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Decision No. \_\_\_\_\_

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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of )  
SOUTHERN CALIFORNIA GAS COMPANY for )  
Authority to Increase Rates Charged )  
By It for Gas Service. )

Application No. 57639  
(Filed October 28, 1977)

David B. Follett and Robert B. Keeler,  
Attorneys at Law, for applicant.  
John W. Witt, City Attorney, by  
William S. Shaffran, Deputy City  
Attorney, for City of San Diego;  
and Burt Pines, City Attorney, by  
Ed Perez, Deputy City Attorney,  
for City of Los Angeles; interested  
parties.  
Thomas F. Grant, Attorney at Law, for  
the Commission staff.

OPINION ON LIMITED REHEARING  
ON INTERIM DECISION NO. 90105

D.90105 dated March 27, 1979 was the third decision issued on Southern California Gas Company's (SoCal) A.57639 seeking authorization to increase its rates approximately \$334.0 million (33.5 percent) annually at the estimated test year level of sales. D.89208 dated August 8, 1978 on this matter granted a partial general increase of \$118.6 million and D.89710 dated December 28, 1978 granted SoCal an additional \$82.9 million, a total of \$201.5 million over base rates in effect in July 1977. The total increase was intended to provide an overall rate of return of 9.73 percent and a return on common

equity of 13.49 percent as shown in the following tabulation as it appears on mimeo page 23 of D.89710:

Item	Adopted Capital Structure		
	Capital Ratio	Cost Factor	Weighted Costs
Long-Term Debt	50.41%	7.62%	3.84%
Preferred Stock	9.99	5.47	0.55
Common Equity	39.60	13.49	5.34
Total	100.00%	-	9.73%

On February 23, 1979 SoCal filed a petition for modification of D.89710 requesting an additional \$12,411,000 in revenues to correct an allegedly erroneous income tax calculation reflecting the inclusion of interest on short-term debt as an income tax deduction when D.89710 excluded short-term debt from the adopted capital structure. According to SoCal the inclusion or exclusion of short-term debt interest in income deductions for tax purposes should coincide with the inclusion or exclusion of short-term debt in the capital structure. On March 1, 1979 Tehachapi-Cummings County Water District (Tehachapi) filed a response to SoCal's petition requesting the petition be denied or at least that it not be granted ex parte. Ex parte D.90105 dated March 27, 1979 granted SoCal's request by modifying D.89710 to increase SoCal's revenues an additional \$12,411,000. This decision was, however, granted on an interim basis with the additional revenues subject to refund in order to provide Tehachapi a full opportunity to present its evidence in public hearing provided an offer of proof established the need therefor. On March 29, 1979 the cities of Los Angeles and San Diego (Cities) also filed a protest to SoCal's petition and on April 23, 1979 filed a petition for rehearing of D.90105. On May 5, 1979 SoCal filed a response asking that Cities' petition be denied.

Cities' petition for rehearing of D.90105 filed April 23, 1979 alleged that SoCal's Petition for Modification of D.89710 was procedurally incorrect in that such petitions are properly utilized only for minor changes and the \$12,500,000 sum in dispute is not a minor change; that the proper vehicle with respect to this issue was a petition for rehearing which our Rules of Procedure and the Public Utilities Code mandate must be filed within thirty days of the entry of the decision which had lapsed on January 12, 1979; that the treatment of short-term debt in D.90105 is erroneous and results in a confiscation of ratepayers' property without due process of law; and that in the case in issue, short-term debt is properly includable in the capital structure.

The thirty-day mandate in our Rules of Procedure and the Public Utilities Code referred to by Cities relates to the retention of eligibility for judicial review but does not preclude this Commission from granting rehearing should the petition be filed more than thirty days after the issuance of the decision. ✓

After careful consideration of each and every allegation of error in Cities' petition, this Commission concluded that good cause existed for granting rehearing and issued D.90472 on June 19, 1979 ordering a rehearing of D.90105 "limited to the receipt of evidence and briefs on the question of the appropriate ratemaking treatment of SoCal's short-term debt." It should be noted that the rehearing was not limited to consideration of whether or not short-term debt interest should be included in tax deductions for income tax calculations, but also encompassed the broader issue of the appropriate ratemaking treatment of SoCal's short-term debt.

The limited rehearing was held before Administrative Law Judge (ALJ) N. R. Johnson on October 10, 1979 in Los Angeles and the matter was submitted upon receipt of concurrent briefs due November 28, 1979. Testimony was presented on behalf of SoCal by its manager of revenue services in the regulatory affairs department, W. F. Stanley; on behalf of Cities by Manuel Kroman; and on behalf of the Commission staff by Bertram Patrick.

Position of Cities

Testimony and briefs presented on behalf of Cities indicated that:

1. Short-term debt should be included in the adopted capital structure of SoCal while maintaining the authorized rate of return of 9.73 percent.
2. The exclusion of short-term debt from the adopted capitalization is to employ a hypothetical capital structure, at odds with reality.
3. It is proper to include the short-term debt interest in income tax deductions when computing the test year 1979 income tax expense irrespective of whether or not short-term debt is included in the capital structure.
4. The inclusion of short-term debt in the capital structure would necessitate a return on common equity of 13.80 percent instead of the adopted 13.49 percent to maintain the allowed rate of return of 9.73 percent. According to the testimony of this witness, however, these two amounts are equivalent when

proper consideration is given to the generally acknowledged inverse relationship between return on equity capital and the equity ratio.

5. D.90105, if affirmed will have the anomalous effect of significantly increasing rates so as to give recognition to a trivial amount of Allowance for Funds Used During Construction (AFUDC).

6. Federal Power Commission (FPC) Order No. 561 is apparently predicated on the proposition that the sum of a utility's permanent capital structure, plus short-term borrowing, is equal to the sum of its rate base plus interest-bearing construction work in progress. In this case, however, the utility's average test year 1979 permanent capital plus short-term debt is less than the rate base even before giving consideration to Construction Work in Progress (CWIP).

7. The interest expense attributable to short-term funds invested in CWIP is of a relatively inconsequential magnitude; therefore, it is clearly erroneous to exclude all short-term debt interest expense from the income tax calculation.

8. The \$12,411,000 rate increase authorized by D.90105 has been erroneously computed in that the product of the amount of short-term debt of \$80 million and the applicable interest rate of 7.75 percent is \$6.2 million rather than the approximately \$12 million used in computing the additional revenues required.

Position of SoCal

The position of SoCal, as set forth in the record and argued in its brief, is as follows:

1. The income tax calculation adopted for the test year 1979 was incorrect because the interest on short-term debt was

included as an income tax deduction when short-term debt was excluded from the capital structure with the result that SoCal was precluded from earning its authorized return on common equity.

2. This Commission recognized the validity of SoCal's claim of incorrect income tax computations and corrected this deficiency by issuing interim D.90105 granting SoCal additional annual revenues of \$12,411,000.

3. Mr. Kroman's testimony indicates that the matching of authorized expenses with corresponding computations of income tax expense is required (Question and Answer 11).

4. The use of Mr. Kroman's recommended capital structure, including \$80 million of short-term debt at an interest rate of 7.75 percent, is improper because the issue was resolved by D.89710 and the period for timely petitions for modification has long passed. In addition, a 7.75 percent interest rate would be entirely inadequate in light of the existing high level of the prime interest rate.

5. Although ostensibly objecting to the correction of the incorrect income tax computation, Cities is actually attempting to relitigate the issue of the inclusion of short-term debt in the capital structure even though the issue was resolved by D.89710, the time for appeal has expired, and all parties are estopped from seeking an alternative determination.

6. The short-term debt is used to pay for plant construction and, lately, to finance undercollections caused by purchased gas costs rising more rapidly than revenue collections.

Position of the Commission Staff

The Commission staff's position as presented into evidence and argued in its brief is that:

1. The staff confirmed that D.89710 inadvertently understated the income tax expense by \$12,411,000 as a result of the

exclusion of short-term debt from SoCal's adopted capital structure without similar exclusion of interest on short-term debt from the income deductions for income tax calculation purposes.

2. The treatment of short-term debt should be consistent in the capital structure and income tax calculation.

3. The incorrect income tax computation resulted because of inadequate consultations between the two staff witnesses who prepared the rate of return and results of operations exhibits.

4. Interim D.90105 was proper and should be affirmed.

5. Several reasons unconnected with AFUDC for excluding short-term debt from SoCal's capital structure were advanced by the staff's rate of return witness including (a) the short-term debt in question constitutes advances from associated companies and is not classified as debt on the company's books and (b) the payables to associated companies represent a return on a portion of dividends which have been paid to SoCal's parent company rather than short-term borrowing from a lending institution.

#### Discussion

Decision No. 89710, dated December 12, 1978 sets forth the capital structure adopted by the Commission after consideration of the exhibits and testimony of all parties. The Commission determined that short-term debt shall be excluded as a component of the capital structure and states the following rationale on page 17:

"By D.89578 dated October 31, 1978 in Cases Nos. 4230 and 6998, our investigations relating to the adoption of revised uniform systems of account, we concluded that Federal Energy Regulatory Commission (FERC) Orders Nos. 561 and 561A should be adopted. Such rules prescribe a formula for determining the maximum allowance for funds used during construction (AFUDC) rate. The inclusion of short-term debt in determining the allowed rate of return, coupled with the FERC formula for computing AFUDC, would result in a double counting of short-term debt. To avoid such a double counting, we will exclude the short-term debt from the cost of capital computations."

In addition, staff witness Leonard in testifying as to why he excluded the shortterm debt from his capital structure stated on transcript page 1162:

Q. "May I explain why I did not include those figures in? Certainly.

A. I think there are several reasons, first of all, the tables, the interest on these advances from associated companies are not really classified as debt in the company's books, as I understand.

They are current liabilities. They are not classified as notes payable, but payables to associated companies, number one. Secondly, I think any amount that you would consider in arriving at these interest figures would have to some kind of an average because the payable to the associated companies fluctuates from month-to-month, and you look at one month there may not be a balance in there at all, so you would have to average it out over the year."

In the limited rehearings on Interim Decision No. 90105 SoCal witness Stanley, testified in response to cross-examination by staff counsel as to the use of the short-term debt by the company on transcript pages 4208-4211 as follows:



CROSS-EXAMINATION

"BY MR. GRANT:

Q. I think it would help the record and help the Commission in this proceeding to find out what the short-term borrowed funds are actually used for. So let me ask you, can you tell us, well, can you tell us what the funds are, borrowed on a short-term basis--

A. Yes.

Q. --by your company are actually used for?

A. The Pacific Lighting Utilities companies operate like most utilities: they satisfy the immediate need of their funds for construction, operating purposes by short-term borrowing, short-term debt, and as soon as that reaches a significant amount, they replace it with long-term debt.

Now, previously, and this was true in this case that's in consideration now, when it was put together it was before we had the so-called Supply Adjustment Mechanism, and the gas company is very susceptible to the variations in weather. (Emphasis added)

In effect, SoCal had to borrow large amounts of short-term debt to operate during the warm periods of the year and then in the wintertime, when the weather was colder, it would pay back that short-term debt.

That was taken into consideration when we put this case together prior to the time SAM was authorized.

Q. Is the institution of SAM the mechanism you refer to as SAM, inclusion of that, is that going to affect the short-term borrowings in the future of the company?

A. Yes.

We no longer have to borrow on a seasonal basis as we have in the past.

Q. You will be doing less short-term borrowing?

A. It's hard to say whether we will be doing less.

I think the absolute magnitude, if all other things would be equal, we will have less short-term borrowings, yes.

Q. Still I don't think your answer to my original question was quite specific enough.

What I was wondering was what actually is the money used to purchase, to buy, where does it go?

A. The money is actually used to pay for plant construction, to put pipelines in the ground, build buildings and that kind of thing.

Also, another use we have for our short-term debt, one that has become very apparent lately is the fact we have very significant undercollections in our purchased gas adjustments.

We have to pay these increased gas costs before we get the money from our customers; so, therefore, we have to borrow money to allow it to, just to operate and pay for these increased gas costs.

Q. So, essentially you have two things, the capital expenditures for pipes, et cetera, and the second one is on purchases of gas?

A. Yes."

Therefore, the use of the short-term debt as originally estimated by SoCal (\$80 million) can be summarized as follows:

1. Weather variations.
2. Construction.
3. Undercollection in Purchased Gas Adjustments.

The company, however, was not able to specifically identify a dollar amount associated with each item.

The record before us is clear that the short-term debt as originally estimated by SoCal of \$80 million included an amount which is no longer applicable because of the adoption of SAM. Regardless of the adoption of SAM, however, short-term borrowings for such a purpose as weather conditions would not be properly includable in the capital structure. Also short-term borrowings used to finance the undercollections in the Purchased Gas Adjustments (PGA) are not properly includable in the capital structure. It must be noted that SAM and PGA proceedings both provide for the recovery of interest costs by the company; therefore, including the short-term debt associated with SAM and PGA in the capital structure would mean that the ratepayers would be paying for interest costs twice.

The remaining item for which the short-term debt was used was plant construction. The inclusion of short-term debt in the capital structure used in determining the allowed rate of return, coupled with the FERC formula for computing AFUDC, would result in a double counting of short-term debt. The company was not able to specify the amount of short-term debt associated with plant construction. Although there is some uncertainty regarding the amount of short-term debt associated with plant construction, there is nothing in the record to convince us that we should change our original findings that short-term debt should not be included in the capital structure adopted in Decision No. 89701.

Another factor which must be considered in this proceeding is the rate of return on equity of 13.49% and the resulting rate of return on rate base of 9.73% found reasonable by the Commission in Decision No. 89710. In adopting these returns, which were based on a capital structure which excluded short-term debt, the Commission stated on p.23 of D.89710:

"This return on capital is the minimum needed to attract capital as a reasonable cost and not impair the credit of SoCal. This rate of return will provide an approximate times interest coverage after income taxes of 2.53 times and an interest plus preferred dividend coverage of 2.22."

Had the Commission considered a capital structure which included the \$80 million of short-term debt, the following would have resulted:

Item	Capital Ratio	Cost Factor	Weighted Costs
Long-Term Debt	47.52%	7.62%	3.62%
Short-Term Debt	5.73	7.75	.44
Preferred Stock	9.42	5.47	.52
Common Equity	37.33	13.49	5.04
	100.00%	-	9.62%

It will be noted that the above provides a rate of return of 9.62 percent, a times interest coverage of 2.37, and a combined coverage factor for all interest and preferred stock dividends of 2.10 compared to 9.73, 2.53, and 2.22, respectively, set forth in Decision No. 89710.

The resulting differences in rate of return, times interest coverage and combined coverage for interest and preferred stock might have caused the Commission to adopt a return on equity and rate of return different than that adopted in Decision No. 89710. For example, the resulting times interest coverage of 2.37, as contrasted to the original 2.53, might have been considered inadequate at that time, supporting an increase in return on common equity to raise the times interest coverage to a more appropriate level.

The Commission therefore determines that a recomputation of the capital structure adopted in Decision No. 89710 is not appropriate at this time.

With respect to the treatment of the income tax effect of SoCal's short-term debt, it should be noted that the generic questions of whether to include interest expense for construction work in progress or on debt that is not part of a utility's capital structure when calculating income tax expense for test year rate-making purposes is, as pointed out in Decision No. 89710, the subject of Order Instituting Investigation No. 24.

However, it is not reasonable to put off making a decision on that issue in this proceeding because we are faced with the fact that we have already adopted a fair and reasonable rate of return for SoCal. Any retrospective change in tax treatment would necessarily affect SoCal's interest coverage and return on equity and require a reanalysis of those issues. SoCal's rate of return, however was not an issue in this rehearing.

As we previously noted when faced with a similar problem as to Pacific Gas and Electric Co.

"...to unilaterally change the method used to estimate increase tax expense without considering the effect on post-tax interest coverage and return on equity (in a proceeding where authorized rate of return could, if warranted, be adjusted) would not be fair or in the best interest of maintaining financially sound utilities...." (Decision No. 89315 (1978) \_\_\_\_\_ CPUC \_\_\_\_\_, at page 28 mimeo.)

Therefore, we shall adopt the staff's tax treatment of SoCal's short term debt interest expense, rather than that of the Cities, for purposes of this proceeding.

#### Findings of Fact

1. The \$80 million of SoCal's 1979 test year short-term debt included an amount no longer applicable because of the adoption of the Supply Adjustment Mechanism (SAM).
2. The \$80 million of SoCal's 1979 test year short-term debt is used for construction; undercollections associated with Purchased Gas Adjustments; and to offset fluctuations in earnings due to weather variations.
3. Short-term debt for reasons attributed to SAM or PGA is not properly includable in the capital structure because the recovery of interest costs associated with such debt are provided for in the respective proceedings.
4. Short-term debt attributed to interest-bearing construction work in progress (CWIP) is not properly includable in the capital structure because coupled with the FERC formula for computing AFUDC, inclusion of short-term debt in the capital structure would result in double counting of short-term debt.

5. For this proceeding, the methodology used in Decision No. 89710 to calculate SoCal's revenue requirement and rate of return necessitates that interest expenses for debt, which was not part of the utility's adopted capital structure, be excluded when calculating SoCal's test year income tax expense.

6. Because test year 1979 is past, and it is problematical whether we would have found the coverage factors resulting from a return on equity of 13.49 percent with \$180 million of short-term debt included in the capital structure adequate, it is inappropriate at this time to recompute the 1979 capital structure adopted in Decision No. 89710.

7. The generic questions of whether to include interest expense for construction work in progress or on debt that is not part of a utility's capital structure when calculating income tax expense for test year ratemaking purposes is, as pointed out in Decision No. 89710, the subject of Order Instituting Investigation No. 24.

#### Conclusions of Law

1. The gas rates authorized for SoCal in Interim Decision No. 90105 are just and reasonable.
2. The Commission concludes that the application should be granted to the extent set forth in the order which follows.

ORDER

IT IS ORDERED that:

The rates authorized by Decision No. 90105 are made final.

The effective date of this order is the date hereof.

Dated JUL 2 1980, at San Francisco,

California.

*John E. Sagers*  
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President

*Vermon L. Stinson*  
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*Robert W. Hoyle*  
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*Clair D. Deidrich*  
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*Edward M. Jensen*  
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Commissioners