**PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

**Communications Division RESOLUTION T- 17626**

**Carrier Oversight and Programs Branch August 23, 2018**

**R E S O L U T I O N**

**RESOLUTION T-17626, Calaveras Telephone Company.** Order Authorizing a Reduction of $196,389 in Adopted Revenue Requirement for Test Year 2018 and a Corresponding Reduction of $196,389 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 $6,003,765 for Calaveras Telephone Company’s Test Year 2018, and a corresponding revised California High Cost Fund-A support amount of $2,736,510, resulting in a reduction of $196,389 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.) 18-04-006 approved an all-party Settlement Agreement in Calaveras Telephone Company’s (Calaveras) general rate case (GRC) for rates effective   
May 1, 2018. This decision’s Ordering Paragraph (O.P.) 8 required Calaveras to submit an advice letter with a revised revenue requirement reflecting changes to the income tax rate after the all-party settlement agreement was submitted. [[1]](#footnote-1)

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]](#footnote-2)

On May 25, 2018, Calaveras filed a Tier 2 Advice Letter (AL) 363 proposing an adjustment in its revenue requirement applicable to taxable operating revenue to reflect the impact of the TCJA. Specifically, Calaveras proposed a $180,292 decrease from the approved revenue requirement of $6,200,154 and an equal $180,292 decrease from the CHCF-A support of $2,932,899 approved in D.18-04-006, resulting in a revenue requirement of $6,019,862 and CHCF-A support of $2,752,607. Calaveras did not propose any other adjustments. [[3]](#footnote-3)

**Notice/Protest**

The Commission Daily Calendar published Notice of AL 363 on June 1, 2018. No protests were received.

**DISCUSSION**

Staff’s Review of Calaveras’ Methodology

Calaveras calculated the new federal income tax by adjusting the operating tax expense and deferred (income) tax reserve at the new 21% tax rate and applied this adjustment to reduce the level of CHCF-A operating revenues. Under Calaveras’ method, the recalculated income tax caused a $180,292 reduction in Calaveras’ revenue requirement for TY 2018 from $6,200,154 to $6,019,862, and the equal amount of reduction in Calaveras’ CHCF-A support for TY 2018 from $2,932,899 to $2,752,607.

Calaveras’ methodology ignores the full impact on deferred income taxes and is incorrect on two fronts. First, Calaveras’ method omits the return of *any* excess deferred taxes to ratepayers. Second, Calaveras’ 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, Calaveras accumulated a fund balance using the prevailing tax rate of 34%. Once the federal income tax rate was reduced to 21%, a lower amount of ratepayer funds is needed to pay those future tax liabilities, and thus these excess funds should be returned to Calaveras’ ratepayers.

Furthermore, Calaveras’ methodology is contrary to Internal Revenue Service (IRS) normalization rules, as Calaveras’ 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.

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. [[4]](#footnote-4) 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.”

Therefore, Staff concludes that a further reduction in Calaveras’ revenue requirement is needed to account for the change in excess deferred taxes consistent with normalization rules.[[5]](#footnote-5) NECA’s revised interpretation of the federal tax change and deferred taxes supports the adjustment as well. Moreover, we have consulted with the Energy and Water Divisions to develop consensus that deferred taxes should be further adjusted consistent with the methodology described here. [[6]](#footnote-6)

Staff’s Calculation

Staff recalculated the tax impact of the TCJA to include the excess deferred tax impact. Prior to the enactment of the TCJA, Calaveras’ deferred income tax liability balance was $145,643. On January 1, 2018, the new tax rate of 21% resulted in deferred income tax of $89,956 causing an excess deferred tax reserve of $55,687. This $55,687 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. [[7]](#footnote-7) 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). [[8]](#footnote-8)

Accordingly, Staff has adjusted the $55,687 excess deferred income tax reserve and returned it to ratepayers over the weighted average of the remaining useful life of Calaveras’ depreciable assets as of December 31, 2017. Appropriately, as the excess deferred tax reserve is returned to Calaveras’ ratepayers, rate base will be incrementally increased by $10,507 per year (as the $55,687 excess remaining in the deferred tax account will be incrementally decreased as it is returned to ratepayers).

To calculate the additional increment for excess deferred tax, Staff relied on the weighted average remaining life of Calaveras’ depreciable assets, which is 5.3 years based on a June 19, 2018, data request response from the company. Staff amortized the excess deferred income tax reserve of $55,687, dividing that amount by 5.3 years to arrive at a credit of $10,507 per year beginning TY 2018. Staff added this amount as a credit to the federal tax obligation.

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 (see Appendix A column C), so that the Total (Revenue Requirement) of $6,003,765 (line 7) equals the sum of Total Operating Expenses of $5,315,524 (line 17) plus Net Operating Income of $688,241 (line 18), demonstrating proof of a balanced result. This process is outlined Appendix C.

Therefore, Staff proposes a further reduction of $16,097 in revenue requirement for   
TY 2018, from $6,019,862 to $6,003,765 (Appendix A, line 7, comparing Calaveras’ proposal in column B and Staff’s result in column C). Staff also proposes a further reduction in CHCF-A support by an equal additional amount, from $2,752,607 to $2,736,510 (line 6, comparing columns B and C). This results in an overall decrease of $196,389 in Calaveras’ revenue requirement, from $6,200,154 to $6,003,765 (comparing line 7, columns A and C), and an overall decrease of $196,389 in CHCF-A support from $2,932,899 to $2,736,510 (comparing line 6, columns A and C for TY 2018).

Summary

Staff accepts Calaveras’ calculation of the reduced tax rate of 21% and has further reduced Calaveras’ proposed revenue requirement and CHCF-A support by an additional $16,097 to consider the normalization return of the excess deferred income tax. For TY 2018, Staff proposes a total decrease to Calaveras’ adopted revenue requirement of $196,389, from $6,200,154 to $6,003,765. Calaveras proposes to reflect the reduced revenue requirement by decreasing its CHCF-A support in an equal amount. Staff agrees with this proposal since approximately half of the company’s revenues come from   
CHCF-A support. For TY 2018, Staff proposes a $196,389 decrease to Calaveras’ adopted CHCF-A support, from $2,932,899 to $2,736,510.

**COMMENTS**

In compliance with P.U. Code § 311(g), the Commission emailed a notice letter on   
July 20, 2018, informing Calaveras of the availability of this Resolution for public comments at the Commission’s website [www.cpuc.ca.gov](http://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.

On August 13, 2018, Calaveras filed timely comments on the draft Resolution. Calaveras argued that D.18-04-006 only mandates a modification for the “tax rate” and does not provide for any change to deferred taxes. Calaveras believes deferred taxes are not ratepayer property and that the draft Resolution is incorrect in stating that these amounts represent funds that should be returned to ratepayers. Further Calaveras argues that no decision orders “normalization” of deferred tax amounts and that forcing a credit of deferred tax amounts to ratepayers would constitute retroactive ratemaking. Finally, Calaveras asked for clarification that the application of deferred tax normalization policy would apply in the future whether a tax increase or decrease.

Staff examined Calaveras’ arguments and is not persuaded that the resolution needs to be modified. The new federal income tax rate impacts more than federal tax expense and needs to be applied to all results of operations items that are tax-related. Moreover, the draft Resolution only seeks to adjust future revenue requirement and associated CHCF-A support payments consistent with the adopted settlement in D.18-04-006, so there is no retroactive ratemaking. Rather than ordering a refund, the draft Resolution is revising the revenue requirement and CHCF-A support prospectively.

Finally, the Commission recognizes the practice of normalizing deferred taxes in accordance with IRS rules.[[9]](#footnote-9) Likewise, the TCJA includes normalization requirement rules that govern the treatment of the excess tax reserve.[[10]](#footnote-10) Nonetheless, we clarify here for Calaveras that federal tax rate changes in the future should be treated similarly, applying normalization to deferred taxes whether a tax increase or decrease.

**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. Calaveras Telephone Company’s (Calaveras) adopted revenue requirement for Test Year (TY) 2018 pursuant to Decision (D.)18-04-006 issued May 1, 2018 was based on an estimated 34% federal income tax rate.
3. D.18-04-006 ordered Calaveras to submit a Tier 2 Advice Letter (AL) with a revised revenue requirement and revised Results of Operations reflecting changes to the income tax rate after the all-party settlement agreement was submitted.
4. Calaveras filed Tier 2 AL 363 on May 25, 2018, revising its revenue requirement and California High Cost Fund-A (CHCF-A) support for 2018.
5. In AL 363, Calaveras proposed a revised revenue requirement of $6,019,862 for   
   TY 2018, which is $180,292 lower than the D.18-04-006 adopted revenue requirement of $6,200,154.
6. In AL 363, Calaveras proposed a revised CHCF-A support of $2,752,607, which is $180,292 lower than the D.18-04-006 adopted CHCF-A support of $2,932,899.
7. In AL 363, Calaveras did not include the appropriate 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 informing that the National Exchange Carrier Association had revised its previous guidance on the treatment of excess deferred income taxes from the   
   flow-through to the normalization method.
9. Staff received information from Calaveras regarding excess deferred income tax reserve through a data request dated June 19, 2018.
10. Calaveras should follow Internal Revenue Service normalization requirements for returning the excess deferred tax reserve to ratepayers.
11. Staff calculates that Calaveras’ excess deferred income tax reserve is $55,687, and this amount should be amortized over the weighted-average life of Calaveras’ depreciable assets and be shown as a line item credit to federal income tax over 5.3 years, while keeping the unamortized balance as a rate base reduction item.
12. Staff calculates that Calaveras’ amortized excess deferred income tax amount is $10,507 per year for 5.3 years, which further reduces Calaveras’ revenue requirement and CHCF-A support, and this should be reflected in Calaveras’ accounting books and its results of operations table.
13. Staff calculates that Calaveras’ rate base should be increased (excess deferred tax balance should be decreased) per year by the $10,507 amount of excess deferred tax listed as a credit to ratepayers. This results in a 2018 rate base of $7,724,364 compared to Calaveras’ proposed $7,769,544.
14. Staff calculates that Calaveras’ revised revenue requirement for TY 2018 should be $6,003,765, which is $196,389 less than the previously authorized $6,200,154 in   
    D.18-04-006.
15. Staff calculates that Calaveras’ CHCF-A support for 2018 should be $2,736,510, which is $196,389 less than the previously authorized $2,932,899 in D.18-04-006.
16. Calaveras’ revised revenue requirement and its 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.
17. In compliance with P.U. Code § 311(g), the Commission emailed a notice letter on   
    July 20, 2018, informing Calaveras of the availability of this Resolution for public comments at the Commission’s website [www.cpuc.ca.gov](http://www.cpuc.ca.gov).
18. Calaveras filed comments on the draft Resolution on August 13, 2018.

**THERFORE, IT IS ORDERED that:**

1. Calaveras Telephone Company’s revised adopted revenue requirement for Test Year 2018 is $6,003,765, which is $196,389 less than the previously authorized $6,200,154, as shown in Appendix A of this Resolution.
2. Calaveras Telephone Company’s revised California High Cost Fund-A support for Test Year 2018 is $2,736,510, which is $196,389 less than previously authorized $2,932,899, as shown in Appendix A of this resolution.
3. Staff shall revise the remaining monthly California High Cost Fund-A support payments to Calaveras Telephone Company so that the total 2018 payments equal $2,736,510.
4. Starting January 1, 2018, Calaveras Telephone Company shall show an amortized excess deferred income tax credit of $10,507 each year as a line item in its results of operations table under the federal income tax item for 5.3 years, until the unamortized balance remaining as a reduction to rate base is fully depleted.
5. Calaveras Telephone Company’s deferred tax balance for ratemaking will contain the unamortized balance of excess deferred income tax as a rate base reduction item until the excess deferred balance is fully amortized.

This Resolution is effective today.

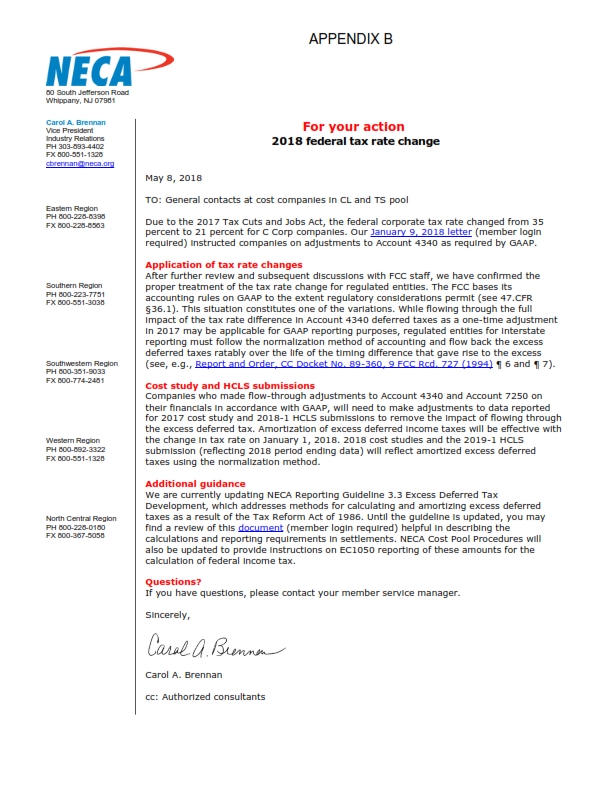
I certify that the foregoing Resolution was duly introduced, passed, and adopted at a conference of the Public Utilities Commission of the State of California held on August 23, 2018, the following Commissioners voting favorable thereon:

Alice Stebbins

Executive Director

Appendix





APPENDIX C – Line Item Changes to Column C, Appendix A Results of Operations

* Staff added the first year of the incremental Excess Deferred Tax of $10,507 as a credit to the federal tax for 2018, lowering tax-related expenses (Deferred Income Tax, line 16, column C);
* The first year of the Unamortized Excess Deferred Tax Balance ($10,507) is then subtracted from the deferred income tax reserve of $55,687 (the difference between line 25, columns A and B), which equals $45,180 in UEDTB remaining for future amortization (line 26, column C);
* Consistent with normalization rules, Staff has reduced Calaveras’ proposed rate base of $7,769,544 (line 28, column B) by the unamortized balance of $45,180 left on the excess deferred tax after taking the yearly income tax credit. Thereafter, the rate base will be increased yearly by the $10,507 amortized amount (see Total Rate Base, line 28, column C, $7,724,364, compared to line 28, column A, $7,713,857);
* The Total Rate Base of $7,724,364 multiplied by the Rate of Return (line 29; 8.91%) equals $688,241 in Net Operating Income (line 18, column C);
* Staff’s adjustments decreased Calaveras’ total operating expenses including income taxes by an additional $12,071 (line 17, comparing columns B and C). This is a sum of two factors: 1) a $1,564 decrease in State and Federal Income Tax (line 15, column C) and the line 16, column C deferred tax credit of $10,507;
* To fully recover revenue requirement including the additional cost of tax liabilities, utilities incorporate a “net to gross multiplier” to account for such liabilities. Calaveras 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%;
* State income tax decreased by $494, as the product of multiplying the difference between Calaveras’ proposed Net Operating Income of $692,267 and Staff’s proposed Income of $688,241 ($4,026, line 18) by the NTGM of 1.38857; then multiplying that amount by the State Tax Rate of 8.84%;
* Federal income tax decreased by $1,070, calculated by 1) subtracting the decrease in state income tax from the product of 2) the $4,026 difference in proposed operating income multiplied by the NTGM, and then 3) multiplying that result by the federal income tax rate of 21% (line 15, columns B and C);
* The resulting gross reduction in Net Operating Income (line 18, $4,026) and Total Expenses (line 17, $12,071) equals $16,097, requiring a further offset to revenue requirement and CHCF-A support between Calaveras’ and Staff’s proposals.

1. D.18-04-006 ordered Calaveras to file a Tier 2 Advice Letter with a revised revenue requirement and revised Results of Operation updating all items within 30 days of the Decision’s May 1 effective date. [↑](#footnote-ref-1)
2. Calaveras’ adopted revenue requirement for TY 2018 per D.18-04-006 was based on a 34% federal income tax rate. [↑](#footnote-ref-2)
3. Calaveras asserted that its methodology was based on the National Exchange Carrier Association (NECA) interpretational guidelines issued in January 2018. [↑](#footnote-ref-3)
4. See Appendix B. [↑](#footnote-ref-4)
5. Staff also corrects for Calaveras’ removal of the entire excess deferred tax balance from rate base. [↑](#footnote-ref-5)
6. 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. [↑](#footnote-ref-6)
7. Internal Revenue Code Sec. 168(f)(2) contain normalization requirements. [↑](#footnote-ref-7)
8. Section 13001 (d)(3)(B) of the Tax Cuts and Jobs Act of 2017 P.L. 115-97, “The average rate assumption method is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its regulated books of account which gave rise to the reserve for deferred taxes”. [↑](#footnote-ref-8)
9. Internal Revenue Code 168(f)(2) states that the code section (use of accelerated depreciation) will not apply to any public utility property that does not use a normalization method of accounting. Therefore, public utilities must use normalization to receive the benefit of accelerated depreciation. The fact that Calaveras has a deferred income tax balance demonstrates that it normalizes its deferred tax. [↑](#footnote-ref-9)
10. The Tax Cut and Jobs Act 13001(d). [↑](#footnote-ref-10)