expense would then be increased by applying the growth factor to the intrastate federal income tax (before ITC) for three years into the future and averaging. The test year federal tax expense would then be deducted from the three-year average to determine the additional tax expense to be included in the test year. This amount would then be multiplied by the net-to-gross multiplier to represent the intrastate change in revenue requirement related to the additional tax expense that must be considered for the same period as the deferred tax reserve as determined in the three-year pro forma method.

2. Annual Reserve and Tax Adjustment. This is an adaptation of the annual or year-to-year adjustment method (which the Supreme Court discussed in Case 3), which has the same disadvantage as the pro forma method because of its use of an out-of-period deferred tax reserve. The current adaptation of this method makes an annual adjustment for the increase in reserve and also brings the additional tax expense forward for the same time period. The additional tax expense is determined in the same manner as in the three-year reserve and tax adjustment method, but the rates would only be adjusted one year at a time. The federal income tax before ITC, plus a normal growth rate, would be determined by the Commission and each year's calculation would be based upon the prior year's calculation until a new test year was established.

3. The Deferred Tax Reserve as No Cost Capital. This method is used by applying the amount in the deferred tax reserve as a component of the capital structure with zero cost assigned to it. Rate base is not reduced by the amount of deferred tax reserve. The effect is to lower the cost of capital and rate of return found reasonable in general rate proceedings.

Pacific's Proposal

Annual Ratemaking Plan. Pacific would annually tender an estimated full intrastate cost of providing telephone service, keeping as constant all the ratemaking adjustments previously adopted in the latest general rate decision and the last authorized rate of return. No new adjustments or change in authorized rate of return would be permitted but all other elements of cost-of-service would be considered. This is a slightly simplified annual rate case, which everyone agrees is permitted under the existing tax laws.

Staff's Proposals[6/]

1. Pro Forma Annual Adjustment. Gross revenue requirement reductions are determined by annual adjustments in the deferred tax reserve for the test year and each of the next three years. The average of these four years' reductions is then applied as a gross revenue reduction in test year rates.

2. Rate of Return Adjustment - Reduced Risk. The authorized rate of return upon which test year gross revenue requirements are based is reduced in order to recognize the reduction of financial risk resulting from the cash flow generated by the tax savings from accelerated depreciation and ITC on a normalization accounting basis.

3. Midpoint Flow-Through Applied to a Normalization Rate Base. In addition to the normalized treatment of deferred tax reserve, one-half of the difference in gross revenue requirements between normalization (for accelerated depreciation) and ratable flow-through (for ITC) and a full flow-through of each is reflected in rate reductions.

4. Normalization with Amortization of Deferred Taxes. This is similar to the method of adjusting the expense and rate base for

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6/ Staff refers to the Utilities Division of the Commission.

contributions in aid of construction. The gross revenue requirements are reduced by the reduction in rate base in the amount of the average deferred tax reserve for the test year, but the deferred tax reserve is also amortized (using the straight-line depreciation rate) by a sum also reflected in a reduction in gross revenue requirements and rates.

5. Rate of Return Adjustment - Cost-Free Funds. This is substantially equivalent to General's no-cost capital proposal.

The City and County of San Francisco's (SF) Proposal

SF recommends full flow-through, or in the alternative, a rate of return reduction contingent upon a favorable IRS ruling on eligibility, but in the event of an unfavorable ruling, rates to be then reset on a full flow-through basis. The purpose of this theory is to provide the companies with an incentive to obtain a favorable tax ruling, or, alternatively, to amend the existing law to avoid the loss of eligibility.

The City of Los Angeles's (LA) Proposal

LA recommends a rate of return reduction up to a maximum of two percentage points,[7/] while continuing the normalization treatment of tax expense. This reduction is to be quantified after considering three factors:

(1) Analysis of the financial risk reduction of a normalization as compared to a flow-through company due to the greater cash flow generated, the reduction of the need for outside financing, the reduction of the cost of embedded debt, the improvement in interest coverage, and the generally favorable effect on the cost of new capital and evaluation of the utility's securities generally. (This position is supported by the city of San Diego.)

7/ For test year 1975-76, the staff calculates that the rate of return for Pacific would be 2.17 percentage points higher on a flow-through basis than on a normalization basis.

(2) The previously found imprudent management in failure to elect accelerated depreciation to avoid rewarding the utilities for their imprudence.

(3) Reflection of the phenomenon of inverse attrition, which is the opposite of the allowance for attrition that the Commission has used in the past as a regulatory tool where there is a projected diminution of the rate of return. Here, since the normalized tax reserve grows at a markedly greater rate than the other components of the utility's operations, the authorized rate of return would be exceeded in subsequent years because no reduction in rate base occurs between test years. The inverse attrition allowance set in the test year will reduce the rate of return in the future. (This is a step beyond the continuous surveillance method now in use, which only applies to earnings in excess of the authorized rate of return.)

LA recommends that ITC be treated in the same manner.

Toward Utility Rate Normalization's (TURN) Proposal

Turn proposes another method of compensating for the reduced risk of normalization by reducing the rate of return. It is calculated by discounting to present value the money which is accumulated in the deferred tax reserve and the measurement of that time value upon the rate of return allowed in addition to the normalization treatment. The method also applies to ITC using a three-year forward averaging amount (test year and two following years). In the beginning this method would produce a refund in excess of the refund produced by full flow-through.

Other Positions

Citizens Action League (CAL). CAL supports a greater sharing of the benefits of accelerated depreciation with ratepayers than exists under normalization accounting, and urges refunds be paid in cash rather than as a bill credit.

Continental Telephone Company of California. This company would be affected by our decision here only if a refund of toll revenues collected by Pacific should be ordered.

The Los Angeles Urban League. This organization seeks equal opportunities for blacks and other minorities in all sectors of our society and is concerned over a decision adverse to Pacific which would be disastrous to Pacific's minority hiring, firing, and promotion practices under Pacific's scenario of service and construction reductions.

Los Padrinos, Inc. This is a nonprofit charitable and educational corporation of predominantly Spanish-surnamed employees of Pacific. It is also concerned about the serious economic consequences depicted by Pacific's witnesses and urges the Commission to adopt an alternative which will preserve Pacific's eligibility for tax benefits.

The National Association for the Advancement of Colored People (NAACP). NAACP is a civil rights organization with the principal purpose of eliminating racial discrimination in every facet of American life. It urges the Commission to allow Pacific the full tax advantages of accelerated depreciation and ITC to preserve the employment of ethnic minorities and aid in employing the large number of unemployed black persons.

The Pacific Telephone Employees for Women's Affirmative Action, Southern California. This is an organization dedicated to aiding Pacific in achieving its affirmative action goals relating to women and urges action similar to the other above-mentioned groups.

Discussion

One of the major difficulties in the resolution of these cases is the length of time that has transpired between the onset of the problem and its latest submission for resolution. In Case 1 the court recognized then (in 1971) that one extreme or the other

in the solution would be harsh to either the utilities or the ratepayers. That proposition has now been exacerbated by the passage of years and many millions of dollars of increase in the deferred tax reserve. Now, in the event of the loss of eligibility for the tax benefits flowing from accelerated depreciation and ITC, Pacific estimates its total potential tax liability here from 1970 through the end of 1976 at $764 million, while General estimates its comparable liability at $223 million, or together almost $1 billion in potential tax liabilities. This is without regard for any rate refunds, ongoing rate reductions, and other costs that might be attributable to a retroactively assessed tax liability, such as the need for raising additional funds for plant investment, the deterioration in financial position, the necessity for increased interest rates and returns on debt and equity, and a myriad of other problems involved, not the least of which are the staggering rate increases that are foreseeable as the bottom line in such a scenario. We are seeking to resolve this dilemma in a middle ground, perhaps pleasing no one, but finally disposing of this problem by more suitably leveling the interest of the utilities and the ratepayers. Eligibility is the first issue to be determined. To render a decision which attempts to resolve these cases without regard for this issue might create problems for these utilities, their ratepayers, the Commission, and the Courts that even exceed (both in scope and complexity) the problems that we are attempting to resolve in this decision. In the final analysis a loss of eligibility to the utilities would not only create service problems (though certainly not of the scope described by Pacific's) but would create staggering financial problems to be ultimately

borne by the ratepayers whose interests we are attempting to redress. We believe that eligibility for these tax benefits should be maintained and proceed on this basis.

Accelerated Tax Depreciation

The parties recommend various positions which encompass the entire spectrum of possibilities from maintaining the status quo with normalization to a method which would refund more money than would be available under flow-through. While the alternatives submitted are plentiful, all are substantially variations on two themes: (1) reduction of rate of return; and (2) some form of reflecting the increase in the deferred tax reserve in order to further reduce the rate base (the annual adjustment method).

The utilities would prefer to maintain the status quo, though Pacific condescended to advocate what amounts to an annual rate case, merely holding the rate of return and any other test year adjustments constant while delving into the entire cost of service each year, a solution that will solve nothing while adding to the specter of regulatory lag.

General was somewhat more generous by offering additional variations on the annual adjustment, while offsetting the increased deferred tax reserve with increased federal tax expense.

The staff basically recommended full flow-through but as a concession to compromise supported a rate of return reduction based on reduced risk only for future rates and a refund based on full flow-through for the rates subject to refund. LA recommended a maximum two percentage point rate of return reduction for the current test year 1975-1976 for Pacific, although it supports flow-through as the only proper ratemaking approach.

For General's test years the rate of return difference between flow-through and normalization was .14 percentage

points in test year 1970, 1.39 in test year 1974, and 1.58 in test year 1976. (Staff Exhibit 45.) For Pacific, the pertinent years and comparable differences are as follows: Test year 1973, 1.52 percentage points; test year ending June 30, 1975, 2; test year ending June 30, 1976, 2.17. (Staff Exhibit 46.) The flow-through basis always produces a higher rate of return because the greater the dollar amount of depreciation differential is between straight-line and accelerated depreciation, the smaller the correlative federal tax expense is for the flow-through company, and the greater the earned rate of return.

While we agree that full flow-through is the proper and best ratemaking method, we shall not consider it further because both Pacific and General would be ineligible for accelerated depreciation and ITC if rates were set on a flow-through basis. We must look to some other alternative, proposed or encompassed in the entire range of possible alternatives.

All the variations on the theme of increasing the deferred tax reserve provide readily estimable items for the purpose of computing the necessary numbers to determine the gross revenue requirements and rates. On the other hand, the reduction in rate of return is subjective, highly judgmental, and most difficult of quantification, as all the parties concede. If we were to adopt reduction in rate of return, what number would we adopt? How is this number to be determined? Is the difference in rate of return because of reduced risk merely a function of the dollar difference, as suggested by LA's witness? (Exhibit 22, page 16.) If not, what other factors are used to compute the actual number? If we adopt reduction in rate of return based on the dollar differences, as computed by the staff, what justification is used to differentiate this return from the return based on normalization accounting? Do we reason that the entire reduction in rate of return is caused by the risk reduction, as we did in D.85627 (Southern California Gas Company)?

In D.83540, the decision on petition for rehearing in D.83162, we stated on page 4: "The impact of normalization upon risk, and hence upon rate of return, was taken into account in the Commission's deliberations and was one of the factors which caused us to reduce the equity return authorized for Pacific below that authorized for other California utilities of similar capital structure. The impact of normalization on Pacific's risk was not specifically discussed because it was not disputed; all parties, including Pacific, conceded that the authorization of normalization reduces risk below that which would otherwise result. This uncontradicted evidence was taken into account in fixing rate of return." To now say that we shall again reduce rate of return in D.83162 when we already conceded that it was taken into account in setting the original rate of return would be unfair as the reduced risk would be reflected twice in rate of return. We believe it fairer to use a variation of the annual adjustment proposed, which we will call the "averaged annual adjustment".

The theory of this method is simple: Because the increase in the deferred tax reserve is deducted from rate base, the authorized rate of return on the smaller rate base produces less revenue. The smaller amount of net revenues will then produce less tax expense since the taxable income will be decreased. Essentially, the total of the reduction in net revenues and the decreased tax expense, together with the adjustment for uncollectibles, amounts to the total gross revenue reduction.

General's expert witness testified (Exhibit 3, page 10): "If the deferred tax reserve is determined as of a time subsequent to the test period, tax expense for ratemaking purposes must be determined as of the same time." This principle is embodied in General's first alternative (pages 13 and 14, above), which remedies the alleged defect of the old pro forma method, which did not take into account tax expense for the same period used to calculate the reserve. (General's opening brief, page 16.) General's opening brief, page 16, describes the methodology, as follows: "...the deferred tax reserve is averaged three years into the future in the same fashion as pro forma normalization, and in addition, federal income tax expense is also averaged for the same three-year period by which test period tax expense and rate base is adjusted. The necessary correlation of the reserve and tax expense provided in the cited Treasury Regulation is thereby achieved (Exhibit 3, page 16)." This is exactly the methodology for the averaged annual adjustment.

General believes it fair to assume growth in the tax expense every year. The actual federal tax expense bears no direct relation to the increase in deferred tax reserve, but fluctuates independently of it. (Exhibit 36, Pacific; Exhibit 27, General.)[8/] TR 1.167(l)-(1)(h)(6) does not discuss revenue growth, nor the direction of federal tax expense, but only the time frame for two specific items. We think it equally fair to assume a tax expense for the averaged annual adjustment that decreases as the deferred tax reserve increases in each year to accurately reflect only the increase in deferred tax reserve in the same period of tax expense. Thus, we will hold constant

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8/ In addition, the effective actual tax rate has been generally declining.

all items of cost-of-service not directly dependent on the increase in deferred tax reserve. The computation starts with the test year figures. Using the latest available estimates, we will compute the reduction in net revenues resulting from the increased deferred tax reserve in each of the next three years, compute the resulting decrease in tax expense in each corresponding year, then average the deferred tax reserve and federal tax expense for the four-year period. These averaged annual adjustment figures for deferred tax reserve and federal tax expense will then be used in the current test years for the pending rate cases. For past years, the total of the decrease in net revenues and decrease in federal tax expense[9/] will be deducted from the gross revenues computed under normalization accounting, and the difference shall be refunded. Tables 1 and 2 (Appendices B and C) show the method and results for Pacific and General, respectively. Total refunds through December 31, 1977 for Pacific are $110,785,000 and for General are $40,230,000. The current rate reduction is $31,609,000 for Pacific and $6,571,000 for General,[10/] based on current test years and estimates for three succeeding years. The refund amounts contain interest at the rate of 7 percent per annum through December 31, 1977 from the time the rates were originally authorized and collection began. The deferred tax reserve amounts used are actual through 1976 and estimated thereafter.

9/ A small factor shall be added as appropriate to compensate for decreased uncollectibles and franchise taxes.

10/ This amount may be adjusted for more current estimates in A.55492 for Pacific.

Pacific's opening brief (pages 42 and 43) indicates that cost-of-service must include the total tax expense[11/] for the test period and the succeeding "pro forma" period. This means the tax expense for each of the future years will have to be estimated. While Pacific agrees that the regulations do not cover how tax expense must be estimated, it indicates that the same method used to estimate future deferred tax reserve must be used to estimate future tax expense or the procedure would be suspect and subject to IRS disapproval. No authority is cited nor is any specific method of estimating proposed, nor does the IRC and the treasury regulations direct or discuss the estimating process. We believe our method is direct, simple, and in full compliance with the applicable federal law. Eligibility will be maintained since the federal tax expense for cost-of-service purposes is computed for the same period as the deferred tax reserve. While we agree that it uses a bookkeeping fiction, it is no more fictitious, no more illogical, and no more unreasonable than the fictitious theory of normalization. In San Francisco v PUC (1971) 6 C 3d 119, 130-131, the court said "Both of the extreme methods (normalization and flow-through) involve a fictitious charge of federal tax expense... Since a fictitious figure must be used under either method it is not improper for the commission to use an additional fictitious factor to limit the harsh results. Insofar as the compromise would impose a lesser burden on Pacific than is permissible consistent with due process (lesser than the burden under imputed accelerated depreciation with flow-through), Pacific is not in a position to make due process objections." We adopt this reasoning here.

11/ General's exception to the Proposed Report makes this same point. Our discussion applies equally to this exception.

The averaged annual adjustment is actually a form of annual ratemaking. It is not objectionable because it uses assumed constants, as these are used in an ordinary test year projection, whether or not we are considering the deferred tax reserve and the tax expense in an isolated manner. If the test year is 1970 and the rates remain in effect until the next test year, which is 1974, we have assumed that the cost-of-service has remained constant for the years 1971, 1972, and 1973. This may be unrealistic, but clearly permissible under our authority and the law. On a normalization basis, we will do the same. We will compute the deferred tax reserve and the tax expense on a normalized basis for the test year, and thereafter until the next test year those items and all other elements of cost-of-service are deemed constant. We see no difference in taking the deferred tax reserve and computing the tax expense and the rates based on those two items (and their variables) for years subsequent to the test year and averaging them back into the test year. Though the method is different, the principle is identical to the ordinary test year principle. Nor is this subject to the objection that this is a flow-through subterfuge. Everything and every method proposed by any party, including normalization as used by the companies here, is a method of flow-through. Normalization, according to Pacific, saves the ratepayers a great deal of money compared to straight-line depreciation, and there is no question that it does. But it does not approach the only sensible and realistic method of setting rates--using the actual tax expense as the cost-of-service tax expense. The method being adopted here is a more equitable and realistic method of normalization than the other proposals and the best available now.

ITC

While we agree with the Supreme Court that the effect of accelerated depreciation and ITC is identical the laws and regulations respecting them differ substantially. Thus, the specific delineation of permissible ratemaking policies in regard to maintaining ITC eligibility as set forth in IRC Section 46, supra, requires a ratemaking treatment for ITC differing from that accorded accelerated depreciation.

There is no question that utilities which did not elect accelerated depreciation with flow-through prior to the effective date of TRA were ineligible to elect Option 3 (immediate flow-through of ITC when it became effective in December, 1971. In D.85627 (Southern California Gas Company (SoCal)), we imposed a rate of return reduction because of the reduced risk and increased cash flow generated in part as a result of SoCal's election of Option 2 for the years 1975 and 1976, when ITC was increased for those years from 4 to 10 percent for utility plant additions and from 7 to 10 percent for transmission plant additions.[12/] It is our position that ITC eligibility was not affected by D.85627. However, the Internal Revenue Service (IRS), in response to a request from SoCal, issued an alleged ruling (Exhibit 52) of which we were notified by letter dated November 22, 1976. In this alleged ruling the IRS concludes that ITC will not be available to SoCal for federal income tax purposes when the benefits to be derived therefrom are treated for ratemaking purposes in the manner provided in D.85627 (as affirmed by D.86117). Our Supreme Court has granted a writ of review on SoCal's appeal of D.85627 and 86117 and has heard oral argument on the matter. While the IRS ruling is not the final determination of this issue, we believe that a rate of return reduction is

12/ This increase in ITC was extended through 1980 in the bill signed into law on October 4, 1976.

not warranted in this proceeding in any event. We also, in this proceeding, reject the concept of a permanent reduction in rate of return for past as well as future rates, as recommended by some of the parties.

We do not believe a rate of return reduction to be any more of a subterfuge for accomplishing flow-through than any of the other methods presented here nor are we rejecting it for that reason. In a full rate case, all the elements of cost-of-service are considered in the process of arriving at a reasonable rate of return. Here, all the parties advocating this method base it solely on the number of dollars of desired refund, and not vice versa. In this proceeding, where we are addressing ourselves to changes in the level of ITC which may be expected to occur beyond the test year, we prefer a more precisely ascertainable result.[13] For these reasons we are adopting for the purposes of ITC and eligibility thereunder the only method that appears to encompass all the factors we desire, the annual adjustment. Sometime prior to the first day of each year after (and including) the test year, we shall recalculate the ITC for the coming year on the basis of the best estimates then available and shall adjust the rates accordingly at the beginning of the year to provide for the full year-to-year growth in the annual amount of ratable flow-through (Option 2). The difference in tax expense between that occurring on the test year because of Option 2 and that estimated for the adjustment year would be computed on the most recent estimate for eligible plant additions. The intrastate factor would be applied and the charge would be converted to revenue requirement

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13/ This reasoning applied equally to accelerated depreciation.

by the proper net-to-gross multiplier and applied as an adjustment to decision rates for the year following the test year. Thereafter, we shall delete the earliest year and use the next year to establish the tax expense difference, and adjust the then current rates.[14] For Pacific. the refund obligation through December 31, 1977 for ITC is $51,231,000 and the approximate current rate reduction is $23,346,000 (Table 3, Appendix D). For General, the comparable figures are $15,649,000 (gross) and $4,771,000 (Table 4, Appendix E).

We are rejecting all the other proposed treatments for varying reasons, principally that they either cause or tend to raise doubts about eligibility, or do not adequately redress the balance between the ratepayers and the utilities.

Imputed Flow-Through of Accelerated Depreciation

In reviewing the record of this proceeding it has come to our attention that certain old vintage plant additions were not previously considered in the ratemaking process. We shall discuss Pacific and General separately.

Pacific

In D.74917 dated November 6, 1968 we imputed flow-through of accelerated tax depreciation for 1967 vintage plant using a 1967 test year. In D.77984 dated November 24, 1970 (test year 1970) the normalization treatment for accelerated depreciation was ordered for Pacific. When this decision was annulled the rates reverted to those set in D.74917 (test year 1967). In D.80347 dated August 8, 1972 rates were increased

[14] Annual adjustments may also be implemented when a Commission decision becomes effective after the beginning of the first annual adjustment period. The first annual adjustment will merely be incorporated in any such decision.

using 1970 vintage plant additions to determine the flow-through of accelerated depreciation ordered there. The rates set in this final decision were effective until August 17, 1974, the effective date of the rates set in D.83162. The net effect of this history is that no accelerated depreciation for 1968 and 1969 vintage plant additions was ever reflected in Pacific's rates, even though our Supreme Court approved the imputed flow-through of accelerated depreciation.

In Exhibit 32 in A.53587 (and the A.51774 rehearing), this imputation was proposed for the two years in question. We shall adopt this recommendation. Further, we shall continue this imputation through Pacific's test years 1973 in D.83162 and 1974-1975 in D.85287 and shall order here an ongoing reduction in pending A.55492 (test year 1975-1976) for this flow-through item. These amounts are as follows:

Flow-Through of 1968 and 1969
Vintage Plant Additions
(Table 5, Appendix F)

(Dollars in Thousands)

D.83162 (Test Year 1973) 8/17/74 to 1/4/76	$24,158
D.85287 (Test Year 1974-75) 1/5/76 to 12/31/77	19,412
	$43,570
Ongoing reduction (TY 1975-76) A.55492	$ 5,539

SUMMARY OF PACIFIC REFUNDS AND
RATE REDUCTIONS THROUGH DECEMBER 31, 1977

(Dollars in Thousands)

REFUNDS

Accelerated Tax Depreciation (Table 1, Appendix B)	$110,785
ITC (Table 3, Appendix D)	51,231
Flow-Through of 1968 and 1969 Vintage (Table 5, Appendix F)	43,570
TOTAL REFUNDS	$205,586

RATE REDUCTIONS (A.55492)

Accelerated Tax Depreciation Table 1, Appendix B)	$ 31.609
ITC (Table 3, Appendix D)	23,346
Flow-Through of 1968 and 1969 Vintage (Table 5, Appendix F)	5,539
TOTAL RATE REDUCTIONS	$ 60,494
TOTAL REFUNDS AND RATE REDUCTIONS	$266,080

General

A similar situation exists for General but it is limited to 1969 vintage plant additions. In D.75873 dated July 1, 1969 we imputed flow-through of accelerated depreciation for 1968 vintage plant using a 1968 test year. In D.79367 dated November 22, 1971 increased rates were ordered using the normalization treatment of accelerated depreciation beginning with 1970 vintage plant additions. Thus, 1969 vintage plant additions were never reflected in General's rates, all of which have been subject to refund since D.79367.

In Exhibit 5-R in A.53935 (and the A.51904 rehearing), this imputation was proposed for 1969. We shall adopt this recommendation and shall continue this imputation from December 12, 1971 (the effective date of D.79367) through test years 1970 (D.79367), 1974 (D.83779), and 1976 (D.87505).

However, in Table 6 of Exhibit 2, General claimed credit for refunds and rate reductions already made as a result of the annulment of D.78851 of Pacific.[15/] In D.83778 dated November 26, 1974 we said, on page 41:

> "The refunds already made by General are attributable to the annulment of Decision No. 78851 while the settlement revenue losses to General are attributable to the annulment of that decision and also to the difference between Pacific's rates authorized in Decision No. 80347 and Pacific's annulled rates."

Failure to give General credit for these sums would amount to requiring double refunds. Since this would be inequitable, we are offsetting the losses already incurred against

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15/ This claim was also made in General's exceptions to the Proposed Report.

the refunds and rate reductions required of General by this decision.[16/]

SUMMARY OF GENERAL NET TOTAL REFUNDS AND RATE REDUCTIONS THROUGH DECEMBER 31, 1977

(Dollars in Thousands)

REFUNDS	
Accelerated Tax Depreciation (Table 2, Appendix C)	$34,987
ITC (Table 4, Appendix E)	15,363
Flow-Through of 1969 Vintage (Table 6, Appendix G)	
a. D.79367 (TY 1970) 12/12/71 to 12/20/74	9,244
b. D.83779 (TY 1974) 12/21/74 to 7/17/77	7,245
c. D.87505 (TY 1976) 7/18/77 to 12/31/77	670
TOTAL REFUNDS	$65,440
RATE REDUCTIONS (D.87505)	
Accelerated Tax Depreciation Table 2, Appendix C)	$ 6,571
ITC (Table 4, Appendix E)	4,771
Flow-Through of 1969 Vintage (Table 6, Appendix G)	1,311
TOTAL RATE REDUCTIONS	12,653
TOTAL REFUNDS AND RATE REDUCTIONS	$78,093

16/ In applying the credit, reductions are treated separately for 1971, 1972, and 1973 (from 1/1/73 to 9/22/73 only) and compared to refunds computed for those years, in accordance with the principle used by General in Exhibit 2, Table 6. Reductions in refunds are made first to the imputed flow-through refunds, then any remaining reduction is credited to ITC, and finally any remaining reduction is credited to accelerated tax depreciation. (See Table 7, Appendix H.)

Service

Pacific has depicted a service and employment scenario of horrendous proportions in the event it loses eligibility for accelerated depreciation and ITC, and assuming a back tax payment of $764 million, rate refunds of $73 million and an ongoing rate reduction of $62.6 million. In 1972 and 1973, however, Pacific refunded $176 million together with a rate reduction of $90 million and had no significant employee layoffs, no deterioration in service and no adverse effects on earnings.

Because the eligibility of both companies is unaffected in our judgment, we foresee no meaningful change in the operations and quality of service, number of employees, level of earnings, impairment of financial integrity, or other deleterious consequences as predicted by Pacific. Thus, the companies are put on notice that any deviation from their current service indices, objectives, standards, and our General Order No. 133 shall be monitored and, when appropriate, punished to the fullest extent of the law. For these purposes, we particularly emphasize Pacific's 1976 Service Objective List admitted as Exhibit 43 in its pending A.55492 as exemplary of the service standards expected, together with the ultimate determination, in the same proceeding, of the acceptable level of held primary orders.

Miscellaneous Contentions

Pacific and General have discussed many other points, some pertinent, some not. We shall briefly discuss due process, actual results of operations, confiscatory rates, retroactive ratemaking, credit for revenues authorized but uncollected, and settlement adjustments.

Pacific relies heavily on the case of West Ohio Gas Company (No. 2) v Public Utilities Commission (1935) 294 US 79. There the regulatory agency had, in setting a rate in 1933, chosen to rely exclusively on data from 1929, ignoring available revenue and expense data from 1930 and 1931. The court said this was an unconstitutional procedure. Our situation here is easily distinguishable, as we are taking into account the actual deferred tax reserve and ITC amounts for the past years and computing the functional variables from that actual number. Our Supreme Court in Los Angeles v PUC (1975) 15 C 3d 680, has already found this procedure to be proper since the tax expenses and reserves under accelerated depreciation vary abnormally with respect to the other components of a utility's finances. The court said on page 703, "Simply to recognize this fact is not to deny due process."

Further, the actual results of Pacific's operations indicate a financial picture much brighter than depicted by Pacific. It is true that the dividend on common stock has not been increased since 1961, as Pacific alleges, but that is a management decision which is not directly related to its per share earnings or any other indicia of financial progress. In 1961 Pacific had 104 million common shares outstanding while at the end of 1975 it had over 168 million such shares and contemplates over 181 million at the end of 1976. Thus, the total dividends paid now are approximately two-thirds greater than in 1961, to over $202 million in 1975. Further, the earnings per share increased from $1.46 in 1970 to $1.82 in 1975 and $2.06 in 1976, all on an increased number of outstanding shares. There has been an increase in the number of employees, an increase to earned surplus from 1972 to 1975 of the staggering sum of $245 million, and an increase in construction budget from 1971

to 1974 of $225 million. And this was all accomplished while refunding $176 million with an ongoing rate reduction of $90 million per year. If this be confiscation, let there be more of the same. In view of these facts, Pacific's arguments regarding confiscatory rates are untenable and rejected.

Neither do we agree with Pacific's position that the imposition of a penalty for imprudence would constitute improper retroactive and punitive ratemaking since this procedure has already been approved by the Supreme Court (6 C 3d 119). Penalties for imprudence, like penalties for civil or criminal wrong, have nothing to do with rates; they are punishment. But we are not imposing a penalty here; we are determining the proper basis for setting rates.

Pacific has suggested that it is appropriate, in the event the Commission orders a refund in this matter, to deduct from the amount of refund the revenues previously authorized but not collected because it has failed to earn its authorized rate of return. If rate of return has not been earned, the remedy for that, as clearly set forth by the court in 15 C3 680, is to seek rate relief, which both companies have done and are presently doing. Further, this recommendation would guarantee the authorized rate of return. Because it is axiomatic that this Commission does not guarantee the rate of return, but merely provides an opportunity to earn it, the requested credit would be inapposite.

Since our action will not render Pacific ineligible, we need not answer its argument that this would unduly burden interstate commerce, particularly as no evidence on this point was tendered.

The rates to be filed by the utilities pursuant to this order will, of course, reflect settlement payments between utilities. However, we will not authorize any retroactive settlement adjustments associated with refunds resulting from this order.

Refunds in the Form of Stock

It was suggested in the event a refund was ordered that it be accomplished via the issuance of capital stock of Pacific and General. The companies introduced a great deal of material setting forth the problems involved with this idea. The major potential problems are with the Securities & Exchange Commission, the difficulty of issuing minute fractional shares for small refunds to ratepayers, the large cost of such a program, and the Commission's authority to order such a securities issue. No party supported this concept in its present form. We shall not order it.

Refunds and Reductions

Refunds in the past have been made in direct proportion to the billing of the various customers without regard to class of service. In this case it was suggested that refunds be made only to residential customers on the theory that since business customers include telephone service cost as part of their cost of doing business, they are being paid by the consumer for the cost of the phone service. A refund theoretically would then create a windfall for the business phone customers since no refunds by the business customers would be made to its customers. It can also be argued, however, that the amount of any refund to the business customer would be used to reduce the cost of business for the period in question and thereby would be

reflected in lower or stable prices. In our opinion there is no evidence, one way or the other, in this proceeding to support either view.

Another suggestion was to refund to all customers on a per capita basis, meaning that the total amount of the refund would be divided by the total number of customers of the company and the same dollar amount refund would be given to each customer whether residential or business. Since the number of residential csstomers is much greater than business customers, and as residential revenues approach 50 percent, it is apparent that individual business customers on average pay much greater monthly revenues to the phone companies than the individual residential customers. This proposal, for example, would have the effect of giving the city of Los Angeles, General Motors, and every individual the same amount of refund. In the case of the residential customers, their refunds might well exceed their monthly bills.

Pacific and General will be directed to file proposed refund plans. Approval, disapproval, or modification of the proposed plans will follow by subsequent Commission order.

The ongoing prospective rate reductions ordered herein shall be reflected in rates for all current subscribers by a uniform proportional reduction in the recurring basic exchange primary service rates. To insure that rates for competitive services are not reduced (since those rates are generally priced as nearly as possible at full cost) we are directing that only rates for basic exchange primary service be reduced. With respect to central office centrex service the reductions shall be made on the trunk rate per station.

IRS Ruling Request

The companies have suggested that any proposed action changing the method of normalization now being used should allow the continuance of existing rates, either by putting the rates aside in a trust fund, as suggested by the Supreme Court, or keeping them subject to refund as at present, until such time as a ruling can be rendered by the IRS regarding the retention of eligibility under the method adopted by this Commission for treating the tax expense problems. This is based on the theory that if the IRS disapproves the proposed treatment the present method of accelerated depreciation shall continue in effect, or another proposed method may be submitted for a ruling. But the companies' requests provide no incentives to obtain an expeditious advance IRS ruling, and might lead to further delay in the implementation of the refunds contemplated in this order. Moreover, General's expert witness Nolan indicated that there are

some instances where the IRS will not issue an advance ruling, nor does the IRS necessarily advise in advance that it will not issue such a ruling. The supplicant merely waits and hopes. Nolan also said that the more difficult the problem, the more likely the IRS is to avoid issuing an advance ruling. We have here a case of first impression under the tax laws, and we think an advance ruling within a reasonable time is not probable. Moreover, the opportunities for such action by the utilities have been ample in the past, yet they took no such action. For these reasons we think that their proposals are inappropriate.

Exceptions to Proposed Report

We shall discuss here, where necessary, the exceptions that have not been discussed elsewhere in this opinion.

Pacific

Pacific's exceptions generally fall into two categories:

1. Since D.83162 was issued in August 1974, its earnings have been below the authorized rate of return and it is improper to order refunds and rate reductions in such circumstances. We have already discussed this point elsewhere, and concluded otherwise. There is nothing sufficiently meritorious in Pacific's exceptions in this area that have not been raised, discussed, and disposed of by this Commission, or our Supreme Court.

2. Pacific's eligibility for accelerated tax depreciation and ITC is endangered by the proposed treatment of these benefits.

(a) Accelerated Tax Depreciation. Pacific complains of the use of recorded data for historical periods, but in its brief cited the West Ohio Gas case (supra) as requiring the recognition of such data. Its position is inconsistent and varies

with the direction the wind is blowing. Further, there is no prohibition in proper ratemaking or the IRC sections in question which bar this procedure.

Pacific also complains of the failure to use the pro rata requirements in Treasury Regulation 1.167([illegible])-1(h)(6)(ii). It overlooks the discussion on page 3 of Exhibit 16 sponsored by staff witness John Quinley, where the use of the pro rata percentage of 46.33 is shown. Mr. Quinley explains the offsetting working cash adjustment which produces a combined effect of 50 percent as the proper figure to be used in determining the average deferred tax reserve and its ultimate revenue effect. Footnote 4, Table 1, Exhibit 16, reflects this combined effect, as does Footnote 4, Table 1, Exhibit 10-A (sponsored by Pacific), which uses the identical percentage as its Table 1 is identical to Table 1 of Exhibit 16.

The other exceptions with respect to accelerated depreciation have been either mentioned or explained elsewhere and merit no further discussion.

(b) Investment Tax Credit. Pacific cites proposed treasury regulations allegedly relating to its interpretation of our ITC treatment. These proposals in our judgment do not effect the validity of our treatment and have no force or effect, in any event, being mere proposals. We reiterate that our treatment of ITC is akin to an annual ratemaking procedure. We see nothing in law or logic that prohibits this treatment.

General

The thrust of General's exceptions relates to the alleged ineligibility for accelerated depreciation which would occur as a result of the treatment of that subject in the Proposed Report. General alleges that the total tax expense must be considered for the same period for which the deferred tax reserve is estimated, and the Proposed Report considers only the reduction in tax expenses. This is not the case, as the reduction in tax expense for years after the test year is used to reduce the test year tax expense used in the succeeding year. The effect is to reduce each succeeding year's tax expense, but the entire tax expense is used for the appropriate period. General also alleges that the proposed method is exactly like the old pro forma method, except for the time period. That is correct, because the failure to consider the deferred tax reserve for the same period as the tax expense is the alleged defect of the old pro forma method regarding eligibility. The Averaged Annual Adjustment remedies this defect by considering the two required items separately for the same period. While the effect is the same as pro forma, we are specifically complying with the existing tax laws by using a proper method to compute the revenue requirement. It must also be noted that this method complies exactly with the method (though not the assumptions) recommended by General and its witnesses.

We have already discussed and decided the other major exception: the double refund effect for revenues authorized but not collected because of Pacific's prior refunds.

There is no retroactive ratemaking involved here since all General's rates since November 22, 1971 have been subject to refund. The fact that ITC was not previously considered does not make it res adjudicata, nor does it prevent this Commission from reflecting its effect where possible. That is what we are doing by this decision.

LA

LA objects to the failure of the Proposed Report to decide the constitutionality of the relevant tax laws under the Tenth Amendment to the U.S. Constitution. We already decided that question in the affirmative in D.83778 and see no reason to go into the matter again.

We have previously discussed, directly or indirectly, all the other matters raised in LA's exceptions.

TURN

TURN filed two exceptions, one relating to its proposed method of determining the amount of refunds (discussed earlier), and the other relating to the effective date of the Proposed Report. We see no need to consider its exceptions.

Epilogue

We desire to discuss the wisdom of using the tax laws for the purpose of providing a capital subsidy (in this instance, phantom taxes) from the taxpayers (in this instance, the ratepayers) to a special interest group (in this instance, state-regulated utilities). This occurs because every dollar of taxes that the utilities pay is obtained in rates from the ratepayer, even when the utilities can defer, and perhaps never pay the taxes collected in rates. The regulators must essentially order two dollars to be paid to the utility by the ratepayer for each dollar in taxes avowedly to be paid by the utility. This seems to us to be a wasteful use of resources as well as a legally sanctioned subsidy to the utility from the ratepayer without the latter's consent. The money is not being contributed by investors in the usual manner, but is being contributed in the form of rates by the ratepayer on a two-for-one basis and not on a one-for-one basis, as is the case for traditional investment capital. The funds are being obtained from the ratepayers under the guise of taxes, while Congress has decreed that the money so collected as taxes need not be used as taxes by the utilities, but may be used by the utilities for whatever purposes they desire. There is no restriction on the use of these funds in the tax laws. The taxes collected, but not paid, in essence amount to a direct capital subsidy which the utilities may use as unrestricted capital. Nothing is paid to the ratepayers for this investment use of the ratepayers' money as would be paid to traditional investors. Thus, this is free capital, and this is occurring in a free enterprise system which traditionally rewards venture and investment capital!! Here, the converse is true.

The ratepayers are actually being penalized instead of being compensated for this subsidy. Their money is being involuntarily contributed on a two-for-one basis, and no return is forthcoming on any basis. We think this is grossly unfair and should be more forcefully presented by the utilities, by the regulatory agencies, and by consumer organizations. Congress has created a situation where in California both the utilities and the ratepayers feel they are being whipsawed by these tax laws and the actions of this Commission in attempting to be fair to all sides. This Commission believes that it has a legal duty to balance the interests of the utilities and the ratepayers and is attempting to do so, but finds itself more frequently hamstrung by the actions of Congress where it appears that the interests of the utility ratepayers are not adequately considered, for whatever reason.

What this Commission proposes and strongly supports, in lieu of this hidden subsidy and no-cost capital contribution to the utilities by the ratepayers (we mean at no cost to the utilities), is the elimination of the income tax upon regulated utilities to be replaced with a gross receipts tax (or, for energy and water utilities, a per unit of consumption tax), as a surcharge to all billings paid by the ratepayers, to be collected by the utilities and paid directly to the IRS. This surcharge would be indicated as such on the utility bills and would not be included in the utility cost-of-service. It could easily be structured to provide revenues to the treasury equivalent to that now being paid as income taxes by the utilities. It would eliminate the ratepayers' involuntary and hidden subsidy to the utilities because what they pay in gross receipts tax is what the IRS gets on a dollar-for-dollar basis. If the utilities desire to obtain funds from the ratepayers for the

purpose of expansion and investment, let it be done forthrightly by direct subsidy so the ratepayers will have knowledge and the opportunity for input. Let the ratepayers share in whatever benefits might accrue to the utility as the result of any such investment by the ratepayers. We see no reason why the ratepayers, in their role of capital investors, should not share in the fruits of their investment. We believe the tax laws are not the proper medium for the creation of involuntary investment capital. Tax law gimmickry should not tilt or distort the balance necessary between state-regulated utilities and ratepayers.

The gross receipts tax would simplify the job of Congress in levying taxes and simplify the job of the regulatory agencies in setting rates, while preserving the rights of both the utility and the ratepayers. It would create faster rate relief on the part of regulatory agencies and maintain the utilities on a solid financial basis, instead of requiring everyone involved in setting rates to go through a series of contortions and distortions to attempt to comply with or legally avoid the effect of the existing tax laws and the concomitant uncertainty and delay.

Findings

1. Pacific and General were imprudent in failing to select accelerated depreciation when that option was available under the federal tax laws. This imprudence denied the companies the option to elect flow-through accounting for ITC and accelerated depreciation purposes.

2. Flow-through of the tax benefits accruing under accelerated depreciation and ITC is the best method of handling these benefits for the purpose of balancing the interest of the ratepayers and the companies for ratemaking purposes.

3. Pacific and General are ineligible to elect flow-through accounting for accelerated depreciation and ITC for ratemaking purposes pursuant to IRC Section 167, et seq. and Treasury Regulation 1.167, et seq. Normalization accounting is the most appropriate method available to Pacific and General. Under the normalization method we are adopting for ratemaking purposes, tax depreciation expense for ratemaking purposes will be computed on a straight-line basis while federal taxes will be computed on an accelerated depreciation basis. The difference between the two tax computations will be accounted for in a deferred tax reserve. The average sum of the test year deferred tax reserve and the deferred tax reserve for the three next subsequent years shall be deducted from rate base in the test year. As a result of each of the deductions from rate base federal tax expense will be recomputed on the same basis in the test year for the test year and the three corresponding subsequent years, thus matching the estimated tax deferral amount for each period with the estimated federal tax expense for the same period. This method complies with Treasury Regulation 1.167(ℓ)-(1)(h)(6) and is normalization accounting.

4. For ITC we shall make an adjustment prior to the end of each calendar year (or as soon thereafter as possible) for the rates to be set beginning January 1 of the next calendar year taking into account at that time the growth in the amount of ITC estimated for the next immediate future calendar year as compared to the last test year (or last preceding year), and recomputing federal tax expense and gross revenue requirements based on that new estimate for each year between rate cases. This method complies with the requirements of ratable (service life) flow-through selected by the utilities under IRC Section 46.

5. The methods described in Findings 3 and 4 are an attempt to more accurately reflect in rates the abnormal growth in these reserves compared to the other components of cost-of-service used in computing rates.

6. The methods adopted in this order as described in Findings 3 and 4 comply with the mandate of the California Supreme Court set forth in City of Los Angeles v Public Utilities Commission (1975) 15 C 3d 680.

7. The methods described in Findings 3 and 4 fairly balance the interests of the ratepayers and the utilities and avoid harsh results to either as a result of the tax benefits accruing under accelerated depreciation and ITC.

8. The amount to be refunded by Pacific to its ratepayers under the method described in Finding 3 for accelerated depreciation is $110,7[illegible]5,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Table 1. The current rate reduction under this method is $31,609,000.

9. The gross amount to be refunded by General to its ratepayers under the method described in Finding 3 for accelerated depreciation is $40,230,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Tables 2 and 7. The current rate reduction under this method is $6,571,000.

10. The amount to be refunded by Pacific to its ratepayers under the method described in Finding 4 for ITC is $51,231,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Table 3. The current rate reduction under this method is $23,346,000.

11. The gross amount to be refunded by General to its ratepayers under the method described in Finding 4 for ITC is $15,649,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Table 4. The current rate reduction under this method is $4,771,000.

12. The maintenance of eligibility under the federal tax laws to allow Pacific and General to use accelerated depreciation and ITC is beneficial to both the ratepayers and the utilities and is an important goal of this Commission in this decision.

13. It is reasonable to order a uniform proportional reduction in the recurring basic exchange primary service rates. With respect to central office centrex service it is reasonable to make the reductions on the trunk rate per station.

14. It is reasonable to impute flow-through of 1968 and 1969 vintage plant additions for Pacific and 1969 vintage plant additions for General, as the Supreme Court has previously approved this procedure in San Francisco v PUC (1971) 6 C 3 119, and accelerated depreciation of these vintages has never been reflected in rates.

15. A gross receipts tax surcharge would abolish the "two-for-one" collection of income taxes from the ratepayers in rate setting for utilities and would allow lower utility rates since the gross receipts tax would allow a dollar-for-dollar collection of taxes paid by the utilities to the federal government.

16. As long as plant investment of the utility continues to expand, the deferred tax reserve is actually a tax saving and not a tax deferral.

17. It is unfair and unreasonable to use the tax laws to create investment dollars flowing from the ratepayers to the utilities on which the ratepayers do not receive any return.

18. The gross receipts tax surcharge would eliminate the involuntary capital contribution incurred by the ratepayers and would abolish the windfall to the utilities by allowing them to collect taxes from the ratepayers which they may never have to pay.

19. The investment tax credit is a tax saving and not a tax deferral.

20. A gross receipts tax surcharge will prevent the distortion of the tax laws to create subsidies from the ratepayers to the utilities in the setting of rates.

21. In computing the refunds and rate reductions computed herein, this Commission has used recorded figures, where available, for the periods in question.

22. The reduction and refunds of rates authorized by this decision are justified and reasonable, and the present rates as they differ from those prescribed therein, are for the future unjust and unreasonable.

23. No revenue adjustments for settlements by Pacific and General with interconnecting carriers will be allowed for the refund period.

24. The amount to be refunded by Pacific to its ratepayers pursuant to Finding 14 is $43,570,000, including interest at 7 percent per annum from the date of the respective order entered from which refunds are being required, as set forth in Appendix F. The current rate reduction under this method is $5,539,000.

25. Because of revenues authorized, but not collected, General is entitled to credit for certain sums refunded and lower rates set due to San Francisco v PUC (1971) 6 C 3 119 and D.78851 of Pacific. It is reasonable to offset these amounts against the other refunds required herein, on an annual basis only, first reducing the imputed flow-through of accelerated depreciation under Finding 14, then the ITC refund, and lastly, the accelerated tax depreciation refund.

26. The net amount to be refunded by General to its ratepayers, pursuant to Findings 14 and 25, is $17,159,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Appendix G. The current rate reduction under this method is $1,311,000.

27. As a result of Finding 25, the refunds due from General, pursuant to Findings 9 and 11, are reduced to the net sums of $34,453,000 (Finding 9) and $13,828,000 (Finding 11).

28. The total net refunds due from Pacific and General, and the total current and/or ongoing rate reductions required respectively, are summarized in the tables contained on page 32 (for Pacific) and page 34 (for General).

Conclusions

1. The methods described in Findings 3 and 4 maintain the eligibility of the utilities to use accelerated depreciation and ITC and comply with the requirements of the Internal Revenue Code relating to Pacific and General.

2. This Commission does not guarantee the utility the rate of return authorized in rate proceedings, but merely provides an opportunity to earn that return.

3. The method described in Finding 3 for accelerated depreciation for Pacific and General is a normalization method of accounting.

4. The method contained in Finding 4 for ITC complies with the ratable (service life) flow-through option of ITC under IRC Section 46.

5. The imputation of flow-through of the accelerated tax depreciation benefits for 1968 and 1969 vintage plant additions for Pacific and 1969 vintage plant additions for General is a proper ratemaking procedure and does not affect eligibility under the TRA of 1969.

6. The rates being set herein are not confiscatory.

7. The offset allowed General due to the revenues authorized, but not realized, is a proper ratemaking procedure.

8. There is no retroactive ratemaking ordered in this decision.

ORDER

IT IS ORDERED that:

1. The Pacific Telephone and Telegraph Company shall refund the sum of $205,586,000 (computed as of December 31, 1977), being the total of the amounts due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, and accelerated depreciation for 1968 and 1969 vintage plant addition on a flow-through basis, as determined herein pursuant to Findings 3, 4, and 14. This amount includes interest at the rate of 7 percent per year from the respective effective dates of the rates being refunded.

2. General Telephone Company of California shall refund the sum of $65,440,000 (computed as of December 31, 1977), being the net total of the amounts due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, accelerated depreciation for 1969 vintage plant additions on a flow-through basis, and certain offsets thereto, as determined herein pursuant to Findings 3, 4, 14, and 25. This amount includes interest at the rate of 7 percent per year from the respective effective dates of the rates being refunded.

3. The Pacific Telephone and Telegraph Company and General Telephone Company of California shall prepare and file refund plans for all current (at the time of filing of the plan) subscribers. This plan shall be filed within thirty days after the effective date of this order. This plan must be approved by an order or resolution of the Commission.

4. The methods described in Findings 3, 4, and 14 shall be applied to all future rates of The Pacific Telephone and Telegraph Company and General Telephone Company of California.

5. The filings required for the continuous surveillance of earned rate of return as previously ordered in D.83540 and D.83778 are no longer required.

6. The Pacific Telephone and Telegraph Company shall reduce current rates by the sum of $60,494,000 (computed as of December 31, 1977), being the total of the reductions due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, and accelerated depreciation for 1968 and 1969 vintage plant additions on a flow-through basis, as determined herein pursuant to Findings 3, 4, and 14.

7. General Telephone Company of California shall reduce current rates by the sum of $12,653,000 (computed as of December 31, 1977), being the net total of the reductions due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, accelerated depreciation for 1969 vintage plant additions on a flow-through basis, and certain offsets thereto, as determined pursuant to Findings 3, 4, 14, and 25.

8. The Pacific Telephone and Telegraph Company and General Telephone Company of California shall prepare and file tariffs reflecting such reductions on a uniform proportional basis on recurring basic exchange primary service rates, and with respect to central office centrex service the reductions shall be made on the trunk rate per station. Such tariffs shall be filed within thirty days after the effective date of this order and shall not become effective until approved by order or resolution of this Commission.

9. Pacific and General shall not recompute intercompany EAS or other settlement amounts between themselves or with other independent companies as a result of the refunds or rate adjustments ordered herein except for business done on or after the effective date of this order.

10. In the event the refund plans and tariffs required to be filed by this order are effective after December 31, 1977, the amounts shown in Ordering Paragraphs 1, 2, 6, and 7 shall be recomputed to the appropriate effective date of the refund plan or tariff filing, with interest as computed in Ordering Paragraphs 1 and 2.

The effective date of this order shall be twenty days after the date hereof.

Dated at San Francisco, California, this 13th day of September, 1977.

I will file a dissent.
William Symons, Jr.

I will file a concurrence
Richard D. Gravelle
Claire T. Dedrick

I will file a written dissent
Vernon L. Sturgeon

Robert Batinovich
President

Richard D. Gravelle
Claire T. Dedrick
Commissioners

APPENDIX A

LIST OF APPEARANCES

Applicants: Robert M. Ralls and Robert Dalenberg, Attorneys at Law, for The Pacific Telephone and Telegraph Company; John Robert Jones, A. M. Hart, and H. Ralph Snyder, Jr., Attorneys at Law, for General Telephone Company of California.

Interested Parties: Thomas M. O'Connor, City Attorney, and Robert Laughead, for City and County of San Francisco; Robert W. Russell and Manuel Kroman, for Department of Public Utilities & Transportation, City of Los Angeles; George R. Gilmour, Attorney at Law, for TURN; James F. Crafts, Jr., Attorney at Law, and Del Williams, for Continental Telephone Company; Louis Possner, for City of Long Beach; John W. Witt, City Attorney, by William S. Shaffran, Deputy City Attorney, for City of San Diego; Alexander Googooian, City Attorney, for City of Bellflower; Burt Pines, City Attorney, by Leonard L. Snaider, Deputy City Attorney, for City of Los Angeles; Jack Krinsky, for Ad Visor, Inc.; Dina G. Beaumont, for Communications Workers of America; Thelma Garcia, for Pacific Telephone Women Employees for Affirmative Action; Joseph J. Salazar, for Los Padrinos, Inc.; William M. Bennett, Attorney at Law, for Consumers Arise Now, and himself; Diamantes P. Katsikaris, for Independent Taxpayers Union of California, Inc.; Timothy J. Sampson, for Citizens Action League; and John Mack, by Ballard W. Brooks, for Los Angeles Urban League.

Commission Staff: Timothy Treacy, Attorney at Law, J. D. Quinley, and K. K. Chew.

TABLE 1

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
INTRASTATE OPERATIONS

COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO LIBERALIZED TAX DEPRECIATION

Test Year	Depreciation Differential[1]	Federal Tax Effect[1]	Average Reserve for Deferred Taxes[1]	Net Revenue Reduction: Normalization[2]	Net Revenue Reduction: Average Annual Adjustment[3]	Net Revenue Reduction: Additional Net Reduction[4]	Federal Income Tax Reduction[5]	Other Gross Revenue Effects[6]	Gross Revenue Reduction Over Normalization[7]	Refunds by Decision and Year's Rates Effective: Year	Refunds by Decision and Year's Rates Effective: Refund[8]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
					(DOLLARS IN THOUSANDS)						
1973	$148,963	$ 71,502	$136,787	$12,106	$24,418	$12,312	$11,364	$480	$24,156	1974	$ 11,501[9]
										1975	30,623[9]
										1976	356[9]
1974-5	207,825[12]	99,756	267,925[12]	23,711	38,687	14,976	13,823	644	29,443	1976	33,836[10]
										1977	34,469[10]
							Total Refunds Through December 31,			1977	$110,785
1975-6	235,807[12]	113,187	374,396[12]	33,134	49,212	16,078	14,840	691	31,609	1978	31,609[11]
							Annual Ongoing Reduction in Excess of Normalization				$31,609

TABLE 1

NOTES

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
INTRASTATE OPERATIONS

1/ Exhibit 10-A, Table 1, Columns (A) and (D).
Tax at 48% of Column (A).

2/ Exhibit 10-A, Table 2, Normalization ÷ NTG
(1.962 for 1973 and 1.966 for other test periods).

3/ Exhibit 16-A, Table 2-A, Column (B) ÷ NTG.

4/ Column (E) minus Column (D).

5/ Column (F) x .92307 /(F) x .48/1 - .48/.

6/ Effects of state income tax and uncollectibles
(.039 x Col. (F) for T.Y. 1973 and .043 x Col. (F)
for T.Y. 1974-75 and 1975-76).

7/ (F) + (G) + (H).

8/ Col. (I) adjusted as per Exhibit 34, page 4 and
Exhibit 41. Interest added at the rate of 7% per
year for 1974-77.

9/ D.83162 rates effective 8-17-74 to 1-4-76.

10/ D.85287 rates effective 1-5-76.

11/ A.55492 test year data adjusted to most recent estimates.

12/ Average of two calendar years.

TABLE 2

GENERAL TELEPHONE COMPANY OF CALIFORNIA
INTRASTATE OPERATIONS

COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO LIBERALIZED TAX DEPRECIATION

Test Year	Depreciation Differential 1/	Federal Tax Effect 1/	Average Reserve for Deferred Taxes 1/	Net Revenue Reduction: Normalization 2/	Net Revenue Reduction: Average Annual Adjustment 3/	Net Revenue Reduction: Additional Net Reduction 4/	Federal Income Tax Reduction 5/	Other Gross Revenue Effects 6/	Gross Revenue Reduction Over Normalization 7/	Refunds by Decision and Year's Rates Effective: Year	Refunds by Decision and Year's Rates Effective: Refund 8/
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
					(DOLLARS IN THOUSANDS)						
1970	$ 3,565	$ 1,711	$ 856	$ 71	$ 1,621	$1,550	$1,431	$255	$3,236	-	-
										1971	$ - 9/12/
										1972	- 9/12/
										1973	5,398 9/
										1974	5,203 9/
1974	45,881	22,023	65,669	5,812	8,797	2,985	2,755	594	6,334	1974	230 10/
										1975	7,986 10/
										1976	8,052 10/
										1977	4,255 10/
1976	47,519	22,809	110,507	9,780	12,865	3,085	2,843	638	6,571	1977	3,329 11/
							Total Refunds Through December 31,			1977	$34,453
										1978	6,571 11/
							Annual Ongoing Reduction in Excess of Normalization				$ 6,571

A.53587, et al. SW/dz/bl *

TABLE 2

NOTES

GENERAL TELEPHONE COMPANY OF CALIFORNIA
INTRASTATE OPERATIONS

1/ Exhibit 2, Table 1, Columns (A), (B), and (D).

2/ Exhibit 2, Table 2, Normalization ÷ NTG (2.087 for T.Y. 1970 and 2.113 for T.Y. 1974 and 1976).

3/ Exhibit 6-A, Table 2-A, Column (B) ÷ NTG.

4/ Column (E) minus Column (D).

5/ Column (F) x .92307 [(F) x .48/1-.48].

6/ Effects of state income tax and uncollectibles (.1645 x Col. (F) for T.Y. 1970, .1990 x Col. (F) for T.Y. 1974 and .20695 x Col. (F) for T.Y. 1976).

7/ (F) + (G) + (H).

8/ Column (I) adjusted as per Exhibit 25, Table A-A-2. Interest added at the rate of 7% per year for 1971-77.

9/ D.79367 rates effective 12-12-71 to 12-20-74.

10/ D.83779 rates effective 12-21-74 to 7-17-77.

11/ D.87505 rates effective 7-18-77. Test year data adjusted to most recent estimates.

12/ Adjustments for revenues not collected are shown on Table 7.

TABLE 3

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
INTRASTATE OPERATIONS

COMPUTATION OF REFUNDS AND 1978 REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO INVESTMENT TAX CREDIT

Test Year (Adjustment Year)	Investment Credit Realized[1/]	Net Revenue Reduction: Service Life Flow-Through[2/]	Net Revenue Reduction: Annual Adjustment[3/]	Net Revenue Reduction: Additional Net Reduction[4/]	Federal Income Tax Reduction[5/]	Other Gross Revenue Effects[6/]	Gross Revenue Reduction Over Service Life Flow-Through[7/]	Refunds by Decision and Year's Rates Effective: Year	Refunds by Decision and Year's Rates Effective: Refund[8/]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)
(Dollars in Thousands)									
1973	$22,028	$ 3,249	$ 3,249	$ -	$ -	$ -	$ -	-	$ -
(1974)	24,901	3,249	4,805	1,556	1,437	60	3,053	1974	1,411[9/]
(1975)	62,157	3,249	9,025	5,776	5,332	225	11,333	1975	13,302[9/]
(1976)	65,983	3,249	13,315	10,066	9,291	392	19,749	1976	245[9/]
1974-75	43,529[12/]	6,915[12/]	6,915[12/]	-	-	-	-		
(1976)	65,983	6,915	13,315	6,400	5,907	275	12,582	1976	13,611[10/]
(1977)	71,965	6,915	17,994	11,079	10,226	476	21,781	1977	22,662[10/]
					Total Refunds Through December 31, 1977				$51,231
1975-76	64,070[12/]	11,170[12/]	11,170[12/]	-	-	-	-		
(1977)	71,965	11,170[13/]	17,994[13/]	6,824	6,299	293	13,416	1978	23,346[11/]
(1978)	77,683	11,170	23,045	11,875	10,960	511	23,346		
				Year 1978 Reduction in Excess of Service Life Flow-Through					$23,346

TABLE 3

NOTES

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
INTRASTATE OPERATIONS

1/ Exhibit 10-A, Table 3, Column (A).

2/ Exhibit 10-A, Table 3, Column (D).

3/ Exhibit 10-A, Table 3, Column (D) in adjustment year.

4/ Column (C) minus Column (B). Note duplication of amounts for 1974, 1975, and 1976.

5/ Column (D) x .92307 /(D) x .48/1-.48/.

6/ Effects of state income tax and uncollectibles (.039 x Col. (D) for T.Y. 1973 and .043 x Col. (D) for T.Y. 1974-75 and 1975-76).

7/ Columns (D) + (E) + (F).

8/ Column (G) adjusted as per Exhibit 40, Computation Method 2. Interest added at the rate of 7% per year for 1974-77.

9/ D.83162 rates effective 8-17-74 to 1-4-76.

10/ D.85287 rates effective 1-5-76. One-half 1977 included.

11/ A.55492 test year data adjusted to most recent estimates. 1978 reduction, Column (G).

12/ Average of two calendar years.

13/ Adjusted as 10/4 times amounts shown in Exhibit 10-A, Table 3 for 1977 in order to approximately reflect the 10% Investment Credit available under the Tax Reform Act of 1976.

TABLE 4

GENERAL TELEPHONE COMPANY OF CALIFORNIA
INTRASTATE OPERATIONS

COMPUTATION OF REFUNDS AND 1978 REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO INVESTMENT TAX CREDIT

Test Year (Adjustment Year)	Investment Credit Realized 1/	Net Revenue Reduction: Service Life Flow-Through 2/	Net Revenue Reduction: Annual Adjustment 3/	Net Revenue Reduction: Additional Net Reduction 4/	Federal Income Tax Reduction 5/	Other Gross Revenue Effects 6/	Gross Revenue Reduction Over Service Life Flow-Through 7/	Refunds by Decision and Year's Rates Effective: Year	Refunds by Decision and Year's Rates Effective: Refund 8/
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)
				(Dollars in Thousands)					
1970	-	-	-	-	-	-	-	-	-
(1971)	$ 2,802	$ -	$ 200	$ 200	$ 185	$ 33	$ 418	1971	$ - 9/ 13/
(1972)	5,119	-	420	420	388	69	877	1972	- 9/ 13/
(1973)	4,477	-	718	718	663	118	1,499	1973	1,520 9/ 13/
(1974)	5,006	-	1,052	1,052	971	173	2,196	1974	2,664 9/
1974	5,006	1,052	1,052	-	-	-	-	-	-
(1975)	9,845	1,052	1,708	656	605	131	1,392	1975	1,632 10/
(1976)	12,267	1,052	2,526	1,474	1,360	294	3,128	1976	3,428 10/
(1977)	20,093	1,052	3,866	2,814	2,597	561	5,972	1977	3,267 10/
1976	12,267	2,526	2,526	-	-	-	-	-	-
(1977)	20,093 12/	2,526 12/	3,866 12/	1,340	1,237	277	2,854	-	1,317 11/
					Total Refunds Through December 31, 1977				$13,828
(1978)	13,495	2,526	4,766	2,240	2,067	464	4,771	1978	4,771 11/
				Year 1978 Reduction in Excess of Service Life Flow-Through					$ 4,771

TABLE 4

NOTES

GENERAL TELEPHONE COMPANY OF CALIFORNIA
INTRASTATE OPERATIONS

1/ Exhibit 2, Table 3, Column (A). Note duplication of amounts for 1974 and 1976.

2/ Exhibit 6, Table 3, Column (D).

3/ Exhibit 6, Table 3, Column (D) in adjustment year.

4/ Column (C) minus Column (B).

5/ Column (D) x .92307 /(D) x .48/1-.48/.

6/ Effects of state income tax and uncollectibles. (.1645 x Col. (D) for T.Y. 1970 and .1990 x Col. (D) for T.Y. 1974 and .20695 x Col. (D) for T.Y. 1976).

7/ Columns (D) + (E) + (F).

8/ Column (G) adjusted as per Exhibit 25, Table 8-A. Interest added at the rate of 7% per year for 1971-77.

9/ D.79367 rates effective 12-12-71 to 12-20-74.

10/ D.83779 rates effective 12-21-74 to 7-17-77.

11/ D.87505 rates effective 7-18-77. Test year data adjusted to most recent estimates.

12/ Adjusted as 10/4 times amounts shown in Exhibit 6, Table 3 for 1977 in order to approximately reflect the 10% investment credit under the Tax Reform Act of 1976.

13/ Adjustments for revenues not collected are shown on Table 7.

APPENDIX F

Table 5

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
INTRASTATE OPERATIONS

COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO IMPUTED FLOW-THROUGH OF ACCELERATED TAX DEPRECIATION FOR VINTAGE YEAR 1968 AND 1969 PLANT ADDITIONS

Test Year	Federal Tax Effect of Accelerated Tax Depreciation-First Year		Additional Net Revenue Reduction Vintage Year 1968-1969 Additions[3]	Federal Income Tax Reduction[4]	Other Gross Revenue Effects[5]	Additional Gross Revenue Reduction[6]	Refunds by Decision and Year's Rates Effective	
	1970[1]	1968[2]					Year	Refund[7]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)
			(DOLLARS IN THOUSANDS)					
1973	$43,131	$50,132	$7,001	$6,462	$273	$13,736	1974	$ 6,540[8]
							1975	17,415[8]
							1976	203[8]
1974-5	57,103	61,359	4,256	3,929	183	8,368	1976	9,616[9]
							1977	9,796[9]
				Total Refunds Through December 31,			1977	$43,570
1975-6	65,782	68,599	2,817	2,600	122	5,539	1978	5,539[10]
						Annual Ongoing Reduction		$ 5,539

APPENDIX F
Page 2 of 2

TABLE 5

NOTES

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
INTRASTATE OPERATIONS

1/ Exhibit 32 in A.53587, Table II, Column (a), Tax Depreciation x 48%. For fiscal years, use average of calendar years.

2/ Exhibit 32 in A.53587, Table II-A, Column (a), Tax Depreciation x 48%. For fiscal years, use average of calendar years.

3/ Column (B) minus Column (A).

4/ Column (C) x .92307 ((C) x .48/1 - .48).

5/ Effects of state income tax and uncollectibles (.039 x Col. (C) for T.Y. 1973 and .043 x Col. (C) for T.Y. 1974-75 and 1975-76).

6/ (C) + (D) + (E).

7/ Col. (I) adjusted as per Exhibit 34, page 4 and Exhibit 41. Interest added at the rate of 7% per year for 1974-77.

8/ D.83162 rates effective 8-17-74 to 1-4-76.

9/ D.85287 rates effective 1-5-76.

10/ A.55492 test year data adjusted to most recent estimates.

11/ Average of two calendar years.

Table 6

GENERAL TELEPHONE COMPANY OF CALIFORNIA
INTRASTATE OPERATIONS

COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO IMPUTED FLOW-THROUGH OF ACCELERATED TAX DEPRECIATION FOR VINTAGE YEAR 1969 PLANT ADDITIONS

Test Year	Federal Tax Effect of Accelerated Tax Depreciation-First Year		Additional Net Revenue Reduction Vintage Year 1969 Additions[3]	Federal Income Tax Reduction[4]	Other Gross Revenue Effects[5]	Additional Gross Revenue Reduction[6]	Refunds by Decision and Year's Rates Effective	
	1970[1]	1969[2]					Year	Refund[7]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)
			(DOLLARS IN THOUSANDS)					
1970	$ 1,811	$ 3,963	$2,152	$1,986	$353	$4,491	-	-
							1971	[8] [11]
							1972	[8] [11]
							1973	$ 2,015[8] [11]
							1974	7,229[8]
1974	11,001	12,055	1,054	973	209	2,236	1974	81[9]
							1975	2,819[9]
							1976	2,843[9]
							1977	1,502[9]
1976	13,789	14,410	621	573	128	1,322	1977	670[10]
				Total Refunds Through December 31,			1977	$17,159
							1978	1,311[10]
					Annual Ongoing Reduction			$ 1,311

TABLE 6

NOTES

GENERAL TELEPHONE COMPANY OF CALIFORNIA
INTRASTATE OPERATIONS

1/ Exhibit 5-R in A.53935 and A.51904 Rehearing, Table I, Column (a) Tax Depreciation x 48% x intrastate factors of .891 for T.Y. 1970, .873 for T.Y. 1974, and .855 for T.Y. 1976.

2/ Exhibit 5-R, Table I-A, Column (a), Tax Depreciation x 48% x intrastate factors as in Footnote 1, above.

3/ Column (B) minus Column (A).

4/ Column (C) x .92307 ((C)x .48/1-.48).

5/ Effects of state income tax and uncollectibles (.1645 x Col. (C) for T.Y. 1970, .1990 x Col. (C) for T.Y. 1974, and .20695 x Col. (C) for T.Y. 1976).

6/ (C) + (D) + (E).

7/ Column (H) adjusted as per Exhibit 25, Table A-A-2. Interest added at the rate of 7% per year for 1971-77.

8/ D.79367 rates effective 12-12-71 to 12-20-74.

9/ D.83779 rates effective 12-21-74 to 7-17-77.

10/ D.87505 rates effective 7-18-77. Test year data adjusted to most recent estimates.

11/ Adjustments for revenues not collected are shown on Table 7.

APPENDIX H

Table 7

GENERAL TELEPHONE COMPANY OF CALIFORNIA
INTRASTATE OPERATIONS

ADJUSTMENTS TO TABLES 2, 4, AND 6
FOR REVENUES NOT COLLECTED

Line No.	Item	Gross Revenue Reductions		
		12-12-71 to 12-31-71	1972	1-1-73 to 9-22-73
		(A)	(B)	(C)
		(Dollars in Thousands)		
1	Total Revenues Not Collected[1/]	$ 846	$12,601	$4,372
2	Line 1 Adjusted to 12-31-77 Refund Levels[2/]	1,313	18,889	5,963
	Refund Offset by Line 2			
3	Imputed Flow-Through	377	7,616	5,476
4	Investment Tax Credit	35	1,299	487
5	Liberalized Tax Depreciation	291	5,486	-
6	Remaining Revenues Not Collected[3/]	393	2,994	-

1/ Exhibit 2, Table 6, line 15 (adjusted for D.83778 refunds).

2/ Adjusted by including interest to match refund amounts.

3/ Line 2, less lines 4, 5, and 6, divided by interest factor.

A. 53587, et al.
Decision No.

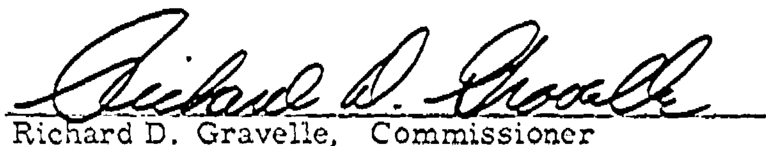
COMMISSIONER RICHARD D. GRAVELLE, CONCURRING.

COMMISSIONER CLAIRE T. DEDRICK, CONCURRING.

We concur.

Today's decision, while attributed to this Commission, is not really ours. We are merely the instrument of delivery. This decision was spawned by the Bell System; nurtured by Congress; brought through adolescence by the efforts of our staff, the cities of San Francisco, Los Angeles, San Diego, and TURN; shaped into maturity by the California Supreme Court; and finally left to us for mere refinement. The entity most responsible for the result of the order as it stands is the Court, which clearly mandated us to achieve a balance between utility and ratepayer which we have finally done. We have also protected eligibility by carefully remaining within the confines of the tax laws and regulations. No one, however, should be confused on the latter point. The ultimate verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be.

San Francisco, California
September 13, 1977



Richard D. Gravelle, Commissioner

Claire T. Dedrick, Commissioner

A. 53587 - D.

PACIFIC TELEPHONE & TELEGRAPH COMPANY
GENERAL TELEPHONE COMPANY OF CALIFORNIA

Re: Accelerated Depreciation and Investment Tax Credit

COMMISSIONER WILLIAM SYMONS, JR., Dissenting

California stands to lose at least a billion dollars, with nothing to gain, as the Public Utilities Commission majority again plays brinkmanship with the United States Government. There is no need to recklessly risk eligibility for such enormous sums in federal tax deferrals and federal tax forgiveness.

Congress enacted the federal tax laws, and in order to qualify for specific federal tax benefits, it is realistic to expect that the intentions of Congress be respected. Eligibility under the federal tax laws makes it possible for the communication companies in California to use accelerated depreciation and to receive investment tax credit. To have the federal government forego the collection of these taxes is most beneficial to both the utilities and the ratepayers. To risk these tax benefits so needlessly is bad regulatory administration. Loss of eligibility through 1976 as a consequence of California Public Utilities Commission action means that Pacific Telephone will have to pay taxing authorities in Washington, D.C., retroactive tax bills of $764 million. General Telephone will have to pay $223 million. Loss of eligibility into the future will cost our communication system and ratepayers additional hundreds of millions of dollars in taxes.

I cannot support a decision which fails to take the opportunity to resolve the "eligibility" issue before the Commission decision is finalized and "set in concrete". Assurance on the issue of eligibility is procedurally feasible if we were to follow the recommendation of the Administrative Law Judge in this case. The order as originally

drafted deferred any effective date until 180 days. This was done to allow the utilities a reasonable period to obtain a ruling on eligibility from the U.S. Internal Revenue Service. Ratepayer interest would have been protected by adequate accounting, refund, and interest provisions.

But today's majority strikes out that simple safeguard. In doing so they ignore the fact that last year's schemes, which the majority reckelessly imposed on the state's largest electric utility and the state's largest gas utility, are in grave danger of causing millions of dollars in unnecessary tax liabilities to fall upon those companies. (See Majority and Minority Opinions: A. 54946 Southern California Edison Company, D. 86794, December 21, 1976; rehearing based on adverse tax attorney opinion, D. 87828, September 7, 1977; and A. 55676, Southern California Gas Company, D. 85627, March 30, 1976, together with adverse IRS ruling, dated November 22, 1976; California Supreme Court decision pending, in Case SF 23495.)

In light of these danger signals, it is imprudent of the Commission not to exhaust available consultive procedures and thus safeguard the state against the catastrophic consequences of ineligibility.

Instead, the majority lectures Congress on legislative goals. Acting as a school marm to Congress, the majority tells the national legislature that federal tax credits and deferrals may be used to lower monthly utility bills, but may not be used to stimulate job development or accelerated capital investment. Such homey advice

is interesting but what the California ratepayer will have to worry about is the bottom line. What will he and the California utility companies have to pay to Washington, D.C., after the IRS has cut through the verbiage of this decision and applied the law?

San Francisco, California
September 13, 1977

WILLIAM SYMONS, JR.
Commissioner

COMMISSIONER VERNON L. STURGEON, Dissenting

The inconsistent and cavalier manner in which the majority treats the key issue of eligibility for accelerated depreciation warrants my strong dissent. The majority recognizes, as it must, that our regulatory treatment of accelerated depreciation and the investment tax credit (ITC) must preserve General's and Pacific's eligibility for these tax saving methods. The majority, in one of its few realistic comments on the question, states that:

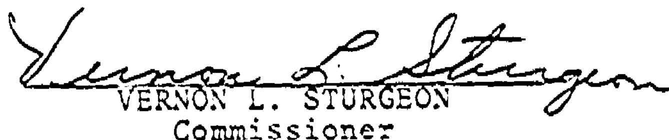
> "Eligibility is the first issue to be determined. To render a decision which attempts to resolve these cases without regard for this issue might create problems for these utilities, their ratepayers, the Commission, and the Courts that even exceed (both in scope and complexity) the problems that we are attempting to resolve in this decision." (Mimeo p. 19)

After recognizing and elaborating upon the importance of eligibility, the majority then, incredibly, moves quickly to jeopardize that eligibility by adopting a regulatory accounting scheme whose compliance with the standards of normalization established by the Internal Revenue Code and Treasury Regulations must be considered a matter of speculation. While the majority states confidently (Finding No. 3) that "This method complies with Treasury Regulation 1.167(ℓ)-(1)(h)(6) and is normalization accounting," they admit (at Mimeo p. 41) that "We have here a case of first impression under the tax laws. . ."

The Examiner's Proposed Report took a sensible approach to the eligibility question by setting an effective date 180 days

after the entry of the order. Had a majority of the Commission had the wisdom to adopt such an approach, Pacific and General would have not only the time but the incentive to seek an expeditious IRS ruling. The majority correctly points that "expeditious" is not an adjective frequently associated with IRS rulings (as it is not with decisions of this Commission). However, even if no such ruling were issued within the 180 days following the entry of the order, what harm would occur? Under the Examiner's approach, the order would simply be final at that time. If a ruling was issued, the Commission would then have the opportunity to modify the order if necessary.

It is doubtful that any of the majority would, in the handling of their own federal income taxes, make a decision involving a risk of substantial tax liability in which their position rested on a legal position which they knew to be a "case of first impression under the tax laws." Today, however, they have asked Pacific, General and their ratepayers to do just that.



VERNON L. STURGEON
Commissioner

San Francisco, California