PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Communications Division **RESOLUTION T- 17618**
Carrier Oversight and Programs Branch **August 9, 2018**

R E S O L U T I O N

Resolution T-17618, Ponderosa Telephone Company. Order Authorizing a Reduction of $292,535 in Adopted Revenue Requirement for Test Year 2018 and a Corresponding Reduction of $292,535 in California High Cost Fund-A Support for Test Year 2018 to flow through changes resulting from the Tax Cuts and Jobs Act of 2017.

SUMMARY

This resolution flows through revenue requirement and California High Cost Fund-A changes from the Tax Cuts and Jobs Act of 2017, which became effective on January 1, 2018. Specifically, this resolution adopts a revised revenue requirement of $10,644,431 for The Ponderosa Telephone Company's Test Year 2018, and a corresponding revised California High Cost Fund-A support amount of $3,324,434 resulting in a reduction of $292,535 in California High Cost Fund-A support for 2018.

BACKGROUND

The California High Cost Fund-A (CHCF-A) program operates in accordance with Public Utilities (P.U.) Code § 275.6. This statute requires the Commission to implement a program to reduce any rate disparity between rural and urban areas charged by Small Incumbent Local Exchange Carriers (hereafter referred to as Small ILECs) that are subject to rate-of-return regulation.

Decision ("D.") 17-11-013 approved an all-party Settlement Agreement in Ponderosa Telephone Company's (Ponderosa) general rate case (GRC) for rates effective January 1, 2018. This decision's Ordering Paragraph (O.P.) 11 required Ponderosa to submit an advice letter informing the Commission of any income tax change within 30 days of its effective date.[1]

[1] On November 30, 2017, the Commission issued D.17-11-013 and ordered that if Ponderosa's then-current income tax rate changes on or after January 1, 2018 and after the decision is issued in this case, Ponderosa shall file a Tier 2 Advice Letter with revised revenue requirement within 30-days of the tax change taking effect.

The Tax Cut and Jobs Act of 2017 (TCJA) was signed into law on December 22, 2017 and became effective January 1, 2018. Among other things, the TCJA reduced the top corporate income tax rate from 35% to 21%.[2]

Accordingly, on February 1, 2018 Ponderosa filed a Tier 2 Advice Letter (AL) 465 proposing an adjustment in its revenue requirement applicable to taxable operating revenue to reflect the impact of the TCJA. Specifically, Ponderosa proposed a $535,647 decrease from the approved revenue requirement of $10,936,666 and an equal $535,647 decrease from the CHCF-A support of $3,616,969 approved in D.17-11-013, resulting in a revenue requirement of $10,401,319 and CHCF-A support of $3,081,322 for 2018. Ponderosa did not propose any other adjustments.

In May 2018, the Small ILECs submitted a letter to the Communications Division's Director, citing a material change in the National Exchange Carrier Association's (NECA) interpretation of how federal rules are to apply to deferred tax calculations in light of the TCJA.[3] NECA works with the Federal Communications Commission (FCC) and is responsible for interpreting federal separations and accounting requirements. The letter revised/updated previous guidance that it provided to carriers in a January 2018 letter. The new NECA interpretation instead requires regulated utilities to "follow the normalization method of accounting and flow back the excess deferred taxes ratably over the life of the timing difference that gave rise to the excess."

Notice/Protest

The Commission Daily Calendar published Notice of AL 465 on February 5, 2018. The Office of Ratepayer Advocate (ORA) filed a protest to AL 465 on February 20, 2018. ORA indicated that (1) Ponderosa did not include all necessary adjustments to accurately reflect changes to the federal income tax rate; (2) Ponderosa proposed a revenue requirement that could result in excess revenue and excess CHCF-A support; and (3) that Ponderosa should calculate excess reserve tax to be "flowed through" back to the ratepayers.

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[2] Ponderosa's adopted revenue requirement for TY 2018 per D.17-11-013 was based on a 34% federal income tax rate.
[3] See Appendix B

Ponderosa responded to ORA's protest on February 28, 2018, stating that AL 465 was properly supported and submitted. Ponderosa claims that ORA's protest has no merit and should be rejected.

DISCUSSION

Staff's Review of Ponderosa's Methodology

Staff has reviewed Ponderosa's AL 465 and observes that Ponderosa calculated the new federal income tax by adjusting the operating tax expense and deferred (income) tax reserve at the new 21% tax rate and then applying this adjustment to reduce the level of the CHCF-A operating revenues. Under Ponderosa's method, the recalculated income tax caused a $535,647 reduction in Ponderosa's revenue requirement for TY 2018 from $10,936,966 to $10,401,319, and the equal amount of reduction in Ponderosa's CHCF-A support for TY 2018 from $3,616,969 to $3,081,322.

While Ponderosa appropriately accepts the reduced corporate tax rate of 21% for operating tax expense, its treatment ignores the full impact on deferred income taxes and is incorrect on two fronts. First, Ponderosa's method omits the return of *any* excess deferred taxes to ratepayers. Second, Ponderosa's method does not address excess deferred taxes from the rate base reduction.

Deferred income taxes for ratemaking represent funds that ratepayers have provided to the utility for income taxes presumably to be paid in the future, due to timing differences between straight line depreciation for ratemaking and accelerated depreciation for income tax filings. Through 2017, these balances were accumulated using the prevailing tax rate of 34% for Ponderosa. Once the federal income tax rate was reduced to 21%, a lower amount of ratepayer funds are needed to pay those future tax liabilities, and thus these excess funds should be returned to Ponderosa's ratepayers.

Furthermore, Ponderosa's methodology would be contrary to Commission normalization rules if it were to be adopted, as Ponderosa's method effectively reduces the excess tax reserve to zero instantly. Under normalization rules, excess deferred taxes should instead be flowed through ratably over the life of the timing difference that gave rise to the excess. Consequently, the impact of reducing past accumulated excess deferred taxes should increase the projected tax savings.

Therefore, Staff concludes that a further change in Ponderosa's revenue requirement from the TCJA to account for the change in excess deferred taxes according to normalization is needed.[4] NECA's revised interpretation also supports a further adjustment for deferred taxes according to normalization rules. Moreover, we have consulted with the Energy and Water Divisions to develop consensus that deferred taxes should be further adjusted.[5]

Staff's Calculation

Staff has recalculated the tax impact of the TCJA to include the excess deferred tax impact. Prior to the enactment of the TCJA, Ponderosa's deferred income tax balance was $2,156,657. On January 1, 2018, the new tax rate of 21% resulted in deferred income tax of $1,332,053 causing an excess deferred tax reserve of $824,604. This $824,604 should be returned to ratepayers ratably over the remaining life of the assets that gave rise to the excess tax reserve balance. The TCJA provides guidance for the return of the excess deferred tax reserve under normalization rules.[6] In summary, the TCJA rules say that if the excess deferred taxes are to be reduced, they should be reduced no faster than using the average rate assumption method (ARAM). But if the utility does not have the appropriate vintage data to use ARAM, an alternative method based on a composite rate is allowed.[7]

As a result, Staff recommends the $824,604 excess deferred income tax reserve should be returned to ratepayers over the weighted average of the remaining useful life of Ponderosa's depreciable assets as of December 31, 2017. Appropriately, as the excess deferred tax reserve is returned to Ponderosa's ratepayers, rate base will be incrementally decreased by $165,916 per year (as the $824,604 excess remaining in the deferred tax account will be incrementally increased as it is returned to ratepayers).

To calculate the additional increment for deferred tax, Staff issued a data request on April 11, 2018, specifically requesting the weighted average remaining life of Ponderosa's depreciable assets, which is 4.97 years. Staff amortized the excess

[4] Staff also corrects for Ponderosa's removal of the entire excess deferred tax balance from rate base.
[5] Energy Division agrees with CD's proposed methodology. Water Division's methodology is quite similar, but further considers changes to franchise fees and uncollectibles, which is not a material factor for communications companies.
[6] Internal Revenue Code Sec. 168(f)(2) contain normalization requirements.
[7] Section 13001(d) of the Tax Cuts and Jobs Act of 2017 P.L. 115-97

deferred income tax reserve[8] of $824,604, dividing that amount by 4.97 years to arrive at a debit-to-expense amount of $165,916 per year beginning TY 2018. Staff added this as a debit to the federal tax amount.

Staff incorporated its methodology and updated the effects of excess deferred tax by line item, which required further steps to reconcile the Results of Operations Table in Appendix A, column C, so that the Total (Revenue Requirement) of $10,644,431 (line 8) equals the sum of Total Operating Expenses of $8,921,726 (line 18) plus Net Operating Income of $1,722,705 (line 19), demonstrating proof of a balanced calculation.

- Staff added the first year of the incremental Excess Deferred Tax of $165,916 as a debit to the federal tax, for 2018, increasing tax-related expenses (Deferred Income Tax, line 17, column C);
- The first year of the Unamortized Excess Deferred Tax Balance ($165,916) is then subtracted from the deferred income tax reserve of $824,604 (the difference between line 26, columns A and B), which equals $658,688 in UEDTB remaining for future amortization (line 27, column C);
- Consistent with normalization rules, Staff has increased Ponderosa's proposed rate base of $19,752,505 (line 29, column B) by the unamortized balance of $658,688 left on the excess deferred tax after inserting the yearly income tax debit. Thereafter, the rate base will be decreased yearly by the $165,916 amortized amount (see Total Rate Base, line 29, column C, $20,411,193, compared to line 29, column A, $20,577,109);
- The Total Rate Base of $20,411,193 was then multiplied by the Rate of Return (line 30; 8.44%) equals $1,722,705 in Net Operating Income (line 19, column C);
- Staff's adjustments increased Ponderosa's total operating expenses including income taxes by an additional $187,518 (line 18, comparing columns B and C). This is a sum of two factors: 1) a $21,602 increase in State and Federal Income Tax (line 16, column C) and the line 17, column C deferred tax debit of $165,916;
- To fully recover revenue requirement including the cost of tax liabilities, utilities incorporate a "net to gross multiplier" to account for such liabilities. Ponderosa calculated and Staff confirms that the NTGM is 1.38857 when California's State Income Tax Rate is 8.84% and the Federal Income Tax Rate is 21%;

[8] Ponderosa's deferred income tax reserve is a positive rate base item, which results when the book depreciation is higher than the tax depreciation.

- State Income Tax increased by $6,824, as the product of multiplying the difference between Ponderosa's proposed Net Operating Income of $1,667,111 and Staff's proposed Income of $1,722,705 ($55,594, line 19) by the NTGM of 1.38857; then multiplying that amount by the State Tax Rate of 8.84%.
- Federal Income Tax increased by $14,778, calculated by 1) subtracting the increase in State income tax from the product of 2) the $55,594 difference in proposed operating income multiplied by the NTGM, and then 3) multiplying that result by the Federal Income Tax Rate of 21% (line 16, columns B and C);
- The resulting gross increase in Net Operating Income (line 19, $55,594) and Total Expenses (line 18, $187,518) equals $243,112, requiring a further offset to revenue requirement and CHCF-A support between Ponderosa's and Staff's proposals;
- Therefore, Staff proposes a further increase of $243,112 in revenue requirement for TY 2018, from $10,401,319 to $10,644,431 (line 8, comparing Ponderosa's proposal in column B and Staff's result in column C);
- And Staff proposes a further increase in CHCF-A support by an equal additional amount, from $3,081,322 to $3,324,434 (line 7, comparing columns B and C).
- This results in a net decrease of $292,535 in Ponderosa's revenue requirement, from $10,936,966 to $10,644,431 (comparing line 8, columns A and C), and a corresponding net decrease of $292,535 in CHCF-A support, from $3,616,969 to $3,324,434 (comparing line 7, columns A and C) for TY 2018.

<u>Summary</u>

While Staff accepts Ponderosa's reduced tax rate of 21% related to the federal income tax reduction, it has increased Ponderosa's proposed revenue requirement and CHCF-A support by $243,112 to consider the normalization of the excess deferred income tax. For TY 2018, Staff proposes an overall decrease to Ponderosa's adopted revenue requirement by $292,535, from $10,936,966 to $10,644,431. Ponderosa proposes to reflect the overall reduced revenue requirement by decreasing its CHCF-A support in equal amount. Staff agrees with this proposal since over 30% of Ponderosa's revenue comes from CHCF-A support. For TY 2018, Staff proposes a $292,535 decrease to Ponderosa's adopted CHCF-A support, from $3,616,969 to $3,324,431.

COMMENTS

In compliance with P.U. Code § 311(g), the Commission emailed a notice letter on July 6, 2018, informing Ponderosa of the availability of this Resolution for public comments at the Commission's website www.cpuc.ca.gov. Comments are due within twenty (20) days of Daily Calendar notification. The notice letter also informed parties that the final conformed Resolution adopted by the Commission will be posted and available at the same website.

FINDINGS

1. The Tax Cuts and Jobs Act of 2017 enacted on December 22, 2017, among other things, lowered the corporate federal tax rate from 35% to 21% effective January 1, 2018.

2. Ponderosa Telephone Company's (Ponderosa) adopted revenue requirement for Test Year (TY) 2018 pursuant to Decision (D.)17-11-013 dated November 30, 2017 was based on an estimated 34% federal income tax rate.

3. D.17-11-013 ordered Ponderosa to submit a Tier 2 Advice Letter (AL) with revised revenue requirement within 30 days of the tax change taking effect.

4. Ponderosa filed Tier 2 AL 465 on February 1, 2018 revising its revenue requirement and California High Cost Fund-A (CHCF-A) support for 2018.

5. In AL 465, Ponderosa submitted a revised revenue requirement as $10,401,319 for TY 2018, which is $535,647 lower than the D.17-11-013 adopted revenue requirement of $10,936,966.

6. In AL 465, Ponderosa proposed a revised CHCF-A support of $3,081,322, which is $535,647 lower than the D.17-11-013 adopted CHCF-A of $3,616,969.

7. In AL 465, Ponderosa did not include the effect of excess deferred income tax reserve created by the lower tax rate on the revenue requirement.

8. In May 2018, the Small ILECs submitted a letter to the Communications Division Director on May 18, 2018, informing that the National Exchange Carrier Association had revised its guidance on the treatment of excess deferred income taxes from the flow- through to the normalization method.

9. Staff received information from Ponderosa regarding excess deferred income tax reserve through a data request dated April 11, 2018.

10. Ponderosa should follow Commission normalization requirements for returning the excess deferred tax reserve to ratepayers.

11. Staff calculates that Ponderosa's excess deferred income tax reserve is $824,604, and this amount should be amortized over the weighted-average life of Ponderosa's depreciable assets, and be shown as a line item debit to federal income tax over 4.97 years, while keeping the unamortized balance as a rate base reduction item.

12. Staff calculates that the amortized excess deferred income tax amount is $165,916 per year for 4.97 years, which further modifies Ponderosa's revenue requirement and CHCF-A support, and this should be reflected in Ponderosa's accounting books and in results of operations table.

13. Staff calculates that Ponderosa's rate base should be decreased (excess deferred tax balance should be decreased) per year by the $165,916 amount of deferred tax listed as a debit to ratepayers. This results in a 2018 rate base of $20,411,193 compared to Ponderosa's proposed $19,752,505.

14. Staff calculates that Ponderosa's revised revenue requirement for TY 2018 is $10,644,431, which is $292,535 less than the previously authorized $10,936,966 in D.17-11-013.

15. Staff calculates that Ponderosa's CHCF-A subsidy for 2018 is $3,324,434, which is $292,535 less than previously authorized $3,616,969 in D.17-11-013.

16. Ponderosa's revised revenue requirement along with revised CHCF-A support and other revenue components as shown in Column C of Appendix A of this Resolution are reasonable and should be adopted for TY 2018.

THERFORE, IT IS ORDERED that:

1. Ponderosa Telephone Company's revised adopted revenue requirement for Test Year 2018 shall be $10,644,431, which is $292,535 less than the previously authorized $10,936,969, as shown in Appendix A of this Resolution.

2. Ponderosa Telephone Company's California High Cost Fund-A support for Test Year 2018 shall be $3,324,434 which is $292,535 less than the previously authorized $3,616,969, as shown in Appendix A of this resolution.

3. Staff shall revise Ponderosa Telephone Company's remaining monthly disbursements of California High Cost Fund-A support so that total 2018 payments equal $3,324,434.

4. Ponderosa Telephone Company shall show an excess deferred income tax debit of $165,916 each year as line item for 4.97 years, until the unamortized balance is fully depleted, in its results of operations table, under the federal income tax item starting January 1, 2018.

5. Ponderosa Telephone Company shall show the excess deferred income tax debit amount of $165,916 in its accounting books and results of operations table for 4.97 years.

This Resolution is effective today.

I certify that the foregoing Resolution was duly introduced, passed, and adopted at a conference of the Public Utilities Commission of the State of California held on August 9, 2018, the following Commissioners voting favorable thereon:

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ALICE STEBBINS
Executive Director

APPENDIX

Appendix A
Ponderosa Telephone Company
Test Year 2018
Results of Operations

		Adopted Results of Operations per D.17-11-013	Ponderosa Proposed Results of Operations with Tax Rate Change	T-17619 Adopted Results of Operations with Tax Rate Change	
		A	B	C	
Operating Revenues:					
1	Local Rev.	$ 2,939,720	$ 2,939,720	$ 2,939,720	
	Intrastate:				
2	Access Rev.	445,929	$ 445,929	$ 445,929	
3	Toll Rev.	-	-	-	
4	Interstate USF	3,501,082	$ 3,501,082	$ 3,501,082	
5	Interstate Settlement Rev.	-	-	-	
6	Miscellaneous Rev. & Uncollect	433,266	433,266	433,266	
7	CHCF-A	3,616,969	3,081,322	3,324,434	
8	**Total**	**$ 10,936,966**	**$ 10,401,319**	**$ 10,644,431**	
Operating Expenses:					
9	Plant Specific	$ 2,690,405	$ 2,690,405	$ 2,690,405	
10	Plt. Non-Spec.(less Depr.)	1,062,950	1,062,950	1,062,950	
11	Customer Operations	541,941	541,941	541,941	
12	Corporate Operations	1,136,304	1,136,304	1,136,304	
13	**Subtotal**	**$ 5,431,600**	**$ 5,431,600**	**$ 5,431,600**	
14	Depr. & Amort.	2,396,939	2,396,939	2,396,939	
15	Other Taxes	309,014	309,014	309,014	
16	State and Federal Income Tax	1,062,705	596,655	618,257	
17	Amortized Excess Deferred Income Tax			165,916	1
18	**Total**	**$ 9,200,258**	**$ 8,734,208**	**$ 8,921,726**	
19	**Net Operating Income**	**$ 1,736,708**	**$ 1,667,111**	**$ 1,722,705**	
Rate Base:					
20	2001 - TPIS	$ 92,970,412	$ 92,970,412	$ 92,970,412	
21	2003 - TPUC	529,743	529,743	529,743	
22	1220 - Mat. and Sup.	240,195	240,195	240,195	
23	1500 - Other Regulatory Asset	-	-	-	
24	Working Cash	744,204	744,204	744,204	
25	Less: Accum. Depr.	(76,059,224)	(76,059,224)	(76,059,224)	
26	Less: Deferred Inc Tax	2,156,657	1,332,053	1,332,053	
27	UEDTB			658,688	2
28	Less: Customer Deposits	(4,878)	(4,878)	(4,878)	
29	**Total Rate Base**	**$ 20,577,109**	**$ 19,752,505**	**$ 20,411,193**	
30	Rate of Return	8.44%	8.44%	8.44%	

[1] Line 17: This amount is to be shown for 4.97 years starting TY 2018

[2] Line 27: UEDTB: Unamotized Excess Deferred Tax Balnce at year 1 of 4.97 years. This balnce will be depleted each year by $165,916.

End of Appendix A-1

APPENDIX B

NECA

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For your action

2018 federal tax rate change

May 8, 2018

TO: General contacts at cost companies in CL and TS pool

Due to the 2017 Tax Cuts and Jobs Act, the federal corporate tax rate changed from 35 percent to 21 percent for C Corp companies. Our January 9, 2018 letter (member login required) instructed companies on adjustments to Account 4340 as required by GAAP.

Application of tax rate changes

After further review and subsequent discussions with FCC staff, we have confirmed the proper treatment of the tax rate change for regulated entities. The FCC bases its accounting rules on GAAP to the extent regulatory considerations permit (see 47.CFR §36.1). This situation constitutes one of the variations. While flowing through the full impact of the tax rate difference in Account 4340 deferred taxes as a one-time adjustment in 2017 may be applicable for GAAP reporting purposes, regulated entities for interstate reporting must follow the normalization method of accounting and flow back the excess deferred taxes ratably over the life of the timing difference that gave rise to the excess (see, e.g., Report and Order, CC Docket No. 89-360, 9 FCC Rcd. 727 (1994) ¶ 6 and ¶ 7).

Cost study and HCLS submissions

Companies who made flow-through adjustments to Account 4340 and Account 7250 on their financials in accordance with GAAP, will need to make adjustments to data reported for 2017 cost study and 2018-1 HCLS submissions to remove the impact of flowing through the excess deferred tax. Amortization of excess deferred income taxes will be effective with the change in tax rate on January 1, 2018. 2018 cost studies and the 2019-1 HCLS submission (reflecting 2018 period ending data) will reflect amortized excess deferred taxes using the normalization method.

Additional guidance

We are currently updating NECA Reporting Guideline 3.3 Excess Deferred Tax Development, which addresses methods for calculating and amortizing excess deferred taxes as a result of the Tax Reform Act of 1986. Until the guideline is updated, you may find a review of this document (member login required) helpful in describing the calculations and reporting requirements in settlements. NECA Cost Pool Procedures will also be updated to provide instructions on EC1050 reporting of these amounts for the calculation of federal income tax.

Questions?

If you have questions, please contact your member service manager.

Sincerely,

Carol A. Brennan

Carol A. Brennan

cc: Authorized consultants