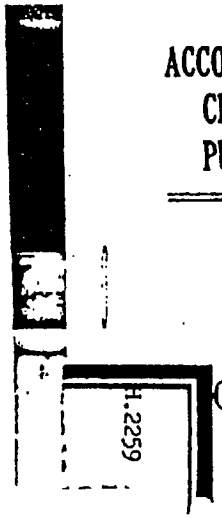

ACCOUNTING TREATMENT OF THE INVESTMENT TAX CREDIT AND ACCELERATED DEPRECIATION FOR PUBLIC UTILITY RATEMAKING PURPOSES

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

H.R. 6806

AND

H.R. 3165

APRIL 15, 1980

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STATEMENT OF DANIEL I. HALPERIN, DEPUTY ASSISTANT SECRETARY FOR TAX LEGISLATION, DEPARTMENT OF THE TREASURY, ACCOMPANIED BY SEYMOUR FIEKOWSKY, ASSISTANT DIRECTOR, BUSINESS TAXATION, AND THEODORE SIMS, ATTORNEY-ADVISER, OFFICE OF ASSISTANT SECRETARY FOR TAX POLICY

Mr. HALPERIN. Let me first see if I can make some effort to try to explain what this, as Mr. Corman pointed out, very complicated provision is all about. We are concerned here with the circumstances under which regulated utilities would be entitled to the benefits of accelerated depreciation and the investment credit. Under the Internal Revenue Code as it now stands they are not entitled to the investment credit and accelerated depreciation in all circumstances but only if they follow an accounting procedure which is known as normalization.

Essentially they are not permitted to use these benefits to reduce their tax expense. When regulators look to determine the amount of taxes paid by a utility in order to fix rates, in order to figure out how much taxes must be recovered from ratepayers, they are required to look at Federal income taxes paid as if the investment credit and accelerated depreciation did not exist.

These items for this purpose are not considered part of the tax law but are considered as investment subsidies which happen to be delivered through the tax system. In other words the investment credit is no different than the Government contributing 10 percent toward the purchase of capital goods and it should be treated as if it were a price reduction. Accelerated depreciation is no different than an interest-free loan from the Government and it should be treated as any other loan would be with the one exception that this loan is provided at a zero interest rate so it is not necessary to recover interest costs on this loan.

There would not be any doubt about this and I assume this hearing would not have to take place if these benefits, accelerated depreciation, the investment credit, were provided by direct grants. If taxpayers in general sent a check to the Internal Revenue Service which had no reduction in it for the investment credit and which did not reflect the tax savings from accelerated depreciation but merely was a gross check, and at the same time another check crossed in the mail in the other direction coming from the Treasury to the corporation involved.

In this particular case, however, we don't do it that way. We do it through one check. In effect the corporation is allowed to reduce the amount of taxes it owes the Government by the amount of the subsidy the Government owes to it. The fact that it is done that way should not change the way it is accounted for in utility ratemaking. However because it is done through the tax system this has been a matter of controversy for 10 or more years.

Recognizing back in 1969 that regulators would be under pressure to treat these subsidies as if they reduce taxes, to actually compute tax expenses for ratemaking purposes as if the investment credit and accelerated depreciation reduced the amount of income tax payable,

Congress, in the 1969 act as to accelerated depreciation and again in 1971 as to the investment credit, mandated normalization as a condition for obtaining the benefit of accelerated depreciation and investment credit.

If these benefits are "flowed through"—that is, treated as reductions of the current tax expense—the benefits would be lost, taken away, and there would be nothing to flowthrough.

If the benefits are to be retained then normalization accounting must be followed. We believe normalization is undoubtedly the proper means of accounting for the subsidy and while we have some more doubt about that we also concluded it is appropriate to place on the Internal Revenue Service the burden of enforcing the normalization requirements.

These matters were discussed in some detail in testimony before the Oversight Subcommittee last March. Mr. Sunley has delivered that testimony and I have attached a copy of Mr. Sunley's testimony to my statement here today. I refer you to it, if you want a more detailed explanation of this matter. In particular, while we did not attach it today there was a very detailed appendix to Mr. Sunley's testimony which takes everyone step by step through the reasons why we believe normalization is appropriate.

Given that, what is the issue that has caused this hearing to occur? As it has been stated, Congress has intended to enforce the normalization requirements by making it a condition to receive the benefits. If you don't normalize then you don't get accelerated depreciation and the investment credit, and then you must pay more money to the U.S. Government.

The California Commission and the California Supreme Court however have required the telephone companies, in particular, to account for the subsidies in what we think is an improper manner. They have flowed through at least a portion of the benefits from accelerated depreciation and the investment credit. And the telephone companies are facing very large tax liabilities which Congress did not expect would arise because it was assumed that normalization would be followed.

The penalty for not normalizing the loss of these tax benefits is so great it was assumed that no ratemaker, no regulator, could afford to do otherwise than to permit normalization. However, despite this and despite what we believe is the intent of Congress, the California regulators have persisted otherwise. Why this does occur is a very complex and politically charged question and probably has something to do with the fact that the 1969 legislation on accelerated depreciation did grow out of a dispute that was then raging in California and grew out of the efforts of the telephone companies to prevent the California Commission from requiring flowthrough.

In any event, whatever the reason, California has persisted in insisting on flowthrough despite the enormous risk. In fact some say the risks here are so enormous that the additional tax liability would never be enforced, and that is what scares us about this potential legislation, the fact that it may give the truth to that statement.

The legislation has two objectives. First it specifically states that the method used in California is not permissible. We think that is clear

under the present language but the issue as to the interpretation of that language is now before the court and it would seem to us that wherever the court would come out on that issue it is appropriate for Congress, not the courts, to determine the rules and therefore we think it is wise for Congress to specifically state that what is being done is not what they intended to be done.

The other part of the legislation is more difficult. It would in effect say to the California Commission and the California utilities "Let us forget the past, let us let bygones be bygones, we won't pay any attention to what you have done up to now. Let us start over from now on." That is the difficult part which I would like to discuss at this point.

We certainly have spent an inordinate amount of our time and resources on this issue and we would like to find a solution as much as anyone, and we have cooperated with everyone involved in the attempt to try to find one.

We certainly must insist that one can expect as part of any legislative solution a reduction, if not the elimination, of future major disputes about the operation of these rules. The difficult question raised by H.R. 6806 is whether it can achieve this goal which we share with its sponsors. In our judgment legislation might be preferable that preserves some measure of sanction—which did not confirm the belief of some that there was little risk in flouting the intent of Congress, because in no circumstances would sanctions be imposed—which would dissuade others from following the route California has followed in attempting some measure of flowthrough.

Such legislation which contains some sanctions for past conduct might serve to defuse the existing situation while making it clear that normalization rules cannot be disregarded with impunity.

But as we have indicated the Treasury is not necessarily opposed to the bill as it now stands. If as a result of its enactment the situation in California could be defused and the California authorities persuaded to accept normalization, if it was considered unlikely that other State regulatory authorities would be induced to start down the road taken by California, and if, finally, this committee and the Congress were to make it clear that attempts to circumvent these rules in the future would meet with no sympathy on the part of Congress, then a measure such as 6806 could be desirable.

Whether it is realistic to have such expectations—which I emphasize in our judgment are essential to our acquiescence in this legislation—is not yet possible to say. We need, as I have indicated, to get more of a feel about it, the likely impact in California, as well as its impact on other States.

We are not really in a position to express an independent judgment as to what the future outcome will be, we look forward to statements from other witnesses to see how this situation develops, and we certainly share Mr. Corman's hope that a solution will appear from the record of these hearings.

Let me now turn to H.R. 3165, which is, as Mr. Stark has indicated, a more technical bill but it is perhaps as controversial a bill. As we indicated in our testimony before the Oversight Committee last year, we support H.R. 3165. The bill deals with the accounting treatment of the investment credit. As we have said, the investment credit is a

subsidy intended to reduce the price of capital goods. If a machinery would normally cost $1,000, it can, with the enactment of the investment credit, be purchased by a utility the same as by other corporations with an actual outlay of only $900.

In determining depreciation expense it is appropriate therefore to permit the regulators to look at $900 as the actual cost, if the utility did not lay out $1,000. It only laid out $900. By doing that rates are reduced and that shows that normalization does help ratepayers. It does permit the cost of the future utility service to be reduced because the amount of depreciation on equipment that must be taken into account is reduced. The only difference between flowthrough and normalization is not whether it helps ratepayers or not but over what period the benefits are to be given to ratepayers. However, the principal issue that H.R. 3165 really comes down to is how much capital is to be considered to have been supplied by the shareholders toward the purchase of that machinery.

It is $1,000, which was the normal price being charged by the machinery manufacturer, or is it the $900, which is actually laid out by the utility given the existence of the 10-percent investment credit? It seems obvious to us that the amount that has been laid out is only $900. The code, however, as I said, requires the regulator to allow a return on $1,000; the commission must, in order to satisfy the conditions of the code, allow the utility to earn a return on $1,000 even though the amount of capital actually supplied is only $900. It has been argued that this splits the benefit of investment credit between consumers and investors. It is also argued unless we do this split, the utility, the shareholders, have no benefit from the investment credit and it will not have an impact on their investment.

We believe that the argument does not reflect a proper understanding of how the credit is intended to operate. The investment credit clearly did reduce the cost of the equipment. You need less return to make it profitable. The investment credit therefore makes certain investments feasible which would not otherwise be feasible. In other words if you look at the dollar that can be produced through a certain activity the amount of dollars that are now needed are the amount needed to meet costs plus a return on not $1,000 any more but only a return on $900. That is less money and the investment which did not produce an adequate return on $1,000 might well produce an adequate return on $900 and will be made.

That is the function of the investment credit. Perhaps it is not clear whether the investment credit also increases the overall return to investors. But if it does, if it makes investments in General Motors or General Electric or any other company more valuable, then presumably rates of returns to utility shareholders will have to increase if their investments are to be as attractive as they were before.

However, that increase in the rate of return should be done directly, not through a mandated return on phantom investment. Perhaps the regulatory process does not react promptly enough as some have argued in defending section 46(f)(2), but we believe it is simply improper to justify improper normalization of the investment credit as an antidote to deficiencies in the ratemaking process.

These deficiencies, if they exist, should be remedied by the regulators.

In conclusion, Mr. Chairman, we support H.R. 3165 and we very much want to solve the problem with which H.R. 6806 is concerned. We remain hopeful that this hearing will point the way toward that solution. We commend Mr. Corman for introducing the bill and this committee for holding this important hearing.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF DANIEL HALPERIN, DEPUTY ASSISTANT SECRETARY (TAX LEGISLATION), DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of this Committee: I am pleased to have the opportunity to appear before this Committee to discuss H.R. 6806 and H.R. 3165. Both bills deal with aspects of the rules of the Internal Revenue Code that require the investment credit and the tax deferral attributable to accelerated depreciation to be "normalized" in establishing rates for regulated public utilities. Last year the Treasury presented extensive testimony on this subject before the Committee's Oversight Subcommittee. For the record of these hearings I am attaching a copy of our previous testimony, which I will not reiterate in detail.

As we testified last year, the Treasury regards the investment credit, and the tax deferral attributable to the excess of accelerated over economic depreciation, as subsidies to investment that are delivered through the tax system. As we also testified at those hearings, the Treasury has concluded that it is appropriate for these tax subsidies to be made available to regulated public utilities, which are among the most capital-intensive industries in the country; but that, as long as those benefits are available to regulated public utilities, they should be treated as subsidies to investment rather than as simple tax reductions.

This point should be underscored. We would not be here today if the cash equivalent of the investment credit and the loan equivalent of the tax deferral attributable to accelerated depreciation were delivered directly rather than through the tax system. We do not believe that accounting for comparable, but appropriated, subsidies would be controversial. The fact that they are cleared through the tax system does not change—and should not be permitted to obscure—their essential character. Thus, in regulated ratemaking, they should be treated in the same manner as any comparable appropriated capital subsidy. Neither should be considered to reduce current regulated tax expense. The investment credit should be treated as a 10-percent reduction in the price paid for equipment, and the tax deferral attributable to accelerated depreciation as an interest-free loan. We believe that this treatment—"normalization"—is unquestionably the correct method of accounting for these subsidies; and that, in the long run, such treatment is in the interests of ratepayers as well as owners of equity in regulated utilities. On balance, we also concluded last year that the normalization requirements of the Internal Revenue Code constitute an appropriate means to ensure proper accounting for these subsidies.

Quite obviously there are those who do not share our point of view. Specifically, the regulatory authorities in the state of California have accounted for the subsidies in a manner that is the equivalent of their being "flowed through" to income (i.e., as a reduction of current tax expense), a result that does not comport with the rules of the Code. But we recognize that the forces that have led to the existing situation in California are both complex and politically charged. Consequently, while we believe the method of regulatory accounting adopted by California unquestionably violates the applicable provisions of the Code and regulations, the Treasury is willing to offer its cooperation in attempting to arrive at a solution to this difficult situation. But we must insist that one can expect as part of any legislative solution a reduction, if not the elimination, of further major disputes about the operation of these rules.

It is with that point of view that we approach H.R. 6806, H.R. 6806, as we understand it, has two objectives. First, under existing law, failure to normalize results in a loss of the benefits of the investment credit and accelerated depreciation. Sections 3 and 4 of H.R. 6806 would operate to absolve those companies, which have been required by California to flow through improperly the investment credit and the tax deferral attributable to accelerated depreciation, from the loss of those benefits. Second, recognizing that the improper flow-through stemmed primarily from an estimating procedure adopted by the California Public Utilities Commission, sections 1 and 2 of H.R. 6806 would amend the investment credit and accelerated depreciation rules to state specifically in the statute that such procedures are impermissible.

We believe that the statutory clarifications of sections 1 and 2 of H.R. 6806 are consistent with existing law and, therefore, are appropriate. The balance of H.R. 6806 we view with reservation. Regulated public utilities are among the most capital-intensive industries and therefore are among the most significant recipients of capital subsidies delivered through the tax system. Consequently, retroactive disallowance of these subsidies exposes the companies subject to the California rate orders to tax deficiencies that by any measure are substantial. If, by reason of legislation, the difficult circumstances as they have developed in California could be defused and the normalization rules made to operate properly there as elsewhere, we see no policy that would be served by collecting such deficiencies.

The difficult question is whether H.R. 6806 can achieve this goal, which both we and its sponsors seek. In our judgment, legislative relief for past violations would be preferable if it preserved some measure of sanction short of collecting the full tax deficiencies or insisting on complete abatement of the rate refunds that already have been ordered by California. Such legislation might serve to defuse the existing situation while making clear that the normalization rules cannot be disregarded with impunity.

But the Treasury is not unalterably opposed to H.R. 6806. If, as the result of its enactment, the situation in California could be defused and the California authorities persuaded to accept normalization; and if it was considered unlikely that other state regulatory authorities would be induced to start down the road taken by California; and if, finally, this Committee and the Congress were to make it clear that attempts to circumvent these rules in the future would meet with no sympathy on the part of the Congress, then a measure such as H.R. 6806 could be desirable.

Whether it is realistic to have such expectations—which, Mr. Chairman, I emphasize are in our judgment essential to the Treasury's acquiescing in this legislation—it is not yet possible to say. If the California authorities, and those public lawyers whose intervention in the California rate proceedings has been an essential feature of this controversy, were prepared to accept normalization for the future, that action would go far toward alleviating our concerns. We say this recognizing that the Supreme Court of California, which we assume cannot speak to the question outside the confines of a judicial proceeding, also has played an essential role in California. But we also point out that, in considering the wisdom of H.R. 6806, this Committee must also reach a judgment about the possibility that its enactment would induce other state regulatory authorities to follow California's lead. We are not in a position to express an independent judgment on the likelihood that this will happen. Perhaps the Committee will hear from witnesses, subject to regulation by states other than California, who will make their views on this subject known.

We must point out, however, that if H.R. 6806 were enacted, and if, contrary to the Committee's expectations, California persevered in the course that it has staked out, or other public utility commissions were persuaded to follow California's lead, the consequences could be quite serious. Our testimony last year to the effect that retention of the normalization rules was appropriate rested on several fundamental premises, among them that the subsidies provided by the investment credit and accelerated depreciation were appropriate for regulated public utilities as long as they were properly accounted for through normalization; that, in general, the tax normalization rules seemed to operate properly; and that, absent such rules, benefits that are intended as subsidies to investment well might be converted into rate subsidies. But we also pointed out that these rules do not operate well when they are the focus of controversy. If, either as the result of California's continued pursuit of flow-through or because of efforts by other public utility commissions to follow suit, the normalization rules prove to be a source of even further controversy, the Treasury might feel constrained to recommend a review of Congressional policy toward the provision of these investment subsidies to regulated public utilities. It might prove necessary to reexamine the wisdom of retaining the normalization rules. Or, recognizing that flow-through operates to convert investment subsidies into direct rate subsidies,

the inability to achieve normalization accounting might warrant reconsideration of allowing these tax subsidies to regulated utilities. We do not mean to suggest that the time for such reconsideration has arrived; only that, if these rules cannot be made to work properly, the underlying policy may have to be reconsidered.

As I mentioned at the outset, Mr. Chairman, the Treasury is prepared to work with this Committee and other interested parties in an attempt to remedy this difficult situation. At this moment we are not confident that H.R. 6806 will provide a solution. We look forward to seeing how the situation develops, and in particular to the views to be expressed before this Committee in the balance of its hearings today.

The other bill dealt with in this hearing, H.R. 3165, addresses the appropriate technique of normalising the investment credit. It is the Treasury's view that the investment credit was intended to stimulate investment in productive capital by reducing the cost of capital goods. Such a reduction means that investments will become feasible at a lower level of expected returns than would be the case in the absence of the credit. Thus, we believe that proper normalisation of the credit would result in its being accounted for in regulated ratemaking in exactly the same way as any other 10 percent reduction in capital costs. First, the regulated taxpayer's "rate base," to which its "fair rate of return" is applied in determining the allowable return to equity investors, would be reduced by the amount of the credit. This would reflect the fact that a portion of the taxpayer's investment had been financed by the government. Second, the base for determining regulated depreciation expense would also be reduced by 10 percent (to reflect the actual cost of the investment), thus reducing annual depreciation charges (and, hence, regulated "cost of service") by 10 percent as well.

In its current form, section 46(f) may not quite accomplish this goal. It provides two alternative methods of normalising the investment credit, neither of which unambiguously permits both a rate base reduction and a reduction in regulated depreciation base. Under one method—section 46(f)(1)—the regulatory body establishing rates may require the regulated taxpayer's rate base to be reduced by the amount of the credit. However, under section 46(f)(1), it is not clear that any other reduction, for example a reduction in depreciation expense, is permitted in the taxpayer's regulated cost of service. Under the alternative—section 46(f)(2)—regulated "cost of service" may be reduced by a ratable portion of the credit earned each year (the equivalent of reducing the taxpayer's base for computing regulated depreciation expense), but the taxpayer's rate base may not be reduced. Consequently, section 46(f)(2) permits the regulated taxpayer to earn a return on the portion of its investment that is paid for by the government through the credit. Most regulated utilities elect section 46(f)(2).

As we testified last year, we believe that the correct technique by which to normalize the investment credit involves a combination of the two existing methods, under which, through reduced depreciation, the regulated taxpayer's cost of service is reduced by a ratable portion of the credit each year; while, simultaneously, the taxpayer's rate base is reduced (to exclude the government's contribution) by the amount of the allowable credit. This treatment would recognize the investment credit as providing a 10-percent reduction in capital costs.

We are convinced that the arguments in support of retaining section 46(f)(2) are based on a misunderstanding of the way in which the investment credit was intended to operate. Many of those who have considered this issue agree that conceptually we are correct, but attempt to justify section 46(f)(2) on other grounds. Specifically, it has been said that allowing a regulated utility to preserve the investment credit in its rate base, as permitted by section 46(f)(2), to some extent mitigates the consequences of "regulatory lag" (i.e., the inability of current ratemaking orders to keep up with financial demands on a regulated utility), a phenomenon that is aggravated by high rates of inflation. We believe that it simply is improper to justify improper normalization of the investment credit as an antedote to deficiencies in the ratemaking process. Those deficiencies, if they exist, should be remedied by the regulators.

In sum, Mr. Chairman, H.R. 3615 attempts to correct what we regard as a deficiency in the existing investment credit normalization rules. While we have some technical reservations, the Treasury supports the objective of H.R. 3615 and would be happy to cooperate with the Committee or its staff to work out suitable revisions.

STATEMENT OF EMIL M. SUNLEY, DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS), BEFORE THE OVERSIGHT SUBCOMMITTEE OF THE COMMITTEE ON WAYS AND MEANS, MARCH 28, 1979

Mr. Chairman and members of the Subcommittee: I welcome this opportunity to appear before you to discuss several important issues involving the distribution of subsidies through the tax system to regulate utilities. This subject is not only of great interest to the Congress and the Administration, but also to regulators, ratepayers and utilities throughout the country.

Let me begin by recalling for the Subcommittee why it is that a tax policy official is testifying before a tax committee on a subject of fundamental importance to regulated utilities, ratepayers and regulators. The issues before the Subcommittee involve two general subsidies to capital formation provided through the Internal Revenue Code: accelerated tax depreciation and the investment tax credit.

When tax depreciation rules permit write-offs at a faster rate than the actual physical deterioration of capital assets, the economic effect is the deferral of tax liability. The result is the same as if the Treasury were to extend a series of interest-free loans to the taxpayer during the early years of the asset's life, which are repayable in the later years.

The other subsidy—the investment credit—was the subject of extensive testimony before the Subcommittee this past week. This credit is roughly equivalent to a direct cash grant paid by the Treasury to purchasers of certain capital assets. The grant is paid by allowing taxpayers to reduce their tax liabilities otherwise payable.

Thus, we are talking about two forms of Federal subsidies—interest-free loans and cash grants—which are "cleared"—that is, paid and distributed—through the Federal income tax system.

If these subsidies had been enacted as direct grant and loan programs administered by the Commerce Department, then not only would we be before a different committee, but most of the issues before us would never have arisen. This is because under a direct loan or grant program, the real character of the payments to assist private capital formation would be obvious to all concerned. The accounting treatment for government grant and loan assistance is simply not controversial in the private sector. Consequently, there would be no need to prescribe accounting rules by Federal law and, therefore, no need to exercise oversight review of such rules.

That we are here at all may be the most persuasive reason for exercising greater restraint in the future when we are tempted to use the tax system as a mechanism to finance Federal subsidy programs. Programs whose objectives and costs are obscured by the method chosen to finance them and whose administration becomes intertwined with administration of the income tax laws impose unnecessary social and political costs we can ill-afford to bear.

WHY PROVIDE THESE SUBSIDIES TO REGULATED UTILITIES?

The investment credit, as originally proposed by the Treasury Department in 1962, would have completely excluded public utilities from the credit. The Treasury argued that, "Investments by these regulated monopoly industries are largely governed by determined public requirements and are subject to regulated consumer service charges designed to provide a prescribed after-tax rate of return on investment". The House Ways and Means Committee compromised by giving the public utilities one-half the credit allowed other industries. The Committee justified the decision as follows:

"The smaller credit [for public utilities] is provided * * * because much of its benefit in these regulated industries is likely to be passed on in lower rates to consumers, thereby negating much of the stimulative effect on investments. Moreover, the size of the investment in regulated public utilities * * * will in large part be determined by the growth of other industries, rather than their own."

The reasoning reflected in the Treasury and Ways and Means statements prevailed until 1975 when Congress placed regulated companies on the same footing as all other companies for investment credit purposes. It is clear today that the earlier reasoning is essentially wrong. In both the regulated and un-

FIGURE RWH-R4
Statement of John G. Wilkins, June 12, 1984

For Release Upon Delivery
Expected at 9:30 a.m., E.S.T.
June 12, 1984

STATEMENT OF
JOHN G. WILKINS
DIRECTOR, OFFICE OF TAX ANALYSIS
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ENERGY CONSERVATION AND POWER
OF THE HOUSE COMMITTEE ON ENERGY AND COMMERCE

Mr. Chairman and Members of the Subcommittee:

We are pleased to present the views of the Treasury Department on H.R. 4923 -- the "Phantom Tax Reform and Least Cost Electric Energy Planning Act of 1984." This Bill would repeal the "normalization" requirements for certain regulated electric utilities for two general subsidies to capital formation provided through the Internal Revenue Code: accelerated tax depreciation and the investment tax credit. 1/

The Treasury Department strongly opposes H.R. 4923. Normalization of the above two capital subsidies by regulated utilities is necessary to ensure that these subsidies will reduce utilities' costs of capital services, placing them, and their charges for electric service, on an equal basis with unregulated companies. If these subsidies are available to both regulated and unregulated companies and are not properly normalized by the regulated companies to reduce their cost of capital, but rather used to directly reduce their current rates, the subsidies will not be achieving their intended purpose and therefore should not be available to regulated companies at all. Further, we do not believe that regulated electric utilities should be singled out for selective treatment. To do so will distort energy pricing

1/ In particular, H.R. 4923 would effectively repeal section 167(e) pertaining to the normalization of deferred taxes arising from the use of accelerated tax depreciation methods allowable before January 1, 1981; section 168(e)(4) pertaining to tax deferral derived from use of ACRS allowances, effective January 1, 1981 and thereafter; and section 46(f), dealing with the investment tax credit.

R-2720

and disrupt competitive balance in the U.S. economy. We should also point out that publicly-owned utilities are tax exempt and are heavily subsidized through the use of federally tax-exempt financing. REA-sponsored electric power generation and distribution cooperatives are also tax exempt and are heavily subsidized through various REA credit subsidies. It would be totally inappropriate, in our view, to single out investor-owner utilities for reductions in tax-related subsidies while public utilities and cooperatives continue to enjoy the special tax benefits that they currently possess.

This statement will discuss in further detail our reasons for opposing H.R. 4923, first describing H.R. 4923, then discussing the above two capital subsidies -- whether they should be provided to public utilities at all, and if so, how they should properly be accounted for. Finally, the statement will point out a defect in the statutory normalization rules for the investment tax credit and recommend a solution to such defect.

I. Description of H.R. 4923

H.R. 4923 would amend the Internal Revenue Code by including "cross references" in sections 46(f), 167(l) and 168(e)(3) to make inapplicable the current normalization requirements for the investment tax credit, accelerated depreciation and ACRS to certain electric utilities that adopt "least system cost plans." The cross references are to the changes made in Titles I and II of the Bill, dealing with State regulated electric utilities and Federally regulated electric utilities respectively.

Title I of the Bill amends the Public Utility Regulatory Policies Act of 1978 to provide for adoption of a "least system cost plan" for State regulated electric utilities. The term "least system cost plan" is defined as a plan which provides for meeting demand for electric energy services under which each measure to be implemented is forecast (1) to be reliable and available within the time needed, and (2) to meet or reduce electric power demand of retail customers at an estimated incremental system cost no greater than that of the least-cost similarly reliable alternative measure or resource, or any combination thereof. The ability to meet or reduce electric power demand is to be determined by the applicable State regulatory authority. If a State regulatory authority adopts a least system cost plan for an electric utility, the State regulatory authority may approve a rate schedule for such utility which provides for the ratemaking treatment of the investment credit, depreciation and ACRS deductions in such manner as the State regulatory authority determines will further the purposes of the plan. Such treatment will apply in lieu of the normalization amounts required by the Internal Revenue Code.

Figure RWH-R4

Title II of the Bill amends the Federal Power Act to provide for adoption of a "least system cost plan," which is defined generally the same as in Title I of the Bill. If the Federal Energy Regulatory Commission (FERC) adopts a least system cost plan for a utility, the FERC may provide for such ratemaking treatment of the investment credit, depreciation and ACRS deductions as FERC determines will further the purposes of the plan and will provide a current return to the ratepayers of the tax benefits attributable to such credit or deductions which is larger than the current return which would be provided to the ratepayers under economic normalization.

II. Discussion

When tax depreciation rules permit deductions at a faster rate than the actual physical deterioration of capital assets, the economic effect is the deferral of tax liability. The result is the same as if the Treasury were to extend a series of interest-free loans to the taxpayer during the early years of the asset's life, which are repayable in the later years. The other subsidy -- the investment credit -- is roughly equivalent to a direct cash grant paid by the Treasury to purchasers of certain capital assets. The grant is paid by allowing taxpayers to reduce their tax liabilities otherwise payable. Thus, we are talking about two forms of Federal subsidies -- interest-free loans and cash grants -- which are "cleared" -- that is, paid and distributed -- through the Federal income tax system.

If those subsidies had been enacted as direct grant and loan programs administered by the Commerce or Energy Departments, then most of the issues concerning the appropriate regulatory accounting for them in ratemaking would never have arisen. This is because under a direct loan or grant program, the real character of the payments to assist private capital formation would be obvious to all concerned. The accounting treatment for a government capital grant and loan assistance is simply not controversial in the private sector. A capital grant universally would be recognized and accounted for as a plant and equipment price-reducing subsidy that proportionately reduces charges for depreciation and rate of return included in cost of service. A below-market interest-rate loan would be recognized as a Federal financing subsidy that reduces the charge for rate of return. Consequently, there would be no need to prescribe accounting rules by Federal law.

A. Why Provide These Subsidies to Regulated Utilities?

The investment credit, as originally proposed by the Treasury Department in 1962, would have completely excluded public utilities from the credit. The Treasury argued that, "Investments by these regulated monopoly industries are largely governed by determined public requirements and are subject to regulated consumer service charges designed to provide a

prescribed after-tax rate of return on investment." The House Ways and Means Committee compromised by giving the public utilities one-half the credit allowed other industries. The Committee justified the decision as follows:

> The smaller credit [for public utilties] is provided ... because much of its benefit in these regulated industries is likely to be passed on in lower rates to consumers, thereby negating much of the stimulative effect on investments. Moreover, the size of the investment in regulated public utilities ... will in large part be determined by the growth of other industries, rather than their own.

The reasoning reflected in the Treasury and Ways and Means statements prevailed until 1975 when Congress generally placed regulated companies on the same footing as all other companies for investment credit purposes by allowing the full investment tax credit to utilities. It is clear today that the earlier reasoning is essentially wrong. In both the regulated and the unregulated sectors of the economy, technology and consumer preferences operate to determine which particular forms of capital will be employed and which kinds of output will be increased. If the full beneficial effect of an investment tax credit for machinery and equipment is to be achieved, it should be made generally available, on the same terms, to all sectors of the private economy -- to the regulated as well as to the unregulated. Only in this way can the structure of product prices and the output mix of the private sector fully reflect technological possibilities and consumer preferences. The capital cost of goods produced by the regulated sector should not be made arbitrarily higher or lower than the capital cost of goods produced by the unregulated sector. Similarly, the capital costs of electric utilities should not be biased vis-a-vis other energy producers.

An argument often made for denying the full investment credit to regulated electric utilities is that the regulatory process inherently biases such utilities to excessive use of capital. As a purely abstract principle, a case can be made that as long as the average "fair rate of return" allowed by the regulators exceeds the marginal cost of funds, the management of regulated utilities will have an incentive to utilize more capital intensive production methods. However, there are several factors in the real world which tend to reduce this effect.

First, the familiar regulatory lag in adjusting the prices of utility services to rising costs will operate to prevent the realization of higher returns from marginal investments. Related to this, is the fact that the regulatory authorities themselves may adjust downward the fair rate of return thus offsetting the tendency toward excessive capital intensity.

Similar checks are provided by competition among utilities (e.g., gas or electric power) and between utilities and large

companies able to produce their own utility services. Finally, to the extent that utilities are interested in maximizing sales rather than profits there would be no pressure for excessive capital intensity.

Attempts at empirically estimating the degree of excessive use of capital in the utility sector have not adequately come to grips with the difficulties in measuring the marginal cost of funds relative to the average "fair" rate of return or with the ability of regulators to adjust their rate of return as conditions warrant. Indeed, throughout the history of regulation, we have seen large variations in the profits of utilities and in their ability to attract funds in capital markets, all while a "fair" return was presumably being earned.

Thus, we conclude that it would be unwise policy to offset a theoretically possible excessive use of capital by electric utilities by denying to them an investment tax credit designed generally to stimulate capital formation by reducing the private cost of acquiring equipment.

B. How Should Tax Subsidies to Capital be Accounted For?

In setting the rates that utilities may charge their customers, utility regulators have two basic goals: (1) to establish prices that cover the cost of providing utility service, and (2) to minimize the costs of providing those services.

The amount utilities charge for services must be sufficient to cover current expenses such as labor, fuel, and taxes, and the costs of acquiring and using capital assets to provide those services. The total costs attributable to the use of capital include a charge for depreciation, as estimated by regulatory authorities, interest payable to creditors, and a sufficient after-tax return to shareholders to maintain and attract equity capital. The amount charged for utility services must, therefore, be set so that after current expenses, including corporation income taxes, as well as interest and depreciation, shareholders receive an adequate after-tax rate of return.

Consequently, the size of the rate base -- that is, the total value of plant and equipment financed by lenders and shareholders -- determines all components of the cost of using capital. The rate of return to lenders and shareholders is some "fair return" as a percentage of the share of rate base they have financed. Depreciation represents the fraction of the rate base used up in each year's production and which must be replaced if the service output is to be maintained.

If part of the rate base is paid for by a source other than shareholders and lenders, such as a government subsidy, the charge for utility services should reflect this fact. If the Federal Government provides a 10 percent purchase subsidy with

Figure RWH-R4

FIGURE RWH-R5
FERC Order No. 144

Figure RWH-R5

same relief was requested by complaint counsel when this case was before the Commission in 1977, and it was denied.

We do not believe that it is in the public interest to enter an order against American General. We are not convinced that there is a reasonable likelihood that American General will reenter the relevant market, nor do we have reason to believe that if they do the reentry would be anticompetitive. With regard to the divestiture of the earnings, we do not believe that any relevant circumstances have changed since our first denial of the request for the earnings divestiture. Complaint counsel have not shown that F&D's competitive viability has been impaired because it lacks sufficient liquid assets.

Because we do not believe it is in the public interest to impose an order at this late date on a respondent no longer doing business in the relevant markets, respondent's motion to dismiss is granted.

Dated: April 21, 1981.

[FR Doc. 81-14375 Filed 5-13-81; 8:45 am]
BILLING CODE 6750-01-M

DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

18 CFR Part 2

[Docket Nos. RM80-42, R-424 and R-446]

Regulations Implementing Tax Normalization for Certain Items Reflecting Timing Differences in the Recognition of Expenses or Revenues for Ratemaking and Income Tax Purposes

Issued: May 6, 1981.

AGENCY: Federal Energy Regulatory Commission.

ACTION: Final Rule Requiring Tax Normalization and Order Removing Refund Contingencies.

SUMMARY: The Commission amends Part 2 of its regulations to require a public utility making a rate filing under the Federal Power Act or an interstate pipeline making a rate filing under the Natural Gas Act to use tax normalization for miscellaneous timing differences to compute the income tax component of its cost of service. The rule requires a rate applicant to use tax normalization for all timing difference transactions except those addressed in prior Commission orders. The rule also codifies the existing Commission practice of adjusting rate base for accumulated deferred income taxes. Finally, the rule requires a rate applicant to make provision in the income tax component of its cost of service for any excess or deficiency in the deferred tax accounts due to tax rate changes and to timing difference transactions within the scope of the rulemaking that had previously been given flow-through treatment.

In addition to this final rule, the Commission orders that refund contingencies imposed in certain cases prior to the issuance of the final rule and relating to tax normalization be removed. The removal is to be effective on the date the final rule becomes effective.

EFFECTIVE DATE: The rule is to be effective July 6, 1981. The removal of refund contingencies imposed in all cases decided subject to the Order Establishing Interim Procedures, issued June 6, 1979 under Docket Nos. R-424 and R-446 is to be effecitve July 6, 1981.

FOR FURTHER INFORMATION CONTACT:

Ronald L. Rattey, Office of Regulatory Analysis, Federal Energy Regulatory Commission, Room 3000F, 825 North Capitol Street, N.E., Washington, D.C. 20426 (202) 357-8186;

Robert F. Shapiro, Office of the General Counsel, Federal Energy Regulatory Commission, Room 8000, 825 North Capitol Street, N.E., Washington, D.C. 20426 (202) 357-8455;

Fredrick L. Jaffe, Office of the General Counsel, Federal Energy Regulatory Commission, Room 8100J, 825 North Capitol Street, N.E., Washington, D.C. 20426 (202) 357-8363;

Russell E. Faudree, Jr., Office of the Chief Accountant, Federal Energy Regulatory Commission, Room 3410, North Building, 825 North Capitol Street, N.E., Washington, D.C. 20426 (202) 357-8188.

SUPPLEMENTARY INFORMATION:

In the matter of tax normalization for certain items reflecting timing differences in the recognition of expenses or revenues for ratemaking and income tax purposes (Docket No. RM80-42), accounting for premium, discount and expense of issue, gains and losses on refunding and reacquisition of long-term debt, and interperiod allocation of income taxes (Docket No. R-424), amendments of the uniform systems of accounts for classes A, B and C public utilities and licensees and natural gas companies: deferred income taxes (Docket No. R-446); Order No. 144.

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Commission noted that while the courts had upheld prior Commission decisions approving flow-through, the courts had never indicated that such a policy was required.[67]

The Commission recognized that different considerations were present in *Texas Gas* than in the prior flow-through cases. In *Texas Gas*, the Commission primarily based its tax normalization decision on the ground that "there is little chance with respect to this plant that there will be any permanent tax savings."[68] The Commission also considered several other reasons for approving tax normalization including:

(1) Before-tax coverage of interest expense would be improved;

(2) The quality of the utility's securities would be enhanced;

(3) Current cash shortages would be alleviated; and

(4) More stable tax costs would result and thus more stable rates.[69]

The United States Court of Appeals for the District of Columbia Circuit reversed the Commission's opinion in *Texas Gas*.[70] The Supreme Court reversed *in toto* and remanded the decision of the D.C. Circuit.[71] The Supreme Court recognized the Commission's wide discretion in setting rates.

Upon remand, after analyzing the Commission's reasons for concluding that a normalization policy should apply,[72] the D.C. Circuit affirmed the Commission's approval of tax normalization of the tax effects of accelerated depreciation for ratemaking purposes as based on substantial evidence.[73] In reaching its decision, the court specifically noted the Supreme Court's finding in *Memphis* that tax normalization was permissible even though it might increase rates.[74]

The courts have explicitly indicated that those decisions adopting tax normalization or flow-through are policy decisions and are within the special competence of the Commission. Prior Commissions based their decisions in those cases primarily on whether tax normalization would or would not likely create a tax deferral or a "tax savings" although they also considered other factors. In these cases, the courts have always dealt with the normalization/flow-through issue in terms of the Commission's own analysis of tax savings versus tax deferral. The courts have never held that the Commission was required to disallow normalization if there were a possibility of a constant or growing balance in the accumulated deferred tax account.

3. Conclusion: Tax Savings versus Tax Deferrals.

The Commission finds that the tax normalization policy, as set out in the final rule, will not cause utilities or their investors to realize a permanent tax savings. Firms that are continuously growing may have continual tax deferrals measured by the total amount in the deferral accounts. Continual tax deferrals are not permanent tax savings since they do not confer a permanent tax benefit on utilities or their investors. When viewed in the aggregate, tax deferrals arising from timing differences can continue into the indefinite future. But the aggregate of all timing difference transactions is simply the sum of the individual timing difference transactions and the individual transactions reverse as do their associated tax effects.

Permanent tax savings can arise from permanent differences as contrasted to timing differences. Permanent differences (in ratemaking) are differences between the amounts of expenses or revenues recognized in one period for income tax purposes and for ratemaking which do not reverse or turn around in one or more other periods. The final rule is not applicable to permanent difference transactions. It requires tax normalization only for timing difference transactions.

To the extent that prior Commissions found that permanent tax savings arose from permanent difference transactions and denied tax normalization on that basis, we agree with and confirm that finding. However, prior Commissions appear to have used the term "permanent tax savings" to apply to "continual tax deferrals". Leaving aside this semantic distinction, the Commission does not believe a finding of evanescent versus continual tax deferrals should be the determinative factor in a decision to adopt a policy of tax normalization or flow-through.

F. Deferred Taxes as Customer-Contributed Capital; the "Loan" Analogy

To illustrate certain aspects of the difference between tax normalization and flow-through in revenue requirements over time, the Notice and the attached Staff Study used an analogy of a customer loan. It is apparent from the comments, however, that this "analogy" increased rather than reduced confusion. Indeed, the source of many of the criticisms of tax normalization can be traced to the erroneous premise that a loan is being made by ratepayers to the utilities.[75] To the extent that the Notice conveyed or supported this notion as fact rather than as an illustrative analogy, the Commission now finds it in error.

The example given in the Notice was misleading, at the least, when it hypothesized that customers make a loan to their utility equal to the tax normalization/flow-through revenue requirement difference. As pointed out by one reply commenter, utilities do not receive this amount. They only receive an amount equal to the deferred tax component of the cost of service. The rest goes to the U.S. Treasury in the form of current taxes.

Second, the example assumed a Type I timing difference. If a Type II of III timing difference had been used, the loan would have appeared to be from the utility to customers.

The analysis also assumed flow-through as the base and evaluated the incremental effects of tax normalization on required revenues as the "loan". If tax normalization had been assumed as the base for the analysis of the Type I timing difference, the loan would have again appeared to be from the utility to customers. Thus, the frame of reference and type of timing difference used in the analysis determined the source and beneficiary of the "loan".

The "loan" analogy is clearly wrong to the extent that it implies that ratepayers have an ownership claim or equitable entitlement to the "loaned monies". Tax normalization does not impose any burden upon ratepayers to pay in excess of the costs associated with the services they receive. Under tax normalization, ratepayers are charged the same rates as they would have been charged had there been no timing differences, *i.e.*, if the IRS allocated expense and revenue transactions to the same time periods as the regulatory agency.

At the most, the "loan" analogy can be viewed as illustrative. It shows that the "return" obtained by ratepayers on the "loan" is equal to the utility's after-tax cost of capital. The important point here, however, is that customers receive in lower rates the full amount of the savings achieved by companies by virtue of their having use of the deferred

[67] 43 F.P.C. at 829.

[68] *Id.*

[69] *Id.* at 829–30.

[70] *Memphis Light, Gas and Water Division v. F.P.C.*, 462 F.2d 853 (D.C. Cir. 1972).

[71] *F.P.C. v. Memphis Light, Gas and Water Division*, 411 U.S. 458 (1973).

[72] *Memphis Light, Gas and Water Division v. F.P.C.*, 500 F.2d at 798, 801–806 (1979).

[73] *Id.* 802, 807.

[74] *Id.* at 807.

[75] This is not to say that customers do not pay rates that recover deferred taxes. They do. But paying deferred taxes in rates does not convey an ownership or a creditor's right.

tax funds. The deferred taxes represent a cost-free form of financial capital to the utilities. The deduction of accumulated deferred taxes from rate base is not intended to provide customers with a return on funds loaned to utilities. Rather, as a number of parties have correctly pointed out, it is simply a way of reflecting the fact that a certain portion of rate base is not financed by investor funds so that there is no "interest" cost to the utility on a portion of its rate base. There is no "interest" cost that requires collection in rates.

The staff study proceeded from here to discuss the implications of the notion that the "return" ratepayers receive is in the form of lower rates and is thus tax-free. This analysis seems to elevate the importance of the fictitious "return" to an unwarranted level. It raises questions about the adequacy of the "return" when, from a policy perspective, this is irrelevant. Utilities employing tax normalization do not increase their earned rates of return above those they are allowed because of normalizing taxes. All the benefits achieved from having the use of deferred taxes are passed to consumers. In order to give ratepayers any higher "return" on the "deferred tax loan", the Commission would have to raise utility rates, not lower them.

The evaluation of the flow-through and tax normalization options from the point of view of whether ratepayer discount rates are below, equal to, or above the utility's after-tax cost of capital presupposes that the two policies are equally attractive from a just and reasonable ratemaking perspective. They are not equal. There are clear-cut differences between the rates set under a tax normalization policy and those set under a flow-through policy. The Commission's evaluation of these differences is that tax normalization achieves rates that are more cost-related and equitable to ratepayers over time.

Since the Commission finds the analysis of tax normalization from the perspective of a customer loan to have little merit, it also finds little merit in the criticisms of the tax normalization policy that are based on the presumption a customer loan.[76]

C. Rulemaking Versus Case-by-Case Treatment of Tax Normalization

1. Authority for Rulemaking. Several commenters argued that to the extent the Commission can adopt tax normalization it must do so through individual rate proceedings. In such proceedings, according to one commenter, the Commission can approve tax normalization only if the utility demonstrated that a tax deferral rather than a permanent tax savings is involved. Another commenter stated that a generic tax normalization rule is a *per se* violation of the just and reasonable rate standard because it permits recognition of tax expenses beyond those "actually paid" without the scrutiny of individual case consideration. As discussed above, the Commission finds that neither the "permanent tax savings" test nor the "actual taxes paid" principle is determinative of the Commission's authority to grant tax normalization. (*See* Sections II–D and II–E.)

As for the argument that the Commission must resolve the tax normalization/flow-through policy issue by adjudication rather than rulemaking, the law is directly to the contrary. Courts have frequently upheld the Commission's discretion to set rates through rulemaking.[77] This has been specifically recognized in *Alabama-Tennessee*.[78] The court held that in deciding whether to adopt flow-through or tax normalization the Commission may proceed by rulemaking or adjudication. The Commission severed the tax normalization issue from a rate case involving Alabama-Tennessee Natural Gas Company and severed the same issue from numerous other rate cases involving natural gas companies.[79] its opinion to determine the just and reasonable rate for Alabama-Tennessee and to apply the general principle as to all other parties.[80]

On review, the court recognized the Commission's wide discretion in choosing the appropriate procedure, including rulemaking, to decide the tax normalization issue:

> The Commission was not obligated to decide the rapid depreciation issue in a rulemaking rather than a ratemaking proceeding. The choice between proceeding by general rule or by individual, ad hoc litigation is one that lies in the informed discretion of the administrative agency.[81]

The court further stated that:

> * * * As long, however, as the Commission stays within constitutional and statutory limits, it is competent to determine whether to deal with a policy problem in an adjudicatory proceeding, a rulemaking proceeding, or a special proceeding of the type employed in this case.[82]

The court concluded that:

> * * * the Commission was within its power in adopting flow-through for Alabama-Tennessee in a proceeding under Section 4 of the Natural Gas Act, even though the findings and order with respect to the petitioner establish a policy that may also affect other interstate pipeline companies.[83]

The Commission notes one commenter's discussion of the cases addressing the Commission's ability to proceed by rulemaking on tax normalization as follows:

> If anything, the courts have approved the Commission's past preference to resolve the tax normalization issue in individual rate proceedings with some misgivings, and have clearly inclined toward the view that adoption of such an industry-wide policy could best be considered in a rulemaking proceeding where all potentially affected parties could participate.[84]

Moreover, the Supreme Court has made it clear that an administrative agency

[76] Examples of this type of criticism include the arguments suggesting that tax normalization discourages self-generation projects or is inequitable to customers who switch dealers because departing customers lose part of the "loan" they have made. *See* Section II–B, above.

[77] *See, e.g., Permian Basin Area Rate Cases*, 390 U.S. 747 (1968) (approving the Commission's authority to set area-wide producer rates through rulemaking). The *Permian* court established that the Commission's determinations in the area of natural gas ratemaking will withstand judicial scrutiny if (1) the Commission has acted within the scope of its authority; (2) its rate order is based upon substantial evidence and (3) the "end result" is just and reasonable. 390 U.S. at 791. There is presently a conflict between the United States Circuit Courts of Appeal over the specific question of whether the "substantial evidence" test or the "arbitrary and capricious" standard applies to judicial review of rulemakings under the Natural Gas Act. However, several courts have indicated that the "arbitrary and capricious" test and the "substantial evidence" test may not, in practical effect, impose a different standard of review for informal rulemakings. *See ECEE v. FERC*, 611 F. 2d 554 (5th Cir. 1980), at 3019–20, n. 22; *American Public Gas Association v. FPC*, 567 F. 2d 1016, 1028–29 (D.C. Cir. 1977); *Associated Industries of N.Y. State, Inc. v. U.S. Department of Labor*, 487 F. 2d 342, 349–50 (2d Cir. 1973); *National Small Shipment Traffic Conferences Inc. v. CAB*, 618 F. 2d 819 (D.C. Cir. 1980). In any event, the Commission believes that this rule satisfies either test.

[78] *Alabama-Tennessee Natural Gas Co. v. FPC*, 359 F. 2d 318 (5th Cir. 1966).

[79] *Alabama-Tennessee Natural Gas Company*, 31 FPC 208 (February 3, 1964), *reh. den.* 31 FPC 928 (April 15, 1964).

[80] *Id.* at 929.

[81] 359 F. 2d at 343 (citation and footnote omitted).

[82] *Id.* (citation omitted).

[83] *Id.* at 344.

[84] Reply Comments of El Paso Natural Gas Company at 7–8. The footnote to the above quoted language provided:

> "*See City of Chicago v. FPC*, 385 F. 2d 629, 643 (D.C. Cir. 1967) (FPC free to utilize adjudication of pipeline rates 'notwithstanding the efforts of courts and scholars to encourage greater use of regulations for broad policy declaration'); *Alabama-Tennessee Natural Gas Co. v. FPC, supra*, note 11, at 341 ('singularly eccentric that a matter as important to the natural gas industry as the Commission's about-face on liberalized depreciation' is resolved in a single pipeline rate proceeding but approves choice of procedure). *See also San Antonio v. United States*, — F. 2d —, No. 78–2051 (D.C. Cir. June 6, 1980) (*Slip Op.* at 33) (application of rule specifying tax normalization to individual rate proceeding upheld)."

FIGURE RWH-R6
Company Response to Request No. TIEC5-68

Request No: TIEC5-68

CENTERPOINT ENERGY, INCORPORATED

PUC DOCKET NO. 29526

SOAH DOCKET NO. 473-04-4555

TEXAS INDUSTRIAL ENERGY CONSUMERS

Q. Please state whether and how the amounts shown in Schedule IX will be recognized during the determination or recovery of stranded costs.

A. The amounts shown on Schedule IX would not affect the determination of stranded costs. The accumulated deferred income tax amounts could affect the recovery of stranded costs if the PUCT uses a time value of money concept similar to the concept used in the first securitization. In the first securitization, the Company used the time value concept only for accumulated deferred income taxes and not for any of the other amounts on Schedule IX. This is consistent with the PUCT Staff's conclusion in Project No. 26892 with respect to accumulated deferred income taxes included on Schedule IX. The PUCT Staff stated:

"Consideration of tax effects has a bearing on the present-value calculations of revenue requirements. Therefore, even if it is the case that consideration of a company's tax information does not have a direct effect on the quantification of stranded costs, such information will need to be considered when the method of recovery of stranded costs is determined."

Sponsor: Robert W. Hriszko

Attachments: None

FIGURE RWH-R7
PLR 9547008

C

Internal Revenue Service (I.R.S.)

Private Letter Ruling

Issue: November 24, 1995
August 23, 1995

CC:DOM:P&SI:Br6 / TR-31-2648-93

Legend:

Taxpayer =

Parent =

Corporation A =

Corporation B =

Commission =

Intervenor =

State X =

State Y =

District =

Plant =

Docket A =

Docket B =

a =

b =

c =

d =

e =

f =

g =

h =

i =

Dear ***

This letter responds to your request, dated October 5, 1993, that was submitted on behalf of the Taxpayer. You have requested whether the ratable reduction in regulated tax expense, for the applicable portions of the Plant, violates the normalization requirements of sections 46(f)(2), 46(f)(10), and 168(i)(9)(B) of the Internal Revenue Code.

The Taxpayer has represented the facts to be as follows:

The Taxpayer is a wholly-owned subsidiary of the Parent. The Taxpayer is an investor-owned regulated public utility engaged in the generation, purchase, transmission, distribution and sale of electric energy in State X and State Y. The Taxpayer requests this ruling with respect to its State X service areas.

The Taxpayer has two wholly owned subsidiaries, Corporation A and Corporation B. Both of these State X corporations were organized as financing vehicles for the Plant. The Commission determined and reaffirmed that these financing vehicles are transparencies as far as rate filings are concerned. All of the operating expenses of Corporations A and B are paid by the Taxpayer. The Corporations and the Taxpayer are consolidated for ratemaking purposes and financial reporting purposes.

The Taxpayer and Parent are calendar year taxpayers and employ the accrual method of accounting. The Taxpayer and the Corporations are included in the consolidated income tax return filed by Parent. The District Director's office in District has examination jurisdiction over the Parent's tax returns.

The Plant generates approximately 30 percent of the Taxpayer's capacity requirements in State X. All of the Plant is used to generate electricity for the Taxpayer's customers and all of the electric output is sold at rates determined by the Commission. All of the operating and maintenance costs for both units of the Plant are included in the rates set by the Commission. All of the Taxpayer's fuel costs for both units of the Plant are included in rates subject to the Commission's authority over a fixed fuel factor.

In Docket A, relating to Unit 1 of the Plant, the Commission made a number of findings. Unit 1 was placed in service for both tax and book purposes during c. Unit 1 qualifies as transitional property under sections 203 and 211 of the Tax Reform Act of 1986 (the "Act") and is, therefore, eligible for the Investment Tax

Credit (ITC) and accelerated tax depreciation using the accelerated cost recovery system (ACRS).

In Docket A, the Commission determined as imprudent a dollars of the b dollars requested costs for Unit 1 and would not allow these costs to be included in rate base. No depreciation expense was provided in cost of service for the costs not included in rate base. No accumulated deferred Federal income taxes (ADFIT) were included for the costs not included in rate base.

In determining cost of service, the Federal income tax calculation did not utilize depreciation on the Unit 1 costs not included in rate base. Furthermore, in determining cost of service the Federal income tax calculation did not utilize ITC on the Unit 1 costs not included in rate base.

In Docket B, relating to Unit 2 of the Plant, the Commission made a number of findings. Unit 2 was placed in service for both tax and book purposes during d. Unit 2 does not qualify as transitional property under sections 203 and 211 of the Tax Reform Act of 1986 and is, therefore, not eligible either for the Investment Tax Credit (ITC) or accelerated tax depreciation using the accelerated cost recovery system (ACRS). Unit 2 will be depreciated under the modified accelerated cost recovery system (MACRS).

In Docket B the Commission allowed in rate base e dollars of the requested f dollars of Unit 2 costs. The Commission further determined that g dollars would be the ultimately allowed costs for Unit 2 but that the excess of g dollars over e dollars would have to be addressed in another rate proceeding. In addition, the Commission determined as imprudent i dollars of h dollars requested as additional costs for Unit 1 and would not allow these costs to be included in rate base.

Furthermore, the Commission made a number of additional findings in the two dockets that relate to the normalization requirements. In determining Federal income tax expense, the Commission did not include a provision for deferred taxes associated with the disallowed property related to the two units of the Plant. Nor, in fact, did the Commission allow a depreciation expense for the costs not included in rate base.

In determining Federal income tax expense, the Intervenor proposed to deduct in the current tax calculation the accelerated depreciation associated with the disallowed portions of Units One and Two. Similarly, the Intervenor proposed to include in the determination of Federal income tax expense the amortized amount of the Investment Tax Credit relating to the disallowed portion of Unit 1.

Thus, the crucial issue in this request is whether or not the tax benefits (investment tax credits and accelerated depreciation deductions) associated with Unit 1 property disallowed and excluded from rate base can be utilized in the Federal income tax calculation for cost of service without violating the normalization requirements of the Code. Taxpayer and Intervenor took opposite positions on this issue. The Commission, while adopting the Taxpayer's position, directed the Taxpayer to request a ruling from the Internal Revenue Service for the purpose of determining whether adoption of the Intervenor's proposals complied with the normalization requirements.

Prior to the enactment of the Act, section 38 of the Code provided for an

investment tax credit. Sections 46(f)(1) and 46(f)(2) imposed limitations on the use of ITC by regulated public utility companies. Section 46(f)(1) applied generally except as to taxpayers that elect the application of section 46(f)(2). The Taxpayer has represented that it made a timely election under section 46(f)(2).

Section 46(f)(2) of the Code provided that no ITC shall be allowed with respect to public utility property if (1) the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the otherwise allowable ITC, or (2) the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the otherwise allowable ITC.

In determining whether, or to what extent, the investment credit has been used to reduce cost of service, section 1.46-6(b)(2)(ii) of the regulations provides that reference shall be made to any accounting treatment that affects cost of service. An example of such treatment is a reduction in the amount of Federal income tax expense taken into account for ratemaking purposes by all or a portion of the credit.

Section 1.46-6(b)(3)(ii)(A) of the regulations provides that in determining whether, or to what extent, the investment credit has been used to reduce rate base, reference shall be made to any accounting treatment that affects rate base. In addition, reference shall be made to any accounting treatment that reduces the permitted return on investment by treating the credit less favorably than the capital that would have been provided if the credit were unavailable.

Section 1.46-6(b)(4)(i) of the regulations provides that cost of service or rate base is also considered to have been reduced by reason of all or a portion of a credit if such reduction is made in an indirect manner. Under section 1.46-6(b)(4)(ii), one type of such indirect reduction is any ratemaking decision in which the credit is treated as operating income subject to ratemaking regulation or is treated less favorably than the capital that would have been provided if the credit were unavailable. For example, if the credit is accounted for as nonoperating income on a company's regulated books of account but a ratemaking decision has the effect of treating the credit as operating income in determining rate of return to common shareholders, then cost of service has been indirectly reduced by reason of the credit.

According to section 1.46-6(b)(4)(iii) of the regulations, a second type of indirect reduction is any ratemaking decision intended to achieve an effect similar to a direct reduction to cost of service or rate base. In determining whether a ratemaking decision is intended to achieve this effect, consideration is given to all the relevant facts and circumstances of each case, including, but not limited to, the record of the proceeding, the regulatory body's orders or opinions (including any dissenting views), and the anticipated effect of the ratemaking decision on the company's revenues in comparison to a direct reduction to cost of service or rate base by reason of the investment tax credits available to the regulated company.

For purposes of determining whether or not the taxpayer's cost of service for ratemaking purposes is reduced by more than a ratable portion of the investment credit, section 46(f)(6) of the Code provides that the period of time used in computing depreciation expense for purposes of reflecting operating results in the

taxpayer's regulated books of account shall be used. Under section 1.46- 6(g)(2) of the regulations, what is "ratable" is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. The term "regulated depreciation expense" means the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes.

According to section 46(f)(10)(A) of the Code, one way in which the requirements of section 46(f)(2) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment that is inconsistent with these requirements. Under section 46(f)(10)(B), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's qualified investment for purposes of the investment credit allowable under section 38 unless such estimate or projection is also used, for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

Taxpayer's ruling requests depend, in part, upon whether or not the disallowed portion of the Plant is public utility property. If the disallowed portion of the Plant is not public utility property, then the ratemaking and accounting treatments of the investment credit generated by the disallowed portion of the Plant are outside the scope of section 46(f) of the Code.

Section 46(f)(5)(A) of the Code defines the term "public utility property" as property that is public utility property within the meaning of section 46(c)(3)(B) . Under section 46(c)(3)(B), public utility property includes property used predominantly in the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale have been established or approved by a public service or public utility commission or other similar body of any State or political subdivision thereof.

Section 1.46-3(g)(2)(i) of the regulations provides that public utility property is property used by a taxpayer predominantly in a trade or business that is a "public utility activity." According to section 1.46-3(g)(2)(ii), a public utility activity includes electrical energy furnished or sold at regulated rates. Section 1.46-3(g)(2)(ii) further provides that if property is used by a taxpayer both in a public utility activity and in another activity, the characterization of the property is based on the predominant use of the property during the taxable year in which it is placed in service.

Section 1.46-3(g)(2)(iii) of the regulations provides that a taxpayer's rates are "regulated" if they are established or approved on a rate-of-return basis. Rates regulated on a rate-of-return basis are an authorization to collect revenues that cover the taxpayer's cost of providing goods or services, including a fair return on the taxpayer's investment in providing such goods or services, where a taxpayer's costs and investment are determined by use of a uniform system of accounts prescribed by the regulatory body. A taxpayer's rates are not "regulated" if they are established or approved on the basis of maintaining competition within an industry, insuring adequate service to customers of an industry, or charging "reasonable" rates within an industry since the taxpayer is not authorized to collect revenues based on the taxpayer's cost of providing goods or services.

In setting the rates in Dockets A and B, the Commission excluded a certain

percentage of Taxpayer's investment in the Plant from both rate base and regulated depreciation expense. However, the rates to be charged for all of the electricity generated by the Plant, including the disallowed portion, are determined by the Commission. Further, the Commission allowed the recovery from ratepayers of all of the operating and maintenance expenses incurred for the Plant. As a result, the Plant is used predominantly to furnish or sell electricity at regulated rates and thus, the entire Plant, including the disallowed portion, is public utility property within the meaning of section 46(c)(3)(B) of the Code. Consequently, the investment credit generated by the Plant, including the portion related to the disallowed portion, is subject to the normalization rules of section 46(f).

Taxpayer's first ruling request relates to whether the Intervenor's proposal for a ratable reduction in regulated tax expense for that portion of the ITC claimed on Unit 1 of the Plant not included in cost of service or rate base violates the normalization requirements of sections 46(f)(2) or 46(f)(10) of the Code. The effect of this accounting treatment would be to allow ratepayers a benefit from the Taxpayer's ITC even where the stockholders neither earn a return on the related property nor recover their investment in the property through rates.

The Service does not determine such purely regulatory questions as whether the proposals of a public utility commission will produce just and equitable rates. Consequently, the Service, in Taxpayer's first ruling request, will determine only whether the normalization provisions of section 46(f)(2) of the Code would be violated when the investment credit attributable to the disallowed costs of the Plant is used to reduce the tax expense component of cost of service.

Any public utility that claims the investment credit for public utility property must use "normalization" accounting in calculating the rates to be charged its customers and in maintaining its regulated books of account. Under normalization accounting, the immediate flow through of the investment credit for public utility property to the utility's customers is prohibited. Instead, under section 46(f)(2) of the Code, for ratemaking purposes the utility defers the investment credit on public utility property that it claimed for Federal income tax purposes and then amortizes the deferred balance ratably over the regulatory life of the property generating the credit.

The normalization rules of section 46(f)(2) of the Code do not require public utility commissions to take investment credit on public utility property into account in determining cost of service, but do permit them to do so provided the reduction to cost of service is by no more than a ratable portion of the credit.

Specifically, the issue is whether the normalization provisions of the Code would be violated if tax savings claimed for the disallowed portion of the Plant are used to reduce the tax expense component of cost of service even though the disallowed costs are excluded from both rate base and regulated depreciation expense.

As determined above, the entire Plant is public utility property. As a result, the investment credit generated by the Plant, including the amount related to the disallowed portion, is subject to the normalization requirements of section 46(f)(2) of the Code. One way in which the requirements of section 46(f)(2) are not met is if the consistency rules of section 46(f)(10) are violated.

Under the consistency rules of section 46(f)(10) of the Code, any ratemaking procedure or adjustment that uses an estimate or projection of the utility's qualified investment for the investment credit allowable by section 38 must be consistent with the estimates and projections of property that are used for regulated depreciation expense and for rate base. In general, a taxpayer's qualified investment is computed under section 46(c)(1) by applying the applicable percentage (as determined under the table in section 46(c)(2)) to the basis of the property.

Under the Intervenor's proposal, the tax expense component of the cost of service would be reduced for the investment credit attributable to the disallowed portion of the Plant. As a result, for ratemaking purposes 100 percent of Taxpayer's basis in the Plant would be used in determining Taxpayer's qualified investment for the investment credit allowable while less than 100 percent of Taxpayer's basis in the Plant would be used for determining regulated depreciation expense and for determining rate base. Thus, the treatment of the tax expense component of the cost of service would violate the consistency requirements of section 46(f)(10) of the Code.

Thus, any reduction to the tax expense component of the cost of service for investment credit on public utility property not included in rate base or not recovered through regulated depreciation expense will constitute a violation of the normalization requirements of section 46(f)(2) of the Code.

Based on Taxpayer's representations and the analysis as set forth above, we conclude, with respect to the Taxpayer's request whether the Intervenor's proposal for a ratable reduction in regulated tax expenses for that portion of Unit 1 of the Plant not included in cost of service or rate base would violate the normalization requirements of sections 46(f)(2) and 46(f)(10) of the Code, we find as follows:

1. All of Unit 1 of the Plant, including the disallowed costs, is public utility property within the meaning of section 46(c)(3)(B) of the Code and, thus, is subject to the normalization provisions of section 46(f).

2. In order to satisfy the requirements of section 46(f)(10) of the Code there must be a consistency in the treatment of costs for rate base purposes, regulated depreciation expense purposes, and ITC purposes. Thus, the Intervenor's proposal for a reduction in the tax expense component of cost of service for any portion of the investment credit claimed on the costs of the Plant not allowed in rate base or in cost of service would violate the normalization requirements of section 46(f)(2).

Taxpayer's second request relates to whether the Intervenor's proposal to reduce the regulated tax expense through means of the immediate flow-through for that portion of accelerated depreciation claimed on the portion of both Units 1 and 2 of the Plant not included in cost of service or rate base, violates the normalization requirements of section 168(i)(9)(B) of the Code. The discussion below is in terms of MACRS under sections 168(i)(9)(A) and 168(i)(9)(B) of the Code. Former sections 168(e)(3)(B) and 168(e)(3)(C) relating to ACRS are essentially the same. Thus, although the discussion specifically relates to MACRS property, the analysis is equally applicable to ACRS property.

Section 168(i)(10) of the Code defines, in part, public utility property as property used predominantly in the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

Prior to the Revenue Reconciliation Act of 1990, the definition of public utility property was contained in section 167(l)(3)(A) of the Code and section 168(i)(10) which defined public utility property by means of a cross reference to section 167(l)(3)(A). The definition of public utility property is unchanged. Section 1.167(l)-1(b) of the regulations provides that under section 167(l)(3)(A), property is public utility property during any period in which it is used predominantly in a section 167(l) public utility activity. The term "section 167(l) public utility activity" means, in part, the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, are regulated, i.e., have been established or approved by a regulatory body described in section 167(l)(3)(A). The term "regulatory body described in section 167(l)(3)(A)" means a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States, or a public service or public utility commission or other body of any State or political subdivision thereof similar to such a commission. The term "established or approved" includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer.

The definitions of public utility property contained in section 168(i)(10) and former section 46(f)(5) of the Code are essentially identical. Section 1.167(l)-1(b) of the regulations restates the statutory definition providing that property will be considered public utility property if it is used predominantly in a public utility activity and the rates are regulated. Section 1.167(l)-1(b)(1) of the regulations provides that rates are regulated for such purposes if they are established or approved by a regulatory body. The terms established or approved are further defined to include the filing of a schedule of rates with the regulatory body which has the power to approve such rates even though the body has taken no action on the filed schedule or generally leaves undisturbed rates filed.

The regulations under section 46 of the Code, specifically section 1.46-3(g)(2), contain merely an expanded definition of regulated rates. This expanded definition embodies the notion of rates established or approved on a rate of return basis. This notion is not specifically provided for in the regulations under former section 167 or section 168 of the Code. Nevertheless, there is an expressed reference to rate of return in section 1.167(l)- 1(h)(6)(i). The operative rules for normalizing timing differences relating to use of different methods and periods of depreciation are only logical in the context of rate of return regulation. The normalization method, which must be used for public utility property to be eligible for ACRS and MACRS, is defined in terms of the method the taxpayer uses in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account. These are explicit elements of the definition of rate of return regulation contained in section 1.46-3(g)(2) of the regulations. Thus,

it is clear that the definition of public utility property is the same for purposes of the ITC and depreciation. It follows, that if property is public utility property for purposes of the ITC it is also public utility property for purposes of depreciation.

Sections 168(f)(2), (i)(9) and (i)(10) of the Code provide that before an owner of public utility property can depreciate that property using an accelerated method of depreciation, the normalization requirements must be met. Section 168(i)(9)(A) states that in order to use a normalization method of accounting with respect to any public utility property for purpose of subsection (f)(2) the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property this is no shorter than, the method and period used to compute its depreciation expense for such purposes; and if the amount allowable as a deduction with respect to such property differs from the amount that would be allowable as a deduction under section 167 using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense, the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that a normalization method of accounting does not exist if for ratemaking purposes a procedure or adjustment is used which is inconsistent with the requirements of section 168(i)(9)(A). Section 168(i)(9)(B)(ii) provides that the procedures and adjustments which are to be treated as inconsistent for purposes of section 168(i)(9)(B)(i) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes unless such estimate or projection is also used, for ratemaking purposes, with respect to the other two such items and with respect to rate base.

Under the Intervenor's proposal, the tax expense component of the cost of service would be reduced for the depreciation allowance attributable to the disallowed portion of the Plant. As a result, for ratemaking purposes 100 percent of Taxpayer's basis in the Plant would be used in determining Taxpayer's qualified investment for the depreciation allowance while less than 100 percent of Taxpayer's basis in the Plant would be used for determining regulated depreciation expense and for determining rate base. Thus, the treatment of the tax expense component of the cost of service would violate the consistency requirements.

Thus, based on Taxpayer's representations and the analysis as set forth above, we conclude, with respect to the Taxpayer's request whether the reduction in regulated tax expense through means of the immediate flow-through for that portion of accelerated depreciation claimed on the portion of the Plant not included in cost of service or rate base violates the normalization requirements of section 168(i)(9)(B) of the Code, we find as follows:

1. All of the Plant (Units 1 and 2), including the disallowed costs, is public utility property within the meaning of section 168(i)(10) of the Code and, thus, is subject to the normalization provisions of section 168(i).

2. In order to satisfy the requirements of section 168(i)(9)(B) of the Code

there must be a consistency in the treatment of costs for rate base purposes, regulated depreciation expense purposes, tax expense purposes, and deferred tax revenue purposes. Under the Intervenor's proposal, the reduction in regulated tax expense through means of the immediate flow-through for that portion of accelerated depreciation claimed on the portion of the Plant not included in cost of service or rate base would violate the normalization requirements of section 168(i)(9)(B).

3. Section 168(i)(9)(A) of the Code requires that the depreciation period used for purposes of determining tax expense for cost of service purposes can be no shorter than the period used for purposes to compute regulated depreciation expense and that the method used for computing depreciation for the tax expense component of cost of service must be the same as the method used for computing regulated depreciation expense. Under the Intervenor's proposal, the fact that depreciation of the disallowed portions of the Plant would be permitted for purposes of computing tax expense but not for purposes of computing regulated depreciation expense is indicative that the methods are not the same. Thus, the requirements of section 168(i)(9)(A) would be violated.

Except as specifically set forth above, no opinion is expressed concerning the federal income tax consequences of the above-described facts under any other provision of the Code or regulations. This letter ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that this ruling may not be used or cited as precedent.

In accordance with the power of attorney on file, a copy of this letter is being sent to your authorized legal representatives.

Sincerely yours,

CHARLES B. RAMSEY

Chief, Branch 6

Office of the Assistant Chief Counsel

(Passthroughs and Special Industries)

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.

PLR 9547008, 1995 WL 693615 (IRS PLR)

END OF DOCUMENT

FIGURE RWH-R8
PLR 9312007

Figure RWH-R8

C

Internal Revenue Service (I.R.S.)

Private Letter Ruling

Issue: March 26, 1993
December 21, 1992

Section 46 -- Amount of Credit

46.00-00 Amount of Credit

46.06-00 Limitation in Case of Certain Regulated Companies

46.06-02 Special Rule for Ratable Flow-Through

46.06-09 Use of Inconsistent Estimates and Projections

46.14-00 Public Utility Property - Section 1.46-3(g) of the Income Tax Regulations

46.14-01 Definition of Public Utility Property

CC:P&SI:06 / TR-31-68-92

In re: Private Letter Ruling Request on Normalization of Investment Credits

LEGEND: * * *

Taxpayer: * * *

Parent: * * *

Commission: * * *

Plant: * * *

State X: * * *

Docket Y: * * *

w dollars: * * *

x dollars: * * *

y: * * *

z, * * *

Dear * * *

This letter responds to your letter of January 9, 1992, requesting rulings under the normalization requirements of sections 46(f)(2) and (10) of the Internal Revenue Code with respect to investment credit claimed for the portion of the Plant that is excluded from both rate base and regulated depreciation expense.

Taxpayer represents that the facts are as follows:

Taxpayer is an investor-owned public utility engaged in the generation, purchase, transmission, distribution, and sale of electricity in State X, and is regulated by the Commission. Taxpayer is a wholly owned subsidiary of Parent, which files a consolidated federal income tax return on a calendar year basis using the accrual method of accounting.

For purposes of the investment credit normalization rules under section 46(f) of the Code, Taxpayer has elected to be treated under section 46(f)(2).

In its request for rate increases in Docket Y, Taxpayer based its revenue requirements on a historical test year ended and made a post test year adjustment by reclassifying its investment in the Plant from Construction Work in Progress to Plant in Service. This investment includes Taxpayer's purchase of minority ownership interests in the Plant ("Purchased Assets").

In its final order in Docket Y, however, the Commission disallowed W dollars of Taxpayer's investment in the Plant, including a portion of the costs related to the Purchased Assets, as imprudent expenses for ratemaking purposes. The w dollars are excluded from both rate base and regulated depreciation expense. The investment credit claimed by Taxpayer for the disallowed costs totalled N dollars.

Although the Commission disallowed a portion of Taxpayer's investment in the Plant, the Commission decided not to deregulate that disallowed portion and consequently, retained jurisdiction over the entire Plant. The rates to be charged for all of the electricity generated by the Plant are determined by the Commission. Further, the Commission has allowed, and Taxpayer believes it will continue to allow, the recovery from ratepayers of all of the operating and maintenance expenses incurred for the Plant.

For financial reporting purposes, Taxpayer recognized the net amount of the prudence disallowance less the associated tax benefits in the account Provision for Regulatory Disallowance. This account was reported as a nonoperating or a below-the-line expense. The journal entry made by Taxpayer for the investment credit related to the disallowed portion of the Plant is as follows:

(1) Debit Accumulated Reserve for ITC (a balance sheet account) for N dollars; and

(2) Credit Provision for Regulatory Disallowance (a nonoperating expense account) for x dollars.
The effect of this accounting treatment for the investment credit is to flow through the credit of X dollars immediately to the shareholders of Taxpayer.

Taxpayer represents that the Plant, including the Purchased Assets, was placed in service for Federal income tax purposes in * * *. As of * * * the disallowed costs of w dollars represents v percent of the Plant's book basis and z, percent of the Plant's tax basis.

Certain intervenors in Docket Y filed appeals to a district court of State X, challenging the Commission's order in Docket Y. Among the issues raised on appeal, the intervenors are contesting the Commission's determination of the tax expense component of cost of service. In Docket Y, Taxpayer's regulated federal income tax expense is computed on the basis of a separate tax return by including only the revenues and expenses that are included in cost of service or rate base. As a result, no federal income tax benefits associated with the disallowed portion of the Plant (including the investment credit of x dollars) are reflected in the tax expense component of cost of service. The intervenors argue that for ratemaking purposes, Taxpayer must calculate its federal income tax expense by taking into account the tax benefits associated with the disallowed costs of the Plant (including the investment credit of N dollars) even though such costs and related tax benefits are reported below-the-line.

The appeals are currently pending before the district court. The intervenors and Taxpayer have the statutory right to appeal the decision of the district court to a Court of Appeals of State X. Review of a court of appeals' decision is discretionary with the Supreme Court of State X upon application for writ of error.

Taxpayer is concerned that the treatment of the investment credit of X dollars as recorded for financial reporting purposes and that the calculation of federal income tax expense for ratemaking purposes as proposed by the intervenors may violate the normalization rules under sections 46(f)(2) and (10) of the Code. Accordingly, Taxpayer seeks the following rulings:

1. Whether the immediate flow-through to Taxpayer's shareholders of the investment credit claimed on the costs of the Plant not allowed in rate base or in cost of service would violate the normalization requirements of section 46(f)(2) of the Code?

2. Whether the reduction in regulated tax expense for any portion of the investment credit claimed on the costs of the Plant not allowed in rate base or in cost of service would violate the normalization requirements of section 46(f)(2) of the Code?

Taxpayer has elected to account for its investment credit on public utility property in accordance with section 46(f)(2) of the Code. This section provides that no investment credit shall be allowed with respect to any public utility property of the taxpayer (a) if the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the investment credit,, or (b) if the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the investment credit.

The term "cost of service" is defined under section 1.46-6(b)(2)(i)(A) of the Income Tax Regulations as being the amount required by a taxpayer to provide

regulated goods or services. Cost of service includes operating expenses, maintenance expenses, depreciation expenses, tax expenses, and interest expenses. Any effect on a taxpayer's permitted return on investment that results from a reduction in the taxpayer's rate base does not constitute a reduction in cost of service, even though, as a technical ratemaking term, cost of service ordinarily includes a permitted return on investment.

In determining whether, or to what extent, the investment credit has been used to reduce cost of service, section 1.46-6(b)(2)(ii) of the regulations provides that reference shall be made to any accounting treatment that affects cost of service. An example of such treatment is the reduction of the amount of Federal income tax expense taken into account for ratemaking purposes by all or a portion of the credit.

Section 1.46-6(b)(3)(ii)(A) of the regulations provides that in determining whether, or to what extent, the investment credit has been used to reduce rate base, reference shall be made to any accounting treatment that affects rate base. In addition, in those cases in which the rate of return is based on the taxpayer's cost of capital, reference shall be made to any accounting treatment that reduces the permitted return on investment by treating the credit less favorably than the capital that would have been provided if the credit were unavailable.

Section 1.46-6(b)(4)(i) of the regulations provides that cost of service or rate base is also considered to have been reduced by reason of all or a portion of a credit if such reduction is made in an indirect manner. Under section 1.46-6(b)(4)(ii), one type of such indirect reduction is any ratemaking decision in which the credit is treated as operating income subject to ratemaking regulation or is treated less favorably than the capital that would have been provided if the credit were unavailable. For example, if the credit is accounted for as nonoperating income on a company's regulated books of account but a ratemaking decision has the effect of treating the credit as operating income in determining rate of return to common shareholders, then cost of service has been indirectly reduced by reason of the credit.

According to section 1.46-6(b)(4)(iii) of the regulations, a second type of indirect reduction is any ratemaking decision intended to achieve an effect similar to a direct reduction to cost of service or rate base. In determining whether a ratemaking decision is intended to achieve this effect, consideration is given to all the relevant facts and circumstances of each case, including, but not limited to, the record of the proceeding, the regulatory body's orders or opinions (including any dissenting views), and the anticipated effect of the ratemaking decision on the company's revenues in comparison to a direct reduction to cost of service or rate base by reason of the investment tax credits available to the regulated company.

For purposes of determining whether or not the taxpayer's cost of service for ratemaking purposes is reduced by more than a ratable portion of the investment credit, section 46(f)(6) of the Code provides that the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used. Under section 1.46-6(g)(2) of the regulations, what is "ratable" is determined by considering the period of time actually used in computing the taxpayer's regulated depreciation expense for the property for which a credit is allowed. The term "regulated depreciation expense"

means the depreciation expense for the property used by a regulatory body for purposes of establishing the taxpayer's cost of service for ratemaking purposes.

According to section 46(f)(10)(A) of the Code, one way in which the requirements of section 46(f)(2) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment that is inconsistent with these requirements. Under section 46(f)(10)(B), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's qualified investment for purposes of the investment credit allowable under section 38 unless such estimate or projection is also used, for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

Both of Taxpayer's ruling requests depend upon whether or not the disallowed portion of the Plant is public utility property. If the disallowed portion of the Plant is not public utility property, then the ratemaking and accounting treatments of the investment credit generated by the disallowed portion of the Plant are outside the scope of section 46(f) of the Code.

Section 46(f)(5)(A) of the Code defines the term "public utility property" as property that is public utility property within the meaning of section 46(c)(3)(B). Under section 46(c)(3)(B), public utility property includes property used predominantly in the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale have been established or approved by a public service or public utility commission or other similar body of any State or political subdivision thereof.

Section 1.46-3(g)(2)(i) of the regulations provides that public utility property is property used by a taxpayer predominantly in a trade or business that is a "public utility activity." According to section 1.46-3(g)(2)(ii), a public utility activity includes electrical energy furnished or sold at regulated rates. Section 1.46-3(g)(2)(ii) further provides that if property is used by a taxpayer both in a public utility activity and in another activity, the characterization of the property is based on the predominant use of the property during the taxable year in which it is placed in service.

Section 1.46-3(g)(2)(iii) of the regulations provides that a taxpayer's rates are "regulated" if they are established or approved on a rate-of-return basis. Rates regulated on a rate-of-return basis are an authorization to collect revenues that cover the taxpayers cost of providing goods or services, including a fair return on the taxpayer's investment in providing such goods or services, where a taxpayer's costs and investment are determined by use of a uniform system of accounts prescribed by the regulatory body. A taxpayer's rates are not "regulated" if they are established or approved on the basis of maintaining competition within an industry, insuring adequate service to customers of an industry, or charging "reasonable" rates within an industry since the taxpayer is not authorized to collect revenues based on the taxpayer's cost of providing goods or services.

In setting the rates in Docket Y, the Commission excluded y percent of Taxpayer's investment in the Plant from both rate base and regulated depreciation expense. However, the rates to be charged for all of the electricity generated by the Plant, including the disallowed portion, are determined by the Commission. Further, the Commission allowed the recovery from ratepayers of all of the operating and maintenance expenses incurred for the Plant. As a result, the Plant

is used predominantly to furnish or sell electricity at regulated rates and thus, the entire Plant, including the disallowed portion, is public utility property within the meaning of section 46(c)(3)(B) of the Code. Consequently, the investment credit generated by the Plant, including the X dollars related to the disallowed portion, is subject to the normalization rules of section 46(f).

Taxpayer's first ruling request relates to its transfer of the investment credit of X dollars associated with the disallowed portion of the Plant to a nonoperating income account. The effect of this accounting treatment in to flow through the credit immediately to Taxpayer's shareholders.

The Service does not determine such purely regulatory questions as whether the proposals of a public utility commission will produce just and equitable rates. Consequently, the Service in Taxpayer's first ruling request will determine only whether the normalization provisions of section 46(f)(2) of the Code are violated when the investment credit generated by the disallowed portion of the Plant is transferred to a nonoperating income account.

Any public utility that claims the investment credit for public utility property must use normalization" accounting in calculating the rates to k>e charged its customers and in maintaining its regulated books of account. Under normalization accounting, the immediate flow through of the investment credit for public utility property to the utility's customers is prohibited. Instead, under section 46(f)(2) of the Code, for ratemaking purposes the utility defers the investment credit on public utility property that it claimed for Federal income tax purposes and then amortizes the deferred balance ratably over the regulatory life of the property generating the credit.

The normalization rules of section 46(f)(2) of the Code do not require public utility commissions to take investment credit on public utility property into account in determining cost of service, but does permit then to do so provided the reduction to cost of service is by no more than a ratable portion of the credit.

In the present situation, the Commission excluded the disallowed costs of the Plant from rate base. The Commission also prohibited the disallow*d costs from being recovered through regulated depreciation expense and determined Taxpayer's regulated tax expense without a reduction for the tax benefits associated with the disallowed costs, including the investment credit of x dollars. Further, Taxpayer's transfer of the investment credit of x dollars to a nonoperating income account is consistent with the Commission's decisions in Docket Y to treat the credit as nonoperating income.

Consequently, neither Taxpayer's cost of service for ratemaking purposes or in its regulated books of account nor Taxpayer's rate base was reduced by the investment credit of x dollars. Thus, the requirements of section 46(f)(2) of the Code are satisfied. The fact that the accounting for the investment credit of x dollars under the rate order will be for the benefit of Taxpayer's shareholders is outside the scope of section 46(f).

Taxpayer's second ruling request concerns the issue raised by certain intervenors in the appeal of the Commission's order in Docket Y. Specifically, the issue is whether the normalization provisions of the Code would be violated if tax savings claimed for the disallowed portion of the Plant are used to reduce the tax

expense component of cost of service even though the disallowed costs are excluded from both rate base and regulated depreciation expense. Although the issue raised by the intervenors in the appeal involves both investment credit and depreciation expense, Taxpayer has requested a ruling only on the issue of whether the intervenors' adjustment to regulated tax expense violates the investment credit normalization provisions of section 46(f)(2) of the Code.

The Service does not discuss the relative merits of "stand-alone", "actual taxes paid", or other methods of regulatory accounting. Accordingly, the Service in Taxpayer's second ruling request will determine only whether the normalization provisions of section 46(f)(2) of the Code are violated when the investment credit attributable to the disallowed costs of the Plant is used to reduce the tax expense component of cost of service.

As determined under this ruling, the entire Plant is public utility property. As a result, the investment credit generated by the Plant, including the x dollars related to the disallowed portion, is subject to the normalization requirements of section 46(f)(2) of the Code. One way in which the requirements of section 46(f)(2) are not met is if the consistency rules of section 46(f)(10) are violated.

Under the consistency rules of section 46(f)(10) of the Code, any ratemaking procedure or adjustment that uses an estimate or projection of the utility's qualified investment for the investment credit allowable by section 38 must be consistent with the estimates and projections of property that are used for regulated depreciation expense and for rate base. In general, a taxpayer's qualified investment is computed under section 46(c)(1) by applying the applicable percentage (as determined under the table in section 46(c)(2)) to the basis of the property.

Under the intervenors' proposal, the tax expense component of the cost of service will be reduced for the investment credit attributable to the disallowed portion of the Plant. As a result, for ratemaking purposes 100 percent of Taxpayer's basis in the Plant will be used for determining Taxpayer's qualified investment for the investment credit allowable while less than 100 percent (that is, 100 percent minus y percent) of Taxpayer's basis in the Plant will be used for determining regulated depreciation expense and for determining rate bass. Thus, the intervenors' proposed adjustment to the tax expense component of the cost of service would violate the consistency requirements of section 46(f)(10) of the Code.

The rate order in Docket Y is not a final determination. A determination is final, as defined by section 1.46-6(f)(8)(iii) of the regulations, if all rights to appeal or to request a review, a rehearing, or a redetermination have been exhausted or have lapsed. Because the rate order entered by Commission in Docket Y has been appealed to a district court of State X and Taxpayer has a statutory right to appeal the decision of the district court to the Court of Appeals in State X, Taxpayer's rights to appeal or to request a review, a rehearing, or a redetermination have neither been exhausted nor lapsed.

When the rate order in Docket Y becomes final, any reduction to the tax expense component of the cost of service for investment credit on public utility property not included in rate base or not recovered through regulated depreciation expense will constitute a violation of the normalization requirements of section 46(f)(2)

of the Code.

Based on Taxpayer's representations and the analysis as set forth above, we conclude as follows:

1. The entire Plant, including the disallowed costs of w dollars, is public utility property within the meaning of section 46(c)(3)(B) of the Code and thus, the investment credit generated by the entire Plant is subject to the normalization provisions of section 46 (f) .

2. The normalization requirements of section 46(f)(2) of the Code would not be violated by Taxpayer's accounting treatment of the investment credit associated with the costs of the Plant not allowed in rate base or in cost of service.

3. The reduction in the tax expense component of cost of service for any portion of the investment credit claimed on the costs of the Plant not allowed in rate base or in cost of service would violate the normalization requirements of section 46(f)(;e) of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney, a copy of this letter is being sent to your authorized representatives.

Sincerely yours,

CHARLES B. RAMSEY

Chief, Branch 6

Office of Assistant Chief Counsel

(Passthroughs and Special Industries)

Enclosures (2):

copy of this letter

copy for section 6110 purposes

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.

PLR 9312007, 1992 WL 464358 (IRS PLR)

END OF DOCUMENT

FIGURE RWH-R9
PLR 9613004

C

Internal Revenue Service (I.R.S.)

Private Letter Ruling

Issue: March 29, 1996
December 19, 1995

Section 167 -- Depreciation

167.00-00 Depreciation

167.10-00 Retirement and Abandonment

167.22-00 Public Utility Property

167.22-01 Normalization Rules

Section 168 -- (Repealed-1976 Act) Amortization of Emergency Facilities

168.00-00 (Repealed-1976 Act) Amortization of Emergency Facilities

168.24-00 Public Utility Property

168.24-01 Normalization Rules

CC:DOM:P&SI:6 / TR-31-1657-95

Re: Letter Ruling Request

Legend:

Taxpayer =

Parent =

Intervenor =

Commission =

State X =

Docket A =

Docket B =

Plant =

Dear ***

This is in response to your letter ruling request, dated July 27, 1995, regarding the above-captioned Taxpayer. At the request of the Commission, the Taxpayer has asked us to rule whether the provisions of § 168(i)(9)(A) of the Internal Revenue Code are violated if a tax deduction for depreciation (straight-line over book life) is included in the calculation of regulated federal income tax expense when the depreciation relates to costs not included in rate base or cost of service.

The Taxpayer has represented the following facts:

The Taxpayer owns a share in the Plant. In Docket A, the Commission had disallowed a certain portion of the Plant's capital costs, and that disallowance was upheld in subsequent litigation. Those costs were not included either in rate base or in cost of service (depreciation expense).

In Docket B, the Intervenor instituted an investigation of the reasonableness of the Taxpayer's rates. The Intervenor proposed that in calculating the federal income tax component of cost of service, a tax deduction for disallowed plant costs be recognized. The proposed annual deduction would equal the tax basis of the disallowed Plant costs divided by its book life. The Commission did not adopt the proposed tax adjustment, but directed the taxpayer to request a letter ruling regarding whether the proposed adjustment would violate the Internal Revenue Code.

The Intervenor contends that the imprudent and disallowed costs are losses under § 165 of the Code that are appropriately deducted through ratable amortization of the tax basis of the disallowed Plant costs over the service life of the Plant. The Intervenor argues that as a consequence, the provisions of Section 168(i)(9), regarding the normalization of federal depreciation tax differences, have no application.

On the other hand, the Taxpayer points out that because the electricity generated by the Plant is sold to its customers at rates established by the Commission, the depreciation claimed by the Taxpayer for federal income tax purposes under § 168 of the Code is subject to the public utility requirements of § 168. Because the disallowed costs were not included in rate base, or in cost of service as depreciation expense, any reduction in the federal income tax by a portion of depreciation for the disallowed costs violates the normalization requirements of § 168(i)(9).

For the reasons set out below, we conclude that reflection of depreciation, relating to the disallowed costs, in the federal tax expense would violate the

normalization rules of § 168(i)(9).

Section 168(a) of the Code provides, in general, that the depreciation is deduction provided by § 167(a) for any tangible property placed in service after 1986 is determined by use of the applicable method, recovery period, and convention. The depreciation allowance provided by § 168 is the amount which is set aside for the taxable year so that the cost or other basis in the property is recovered by the end of the recovery period. See § 1.167(a)-1(a) of the Income Tax Regulations.

Section 168(f)(2) of the Code provides that a public utility must use a normalization method of accounting in order to be eligible for the § 168(a) depreciation allowance. Thus, the threshold question is whether the costs or the entire Plant were made for public utility property.

Section 168(i)(10) of the Code defines, in part, public utility property as property used predominantly in the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof.

Prior to the Revenue Reconciliation Act of 1990, the definition of public utility property was contained in § 167(l)(3)(A) of the Code and § 168(i)(10), which defined public utility property by means of a cross reference to § 167(l)(3)(A). The definition of public utility property is unchanged. Section 1.167(l)-1(b) of the regulations provides that under § 167(l)(3)(A), property is public utility property during any period in which it is used predominantly in a § 167(l) public utility activity. The term "§ 167(l) public utility activity" means, in part, the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, are regulated, i.e., have been established or approved by a regulatory body described in § 167(l)(3)(A). The term "regulatory body described in § 167(l)(3)(A)" means a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States, or a public service or public utility commission or other body of any State or political subdivision thereof similar to such a commission. The term "established or approved" includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, even though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer.

The definitions of public utility property contained in § 168(i)(10) and former § 46(f)(5) of the Code are essentially identical. Section 1.167(l)-1(b) of the regulations restates the statutory definition providing that property will be considered public utility property if it is used predominantly in a public utility activity and the rates are regulated. Section 1.167(l)-1(b)(1) of the regulations provides that rates are regulated for such purposes if they are established or approved by a regulatory body. This includes the filing of a schedule of rates with the regulatory body which has the power to approve such rates even though the body has taken no action on the filed schedule or generally leaves undisturbed rates filed.

The regulations under former section 46 of the Code, specifically § 1.46-3(g)(2), contain an expanded definition of regulated rates. This expanded definition embodies the notion of rates established or approved on a rate of

return basis. This notion is not specifically provided for in the regulations under former § 167 of the Code. Nevertheless, there is an expressed reference to rate of return in § 1.167(l)-1(h)(6)(i). The operative rules for normalizing timing differences relating to use of different methods and periods of depreciation are only logical in the context of rate of return regulation. The normalization method, which must be used for public utility property to be eligible for the depreciation allowance available under § 168, is defined in terms of the method the taxpayer uses in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account. These are explicit elements of the definition of rate of return regulation contained in § 1.46- 3(g)(2) of the regulations. Thus, it is clear that the definition of public utility property is the same for purposes of the investment tax credit and depreciation. It follows, that if property is public utility property for purposes of the credit it is also public utility property for purposes of depreciation.

Section 168(f)(2), (i)(9) and (i)(10) of the Code provide that before an owner of public utility property can depreciate that property using an accelerated method of depreciation, the normalization requirements must be met. Section 168(i)(9)(A) states that in order to use a normalization method of accounting with respect to any public utility property for purposes of subsection (f)(2) the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes; and if the amount allowable as a deduction with respect to such property differs from the amount that would be allowable as a deduction under § 167 using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense, the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that a normalization method of accounting does not exist if for ratemaking purposes a procedure or adjustment is used which is inconsistent with the requirements of § 168(i)(9)(A). Section 168(i)(9)(B)(ii) provides that the procedures and adjustments which are to be treated as inconsistent for purposes of § 168(i)(9)(B)(i) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes unless such estimate or projection is also used, for ratemaking purposes, with respect to the other two such items and with respect to rate base.

Section 165 provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 1.165-1(b) provides that to be allowable as a deduction under § 165(a), a loss must be evidence by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year.

Section 1.165-2(c) specifies that for the allowance under § 165(a) of losses arising from the permanent withdrawal of depreciable property from use in the

trade or business or in the production of income, see § 1.167(a)-8. Under that section, where an asset is retired by actual physical abandonment as, for example, in the case of a building condemned as unfit for further occupancy or other use), loss will be recognized measured by the amount of the adjusted basis of the asset abandoned at the time of such abandonment. In order to qualify for the recognition of loss from physical abandonment, the intent of the taxpayer must be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale, exchange, or other disposition.

The argument is made by the Intervenor that "imprudent and disallowed" plant costs not includible in taxpayer's rate base are deductible under § 165 of the Code. The costs referred to are capital costs incurred in the construction of the plant. Such costs may be recovered through depreciation, to the extent allowable, or through abandonment. However, since the plant is operating and generating electricity, it is clear that the plant has not been abandoned. See Gulf Oil Corp. v. Commissioner, 87 T.C. 135 (1986) and CRC Corp v. Commissioner, 693 F.2d 281 (3d Cir.1982), cert denied, 462 U.S. 1106 (1983). Therefore, no loss is allowable under § 165.

Based on Taxpayer's representations and the tax law as set forth above, we conclude, as follows:

1. The disallowance of the portion of the Plant's costs as imprudently incurred is not a loss within the meaning of § 165 of the Code. Further, the amortization of the cost basis of that disallowed portion is consistent with the depreciation allowance described in § 1.167(a)-1 of the regulations.

2. The Plant, including the disallowed costs set out above, is public utility property within the meaning of § 168(i)(10) of the Code and, thus, is subject to the normalization provisions of § 168(i).

3. In order to satisfy the requirements of § 168(i)(9)(B) of the Code there must be consistency in the treatment of costs for rate base, regulated depreciation expense, tax expense, and deferred tax revenue purposes. Consequently, those consistency rules would be violated if, as the Intervenor proposes, the federal income tax component of cost of service reflects depreciation of the Plant's disallowed costs but those costs are not included in rate base or the depreciation component of cost of service.

Except as specifically set forth above, no opinion is expressed concerning the federal income tax consequences of the above-described facts under any other provision of the Code or regulations. This letter ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that this ruling may not be used or cited as precedent.

In accordance with the power of attorney on file, a copy of this letter is being sent to your authorized legal representatives.

Sincerely yours,

HAROLD E. BURGHART

Assistant to the Chief, Br. 6

Office of the Assistant Chief Counsel

(Passthroughs and Special Industries)

This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code.

PLR 9613004, 1996 WL 142009 (IRS PLR)

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FIGURE RWH-R10

PUC V. GTE - Southwest, Inc. 901 S.W. 2d 401 (Tex. 1995)

PUBLIC UTILITY COMMISSION OF TEXAS, State Purchasing and General Services Commission, Office of Public Utility Counsel and Cities of Abernathy et al., Petitioners,

v.

GTE–SOUTHWEST, INCORPORATED, et al., Respondents.

No. D–2830.

Supreme Court of Texas.

Argued Sept. 13, 1993.

Decided April 13, 1995.

Rehearing Overruled Aug. 1, 1995.

Suit was brought for judicial review of Public Utility Commission (PUC) order reducing telephone local exchange carrier's (LEC) rates. The District Court Number 201, Travis County, Joseph H. Hart, J., reversed portion of order mandating retroactive rate reduction and affirmed in part. On appeal, the Austin Court of Appeals, Powers, J., 833 S.W.2d 153, affirmed in part, and reversed and remanded in part with instructions. On application for writ of error, the Supreme Court, Hightower, J., held that: (1) PUC lacked authority to make LEC's new rates retroactively effective on date prior to issuance of final rate order; (2) PUC was not compelled to include losses of unregulated affiliated companies when determining LEC's "fair share" of reduction in its federal income tax liability resulting from filing of consolidated income tax return; (3) PUC was not required to include income tax deductions actually taken by LEC for expenses disallowed, by statute prohibiting consideration of certain expenses for rate-making purposes, when determining LEC's federal income tax liability for rate-making purposes; (4) PUC's finding of fact and section of hearing examiner's report adopted and incorporated by reference in PUC's order were sufficient to support PUC's determination that LEC's payments to affiliated corporation for planning, support, centralized service, and home-office functions were reasonable and necessary operating expenses; and (5) PUC's finding of fact and section of examiner's report adopted and incorporated by reference in order were not sufficient to support PUC's determination that LEC's payments to affiliated corporation for printing and publication of telephone directories were reasonable and necessary operating expenses.

Reversed in part, affirmed in part, and remanded with instructions.

Gonzalez, J., concurred in part and dissented in part and filed opinion in which Gammage, J., joined.

Spector, J., dissented and filed opinion.

1. Telecommunications ⇐336

Public Utility Commission (PUC) lacked authority in rate case to make telephone local exchange carrier's (LEC) new rates retroactively effective on date prior to issuance of final rate order, where carrier did not attempt to institute its new rate by filing bond, carrier agreed to extend 150–day new rate suspension period until date of Commission's final order, and Commission had redesignated carrier's current rates as temporary rates. Vernon's Ann.Texas Civ.St. art. 1446c, §§ 42, 43, 43(d-f, i).

2. Public Utilities ⇐119.1, 189

Procedures in Public Utility Regulatory Act (PURA) for Public Utility Commission's (PUC) review of utility's rates and for utility to change its existing rates are designed, in part, to compensate utility for regulatory lag. Vernon's Ann.Texas Civ.St. art. 1446c, §§ 42, 43.

3. Public Utilities ⇐128

For utility rate-making purposes, "regulatory lag" is period of time between utility's filing of statement of intent to change rates and PUC's issuance of final rate order. Vernon's Ann.Texas Civ.St. art. 1446c, § 43.

See publication Words and Phrases for other judicial constructions and definitions.

4. Public Utilities ⇐147

Public Utility Commission (PUC) is creature of legislature and has no inherent authority.

5. Public Utilities ⇐128

Federal income tax is one of "reasonable and necessary operating expenses" within meaning of Public Utility Regulatory Act (PURA) provision requiring Public Utility Commission (PUC) in fixing public utility rates to fix utility's overall revenues at level which will permit utility reasonable opportunity to earn reasonable return on its invested capital over and above its reasonable and necessary operating expenses. Vernon's Ann.Texas Civ.St. art. 1446c, § 39(a).

See publication Words and Phrases for other judicial constructions and definitions.

6. Telecommunications ⇐313

Public Utility Commission (PUC) was not compelled in telephone local exchange carrier (LEC) rate case by Public Utility Regulatory Act (PURA) provision or actual taxes paid doctrine to include losses of unregulated affiliated companies when determining carrier's "fair share" of reduction in its federal income tax liability resulting from filing of consolidated income tax return, and Commission had discretion in determining carrier's fair share of savings, where carrier's parent company filed consolidated income tax return on behalf of itself and its subsidiary companies. Vernon's Ann.Texas Civ.St. art. 1446c, § 41(c)(2).

See publication Words and Phrases for other judicial constructions and definitions.

7. Public Utilities ⇐119.1

Public Utility Commission's (PUC) discretion in regulating public utilities extends throughout rate-making process. Vernon's Ann.Texas Civ.St. art. 1446c, §§ 2, 16, 18, 37, 38, 89.

8. Public Utilities ⇐128

"Actual taxes incurred" language of Supreme Court decision in *Public Util. Comm'n v. Houston Lighting & Power Co.* regarding actual taxes paid doctrine cannot be applied literally when determining income tax liability in utility rate-making case.

9. Telecommunications ⇐313

Public Utility Commission (PUC) was not required in telephone local exchange carrier (LEC) rate case to include income tax deductions actually taken by carrier for expenses disallowed, by Public Utility Regulatory Act (PURA) provision prohibiting consideration of certain expenses for rate-making purposes, when determining carrier's federal income tax liability for rate-making purposes. Vernon's Ann.Texas Civ.St. art. 1446c, § 41(c)(3).

10. Public Utilities ⇐128

Public Utility Commission (PUC) has neither power nor discretion to consider for utility rate-making purposes expenses disallowed under Public Utility Regulatory Act (PURA) provision prohibiting consideration of certain expenses for rate-making purposes. Vernon's Ann.Texas Civ.St. art. 1446c, § 41(c)(3).

11. Public Utilities ⇐168

Appellate courts do not have authority to impose precise form of findings of fact to be made by Public Utility Commission (PUC).

12. Telecommunications ⇐336

Public Utility Commission's (PUC) finding of fact and section of hearing examiner's report adopted and incorporated by reference in Commission's final order, although not in exact form stated in statute governing rate-making treatment of transactions with affiliated interests, were sufficient to support Commission's determination in rate case that telephone local exchange carrier's (LEC) payments to affiliated corporation for planning, support, centralized service, and home-office functions were reasonable and necessary operating expenses, where finding and section found that items allowed were reasonable and necessary and that price paid by carrier was no higher than prices charged by affiliate to others. Vernon's Ann.Texas Civ. St. art. 1446c, § 41(c)(1).

13. Telecommunications ⇐336

Public Utility Commission's (PUC) finding of fact and section of hearing examiner's report adopted and incorporated by reference in Commission's final order were not sufficient to support Commission's determination in rate case that telephone local exchange carrier's (LEC) payments to affiliated

corporation for printing and publication of telephone directories were reasonable and necessary operating expenses, absent finding that each item or class of items allowed was reasonable and necessary. Vernon's Ann.Texas Civ.St. art. 1446c, § 41(c)(1).

Don R. Butler, Geoffrey M. Gay, W. Scott McCollough, Richard A. Muscat, John L. Laakso, Austin, Luis A. Wilmot, San Antonio, Walter Washington, Norma K. Scogin, Steven Baron, Austin, for petitioners.

Joe N. Pratt, P.M. Schenkkan, Kim E. Brightwell, Susan C. Conway, Patrick F. Thompson, Eva C. Ramos, Austin, Harry M. Reasoner, Houston, William G. Mundy, Irving, for respondents.

HIGHTOWER, Justice, delivered the opinion of the Court, in which PHILLIPS, Chief Justice, and HECHT, CORNYN, ENOCH and OWEN, Justices, join.

This is an administrative appeal from a final order of the Texas Public Utility Commission (PUC) concerning ratemaking proceedings over which the PUC has exclusive original jurisdiction under sections 42 and 43 of the Public Utility Regulatory Act (PURA). On February 23, 1989, the PUC issued a final order which established new rates and resulted in a $59 million annual rate reduction for GTE Southwest Incorporated (GTE).[1] The PUC set January 1, 1987 as the effective date of the rate reduction and ordered GTE to refund $140 million to its customers. The trial court reversed that portion of the PUC's order setting January 1, 1987 as the effective date of the rate reduction and affirmed the remainder of the PUC's order. The court of appeals affirmed that portion of the trial court's judgment concerning the effective date of the rate reduction, reversed that portion of the trial court's judgment which affirmed the PUC's order and remanded the cause to the trial court with instructions that the cause be remanded to the PUC for proceedings not inconsistent with the opinion. 833 S.W.2d 153. For the reasons explained herein, the judgment of the court of appeals is reversed in part and affirmed in part and the cause is remanded to the trial court with instructions that it be remanded to the PUC for further proceedings consistent with our opinion.

The issues before this court are (1) whether under the circumstances present in this case, the PUC has the authority to make GTE's new rates effective on a date prior to the issuance of the final rate order, (2) whether the PUC was compelled by section 41(c)(2) and/or *Public Util. Comm'n v. Houston Lighting & Power Co.*, 748 S.W.2d 439 (Tex.1987), to include losses of unregulated affiliated companies when determining GTE's "fair share" of a reduction in its federal income tax liability, (3) whether the PUC was required to include the income tax deductions actually taken by GTE for expenses disallowed by section 41(c)(3) when determining GTE's federal income tax liability, and (4) whether the PUC's findings of fact were sufficient to support its determination that payments by GTE to certain affiliated companies—GTE Service Corporation and GTE Directories—were reasonable and necessary operating expenses.

I.

GTE, a wholly owned subsidiary of GTE Corporation, is a public utility and a local exchange company as defined in section 3 of PURA.[2] As such, GTE's rates are governed by PURA. In February 1984, GTE filed a statement of intent to increase the rates it is permitted to charge its customers for intrastate telecommunication services under section 43 of PURA. Several weeks later, the General Counsel of the PUC filed an answer asserting that GTE's current rates may not be just and reasonable and requesting that the PUC review GTE's rates without regard to whether GTE proposed a change to any particular rate.[3] Pursuant to section 43(d) of PURA, the PUC suspended GTE's proposed rates for 150 days and, by agreement, the

1. The PUC made limited modifications to the February 23, 1989 order in its Order on Rehearing issued on April 7, 1989.

2. Tex.Rev.Civ.Stat. art. 1446c, § 3(c), (v).

3. Apparently this proceeding was filed under section 42.

rates continued to be suspended for an extended period. Several parties opposed the application and/or intervened in the proceeding. Subsequently, this proceeding was postponed pending the outcome of another PUC proceeding which did not become final until January 1987. In March 1987, GTE filed a statement withdrawing its application for a rate increase. In September 1987, the PUC, after determining that some of the parties raised counterclaims or requests for affirmative relief and that GTE should not be able to defeat or prejudice these claims merely by withdrawing its application for a rate increase, permitted GTE to withdraw its application for a rate increase. However, the PUC ordered GTE to file a new application for a rate increase to facilitate a determination of the justness and reasonableness of its rates. On June 1, 1988, GTE filed a new application for a rate increase. The PUC suspended GTE's proposed rates for 150 days and, by agreement, the rates continued to be suspended until February 23, 1989. Although GTE's proposed rates were suspended, the PUC only briefly established temporary rates,[4] and GTE did not implement a system of unofficial bonded rates.

On February 23, 1989, the PUC ordered GTE to reduce its rates to decrease its annual revenue by approximately $59 million effective January 1, 1987.[5] The PUC also ordered GTE to refund $140 million to its customers by credits on future bills. When the PUC determined GTE's reasonable and necessary operating expenses, it considered, among other things, GTE's federal income tax liability. In calculating GTE's income tax liability based upon the filing of a consolidated income tax return, the PUC did not include in GTE's tax expense any losses which were suffered by unregulated affiliated companies. In addition, the PUC did not reduce GTE's federal income tax liability by including tax deductions taken for GTE's expenses which the PUC could not consider for ratemaking purposes under section 41(c)(3) of PURA. The PUC also included certain payments by GTE to affiliated companies in GTE's reasonable and necessary operating expenses.[6] On appeal, the trial court rendered judgment reversing that portion of the PUC's order which retroactively reduced the rates for GTE prior to February 23, 1989. The trial court determined that neither sections 42 nor 43(f) of PURA authorized the retroactive reduction of final approved rates. The trial court affirmed the remainder of the PUC's order. The court of appeals affirmed in part and reversed in part, holding that PURA does not authorize the PUC to make its new rates effective at a date earlier than the date of the order fixing those rates, that the PUC erroneously calculated GTE's federal income tax liability in estimating its operating expenses, and that the PUC's findings of fact were not sufficient to support its determination that payments by GTE to certain affiliated companies were reasonable and necessary operating expenses. 833 S.W.2d 153.

II.

RETROACTIVE EFFECTIVE DATE OF RATES

[1] The PUC argues that it has the authority to make GTE's new rates effective on a date prior to the issuance of the final rate order. Under the circumstances present in this case, we disagree.

This case involves ratemaking proceedings over which the PUC has exclusive original jurisdiction under sections 42 and 43 of PURA. Section 42 sets forth the procedure for the PUC—"on its own motion or on com-

4. Apparently on January 4, 1989, the PUC redesignated GTE's current rates as temporary rates.

5. In amended finding of fact 11 of its order on rehearing dated April 7, 1989, the PUC clarified the reasons why it made GTE's new rates effective January 1, 1987:

> The record in this case establishes that GTE Southwest's new rates should be made effective January 1, 1987, in part because the gross receipts taxes and federal income taxes embedded in the company's rates were at higher levels than the company actually paid since that date and because of the facts stated in FF 10 and also in order to do equity in light of the dilatory tactics of GTE Southwest in this case.

6. The calculation of GTE's reasonable and necessary operating expenses is significant because a reduction in its operating expenses is passed on to consumers in the form of a lower rate.

plaint by any affected person"—to review a utility's existing rates. After notice and hearing, if the PUC finds the utility's rates to be unreasonable or in violation of any provision of law, the PUC will determine the just and reasonable rates to be charged by the utility by an order which is served upon the utility. These rates are "to be thereafter observed and in force ... and such rates shall constitute the legal rates of the public utility until changed as provided in this Act." Tex.Rev.Civ.Stat. art. 1446c, § 42.

Section 43 sets forth the required procedure for a utility to change its existing rates. The utility must file a statement of intent to change its rates with the PUC at least 35 days before the effective date of the proposed change. Tex.Rev.Civ.Stat. art. 1446c, § 43(a). If the proposed rate change constitutes a "major change," if any affected person complains or if the PUC so desires, the PUC may conduct hearings to determine the propriety of the change. Tex.Rev.Civ.Stat. art. 1446c, § 43(b) & (c). "Pending the hearing and decision," the PUC may suspend the effective date of the utility's proposed rate change up to 150 days after the date on which the proposed rate change would otherwise go into effect. The suspension period will be extended two days for each day of actual hearing on the merits of the proposed rate change that exceeds 15 days. If the PUC suspends the proposed rate change, the utility's existing rates continue in effect unless the PUC fixes temporary rates in lieu of the existing rates. Tex.Rev.Civ.Stat. art. 1446c, § 43(d). If the PUC fails to make its final determination of rates "prior to expiration of the period or periods of suspension," the proposed rate change shall be considered approved by the PUC. However, "[t]his approval is subject to the authority of the ... [PUC] to continue a hearing in progress." Tex.Rev.Civ.Stat. art. 1446c, § 43(d).[7] If the 150 day suspension period is extended and the PUC fails to make its final determination of rates within 150 days from the date that the proposed effective date of the rate change otherwise would have gone into effect, the utility may implement a changed rate up to, but not exceeding, the proposed rate, provided the utility files and the PUC approves a bond to secure the utility's obligation to refund (or credit against future bills) all sums collected during the period of suspension over and above the rate finally determined by the PUC. Tex.Rev.Civ.Stat. art. 1446c, § 43(e). After the hearing, if the PUC finds the proposed rates to be unreasonable or in violation of any provision of law, the PUC will determine and fix the rates to be charged by the utility by an order which is served upon the utility. "[T]hese rates are thereafter to be observed until changed, as provided by this Act." Tex.Rev. Civ.Stat. art. 1446c, § 43(f).

[2, 3] These procedures are designed, in part, to compensate a utility for "regulatory lag." *See Railroad Comm'n v. Lone Star Gas Co.*, 656 S.W.2d 421, 426 (Tex.1983). "Regulatory lag" is that period of time between the utility's filing of a statement of intent to change rates and the PUC's issuance of a final rate order.[8] Section 42 includes no provisions which authorize the PUC to set a retroactive effective date for a

7. Concerning the rates of a local exchange company such as GTE, if the PUC fails to make its "final determination ... of rates prior to the expiration of the 150–day suspension period, the schedule of rates finally approved by the commission shall become effective and the local exchange company shall be entitled to collect such rates from the date the 150–day suspension expired." However, "[a]ny surcharges or other charges necessary to effectuate this subsection shall not be recovered over a period of less than 90 days from the date of the commission's final order." Tex.Rev.Civ.Stat. art. 1446c, § 43(i).

8. In *State v. Public Util. Comm'n*, 883 S.W.2d 190, 197 (Tex.1994), this court determined that the PUC has the authority under PURA to permit a public utility to defer post-in-service costs incurred during the regulatory lag period in order to protect the utility's financial integrity. "[I]f the effects of regulatory lag infringe on the Commission's ability to regulate in a manner necessary to carry out the provisions of PURA, then the Commission may respond within its powers, both express and implied, under PURA to alleviate the impact of regulatory lag in order to fulfill its statutorily imposed duties." *Id.* at 196. In addition, this court determined that the deferral of post-in-service costs did not violate any general prohibition against retroactive ratemaking. *Id.* at 199. *See Office of Public Util. Counsel v. Public Util. Comm'n*, 888 S.W.2d 804, 807–08 (Tex.1994); *City of El Paso v. Public Util. Comm'n*, 883 S.W.2d 179, 187 (Tex.1994).