rr

Decision No. 91337 FEB 13 1980

10

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for 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)
And Related Matters. (Re Tax Reserve Matters)	Application No. 51774 Application No. 55214 Case No. 9503 Case No. 9802 Case No. 9832 Application No. 51904 Application No. 53935 Case No. 9100 Case No. 9504 Case No. 9578

(See Decision No. 87838 for appearances.)

Additional Appearances

Walter J. Sleeth and Gerald H. Genard, for The Pacific Telephone and Telegraph Company, applicant.
Kenneth K. Okel, Attorney at Law, for General Telephone Company of California, respondent.
George Agnost, City Attorney, and Leonard L. Snaider, Deputy City Attorney, for the City of San Francisco; Ann Murphy, Glenn L. Moss, and Edward M. Goebel, Attorneys at Law, for TURN; Edward J. Perez, Deputy City Attorney, and Thomas C. Bonaventura, Senior Assistant City Attorney, for the City of Los Angeles; Brobeck, Phleger & Harrison, by Gordon E. Davis and William H. Booth, Attorneys at Law, for California Retailers Association; William L. Knecht, Attorney at Law, for California Interconnect Association; Graham and James, by Boris H. Lakusta, David J. Marchant and Thomas J. MacBride, Jr., Attorneys at Law, for California Hotel and Motel Association; and Frederick W. Bray, Attorney at Law, for Legal Assistance to the Elderly, Inc., interested parties.
James D. Pretti, Robert C. Moeck, and Ermet J. Macario, for the Commission staff.

OPINION AND ORDER IMPLEMENTING REFUNDS
ORDERED BY DECISION NO. 87838

On August 20, 1979 The Pacific Telephone and Telegraph Company (Pacific) filed its Motion for Order Approving Refund Plan and Rate Reductions, which was subsequently amended on October 15, 1979. General Telephone Company of California (General) filed its refund plan by letter dated August 22, 1979 and its rate reduction proposals by Advice Letters Nos. 4470 and 4471 also dated August 22, 1979. General also filed a motion pursuant to Section 1708 of the Public Utilities Code requesting the Commission to reopen Decision No. 87838 to modify Ordering Paragraphs Nos. 7 and 8 to permit General to collect prospectively, subject to refund, rates at levels authorized in Decision No. 87505 (i.e., on a test year period normalization basis for accelerated depreciation (AD) and investment tax credit (ITC)less an amount to reflect full flow-through for 1969 vintage plant additions.

Responses to Pacific's Motion for Approving Refund Plan and Rate Reductions were filed by the Cities of San Francisco, Los Angeles, and San Diego (Cities), Toward Utility Rate Normalization (TURN), Independent Taxpayers Union of California, and California Retailers Association (CRA). Reply to such responses was filed by Pacific on September 6, 1979. TURN also filed on October 18, 1979 a Petition for Modification of Decision No. 87838 and Immediate Implementations of Refunds and Rate Reductions at 14 percent interest.

Pacific on October 5, 1979 filed its Supplemental Memorandum of Points and Authorities in support of its Application for Rehearing, Modification and Stay of Decision No. 90642 in Application No. 58223 requesting modification of the decision to permit Pacific to collect, subject to refund, rates designed to re-establish Pacific's eligibility for AD and ITC.

On October 10, 1979 the Commission in Decision No. 90919 stated:

> "In view of the substantial differences among the positions of the parties as to the appropriate procedure for refunds and rate reductions pursuant to Decision No. 87838, the Commission believes brief further consideration of these issues to be in order. For this purpose we will set a prehearing conference and oral argument for October 22, 1979, before Administrative Law Judge Tomita. The parties should be prepared to address both the proper disposition of the refund and rate reduction proposals contained in Pacific's Motion, and whether further hearings are necessary. If the hearings are necessary, the parties should be prepared to proceed immediately. The arguments of the parties herein with regard to accelerated depreciation and ITC, including Pacific's supplemental memorandum and any responses thereto, will be considered at that time."

Oral arguments were heard on October 22, 1979 at which time Pacific and General argued for additional hearings to demonstrate the necessity for adoption of a 5-year refund plan and even more compelling, the need for the Commission to take appropriate action to preserve eligibility to take AD and ITC in 1980 and the future.

The staff, Cities, and TURN argued against further hearings as they alleged that anything less than a lump sum refund would result in a further stay in implementing Decision No. 87838 which the companies sought in the various courts and ultimately failed to achieve. It was further argued that failure to order rate reductions would result in a disincentive for Pacific and General to win the tax case before the IRS and the courts. TURN further argued that interest on the refunds should be reassessed at the prime rate from the time of initial overcollection.

CRA objected to Pacific's refund proposal as not being consistent with Section 453.5 of the Public Utilities Code and requested additional hearings to develop a refund plan which would be consistent with Section 453.5. California Interconnect Association (CIA) concurred with CRA's arguments but suggested that the proposal to set the interest rate at prime rates, as suggested by some of the other parties, was too modest.

Upon conclusion of the arguments, the Administrative Law Judge ordered further hearings to be held commencing October 24, 1979 on the issues of the need for a multi-year refund plan as opposed to a lump sum plan and any new evidence relating to changed circumstances that would justify a change in the rate reduction orders in Decision No. 87838. Based on further arguments by various parties to this proceeding it was agreed that evidence in this proceeding would be phased into two parts with the initial phase to cover the refund issue and the second phase to cover the rate reduction issue. Although the Administrative Law Judge initially ruled not to admit any further evidence on alternate refund plans, on November 23, 1979

a ruling was issued which ordered additional evidence be received to ensure a refund plan which would be in compliance with Section 453.5 of the Public Utilities Code.

Hearings on the refund phase were held on October 24, 25, and 29th, 1979 and submitted subject to receipt of concurrent briefs on November 7, 1979. Hearings on the rate reduction phase were held on November 8, 13, and 14, 1979 and submitted subject to receipt of concurrent opening briefs due on November 27, 1979, and reply briefs on December 3, 1979. Hearings on the reopened refund phase were held on December 4, and 5, 1979, and submitted subject to filing of concurrent briefs on December 11, 1979.

We are now ready for decision.

Synopsis of Opinion

This opinion and order implements the refunds ordered by Decision No. 87838 resulting from the overcollections of revenues based on the difference in revenue requirements between rates set on the method of accounting adopted in Decision No. 77984 and the methods of normalization adopted in Decision No. 87838. The method adopted in Decision No. 77984 was invalidated by the California Supreme Court because it was unnecessarily "harsh" to ratepayers, and because the Commission did not consider alternatives. Ratepayers will receive interest on the gross amounts to be refunded as follows: On amounts that accrued prior to today 7 percent per annum, and on amounts due after this order at the Commercial Paper Rate (both rates to be applied compounded monthly). In order to provide a reasonable timely refund period to customers, while minimizing the effect on the cash flow and financial integrity of the utilities, refunds will be made in installments. The decision requires Pacific and General to commence making refunds for the period of overcollection ending the date of this decision in two installments and in the form of bill credits to current customers and by check to certain prior customers of Pacific and General. Both utilities request five years in which to make refunds. Initial refunds are to commence 120 days after the effective date of this order, with a maximum payment of $35 per customer. Any unpaid balance due on the refunds will be made one year after the date of the initial distribution.

Refunds to residential customers of Pacific and General are limited to current customers (those who were customers of Pacific or General as of the date of this decision) and are based on each customer's current recurring monthly exchange charges. Evidence shows that it is not practicable to make refunds to prior residential customers who are no longer served, in that the time and expense required would be inordinate. It is anticipated that the initial distribution will represent the total refund due for approximately 75 percent of the residential customers. For business customers refunds will be made to all current and prior customers of Pacific and for all current and certain prior customers of General. Prior business customers receive refunds because there are fewer as compared to residential customers; the larger amounts involved justify the administrative expense.

The spreading of the refunds into two installments is intended to alleviate the cash flow problems of the two companies and at the same time return initially the full refund to the bulk of the companies' customers; Pacific's total refund will amount to approximately $363 million[1] at October 29, 1979 plus additional interest until the date of refund. General will refund the principal amount of $86 million [2] plus additional interest until the date of refund.

On the issue of rate reductions, the Commission finds that based on the present record it would be in the public interest to place a cap on Pacific and General's potential tax liability estimated to be over $1 billion for Pacific and approximately $391 million for General as of year end 1979, by providing that henceforward rates will be set on full normalization subject to refunds pending the outcome of litigation with the IRS concerning the modified normalization methods required by a 1977 Commission decision. Although the Commission is convinced that its ratemaking methods not only comply with the mandate of the California Supreme Court but also with the eligibility conditions of the Internal Revenue Code, the financial community to whom the utilities must look for additional capital exacts a price for the growing amount of potential tax liability which will only be settled in the distant future. Our action will help to keep the cost for additional capital as low as possible, which will benefit the utilities' ratepayers as well as shareholders. When eligibility is affirmed, refunds with accumulated interest for the period from this date until that affirmation will be ordered, and rates will thenceforward be set in accordance with Decision No. 87838. Should eligibility be denied, the Commission will undertake adoption of a method of accounting which will both insure eligibility and allow refunding of overcollections consistent with the orders of the California Supreme Court. Futhermore, in order to protect the interests of the ratepayers we will require that the interest rate on refunds effective as of the date of this decision reflect the prime commercial paper interest rates adopted in Decision No. 91269 in OII 56.

1/ Estimated to be approximately $381 million including interest as of 1/31/80.

2/ Estimated to be approximately $111 million including interest as of 1/31/80.

REFUND ISSUE

Pacific's Position

Pacific's Treasurer Robert H. Joses testified for the company in support of its proposal to spread the refunds ordered by Decision No. 87838 over a five-year period. Mr. Joses testified that recent developments have resulted in a serious deterioration in the company's financial condition such that its very ability to continue the financing of its essential ongoing operations is in grave jeopardy. These developments were described as follows:

1. The Internal Revenue Service has issued a notice of deficiency for 1974.
2. Both major bond rating agencies have reduced the ratings on Pacific's outstanding debt to single A. Mr. Joses estimated that under current conditions the difference between "AAA" rated issues and "A" rated issues is about 120 basis points and the difference between an "A" rated issue and a "BBB" rated issue was now 80 basis points or higher. Mr. Joses further explained that should Pacific be further downgraded to a "BBB" rating, it may not be able to raise the capital it requires, and, in severely depressed markets Pacific may not be able to raise capital at all.

3. Pacific's post-tax interest coverage for the twelve months ended August 31, 1979 was 1.78 compared to a 2.02 times coverage for the same period ended August 31, 1978. The estimated post-tax coverage for 1980 drops to 1.3 times if a lump sum refund is ordered, while under a five-year refund plan the coverage is 1.32.
4. While Pacific's current dividend, viewed by many as inadequate, is $1.40 per share, earnings per share for 1980 have been estimated at only 81 cents per share if a one-time refund is ordered and a slightly higher 87 cents per share if a five-year refund plan is adopted.

Mr. Joses concluded that absent adequate rate relief the above developments would make it next to impossible for Pacific to raise the capital it needs to meet its construction budget at unreasonable costs, much less at reasonable costs.

Mr. Joses testified that under a lump sum plan short-term borrowings would reach $694 million by December 31, 1979 and exceed $1 billion, an unprecedented level, in February 1980 assuming that refunds are made in December 1979. Assuming a 5-year refund scenario, Pacific's short-term borrowings were estimated to be $447 million at December 31, 1979 and $750 million in February, 1980 before equity and long-term debt offerings planned in March 1980 of approximately $645 million would reduce short-term borrowings. Witness Joses testified on the necessity to alleviate the serious cash flow problem that would be created by a lump sum refund order especially in light of Pacific's current poor financial ratios and Pacific's continuing need to go to the security market for substantial additional financing in 1980 and future years. Mr. Joses also testified that Commission action which would authorize refunding over a 5-year period would be looked upon as a favorable factor by the financial market in appraising Pacific's security offerings both long- and short-term.

Pacific also offered witness Richard W. Lambourne to testify on the present condition of the financial markets and the uncertainties that exist with respect to the outlook in 1980. He also testified on the prospect of Pacific's ability to attract sufficient capital to meet Pacific's construction needs and refund requirements. He also questioned Pacific's ability to have a successful common stock offering unless significant rate relief brings earnings back well above the current dividend rate and, without a successful sale of common, financing by an even higher amount of debt would be necessary with negative results on Pacific's debt rating and ability to finance both short-term and long-term. It was Mr. Lambourne's opinion that it was advisable to spread the refund over a period of years and thereby lessen the current cash flow and financing problems of Pacific.

Mr. David M. Craig, Assistant Vice President-Capital and Expense budget testified on Pacific's construction budget of $2,238 million for 1979 and $2,374 million for 1980. He explained that Pacific's budgets are constrained budgets and for 1979 was $60 million below the engineering tested levels and for 1980 $250 million below engineering tested levels. He also testified that Pacific was now reviewing a further $150 million reduction in the 1980 construction budget as well as an alternate reduction of $50 million to build up a construction contingency fund to provide for unexpected service demands and unforecasted price increases. Such reductions would further strip Pacific's modernization program and introduce additional service risk to a level Pacific considers unwise.

At the reopened hearings on December 4 and 5, 1979, John Dennis, Assistant Vice-President Regulatory Planning for Pacific testified as to the various alternatives available to allocate the refund between the residential and business classes, the cost of making refunds to current customers as well as to current and prior customers, the feasibility of making refunds under various refund options, and a revised refund proposal. Mr. Dennis testified that although Pacific had records available to develop total historical billings to the residential and business classes by basic exchange service billings, recurring exchange charge billings and total intrastate billings for the refund period, its records did not permit it to develop total intrastate billings or total basic exchange billings for the refund period by individual customers.

Exhibit R-27 sponsored by Mr. Dennis shows that billings to the business class for basic exchange service for the period August 1974 through October 1979 represented 33.4 percent of the total $2,979,000,000 basic exchange service billings made during the period compared to 66.6 percent for the residential class. Using recurring exchange charges, billings to the business class represented 55.9 percent of the $6,181,000,000 total for the period, compared to 44.1 percent for the residential classes. Based on total intrastate billings for the period, billings to the business class represented 56.6 percent of the $16,031,000,000 total for the period compared to 43.4 percent for the residential classes.

Exhibit No. R-27 also shows that based on October 1979 billings the business class was responsible for 35.2 percent of the total basic exchange service billings for the month compared to 64.8 percent for the residential class, 57.4 percent of total recurring exchange charge billings compared to 42.6 percent for the residential class, and 56.7 percent of total intrastate billings compared to 43.3 percent for the residential class.

Table 2 of Exhibit R-27 shows the allocations of refunds to the residential and business classes based on three historical billing options and three current billing options.

	Percent Distribution		Resulting Refund Amounts $(000)	
	Business	Residence	Business	Residence
Based on Historical Billing				
1. Basic Exchange Revenues	34.4%	66.6%	$121,391	$242,056
2. Recurring Exchange Revenues	55.9	44.1	203,167	160,280
3. Total Intrastate Revenues	56.6	43.4	205,711	157,736
Based on Current Billing 10/79				
1. Basic Exchange Revenues	35.2	64.8	127,933	235,514
2. Recurring Exchange Revenues	57.4	42.6	208,619	154,828
3. Total Intrastate Revenues	56.7	43.3	206,074	157,373

Pacific recommends that the refund amount be proportionately allocated to the residential and business classes on the basis of historical recurring exchange charges since it believes that such an allocation would represent an equitable pro rata allocation. Pacific demonstrates that an allocation based on recurring exchange charges produces a ratio quite similar to an allocation based on total intrastate billings and since it does not have the records to make a distribution to individual customers on the basis of total intrastate billings, it would be consistent to make an allocation and distribution using recurring exchange charges.

For residential customers Pacific recommends the refunds be distributed to all current customers using each customer's current recurring exchange charges as the proportional factor with no distribution to prior residential customers. It also proposes that such refunds be made by billing credits to the customer's current account. Pacific justifies restricting refunds to current residential customers since the costs involved in making refunds to prior residential customers would be both costly and largely unsuccessful. It estimates the costs involved in making

refunds to prior residential customers to be approximately $24.4 million if checks are issued and nearly $22 million if refund request forms are mailed out. Pacific further contends that approximately 50 percent of the refund checks or refund request forms would be returned in the initial mailing. As further justification Pacific contends that Pacific and General currently provide telephone service to approximately 97 percent of the total telephones in California and therefore nearly all past and present customers would be receiving refunds under its revised refund proposal contained in Table 6 of Exhibit R-27. Only customers who have moved out of state or into non-Pacific or General service areas would not receive a refund.

For business customers Pacific recommends that refunds to both past and current customers be made on the basis of historical recurring exchange charges billed. While Pacific anticipates it will have some problems in making refunds to prior business customers, it believes that it would be practicable to make refunds to prior business customers since the numbers involved are much smaller than for residential customers. As a consequence the costs involved in making refunds to prior business customers is estimated to be roughly 1/10 of the cost of making refunds to prior residential customers and while large, are considered not unduly burdensome considering the size of the refunds involved.

Pacific also states in its brief that since Section 453.5 permits the Commission to authorize a refund plan for residential and other small customers to be based on current usage, it would support a proposal by the staff that refunds to small business customers also be limited to current customers thereby appreciably reducing its expenses and also reducing the amount subject to escheat. Pacific suggests the use of a $25 figure as the average monthly recurring exchange billable amount to separate small from large business customers.

Pacific contends that its refund plan is in compliance with Section 453.5 of the Public Utilities Code and recommends that refunds be made over a five-year period since such extended refund period would place considerably less burden on Pacific's financing requirements.

General's Position

Richard L. Ohlson, Vice President-Revenue Requirements testified on General's proposed refund plan to be made over a five-year period. Mr. Ohlson testified that in preparing its refund proposal a primary consideration was to minimize the financial impact of the refunds on General in view of its growing construction program and the size of external financing forecasted for the future. General's construction program for the five-year period ending with 1975 averaged approximately $172 million per year and increased to $234 million in 1976, $317 million in 1977, $479 million in 1978 and is estimated to be $540 million in 1979. General anticipates that this rate of growth will continue and that its construction budget will average $750 million per year for the five-year period commencing with 1980. General estimates that its financing program will average more than $300 million per year for the five-year period of which approximately $200 million per year will be in the form of long-term debt.

Mr. Ohlson expressed his concern with General's single "A" debt rating which was downgraded from an A+ rating by Standard & Poor's at the time of General's last debt issue and the possibility of further downgrading if General's pretax interest coverage continues to decline. General's pretax interest coverage for the 12 months ending August 1979 was 2.64, and it is anticipating a 2.3 times coverage for 1980 before the impact of any refunds. Mr. Ohlson added that a 2.2 pretax coverage would be the low end of the scale for an "A" rated company and any downgrading of its securities may make it impossible for General to finance its construction program and refunds in a period of capital shortages.

General's refund plan proposes to make refunds to all current customers on the basis of a percentage of the recurring exchange charges appearing on the customers' monthly bills. At the reopened proceedings on December 4 and 5, 1979, General did not revise its original refund proposal nor submit a new plan as Pacific did. General in its brief dated December 11, 1979 did indicate that, while it still believes its original refund proposal is fair and in compliance with Section 453.5 of the Public Utilities Code, it would support a modified plan based on:

1. Allocating the total refund amount between business and residential customers based on the proportion of the total recurring exchange charges billed to each class of service for the period January 1, 1973 to December 31, 1979;

2. Allocating the residential portion of the refund in the manner proposed by Pacific and the staff, i.e., to current customers only as a proportion of their current recurring exchange billing;

3. Making refunds to current business customers and to prior business customers who have disconnected service since January 1, 1979 on the basis of their current recurring exchange billing, but with the refund amounts received by each such customer weighted to reflect the number of months that the customer has been in continuous service during the refund period.

General's information systems Director Loretta Lancaster testified that General was able to develop estimated total billings for recurring exchange charges by residential and business classes for the period January 1, 1973 through December 31, 1979. She also testified that it would take eight weeks to develop comparable data on the basis of basic exchange charges and three to six months on the basis of total intrastate charges.

Using recurring exchange charges as a basis of allocation, the residential class would receive 48 percent of total refunds and the business class 52 percent. Witness Lancaster further testified that if refunds are based strictly on historical billing records it would take 10-18 months for data processing and 24 months for full implementation of the refunds. Should refunds be restricted to current customers based on current billings but with refunds proportioned to the number of months of service, the data processing time was estimated to take 7-10 months with full implementation of the refunds requiring 12 to 14 months. However, if refunds are restricted to current customers based on current month's basic or recurring exchange charge it was estimated that data processing time would take 1½ months with full implementation of the refunds to customers in approximately 4 to 6 months. If total current month's intrastate billing is used as a base, it was estimated that there may be some additional time required to process current toll information.

Patricia Jones, Service Manager-Customer Services testified on the estimated cost and time required to make refunds under various assumptions. Witness Jones testified that the cost of making refunds to all customers on a historical billing basis would be approximately $9.7 million dollars with initial distribution of refund checks being made in 20 months and full implementation of the refund plan in 24 months under a lump sum refund order. If refunds were made only to current customers based on current recurring exchange charges, General estimates it would cost $116,000 with initial refunds distributed in 4 months and full implementation in 6 months.

Staff Position

The staff in its initial brief on the refund issue stated that Pacific and General have failed to prove that an extended refund period is necessary. The staff argued that the Commission must consider the interest of ratepayers in arriving at a decision to extend or not extend the refund period and, should an extended refund period be authorized, an interest rate more realistic than the 7 percent rate currently being accrued should be used. The staff also agreed with CRA that refunds must comply with Section 453.5 of the Public Utilities Code.

In the reopened proceedings held on December 4, and 5, 1979 staff witness Ermet Macario set forth the following refund plan objectives:

1. Must comply with Public Utilities Code Section 453.5.
2. Must be practicable.
3. Should result in equitable and prompt distribution of refunds to customers.
4. Should be economical.
5. Should have least adverse impact on utility's financing.

Mr. Macario offered a proposed refund plan which would apportion the total refund amount to business and residential categories on the basis of actual or estimated cumulative historical recurring monthly exchange billings for each of the two classes. He recommended that refunds to residential customers be made to each current customer proportionate to the individual customer's current recurring monthly exchange service bill. For business customers he proposed that each current and former customer receive a refund proportionate to each customer's total recurring monthly exchange service billing for the refund period.

Based on the additional evidence presented by General, Mr. Macario modified his refund proposal for General's business customers by recommending that the distribution to General's business customers be made to current customers and prior customers who received service from January 1, 1979 and to weight the refunds by the months of service during the refund period. Mr. Macario indicated that General would be able to extract information needed for weighting purposes from other files and therefore this should not be overly burdensome.

In recommending that refunds to residential customers be restricted to current customers, Mr. Macario testified that the number of residential customers and the turnover of such customers would make refunds to prior residential customers expensive and largely unsuccessful. He also testified that the average refund to a residential customer would be approximately $24 per customer and should the Commission authorize an extended period refund plan but require that refunds up to $25.00 per customer be paid in the initial distribution, approximately 75 percent of the residential customers would get their total refund in the initial distribution thereby reducing the cost of subsequent distributions.

Cities' Position

The Cities in their brief filed November 7, 1979 take the position that a one-time refund should be ordered by the Commission and that there is no financial justification for spreading the refunds over a period of years. The Cities further argue that should the Commission authorize any deferral of refunds, it must exact a promise from Pacific and General, that they would promise not to challenge making such deferred refund in the future. The Cities also advocate the usage of the prime rate after December 31, 1977 as the appropriate interest rate to be used in determining the total payments under the refund plan. The Cities further suggest that the Commission

should adopt an interest policy of prime rate plus a reasonable percent as a disincentive for the use of involuntary capital contributions from ratepayers.

Although the Cities did participate in the cross-examination of the witnesses in the reopened proceedings held on December 4 and 5, 1979 the Cities did not file a brief on the various refund plan proposals offered in evidence in the proceeding.

California Retailers Association's Position

CRA opposed the original refund plans of Pacific since the plans were based solely on basic exchange billings and not on total billings or total intrastate billings and also since refunds would be calculated on current customers billings and not on billings during the period when the excessive rates were being paid. CRA argued that the distribution of refunds is governed by Section 453.5 of the Public Utilities Code and that Pacific's plans filed on August 20, 1979 did not comply with Section 453.5. CRA renewed its request that the record be reopened to permit it to demonstrate that refunds based on current exchange billings would result in disproportionate refunds to various customers.

In its final brief filed on December 11, 1979 after the reopened proceedings of December 4 and 5, 1979 CRA supports the use of total recurring exchange billings for the refund period as the basis for allocation of the refund pot between the residential and business classes and the further distribution of such refunds to the residential customers on the basis of current recurring exchange charges, with refunds to current and prior business customers to be based on the recurring exchange charges billed since the start of the refund period. CRA argues that Pacific's revised refund plan set forth in Table 6 of Exhibit 27 meets the requirement of Section 453.5 and that it would result in an "equitable pro rata" distribution of the refunds.

CRA also states in its brief that while it favors immediate refunds, it is cognizant of the present financial condition of Pacific and therefore has no objection to the staff proposal for initial distribution of the residential refunds within 120 days with refunds to business customers spread over 2 to 5 years with reasonable interest provisions for any delay in refunds.

With respect to General's refund proposal CRA believes General's cost estimates are overstated and could be substantially reduced. CRA points out that a substantial portion of the costs could be eliminated if refunds are made by bill credits to current customers with checks to certain former customers and also if refunds to residential and other small users were made only to current customers based on current usage. CRA believes that General could make a refund distribution on a substantially similar basis to that proposed by Pacific without incurring excessive costs. As an alternative CRA recommends that refunds be based on current billings with a weighting for the number of months of service.

California Hotel and Motel Association's (CHMA) Position

CHMA in its brief filed November 7, 1979 requested that the proceedings on the refund plan be reopened to receive additional evidence to establish an "equitable pro rata basis" for making refunds and to demonstrate the dramatic impact the various bases of refunds have on the allocation of refunds between the residential and business classes.

In its brief following reopening of the proceeding on December 4 and 5, 1979, CHMA takes the position that refunds based on basic exchange rates violate the mandated basis for refunds. Although CHMA believes that, ideally, refunds should be both allocated and distributed on the basis of total intrastate billings both to the residential and business classes during the refund period it acknowledges that such information is not available

for Pacific and would be both costly and time consuming to develop for General. It recommends as a minimum that the refund plan should be based on individual recurring monthly exchange service billings after an initial allocation of the total refund to the residential class and to the business class on the basis of total intrastate billings for the respective classes.

California Interconnect Association's (CIA) Position

CIA in its brief dated November 7, 1979 takes the position that refunds must be made to those customers who were taking service during the refund period and that such refunds must be made on the basis of total billings or if not total billings then on the basis of monthly recurring charges. It also argues for immediate lump sum refunds; however, should the Commission authorize deferred refund payments the utilities should be required to accrue interest on such deferral at the installment payment rate of 18 percent per annum.

TURN's Position

TURN in its brief of November 7, 1979 and December 11, 1979 supports the adoption of Pacific's refund plan filed on August 20, 1979 based on basic exchange charges because it comports with Decision No. 87838 and Section 453.5 of the Public Utilities Code and is capable of immediate implementation. It also takes the position that Decision No. 87838 should be modified to provide interest at prime rate instead of the 7 percent rate.

TURN in support of its position states that "rate refunds" refers to overcollections for the period of time prior to the effective date of Decision No. 87838 and "rate reductions" refers to overcollections for the time after the effective date of Decision No. 87838. TURN argues that no specific distribution formula is designated in Decision No. 87838 for the period of time covered by "rate refunds" whereas a specific distribution formula is designated for rate reductions in Decision No. 87838.

TURN argues that Decision No. 87838 became effective on October 3, 1977, 20 days after issuance of the original decision and the fact that the decision was thereafter stayed is of no legal consequence. TURN argues that the distribution formula of Decision No. 87838 was rightfully subject to direct attack on rehearing and appeal; however, no direct attack was made and the distribution formula is now final and must be implemented.

TURN argues that since no methodology was ordered for rate refunds prior to Decision No. 87838, they are properly the subject of the current proceedings; however, for the period subsequent to Decision No. 87838 TURN argues that rate reductions were ordered for all current subscribers by applying a uniform proportional reduction in the recurring basic exchange primary service rates. It was TURN's opinion that adoption of any other distribution methodology would be in contravention of Decision No. 87838 and would constitute retroactive ratemaking.

TURN agrees that "rate refunds" ordered in Decision No. 87838 for the period prior to the effective date of Decision No. 87838 are subject to Section 453.5 of the Public Utilities Code. TURN points out that the Commission in Decision No. 90423 made a reasoned analysis of the application of Section 453.5 and authorized a refund plan similar to Pacific's August 20, 1979 plan based on a customer's current monthly billing for exchange lines and trunks. TURN further argues that distribution of refunds in proportion to basic exchange rates would be administratively more convenient and if ordered for the prior period would be in accord with the distribution formula required for the period subsequent to Decision No. 87838 and would be similar to the plan authorized by Decision No. 90423.

TURN also takes the position that it is practicable to make refunds to prior customers as well as current customers and that provisions must be made to locate prior customers who have moved out of state or relocated into non-Pacific or non-General service areas.

Discussion

The two main issues on the refund phase are:

1. Is there a need for an extended refund period?

2. Does the refund plan conform with Section 453.5 of the Public Utilities Code.

Both Pacific and General witnesses testified that an extended refund period was necessary to alleviate the burden on the respective ~~company's~~ companies' financing requirements over the next several years because of the continuing increasing need to attract funds to meet its growing construction requirements. Both Pacific's and General's financial witnesses expressed concern with their existing single "A" bond ratings and the threat of further downrating if the coverage ratios and financial ratios of the respective companies do not improve. Pacific's witness Joses further testified that if Pacific could not sell its common stock and long-term debt issues and was required to go too heavily into short-term borrowings it could also lose its Commercial Paper Ratings.

It is obvious from a comparison of the various exhibits offered into evidence in this proceeding that Pacific's financial situation is relatively more critical than General's. While it is true that a multi-year refund plan does not significantly improve the coverage ratios or earnings, it does have an important impact on the cash flow for both companies.

Although we are concerned with the pressing financing problems of Pacific, in particular, and also General, we are also concerned in returning the court-ordered refunds to the customers as expeditiously as possible. While we are of the opinion that the companies should be granted some leeway to lighten the burden of making lump sum refunds, we do not believe a five-year refund period is justified. We are, however, of the opinion that a ~~two-year~~ two phase refund period will ~~significantly~~ alleviate the cash flow problems of Pacific and General and under our adopted refund plans still result in expeditious refunds being made to the bulk of the customers of the two companies.

Discussion

The two main issues on the refund phase are:

1. Is there a need for an extended refund period?

2. Does the refund plan conform with Section 453.5 of the Public Utilities Code.

Both Pacific and General witnesses testified that an extended refund period was necessary to alleviate the burden on the respective companies' financing requirements over the next several years because of the continuing increasing need to attract funds to meet its growing construction requirements. Both Pacific's and General's financial witnesses expressed concern with their existing single "A" bond ratings and the threat of further downrating if the coverage ratios and financial ratios of the respective companies do not improve. Pacific's witness Joses further testified that if Pacific could not sell its common stock and long-term debt issues and was required to go too heavily into short-term borrowings it could also lose its Commercial Paper Ratings.

It is obvious from a comparison of the various exhibits offered into evidence in this proceeding that Pacific's financial situation is relatively more critical than General's. While it is true that a multi-year refund plan does not significantly improve the coverage ratios or earnings, it does have an important impact on the cash flow for both companies.

Although we are concerned with the pressing financing problems of Pacific, in particular, and also General, we are also concerned in returning the court-ordered refunds to the customers as expeditiously as possible. While we are of the opinion that the companies should be granted some leeway to lighten the burden of making lump sum refunds, we do not believe a five-year refund period is justified. We are, however, of the opinion that a two-phase refund period will alleviate the cash flow problems of Pacific and General and under our adopted refund plans still result in expeditious refunds being made to the bulk of the customers of the two companies.

The primary concern about any refund plan we may authorize is whether such plan conforms to Section 453.5 of the Public Utilities Code. While refund plans have been authorized by the Commission subsequent to the enactment of Section 453.5 in 1977, we now have the benefit of the interpretations of Section 453.5 made by the California Supreme Court in its decision in California Manufacturers Association v Public Utilities Commission (1979) 24 Cal 3d 836. The parties are in general agreement that the refund plan must conform to Section 453.5, although TURN takes the position that the refunds relating to overcollections for the period subsequent to Decision No. 87838 should follow the formula established by Decision No. 87838 with respect to rate reductions, that is rate reductions should be made by proportional reduction of recurring basic exchange charges. TURN argues that had Decision No. 87838 been placed into effect with no staying of the decision, there would be no refunds for overcollections for the period subsequent to Decision No. 87838 and instead the customers would have received proportionate rate reductions in recurring basic exchange charges. The staff and certain other interested parties contend that Section 453.5 does not provide for such distinction and that all refunds must comply with the requirements of Section 453.5. We agree with the latter position.

Section 453.5 sets forth as a basic requirement that when the Commission orders rate refunds to be distributed, such refunds must be made on an "equitable pro rata basis" without regard to whether the customer is classified as a residential, commercial, industrial, or any other type entity. The section defines "equitable pro rata basis" to mean in proportion to the amount originally paid for the utility service involved, or in proportion to the amount of such utility service actually received. The Section also requires that refunds be made to all current customers, and, when practicable to prior customers. An exception is provided in the case of residential customers and other small customers, for whom refunds may be based on current usage.

The allocation of the total refund between the residential and business classes in proportion to the gross intrastate billings made to each class in the refund period would appear to be an equitable pro rata allocation and in conformance with Section 453.5. However, the evidence in this proceeding indicates that such information is not readily available for General and would require substantial additional time and cost to develop. Moreover, the record indicates that an allocation based on recurring exchange charges would produce a similar end result unlike an allocation based on basic exchange charges. We will therefore adopt as reasonable an allocation of refunds to the residential and business classes based on recurring exchange charges.

While Pacific indicated that it would be able to make refunds to individual customers on a historical basis using recurring exchange charges as a basis of distribution, it would be extremely expensive to attempt to make refunds to prior customers and in particular prior residential customers because of the large numbers involved. Moreover, Pacific indicates that it would be unsuccessful in locating a substantial number of prior customers in that it estimates 50 percent of the refunds made to prior customers will be returned for lack of a forwarding address.

General indicates that it would have similar problems in locating prior customers, but in addition would require 10 to 18 months of data processing work to develop the data necessary to make refunds on a historical basis. Testimony in this proceeding also shows that a substantial portion of General's costs involved in making refunds could be eliminated by not making refunds to a substantial number of prior customers and thereby reduce the number of checks that have to be issued and processed when returned.

While we believe that it is desirable to make refunds to all customers on a historical basis, it appears from the evidence in this proceeding it would not be practicable to make refunds to prior residential customers of Pacific and General. In the case of General we are also of the opinion that it would not be practicable to make refunds to all prior business customers. However, we believe that a compromise proposal suggested by the staff that General make refunds to all current business customers and prior business customers who were customers on or after January 1, 1979 with refunds based on current recurring exchange charges, but weighted to reflect the number of months of continuous service each such customer has received during the refund period, would be reasonable.

While we are concerned that it is not practicable to make refunds to all customers (both current and prior) based on exchange billings, we note that 97 percent of the telephone customers in California are served either by Pacific or General and will be receiving refunds. Only those few customers who moved out of state or into those areas of California not served by Pacific or General or those customers who no longer take telephone service will not share in the refunds.

In our adopted refund plans set forth in Appendix A and B, we will permit Pacific and General to make refunds in two annual payments with the maximum initial payment to current customers to be limited to $35.00 for both business and residential customers. This figure is selected in view of our concern that most customers should receive the full refund to which they are entitled as promptly as possible, and our uncertainty as to the precise number who would receive their full refund at the $25.00 initial refund level discussed by the staff witness. We anticipate that for approximately 75 percent of the residential customers the initial payment will represent the total refunds due.

The various parties proposed various interest rates ranging from the 7 percent interest rate currently being accrued on the overcollections to as high as 18 percent charged for retail credit transactions.

We take official notice of Decision No. 91269 in OII No. 56, dated January 29, 1980, wherein we ordered the application of an interest rate in excess of 7 percent per annum to balancing account accruals. The method of determining an applicable interest rate in that decision, which applies on funds owed between utilities and ratepayers (depending on how recorded energy-related expense matches billing factor revenues), is equally suitable under the circumstances presented herein. Accordingly, we will direct that the interest rate to be applied to the amounts to be refunded shall be the Federal Reserve Board Commercial Paper Rate 3-Month Prime, published monthly in Federal Reserve Board Statistical Release G-13, with interest compounded monthly. That rate realistically reflects money market conditions and strikes a reasonable balance between the interests of ratepayers and the utilities.

Prior decisions in these proceedings indicated interest on the funds held subject to refund would be 7 percent per annum. We do not believe it reasonable to retroactively modify the applicable interest rate on which the utilities and interested parties have generally relied. Accordingly, the Commercial Paper Rate adopted herein will apply only to all sums collected subject to refund from the effective date of the following order. Both utilities contend the statutory interest rate set forth in the Civil Code (7 percent per annum) must be applicable. However, we set interest rates in our quasi-legislative capacity in ratemaking matters and do not issue judgments for damages as do the courts who are governed by Civil Code provisions.

Adopted Refund Plan - Pacific

We will authorize Pacific to implement a refund plan quite similar to its proposed plan shown in Table 6 of Exhibit R-27, modified to provide for a two-step refund with a maximum initial payment to both residential and business customers of $35.00. (See Appendix A). The initial distribution shall be made within 120 days after the effective date of this decision with the second and final payment to be made one year after the initial distribution. Refunds will be in the form of billing credits. Refunds to prior business customers will also be made in full, by check, within 120 days after the effective date of this decision. All current customers who discontinue service will receive a final bill credit plus a check if the unrefunded balance exceeds the final bill.

Based on data in Exhibit R-27, of the $363 million [3/] refundable by Pacific for the period August 1974 through October 29, 1979, $203 million will go to business customers and $160 million to residential customers based on an allocation using total recurring exchange charges billed to the respective classes. The average refund to a residential customer will be approximately $24.00, but will vary for each customer according to his current month's recurring exchange charge. Refunds for Pacific will be required for overcollections to the effective date of this order. Current customers are customers who were receiving service on the effective date of this decision.

3/ Refunds are estimated to be approximately $381 million at January 31, 1980.

Refund Plan - General

We will require General to follow a modified refund plan which was advocated by the staff and which General states it could support in its brief dated December 11, 1979. The modified refund plan is contained in Appendix B and is summarized below:

1. The total refund for the refund period January 1, 1973 to the effective date of this order, for General before accrued interest was estimated to be approximately $86 million.[4/] Allocation of such amount based on total recurring exchange charges for the refund period would result in $41 million to the residential class and $45 million to the business class.

2. Refunds to the residential class will be made in a way similar to that for Pacific's residential customers and will be based on current recurring exchange charges limited to a maximum payment of $35.00 in the initial distribution with payment to be made within 120 days after the effective date of this order.

3. For business customers General will make refunds to all current business customers and those which have discontinued service since January 1, 1979. Such refunds will be based on recurring exchange charges weighted for the number of months each customer was in continuous service during the refund period.

4. All refunds to current customers will be in the form of bill credits.

5. All refunds to prior customers will be by check.

6. All refunds in excess of $35.00 for current customers will be paid in two steps, an initial refund credit of $35.00 within 120 days after the effective date of this decision and the balance to be credited one year after the initial distribution.

7. Current customers are customers who were receiving service from General on the effective date of this decision.

4/ Refunds are estimated to be approximately $111 million at January 31, 1980 including interest to that date.

RATE REDUCTION ISSUE

General's Position

General offered two witnesses, Mr. John B. Jones, Jr. and Mr. Robert L. Giffin, to testify on the impact of disallowance of intrastate deferred taxes and investment tax credit and the reestablishment of eligibility in 1980. Mr. Jones of the legal firm of Covington & Burling testified that he represented General in the presentation of a Ruling Request to the Internal Revenue Service (IRS) based on the "averaged Annual Adjustment" (AAA) method of determining tax expense for accelerated depreciation and the "Annual Adjustment"(AA) method of determining investment tax credits as set forth in Decision No. 87838. Witness Jones stated that although these proceedings are being conducted to implement Decision No. 87838, no court has yet spoken on whether the AAA method or AA method will deprive the California telephone companies of accelerated depreciation and/or the investment credit. He further testified that as long as General was collecting rates on a normalization basis, its eligibility for accelerated depreciation and investment tax credit was preserved until a decision was actually put into effect ordering refunds from these rates. He believes once refunds are made, there is no way under present law in which eligibility for the years affected can be preserved or restored if the court determines at some future date that Decision No. 87838 is inconsistent with eligibility.

Mr. Jones stated that once refunds are made for prior years, eligibility for those years will be irretrievably lost if the AAA and AA methods are found not to satisfy tax requirements. However, it would be possible to protect eligibility for future years and still offer ratepayers a refund if it is determined that the AAA and AA methods do not cause a loss of eligibility if General is permitted to collect rates on a normalization basis subject to refund.

Mr. Jones also testified on the procedures available to General should the IRS challenge General's tax returns. Mr. Jones testified that at the conclusion of an audit, the IRS first issues a "30-day letter" which is the basis for an internal appeal. If that appeal does not resolve the issue, the IRS then issues a "90-day letter" asserting a deficiency in tax. General Telephone and Electronics Corporation, General's parent, must then decide whether to contest the proposed deficiency in the United States Tax Court or pay the proposed deficiency, claim a refund, and sue in the United States District Court or in the Court of Claims. Appeals from either the Tax Court or the District Court would go to the Second Circuit Court of Appeals assuming suit is filed in New York or Connecticut, whereas decisions of the Court of Claims are reviewable only by the United States Supreme Court on petition for certiorari. The same would be true for any decision of the Second Circuit Court of Appeals. In the case of General, Mr. Jones estimated that it would take a minimum of four years and possibly six or seven years before a final judicial determination of the tax eligibility issue could be obtained.

Mr. Giffin, Vice President-Controller of General testified as to the estimated tax liability and accrued interest that will result if deferred taxes and investment tax eligibility are disallowed from 1970 through 1984 and the reduced dollar loss if eligibility for these tax benefits can be restored commencing in 1980. Exhibit R-22 shows that the estimated tax loss for General, should eligibility be lost through 1984, would be over $1 billion whereas the potential tax liability including interest can be reduced to $513 million if General is able to restore eligibility for AD and ITC in 1980.

Mr. Giffin testified that should General lose eligibility for AD and ITC through 1984, the company will be placed in a

financially untenable position and doubted the ability of the company to obtain $1 billion in additional financing to pay the back taxes and interest. He strongly urged that the Commission hold the rate reductions ordered in Decision No. 87838 in abeyance pending resolution of the tax issue and further that the Commission should do everything within its power to reestablish eligibility at the earliest possible date.

General states several reasons why the Commission should not allow its tax liability to remain in limbo for another four to seven years. They are the deficiency assessment levied by the IRS against Pacific of $89,000,000 which was attributed to the alleged ineligibility of Pacific because of the ratesetting formulas used in Decision No. 87838, the IRS letter advising General that similar treatment will be accorded General's tax return, and finally the impact of an additional $500 million of potential back taxes by 1984 in addition to the $500 million of back taxes and interest for the period prior to 1980 on General's financial position and its ability to provide service to its customers. General further argues that should the Commission fail to take any action to preserve eligibility and gamble that its ratesetting formulas preserve eligibility, General and its ratepayers will be the losers if the Commission loses that gamble.

Pacific's Position

Pacific in this proceeding as well as in Application No. 58223 requested that Pacific be permitted to collect, subject to refund, rates that are indisputably consistent with eligibility for AD and ITC and that are explicitly designed to reestablish Pacific's eligibility if Decision No. 87838 is later found to be inconsistent with eligibility.

In support of its position Pacific argues that:

1. The Commission in Decision No. 87838 recognized that federal tax benefits were an important source of financing for

Pacific, that loss of eligibility would create staggering problems, and that eligibility should be preserved.

2. Since Decision No. 87838 has been put into effect and refunds for the period August 1974 through October 1979 will be made, Pacific's eligibility for tax benefits under Decision No. 87838 will be fully tested. The IRS has served a deficiency letter on Pacific and over a billion dollars of potential back tax liability for 1974-1979 are now at risk.

3. This enormous risk, coupled with present market conditions and the growing demand for telephone service in California, has put Pacific in a precarious financial condition. Its present "A" bond ratings probably cannot be maintained absent substantial rate relief and Pacific's ability to finance its needed construction is now in doubt.

4. In view of Pacific's precarious financial situation, it is not wise to risk eligibility over an even longer period nor add to the already enormous potential back tax liability.

5. The telephone rates that went into effect on October 30, 1979 were based on normalization and ratable flow-through, and probably reestablish Pacific's eligibility for the tax benefits. These rates therefore constitute a first step in limiting Pacific's potential back tax liability to the sum accumulated for the period August 1974 to October 1979.

6. Eligibility can be made more certain if the Commission explicitly states that the AAA and AA methods will be applied to present rates and refunds ordered, <u>only</u> if and when litigation with the IRS establishes that these methods will preserve eligibility for tax benefits.

7. A proper refund provision should permit Pacific's financial statements to show the deferred tax liability that accrues

in connection with normalization after October 30, 1979 as a deferral, without the accrual of interest due the United States on the taxes. This change in the financial statements will significantly help the key "times interest coverage" indicator and thus improve the prospects of attracting investment.

8. Care taken by the Commission to minimize further risk of injury from a loss of tax eligibility will be seen by prospective investors as an important and positive sign.

In support of its position Pacific's financial witness Mr. Joses, Treasurer, testified on Pacific's bleak financial picture if the AAA and AA formulas were put into effect on an ongoing basis and eligibility were lost. Mr. Joses testified as to Pacific's growing capital budgets and the problems of funding such large budgets and what the potential loss of tax benefits would have on such financing requirements.

Mr. Joses further testified that Pacific has hired special tax counsel to help Pacific secure a favorable ruling on its deficiency litigation with the IRS. Counsel for Pacific stated for the record that Pacific will be directing the litigation with the IRS on the deficiency notice with full consent of American Telephone and Telegraph Company (AT&T): This statement is somewhat contradictory of General's witness Jones' testimony that the tax-paying parent would be expected to litigate the matter. Pacific's counsel stated that it knows it has the authority to direct the litigation. Mr. Joses further testified that if rates are continued to be set on a full normalization basis and a favorable eligibility verdict is obtained, Pacific would refund the difference between the AAA and AA rates over full normalization rates on a lump sum basis if the company has the financial viability to do so.

<u>Staff Position</u>

The staff takes the position that Pacific and General have not justified their proposal to continue rates on a full

normalization basis subject to refund and therefore reductions should be ordered consistent with the mandate of the California Supreme Court in City of Los Angeles v Public Utilities Commission (1975) 15 C 3d 680 and the order of the Commission in Decision No. 87838.

The staff contends that Decision No. 87838 is final as General and Pacific unsuccessfully sought rehearing before this Commission, and judicial review before the California Supreme Court and federal courts, including the United States Supreme Court on several occasions.

In their various appeals General and Pacific urged a stay of the operation of Decision No. 87838 until the various tax questions associated with the proceedings were finally settled before the IRS. The staff points out that the Commission took the position in these matters that these latter tax questions are a matter between General and Pacific and the IRS, and that they do not involve this Commission's ratemaking authority. The staff further argues that this important distinction was made clear in City of Los Angeles v Public Utilities Commission, supra, which led to Decision No. 87838, hopefully the final resolution of the matter.

The staff argues that Pacific's and General's witnesses have testified that in order to retain eligibility to take ITC, the Commission's order continuing rates on the Option 2 method provided in Internal Revenue Code Section 46(f) must be a final determination. However, the staff alleges Pacific's witness offered no analysis on what would constitute such a "final determination" within the meaning of the statute, and General's witness was also lacking in any substantive rationale for the opinion that an order continuing rates subject to refund was a final determination.

The staff argues that Pacific and General cannot say with assurance or based on authority that eligibility would be preserved during the succeeding years in which they would have rates set on normalization subject to refund, nor can they say that the Bell Normalization method will preserve eligibility at all. In weighing Pacific's and General's request the staff contends the Commission must consider the following costs and effects of an order to continue rates based on normalization:

1. The order is sought pending eventual resolution of the tax deficiency assessed for four months of 1974 which could take six or seven years for a final resolution during which rates would be collected on a Bell Normalization basis.

2. The amounts of tax deferrals and ITC accrued during this period would be substantial amounting to approximately $522.2 million at a 9.73 percent rate of return for Pacific through 1984 and $192 million for General.

3. In view of the substantial refunds involved, Pacific and General will make no assurance to the Commission that they will be financially able or willing to make any refunds in the future. Further General and Pacific might very well ask for an additional five-year refund plan.

4. During the four to seven years in which rates are collected subject to refund and an additional five years over which the companies may request refunds be paid, Pacific and General would accrue interest of at least 7 percent, which would represent a heavy cost to the ratepayers.

5. The proposed Bell Normalization method of itself cannot be said with certainty to preserve eligibility.

The staff concludes that the rationale offered by Pacific and General that a normalization order will preserve eligibility is tenuous at best and outweighed by the economic burdens and uncertainties to the ratepayers. Therefore, the staff recommends that prospective rate reductions be ordered now.

Cities' Position

The Cities argue that prospectively rates be set on a full flow-through basis as it was consistent with eligibility and secondly, any resulting loss of eligibility would be essentially compelled by the managerial imprudence and obstinacy of the telephone companies, going back to not electing full flow-through as did most other California utilities and/or not seeking legislation that would enable them to elect flow-through. The Cities argue that the IRS affirmed the Commission's full flow-through method for the years 1970-1973 and through August 16, 1974 by not levying any deficiency assessments but made an assessment for the methodology used after August 16, 1974 based on the Commission's normalization methodology. The Cities argue that Pacific and General willfully refused to take AD between 1954 and 1969, willfully sought legislation that could cause loss of eligibility, willfully asked the IRS to declare themselves ineligible for the benefits of AD, and made no effort to work for a legislative change that would preserve or restore eligibility. Cities argue that AT&T's and General Telephone and Electronic Company's (GT&E) nationwide financial interest demand ineligibility and this course has been followed consistently and will continue to be followed.

Cities specify the following reasons for rejection of Pacific's and General's proposals to collect revenues on a Bell Normalization basis subject to refund:

1. Collection subject to refund pending federal appeal has previously been rejected by the Commission and courts on various occasions.

2. Pacific's proposal will not ensure eligibility.

3. Collection of rates subject to refund provides an extreme incentive for the companies to seek ineligibility.

Should the Commission permit collection of rates subject to refund pending federal adjudications, Cities argue that such orders must have the following safeguards for the consumers:

1. The Commission must retain flexibility to reset rates on any basis it finds reasonable after a federal tax adjudication.

2. The Commission must ensure that the companies will absolutely refund all moneys collected subject to refund.

3. The funds should carry with them a specified interest rate or interest formula.

4. The utilities and their parents must pledge active cooperation in retaining eligibility and restoring financial integrity as a condition of any Commission order. Parents must:

(a) Provide equity capital to Pacific and General on the same basis as to all other system-operating companies.

(b) Actively support their California subsidiary efforts to retain eligibility via litigation and by providing assistance in sponsoring legislation to enable the subsidiary to retain eligibility.

Cities recommend, to insure good faith support by the parents, rates should be reset on flow-through if the parents fail to support the subsidiaries as indicated or if ineligibility results.

5. Reduction in rates of return since the companies profess that such action would be beneficial.

TURN'S Position

TURN takes the position that setting rates on a full normalization basis subject to refund if the Commission's normalization formulas are found not to violate IRS Code provisions would further encourage Pacific and General to continue to seek ineligibility since full normalization-based rates are substantially higher than rates based on the Commission's methodology. Since Pacific is but one of 19 affiliates of AT&T and General is but one of 14 affiliates of GT&E, the national implications of the tax ruling on the Commission's AAA and AA formulas must not be ignored. If litigation is handled by the parent corporations, TURN doubts that the corporate interests of the parents would be put aside for the interest of the California subsidiaries.

TURN also argues that it would be illegal to set telephone rates on a Bell Normalization basis since Ordering Paragraph No. 4 of Decision No. 87838 states that the AAA and AA tax methodologies "shall be applied to all future rates" of Pacific and General and also would be contrary to prior Supreme Court Cases, San Francisco v PUC (1971) 6 C 3d 119, 127 regarding normalization "notwithstanding the federal tax statute".

TURN also argues that the requested Commission order setting rates on a Bell Normalization basis subject to final ruling on the IRS deficiency assessment will not be final until a final determination is rendered on the deficiency assessment. Therefore, TURN believes prospective eligibility would date from the time of the final ruling on the IRS deficiency assessment and not from the date of a Commission order setting rates subject to some future event.

Discussion

Pacific and General argue that changed circumstances since the issuance of Decision No. 87838 justify the Commission's reconsideration of Ordering Paragraph 8 requiring rate reductions to set future rates on the AAA and AA normalization methodologies. The changed circumstances are the Notice of Deficiency Pacific received from the IRS on September 27, 1979 relating to the use of AD and ITC in 1974, an IRS letter indicating that it will apply the IRS ruling on General's tax return as to AD and ITC, and the enormous risks that Pacific and General will face if eligibility to use AD and ITC for 1980 and future years is lost.

Although TURN and other parties agree that Decision No. 87838 is final, only TURN takes the position that the Commission is precluded from setting rates prospectively on a full normalization basis after ordering in Decision No. 87838 that all future rates would be set using the AAA and AA formulas.

We are not moved by TURN's argument since the Commission has often adopted new ratemaking methodologies or modified existing ratemaking methodologies in the past. What is essential is that we consider in light of the present record whether it would be in the public interest either to permit Pacific and General to continue collecting rates on a full normalization basis or to place into effect the rate reductions ordered in Decision No. 87838.

We do not believe it to be in the best interests of either the utilities or their ratepayers to allow the potential tax liability to continue to increase beyond today's total. Pacific and General have both undertaken significant capital expansion programs in order to meet the growing demand for modern communication services. These plans, of course, require the infusion of large amounts of capital, which, in today's market, are increasingly costly.

While we are convinced that our ratemaking methods not only comply with the mandates of the California Supreme Court but also the eligibility conditions of the Internal Revenue Code, the financial community to whom the utilities must go in the pursuit of capital is influenced by the growing amount of potential tax liability which will only be finally settled on some uncertain date in the perhaps distant future. We note that Pacific's estimated further liability for the years 1980-1983, for example, is over $1.6 billion including interest, and for General $365 million before interest for the period 1980-1984. Thus, in order to keep the cost for additional capital as low as possible, which of course, inures to the benefit of the utilities' ratepayers as well as shareholders, and at the same time insure that the ratepayers will be made whole when litigation regarding consistency of our AAA and AA methodologies comply with the eligibility conditions of the Internal Revenue Code is concluded, we will set rates prospectively using Bell or full normalization methods subject to refund upon completion of the extensive litigation.

To do otherwise at this juncture exposes the companies to a further potential tax liability of nearly $2 billion, from which California ratepayers can gain no advantage, and for which the companies will claim the ratepayers are liable. This amounts to needless risk. A failure to recognize the uncertainties of litigation could lead to unnecessarily harsh consequences. The current situation can be likened to a variation on Russian Roulette: a trigger is being pulled, and the Commission cannot say for sure whether there are any bullets in the cylinder, or in what chamber a bullet may lie. What the Commission can do is avoid as much damage as possible if the gun should go off. The way to do this is to shield from damage in the form of unnecessary federal tax liability as much as it is practicable to shield. The Commission therefore commits itself to not apply the AA and AAA methods on a prospective basis until eligibility uncertainties are resolved, at which time refunds with accumulated interest at the formula arrived at in OII 56, currently exceeding 13 percent, will be ordered in the method applied on an ongoing basis, subject, however, to the following observations.

Adoption of the AA and AAA methods was ordered pursuant to decisions of the California Supreme Court, City of San Francisco v. PUC, 6 C3d 119 (1971). City of Los Angeles v. PUC (I), 7 C3d 331 (1972), City of Los Angeles v. PUC (II), 15 C3d 684 (1975). The court held in City of San Francisco that Commission Decision No. 77984 was invalid because of the failure of the Commission to consider alternatives to the full normalization method, which was found to be harsh to the ratepayer. Among the alternatives that the Court ordered the Commission to consider at that time, and in City of Los Angeles v. PUC (II), were application of the "imputed flow-through" method adopted in 1968 in Commission Decision No. 74917, and the AA and AAA methods ordered in Decision No. 87838.

Since the Commission continues to act pursuant to those Supreme Court decisions, it is important to examine our actions - and those of Pacific and General - in light of the language of the court.

Throughout the period since adoption of Internal Revenue Code Sections 46 (f) and 167 (l), the Commission has attempted to preserve Pacific's and General's eligibility for accelerated depreciation and the investment tax credit. Decisions 77984, 78851, 83162, 87838. In the first three of those Decisions, the Commission granted full normalization. In the case of each of those decisions, as noted above, the California Supreme Court annulled the Commission's treatment of income tax expense. In Decision No. 87838, we adopted the AA and AAA method suggested by the Court in City of Los Angeles (II).

It is important to observe - and for the companies to recognize - that the Commission's appreciation of the importance of eligibility is based upon practicality and not upon the due process clause. In City of San Francisco, the Court explicitly held that loss of eligibility and required flow-through of tax benefits i.e. imputed flow-through would not be "a denial of due process" because of "Pacific's conduct" which was characterized as "imprudent".

In today granting normalization rates subject to refund, the Commission recognizes the flexibility it retains under the holdings of the California Supreme Court. The outcome of litigation can never be certain until a final ruling takes effect. If, as the Commission expects, AA and AAA are eventually held consistent with eligibility, then the difference between the normalization rates granted today and the rates as they would be under AA and AAA will be refunded with accumulated interest, and the rates thenceforward will be set by the AA and AAA methods.

Some parties have expressed the fear that our order today provides an incentive for Pacific and General to undermine the case for eligibility in the hope of then gaining full normalization on a permanent basis. We believe this fear has been substantially mitigated by the vast sums which are already at risk. Sensitive to this legitimate fear, however, the Commission today affirms that loss of eligibility under AA and AAA does not necessarily imply permanent adoption of full conventional normalization.

If eligibility is lost under the AA and AAA methods several courses remain open to the Commission other than adoption of conventional normalization. First, it is likely that the Commission would initiate the consideration of additional alternatives to full normalization which would avoid the extreme positions - full normalization and imputed flow-through - which the Supreme Court held harsh to ratepayers and utilities, respectively. The orders of the California Supreme Court did not limit the Commission to consideration of one alternative. The Commission, naturally, does not welcome the prospect of additional years of dispute such as has attended litigation of issues raised by Decision No. 87838. The companies can help avoid such a prospect through ardent efforts to retain eligibility under Decision No. 87838.

The Commission is most concerned by the past actions of Pacific which serve not to preserve the eligibility which it claims is so vital to its financial health, but which undermine that eligibility. In public statements and press releases, and in appearances in legislative forums, representatives of Pacific and its parent have claimed that the normalization rules of Decision No. 87838 denied Pacific its eligibility. They have often relied upon IRS private letter rulings and deficiency notices, which are not binding upon courts of law, to support their claims. At every opportunity Pacific and its parent have opposed legislation which would have insured an end to the eligibility issue and would be consistent with the law of California. And in seeking an IRS ruling on eligibility under the AA and AAA normalization methods, Pacific took the position that the Commission's orders had made it ineligible. They took this position despite briefs filed in the Commission proceedings by inter alia, the Secretary of Defense, supporting the AA and AAA methods, and despite independent law review commentaries supporting eligibility under AA and AAA.

The companies should be aware that the Commission could at any time order current rate-setting under AA and AAA, even before a final ruling on the eligibility question. Such action could be taken if the Commission found that the companies were not making a good faith effort in seeking to retain eligibility.

In judging whether the good faith effort is undertaken, the Commission will look to the following: The willingness of the companies and special counsel to report to the Commission on the progress of litigation; the willingness of the companies to support the Commission as full partner and intervenor in the litigation; and the degree to which actions of special counsel and oversight of special counsel are undertaken independent of those elements of Pacific which continue to claim that eligibility is lost under Decision No. 87838.

Although certain parties have advocated the use of flow-through since the IRS did not levy a deficiency assessment for the years 1970-1973 and January 1, 1974 through August 16, 1974, when rates were set on the basis of flow-through, we are not convinced that flow-through is a viable alternative for Pacific and General. We view the IRS failure to assess a deficiency for the periods when rates were based on flow-through as entirely inconsistent with the deficiency assessment beginning August 16, 1974. However, the failure to assess a deficiency until August 16, 1974 merely strongly confirms our opinion that our more conservative AAA and AA adjustments must comply with the Internal Revenue Code.

Findings of Fact on Rate Reduction Issue

1. Pacific has been served a Deficiency Letter by the IRS for 1974 in the amount of approximately $89 million due to the methods of normalization adopted in Decision No. 87838.

2. General has been advised by the IRS that similar treatment will be accorded General's tax returns.

3. Pacific and General have stated on the record that they will vigorously challenge the IRS determinations.

4. It is estimated that it may take from four to seven years before there is final judicial resolution as to whether the AAA and AA methods used in Decision No. 87838 are acceptable normalization methods.

5. Pacific and General are confronted with substantial potential back tax liabilities of approximately $1 billion and $390 million, respectively, for 1979 and prior years and $1.250 billion and $378 million, respectively, for 1980-83.

6. Pacific and General estimate a continuing growth of customers in the 1980's. Pacific estimates construction budgets for 1980 of $2.4 billion, for 1981 of $2.7 billion, and for 1982 of $3.0 billion. General's construction budget estimates for 1980, 1981, and 1983 are $610 million, $675 million, and $748 million, respectively.

7. Pacific and General estimate that their external financing requirements will be correspondingly large in the 1980's. Pacific estimates $1.2 billion of external financing in 1980 and General estimates that its financing will average more than $300 million per year for the period 1980-84.

8. Both Pacific and General have single A debt ratings and express concern about maintaining their ratings.

9. The Internal Revenue Code or regulations require a subsequent determination consistent with the eligibility conditions in Section 46(f) be put into effect to reestablish eligibility.

10. Under current economic conditions, it is reasonable to place a cap on Pacific and General's potential tax liability by providing that henceforward rates will be set on full normalization subject to refunds pending the outcome of litigation with the IRS concerning the AAA and AA methods.

11. The IRS failure to assess a deficiency for the years 1970-1973 and January 1, 1974 to August 16, 1974 confirms that the Commission's more conservative ratemaking methods comply with the IRS Code.

Findings of Fact - Rate Refunds

1. If lump sum refund is ordered, Pacific and General will be confronted with severe cash flow problems considering the magnitude of external financing both companies must seek in 1980 and future years to finance their needed construction programs.

2. The five-year extended refund period sought by Pacific and General is too long and imposes an unfair burden on the ratepayers.

3. A two-step refund will substantially alleviate the cash flow problems of Pacific and General but will result in reasonably expeditious refunds to the ratepayers.

4. Section 453.5 of the Public Utilities Code sets forth the legal requirements any refunds ordered by this Commission must satisfy.

5. Allocation of the refund between the residential and business classes in proportion to the total recurring exchange billing for the two classes for the refund period represents an equitable pro rata basis.

6. Refunds to prior residential customers of Pacific and General will be extremely costly, time-consuming, and unsuccessful because the current addresses of such prior customers are frequently not available.

7. Refunds to prior business customers of Pacific are practicable because the number of business customers is substantially less than the number of residential customers.

8. Refunds to all prior business customers of General are not practicable because it would take 10 to 18 months and substantial cost to accomplish the data processing work alone to develop the necessary data.

9. General can make refunds to business customers who were customers on or after January 1, 1979 and has other records to determine the number of months of continuous service each business customer had during the refund period.

10. General and Pacific provide telephone service to 97 percent of the telephone customers in California.

11. Most prior customers of General and Pacific are current customers of Pacific and General.

12. If refunds for residential customers are restricted to current customers, only those prior customers who are currently in non-Pacific or General service areas, customers who have moved out of state, or customers who have become deceased or are no longer taking any telephone service will not share in the residential refunds.

13. It is not practicable to make refunds to all prior residential customers since the costs and time involved do not warrant such an effort and will be substantially unsuccessful.

14. It is practicable to make refunds to all current and prior business customers of Pacific as the records are readily available to make such a distribution whereas it would not be practicable to make refunds to all prior business customers of General as it would require the processing of 17,000 reels of tapes to extract similar information for General's business customers.

15. It would be reasonable to require General to make refunds to all business customers of General who were customers as of January 1, 1979 and to make refunds proportional to the number of months of continuous service.

16. It is reasonable to compute refunds to Pacific's business customers in proportion to historic recurring exchange charges billed to each business customer during the refund period, whereas

for General's business customers refunds would be proportionate to current recurring exchange billing weighted to reflect number of months of continuous service.

17. It is reasonable to make refunds in the form of bill credits to current customers and by checks to prior customers to: (1) avoid the considerable cost of issuing and processing checks, and the handling of a number of returned checks, and (2) avoid the possibility of checks being stolen, misplaced by customers, or confused with bill stuffer material often discarded.

18. It is reasonable to require Pacific and General to file reports showing the refunds distributed within 90 days after each distribution date and a final report as to any unrefunded balances for further distribution at some future time.

19. Interest on refunds can and should be set prospectively at the same levels set in Decision No. 91269.

Conclusions of Law

1. The refund plans authorized for Pacific and General as shown in Appendices A and B are reasonable plans that conform to the requirements of Public Utilities Code Section 453.5.

2. Pacific and General should be authorized to continue collecting rates based on a full normalization basis until there is legal resolution on whether the AAA and AA methods are acceptable normalization methods.

3. Pacific's rates set in Decisions Nos. 90919 and 91121 should be based on a full normalization basis, subject to refund.

4. General's rates should be established on the basis set forth in Decision No. 87505, less an amount to reflect full flow-through for 1969 vintage plant additions, and as filed in Advice Letter No. 4471.

5. In order to expeditiously proceed with the refund plan adopted herein, the following order should be effective the date of signature.

IT IS ORDERED that:

1. Within one hundred twenty days after the effective date of this order, The Pacific Telephone and Telegraph Company shall refund the overcollection in rates for the refund period August 1974 to the date of this decision of approximately $381 million, plus additional interest to payment dates pursuant to the refund plan attached hereto as Appendix A.

2. Within one hundred twenty days after the effective date of this order, General Telephone Company of California shall commence refunding the overcollection in rates for the refund period January 1, 1973 to the date of this decision of approximately $111 million plus additional interest to payment dates pursuant to refund plan attached hereto as Appendix B.

3. The Pacific Telephone and Telegraph Company and General Telephone Company of California shall inform each recipient of a refund either by transmittal letter or notation on the bill or check reflecting the refund that: "This refund is pursuant to an order of the California Public Utilities Commission."

4. Decisions Nos. 90642, 90919, and 91121 in Application No. 58223 which establish rates on a full normalization basis, subject to refund, shall be revised as follows:

> "The rates established shall be subject to refund on further order of the Commission after completion of litigation with the IRS concerning the AAA and AA methods. It is the Commission's intent, as expressed in Decision No. 87838, that eligibility be preserved."

5. General Telephone Company of California is directed to file with this Commission within five days after the effective date of this order and in conformity with the provisions of General Order No. 96-A, revised tariff schedules with rates, charges, and conditions established on the basis set forth in Decision No. 87505, less an amount to reflect full flow-through for 1969 vintage plant additions, (See Advice Letter 4471), and shall be effective upon filing.

6. Interest on amounts subject to refund shall be computed by applying the rate of 7 percent per annum to the date of this order, hereafter the rate will be the Federal Reserve Board Commercial Paper Rate 3-Month Prime, published monthly in Federal Reserve Board Statistical Release G-13; both rates will be applied with monthly compounding.

7. Any motion not heretofore ruled on in these proceedings is denied.

The effective date of this order is the date hereof.

Dated FEB 13 1980, at San Francisco, California.

President

Commissioners

APPENDIX A
Page 1 of 2

Refund Plan For The Pacific Telephone and Telegraph Company To Disburse Funds As Ordered By Decision No. 87838

1. Apportionment

   a. The actual billing amounts for recurring exchange charges for the residential and business classes will be computed for the full refund period.

   b. Using the actual billing amounts from (a) above, the total amount of the refund which has been fixed will be proportionately allocated to the residential and business classes on the basis of recurring exchange charges.

2. Distribution

   a. The refund amount for the residential accounts will be distributed to current customers on an equitable pro rata basis, using each customer's current recurring monthly exchange charges as the proportional factor. Current customers mean customers who were receiving service on the effective date of this decision.

   b. For business customers, the refund amount will be distributed on the basis of historical billing records to all customers connected since the start of the period for refund. The total billed amount for recurring exchange charges for the customer's full connection period will be used as the proportional factor. In the case of business customers, both current and former customers will receive refunds.

3. Manner of Refund

   a. Current customers - by bill credit.

   b. Current customers who discontinue service - by final bill credit plus check if refund balance exceeds final bill.

   c. Former customers - by check.

4. Timing

   a. Refunds will be made in two steps. Initial distribution will provide for full refund but no more than $35 within 120 days of the effective date of this order, to all current business and residential customers. Balance due will be refunded one year from the date of initial distribution.

b. Refunds to business customers who are not current customers, and to residential customers who discontinued service after the effective date of this decision and who are not current customers, will receive full refunds within 120 days of the effective date of this order.

5. Refund Period

Refunds will be for the period from August 17, 1974 when rates under Decision No. 83162 went into effect through the effective date of this decision plus applicable interest to refund date.

6. Interest Rates

Interest on unrefunded balance will be continued at the rate of 7 percent per annum to the effective date of this decision and at the Commercial Paper Rate (3 months prime) effective after the date of this decision.

7. Reporting Requirements

Pacific Telephone will file a report with the Commission within 90 days of the completion of each distribution. The report will contain the following information:

a. The total basic amounts plus interest due customers.

b. The total amount credited on bills either initially or through adjustments.

c. The total amount of drafts issued.

d. The total amount of drafts returned as undeliverable.

e. The total amount of drafts outstanding and an estimate of the portion which will never be presented for payment.

f. The total amount which remains undisbursed (a-b-c+d+e (portion)).

g. The amount of expense incurred to implement this Plan and the accounts charged therewith.

8. Other Requirements

a. Pacific Telephone is no longer required to maintain records relating to charges authorized by Decisions Nos. 83162 and 85287 for the period from August 17, 1974 to October 29, 1979 and Decisions Nos. 90642, 90919, and 91121 rates to the date of this decision.

b. No attorney's fees for any intervenor shall be paid in connection with the refunds.

Refund Plan For General Telephone Company of California
To Disburse Funds As Ordered By Decision No. 87838

1. Apportionment

   a. The actual billing amounts for recurring exchange charges for the residential and business classes will be computed for the full refund period.

   b. Using the actual billing amounts from (a) above, the total amount of the refund which has been fixed will be proportionately allocated to the residential and business classes on the basis of recurring exchange charges.

2. Distribution

   a. The refund amount for the residential accounts will be distributed to current customers on an equitable pro rata basis, using each customer's current recurring monthly exchange charges as the proportional factor. Current customers mean customers who were receiving service on the effective date of this decision.

   b. For business customers, the refund will be made to current customers and to prior business customers who have disconnected service since January 1, 1979 on the basis of their current monthly recurring exchange billing*, but with the refund amounts received by each customer weighted to reflect the number of months that the customer has been in continuous service during the refund period.

3. Manner of Refund

   a. Current customers - by bill credit.

   b. Current customers who discontinue service - by final bill credit, plus check if refund balance exceeds final bill.

   c. Former customers - by check.

* For prior business customers who have disconnected service since January 1, 1979 on the basis of their last monthly recurring exchange billing.

4. Timing

   a. Refunds will be made in two steps. Initial distribution will provide for full refund but no more than $35 within 120 days after the effective date of this order to all current business and residential customers. Balance due will be refunded one year from the date of initial distribution.

   b. Refunds to residential customers who discontinued service after the effective date of this decision and who are not current customers will receive full refunds within 120 days of the effective date of this order. Business customers who discontinued service on or after January 1, 1979 will receive full refunds within 120 days after the effective date of this order.

5. Refund Period - Refunds will be for the period January 1973 to the effective date of this decision. Although the refund period commences with December 1971, the Commission in Decision No. 87838 recognized certain credits and rate reductions made by General as a result of the annulment of Decision No. 78851 of Pacific.

6. Interest Rates

   Interest on the unrefunded balance will be continued to accrue at the rate of 7 percent per annum to the effective date of this decision and at the 3-month Prime Commercial Paper Rate as of the effective date of this decision.

7. Reporting Requirements

   General will file a report with the Commission within 90 days of the completion of each distribution. The report will contain the following information:

   a. The total basic amounts plus interest due customers.

   b. The total amount credited on bills either initially or through adjustments.

   c. The total amount of drafts issued.

   d. The total amount of drafts returned as undeliverable.

   e. The total amount of drafts outstanding and an estimate of the portion which will never be presented for payment.

f. The total amount which remains undisbursed (a-b-c+d+e (portion)).

g. The amount of expense incurred to implement this Plan and the accounts charged therewith.

8. Other Requirements

a. General is no longer required to maintain records relating to charges authorized by Decisions Nos. 79367, 83779, and 87505 for the period from January 1979 to the effective date of this decision. Records for Decision No. 87505 will have to be maintained from the effective date of this decision.

b. No attorney's fees for any intervenor shall be paid in connection with the refunds or rate reductions.