rate change and does not include any procedures to avoid regulatory lag. However, section 43 limits the periods of suspension, grants the agency authority to fix temporary rates, and permits the utility to institute its new rates by filing an adequate bond approved by the agency. In addition, the setting of a retroactive effective date for a rate change is also a method of compensating for regulatory lag. However, the setting of a retroactive effective date for a rate change has been characterized as prohibited retroactive ratemaking. *See Public Util. Comm'n v. United Fuel Gas Co.*, 317 U.S. 456, 464, 63 S.Ct. 369, 374, 87 L.Ed. 396 (1943); Stefan H. Krieger, *The Ghost of Regulation Past: Current Applications of the Rule Against Retroactive Ratemaking in Public Utility Proceedings*, 1991 U.ILL.L.REV. 983, 1009–1012 (1991). "The basic premise underlying the prohibition against retroactive ratemaking is that the setting of utility rates is a legislative function, even if carried out by administrative agency; therefore, utility rates, like any other legislation, generally can have only prospective application and cannot be used to recoup losses or gains incurred under prior legal rates." *Texas Ass'n of Long Distance Tel. Co. (TEXALTEL) v. Public Util. Comm'n*, 798 S.W.2d 875, 882 (Tex.App.—Austin 1990, writ denied).

A. Sections 42 and 43 of PURA

In determining whether the PUC has the authority to make GTE's new rates effective on a date prior to the issuance of the final rate order in this case, we first consider whether sections 42 or 43 of PURA confer such authority upon the PUC.[9] Through the enactment of PURA, the legislature has granted the PUC broad powers in regulating public utilities. *See* Tex.Rev.Civ.Stat. art. 1446c, §§ 2, 16, 18, 37, 38, 89. Section 2 of PURA states:

> This Act is enacted to protect the public interest inherent in the rates and services of public utilities.... The purpose of this Act is to establish a comprehensive regulatory system which is adequate to the task of regulating public utilities as defined by this Act, to assure rates, operations, and services which are just and reasonable to the consumers and to the utilities.

Tex.Rev.Civ.Stat. art. 1446c, § 2. Section 16 states that the PUC "has the general power to regulate and supervise the business of every public utility within its jurisdiction and to do all things, whether specifically designated in this Act or implied herein, necessary and convenient to the exercise of this power and jurisdiction." Tex.Rev.Civ.Stat. art. 1446c, § 16(a). Concerning telecommunications utilities, section 18 provides:

> It is the policy of this state to protect the public interest in having adequate and efficient telecommunications service available to all citizens of the state at just, fair, and reasonable rates.... It is the purpose of this section to grant to the commission the authority and the power under this Act to carry out the public policy herein stated.

Tex.Rev.Civ.Stat. art. 1446c, § 18(a). Section 37 states that the PUC "is hereby vested with all authority and power of the State of Texas to insure compliance with the obligations of public utilities of this Act. For this purpose the regulatory authority is empowered to fix and regulate rates of public utilities...." Tex.Rev.Civ.Stat. art. 1446c, § 37. Section 38 states that "[i]t shall be the duty of the regulatory authority to insure that every rate made, demanded, or received by any public utility ... shall be just and reasonable." Tex.Rev.Civ.Stat. art. 1446c, § 38. Section 89 provides that PURA "shall be construed liberally to promote the effectiveness and efficiency of regulation of public utilities to the extent that such construction preserves the validity of this Act and its provisions." Tex.Rev.Civ.Stat. art. 1446c, § 89.

[4] However, the PUC is a creature of the legislature and has no inherent authority. *Denton County Elec. Co-op v. Public Util. Comm'n*, 818 S.W.2d 490, 492 (Tex.App.—

9. In conclusion of law 6 in its final order, the PUC stated:

> Pursuant to section 42 [of PURA], the Commission may make the new rates in this case effective as early as February 27, 1984, the date of the General Counsel's answer. Pursuant to section 43 [of PURA], the Commission may make the new rates in this case effective as early as June 1, 1988, the date of GTE Southwest's second application.

Texarkana 1991, writ denied). *See Texas DHS v. Christian Care Ctrs.*, 826 S.W.2d 715, 719 (Tex.App.—Austin 1992, writ denied). "An agency may exercise only those specific powers that the law confers upon it in clear and express language. As a general rule, the legislature impliedly intends that an agency should have whatever power is reasonably necessary to fulfill a function or perform a duty that the legislature has expressly placed in the agency." *Kawasaki Motors v. Motor Vehicle Comm'n*, 855 S.W.2d 792, 797 (Tex. App.—Austin 1993, writ denied); *Texas DHS v. Christian Care Ctrs.*, 826 S.W.2d at 719. "The agency may not, however, on a theory of necessary implication from a specific power, function, or duty expressly delegated, erect and exercise what really amounts to a new and additional power or one that contradicts the statute, no matter that the new power is viewed as being expedient for administrative purposes." *Sexton v. Mount Olivet Cemetery Ass'n*, 720 S.W.2d 129, 137–38 (Tex.App.—Austin 1986, writ ref'd n.r.e.) (citations and emphasis in original omitted); *Kawasaki Motors v. Motor Vehicle Comm'n*, 855 S.W.2d at 798.

Reviewing the pertinent sections of PURA, we find that PURA generally confers authority upon the PUC to regulate and supervise public utilities, to fix and regulate rates of public utilities, and to insure rates, operations, and services which are just and reasonable to the consumers and to the utilities. Reviewing section 42, we find no express provisions which authorize the PUC to set a retroactive effective date for GTE's rate change.[10] Reviewing section 43, we find express provisions which authorize the PUC to set a retroactive effective date for GTE's rate change; however, these provisions are not applicable under the circumstances present in this case. Section 43 provides several limited procedures for the PUC to set a retroactive effective date for a rate change.[11] First, under certain circumstances, section 43(e) permits the utility to institute its new rate provided that 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. However, GTE did not attempt to institute its new rate by filing a bond. Second, concerning rates of a local exchange company such as GTE, section 43(i) states that 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, GTE agreed to extend the 150–day suspension period until February 23, 1989—the date of the final order. Third, although technically not a procedure for setting a retroactive effective date for a rate change, under certain circumstances, section 43(d) permits the PUC to fix temporary rates in lieu of existing rates until the PUC makes its final determination of rates. However, in this case, the PUC redesignated GTE's *current* rates as temporary rates on January 4, 1989.[12]

10. In fact, section 42 provides that following the hearing, the PUC "shall determine the just and reasonable rates ... to be *thereafter* observed...." Tex.Rev.Civ.Stat. art. 1446c, § 42 (emphasis added).

11. In addition, under section 43, unless one of the provisions which addresses retroactivity applies, and if the PUC finds the proposed new rate is unreasonable or violates the law, the PUC sets the rate which is "thereafter to be observed until changed...." Tex.Rev.Civ.Stat. art. 1446c, § 43(f).

12. However, the PUC had previously attempted to fix a temporary rate. Effective October 1, 1985, the Tax Code was amended to exclude from the gross receipts tax any sums received by a utility from its sale of telecommunication services. *See* 1985 Tex.Gen.Laws, ch. 206, § 10, at 793 (since repealed); 1959 Tex.Gen.Laws, 3d C.S., ch. 1, art. 11.06, at 304 (since repealed). In June 1986, pursuant to section 43(c) of PURA, the PUC ordered the examiners to conduct an evidentiary interim rate hearing to determine the dollar amount of GTE's reduced gross receipts tax expense, to determine interim rates based on the amount of reduction in GTE's gross receipts tax expense, and to order interim refunds or credits to GTE's customers. GTE sought injunctive relief in district court in Travis County. After briefing and argument, in December 1986, the district court announced that it would grant injunctive relief. However, the district court never issued an injunction and the PUC made no further attempts to implement an interim rate reduction based upon GTE's reduced gross receipts tax expense.

In determining whether authority for the PUC to set a retroactive effective date for a rate change is implied in PURA, we consider the purpose of setting a retroactive effective date. The setting of a retroactive effective date for a rate change is a method of compensating for regulatory lag. *See Railroad Comm'n v. Lone Star Gas Co.*, 656 S.W.2d at 426. As noted above, section 43 provides a detailed procedure to avoid regulatory lag. As a result, it is not necessary to imply authority in PURA for the PUC to set a retroactive effective date for a rate change. Neither section 42 nor 43 confers implied authority upon the PUC 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. *See Public Util. Comm'n v. General Tel. Co.*, 777 S.W.2d 827, 830 (Tex.App.—Austin 1989, writ dism'd). Consequently, we conclude that under the circumstances present in this case, the PUC does not have the authority to make GTE's new rates effective on a date prior to the issuance of the final rate order.

B. *Railroad Comm'n v. Lone Star Gas Co.*

In determining whether the PUC 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 must also consider *Railroad Comm'n v. Lone Star Gas Co.*, 656 S.W.2d 421 (Tex.1983). In *Lone Star*, this court discussed the authority of a regulatory agency to determine the effective date of a new rate, stating generally that "[t]he courts of this state have provided that in order to compensate for 'regulatory lag,' the Commission in its discretion may make the new rates effective at any date prior to the issuance of the order but following the attachment of the agency's jurisdiction." *Id.* at 426. However, *Lone Star* is distinguishable from the present case. *Lone Star* primarily involved the appellate jurisdiction of the Railroad Commission under section 26 of PURA, although a relatively small portion of the rates at issue were before the Commission under section 43. Lone Star had filed for rate increases with the City of Kaufman, and upon rejection of those rates, Lone Star appealed to the Commission. Lone Star also filed for a rate increase to the "environs" of the City of Kaufman (those living outside the limits of the City). This was filed directly with the Commission, invoking its original jurisdiction under section 43.

In applying *Lone Star* in this case, we must first recognize that the Commission was exercising its appellate jurisdiction with respect to most of the rates at issue. Just as an appellate court would have the authority to make its judgment effective as of the date of the trial court judgment under review, the Commission had the authority to make rates effective as of a date earlier than its final order.[13] In *Lone Star*, this court did not discuss the source, if any, of the Commission's authority to make rates under section 43 retroactive. In fact, neither party in *Lone Star* disputed the PUC's authority under section 43 to make the new rates effective on a date prior to the issuance of the final rate order. Consequently, *Lone Star* does not stand for the proposition that the PUC has the implied authority under section 43 to make rates effective retroactively.

III.

FEDERAL INCOME TAX LIABILITY

The PUC and GTE argue that the PUC properly calculated GTE's federal income tax liability in determining GTE's reasonable and necessary operating expenses. However, this general issue presents us with two more specific questions. First, whether the PUC was compelled by section 41(c)(2) and/or

13. When *Lone Star* was decided, section 26, granting appellate jurisdiction to the Commission, provided that the final order "shall fix such rates as the municipality should have fixed in the ordinance from which the appeal was taken." Tex.Rev.Civ.Stat. art. 1446c, § 26(e) (Vernon 1980). Although the court did not refer to or rely upon this provision, it could be construed to give the Commission the authority to make the rates effective retroactively. Section 26(e) has since been amended to prohibit such a result. Section 26(e) is now section 26(g) and the following has been added: "Any rate, whether temporary or permanent, set by the commission, shall be prospective and observed from and after the applicable order of the commission, except interim rate orders necessary to effect uniform system-wide rates."

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 resulting from the filing of a consolidated income tax return? Second, 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?

[5] It is the PUC's duty "to insure that every rate made, demanded, or received by any public utility ... shall be just and reasonable." Tex.Rev.Civ.Stat. art. 1446c, § 38. "In fixing the rates of a public utility the ... [PUC] shall fix its overall revenues at a level which will permit such utility a reasonable opportunity to earn a reasonable return on its invested capital used and useful in rendering service to the public over and above its reasonable and necessary operating expenses." Tex.Rev.Civ.Stat. art. 1446c, § 39(a). One of the "reasonable and necessary operating expenses" which a utility incurs is federal income tax. The calculation of GTE's federal income tax liability is significant because a reduction in its income tax liability reduces its operating expenses which are passed on to consumers in the form of a lower rate.

Section 41(c) of the PURA states that the PUC

> shall determine expenses and revenues in a manner consistent with the following:
>
> * * * * * *
>
> (2) Income Taxes. If the public utility is a member of an affiliated group that is eligible to file a consolidated income tax return, and if it is advantageous to the public utility to do so, income taxes shall be computed as though a consolidated return had been so filed and the utility had realized its fair share of the savings resulting from the consolidated return, unless it is shown to the satisfaction of the regulatory authority that it was reasonable to choose not to consolidate returns....
>
> (3) Expenses Disallowed. The regulatory authority shall not consider for ratemaking purposes the following expenses:
>
> (A) legislative advocacy expenses, whether made directly or indirectly, including but not limited to legislative advocacy expenses included in trade association dues;
>
> (B) payments ... made to cover costs of an accident, equipment failure, or negligence at a utility facility owned by a person or governmental body not selling power inside the State of Texas;
>
> (C) Costs of processing a refund or credit ...; or
>
> (D) any expenditure found by the regulatory authority to be unreasonable, unnecessary, or not in the public interest, including but not limited to executive salaries, advertising expenses, legal expenses, and civil penalties or fines....

A. Consolidated Income Tax Returns

[6] The PUC and GTE argue that the PUC was not compelled by section 41(c)(2) to include losses of unregulated affiliated companies when determining GTE's "fair share" of a reduction in its federal income tax liability resulting from the filing of a consolidated income tax return. We agree.

[7] Through the enactment of PURA, the legislature has granted the PUC broad powers and discretion in regulating public utilities. *See City of Corpus Christi v. Public Util. Comm'n*, 572 S.W.2d 290, 297 (Tex. 1978) ("An administrative agency is created to centralize expertise in a certain regulatory area and, thus, is to be given a large degree of latitude by the courts in the methods by which it accomplishes its regulatory function."); Tex.Rev.Civ.Stat. art. 1446c, §§ 2, 16, 18, 37, 38, 89. The PUC's discretion in regulating public utilities extends throughout the ratemaking process. *See Southwestern Bell Tel. v. Public Util. Comm'n*, 571 S.W.2d 503, 515 (Tex.1978) (PUC has discretion in setting rate of return); *Texas Alarm & Signal Ass'n v. Public Util. Comm'n*, 603 S.W.2d 766, 772 (Tex.1980) (PUC has discretion to determine the method of rate design); *Suburban Util. Corp. v. Public Util.*

Comm'n, 652 S.W.2d 358, 362 (Tex.1983) ("The PUC's ratemaking power includes the discretion to disallow improper expenses."); *Public Util. Comm'n v. AT & T Communications*, 777 S.W.2d 363, 366 (Tex.1989) ("As long as the commission addresses the rate considerations set by the Public Utility Regulatory Act, the particular factors and the weight to be given those factors are within the discretion of the commission.").

In this case, GTE's parent company, GTE Corporation, filed a consolidated income tax return on behalf of itself and its subsidiary companies. Under the conditions set out in section 41(c)(2),[14] the PUC is required to calculate GTE's federal income tax liability "as though a consolidated [income tax] return had been ... filed and ... [GTE] had realized its fair share of the savings resulting from the consolidated return...." As a result, the PUC was required to determine GTE's "fair share" of a reduction in its federal income tax liability which resulted from the filing of a consolidated income tax return. However, the language of section 41(c)(2) neither includes nor excludes losses of unregulated affiliated companies. Consequently, the PUC had discretion in determining GTE's "fair share of the savings" and was not compelled by section 41(c)(2) to include losses of unregulated affiliated companies when determining GTE's federal income tax liability.

The PUC and GTE argue that the PUC was not compelled by *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 resulting from the filing of a consolidated income tax return. We agree.

In *Public Util. Comm'n v. Houston Lighting & Power Co.*, the PUC disallowed $166 million of expenditures related to a nuclear power project as imprudent. In other words, these expenditures could not be included as operating expenses for ratemaking purposes. "The PUC recognized that HL & P [Houston Lighting & Power] intended to write-off for tax purposes, the $166 million of imprudent ACNP [Allen's Creek Nuclear Project] expenditures. The effect of such a write-off would provide tax savings to HL & P and cause it to bear less than its $166 million share of ACNP. In order to give effect to its ruling that HL & P bear the full burden of these imprudent expenses, the PUC determined that any tax savings derived from a write-off should inure to the benefit of the ratepayers." 748 S.W.2d at 440–41. This court stated:

> [T]he PUC asserts that the court of appeals erred as a matter of law by allocating the tax savings attributable to HL & P's write-off of the ACNP disallowed expenses to the utility and its shareholders rather than to the ratepayers. The issue before this court then is whether HL & P can recover from ratepayers a federal income tax expense which it did not incur. The resolution of this issue does not rest upon a determination of whether the disallowed expenses which generated the tax savings have been included in the calculation of the new rate. The question is whether HL & P actually incurred this tax expense.
>
> * * * * * *
>
> [R]atepayers can be held accountable only for those tax expenses that are *actually* incurred by a utility. Accordingly, when a utility claims federal income tax deductions for *all* of the expenses it has incurred, the resulting tax savings will necessarily reduce the utility's actual federal income tax expense. This will be the effect regardless of whether the expenses are allowed or disallowed in the calculation of a new rate.

Id. at 441–42 (emphasis in original).[15] This court held "that the tax savings generated from HL & P's imprudent expenses should

14. It is not disputed that filing a consolidated tax return was advantageous to GTE.

15. This has sometimes been described as the "actual taxes paid doctrine." *See Cities of Abilene v. Public Util. Comm'n*, 854 S.W.2d 932, 944–45 (Tex.App.—Austin 1993, writ pending); *City of Somerville v. Public Util. Comm'n*, 865 S.W.2d 557, 563 (Tex.App.—Austin 1993, no writ). *See generally* Ron Moss, *Ratemaking in the Public Utility Commission of Texas*, 44 BAYLOR L.REV. 825, 833–43 (1992).

inure to the benefit of the ratepayers. The utility's rates must reflect the tax liability actually incurred." *Id.* at 442. *See Southern Union Gas v. Railroad Comm'n of Texas*, 701 S.W.2d 277, 279 (Tex.App.—Austin 1985, writ ref'd n.r.e.).

[8] However, the "actual taxes incurred" language of *Public Util. Comm'n v. Houston Lighting & Power Co.* cannot be applied literally when determining the income tax liability in a ratemaking case. First, the determination of just and reasonable utility rates is far from a precise process; instead, ratemaking relies substantially upon informed judgment and expertise and utilizes projections and estimates in virtually all areas. The ratemaking process is not capable of being neatly characterized as "actual" or "hypothetical." Ratemaking begins with an historic test year. Although the use of historic data adds some certainty, this does not mean that the process begins with actual cash paid by the utility. Because utilities use accrual accounting, the books and records include certain expenses—such as pension, depreciation and nuclear decommissioning expenses—that are estimated allocations to the period in question. Since the rates are to be charged in the future, the historic test year amounts must be adjusted to more accurately reflect costs which will be incurred in the future. These adjustments include normalizing and prospective adjustments such as removing non-recurring expenses, modifying test year data to reflect the number of customers served at the end of the period and modifying expenses and rate base for known and measurable changes. In addition, the test year results must be separated between interstate and intrastate service. After the appropriate adjustments have been made, the adjusted test year results are further adjusted to produce the return level that the PUC determines to be appropriate. The income tax calculation is no different than other elements of utility ratemaking. Since rate determinations are made using an adjusted test year, the tax expenses will always be a hypothetical amount because the components which produce the calculation of income tax have been adjusted from the test year amounts.

Second, under certain conditions, section 41(c)(2) requires the determination of GTE's "fair share" based upon the filing of a hypothetical consolidated income tax return. "If the public utility is a member of an affiliated group that is eligible to file a consolidated income tax return, and if it is advantageous to the public utility to do so ..." section 41(c)(2) specifically requires the PUC to calculate GTE's federal income tax liability "as though a consolidated [income tax] return had been ... filed and ... [GTE] had realized its fair share of the savings resulting from the consolidated return...." In other words, even if a consolidated income tax return is not filed, under certain conditions, the PUC is required to calculate GTE's federal income tax liability as if a consolidated income tax return had been filed—GTE's rates would not reflect the tax liability actually incurred. Consequently, we conclude that *Public Util. Comm'n v. Houston Lighting & Power Co.* does not compel the PUC to include losses of unregulated affiliated companies when determining GTE's "fair share" of a reduction in its federal income tax liability under section 41(c)(2).

B. Disallowed Expenses

[9] The PUC and GTE argue that the PUC was not 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. We agree.

[10] First, the PUC has neither the power nor the discretion to consider expenses disallowed under section 41(c)(3) for ratemaking purposes. Although the legislature granted the PUC broad powers and discretion in regulating public utilities including the ratemaking process, the legislature specifically limited the PUC's powers and discretion concerning disallowed expenses. Section 41(c)(3) states that the PUC "shall not consider for ratemaking purposes the following expenses ..." which include lobbying expenses and "any expenditure found by the regulatory authority to be unreasonable, unnecessary, or not in the public interest...." The language of section 41(c)(3) is clear and unequivocal.

Second, the "actual taxes incurred" language of *Public Util. Comm'n v. Houston*

Lighting & Power Co. cannot be applied literally when determining the income tax liability in a ratemaking case. For example, a literal application of the "actual taxes incurred" language would require that expenses incurred in providing interstate and unregulated services be included in the determination of income tax liability. In addition, as discussed above, tax expenses will always be a hypothetical amount because the components which produce the calculation of income tax have been adjusted from the test year amounts. Third, *Public Util. Comm'n v. Houston Lighting & Power Co.* considered only the costs related to a nuclear power project which costs were found to be imprudent. No disallowed operating expenses were addressed and no indication was given that this court considered whether the general statements concerning the "actual taxes incurred" would under all circumstances require the PUC to include all expenses when determining the income tax liability in a ratemaking case. In fact, *Public Util. Comm'n v. Houston Lighting & Power Co.* did not address or even consider the current version of section 41(c)(3) [16] or statutorily disallowed expenses. Consequently, we conclude that the PUC was not 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. To the extent that they conflict with this opinion, we disapprove *Southern Union Gas v. Railroad Comm'n of Texas*, 701 S.W.2d 277 (Tex.App.—Austin 1985, writ ref'd n.r.e.) and *City of Somerville v. Public Util. Comm'n*, 865 S.W.2d 557 (Tex.App.—Austin 1993, no writ).

IV.

PAYMENTS BY GTE TO AFFILIATED COMPANIES

The PUC and GTE argue that the PUC's findings of fact were sufficient to support its determination that certain payments by GTE to affiliated companies—specifically GTE Service Corporation and GTE Directories—were reasonable and necessary operating expenses. We agree concerning payments to GTE Service Corporation, but we disagree concerning payments to GTE Directories.

One of a utility's "reasonable and necessary operating expenses" may include payments to affiliated companies. Section 41(c) of the PURA states that the PUC

> shall determine expenses and revenues in a manner consistent with the following:
>
> (1) Transactions with Affiliated Interests. Payments to affiliated interests for costs of any services, or any property, right or thing, or for interest expense shall not be allowed either as capital cost or as expense except to the extent that the regulatory authority shall find such payment to be reasonable and necessary for each item or class of items as determined by the commission. Any such finding shall include specific findings of the reasonableness and necessity of each item or class of items allowed and a finding that the price to the utility is no higher than prices charged by the supplying affiliate to its other affiliates or divisions for the same item or class of items, or to unaffiliated persons or corporations.

This court has stated that appellate courts have "neither the right nor the authority to lay out a precise form of findings to be made by the Commission." *Texas Health Facilities Comm'n v. Charter Medical-Dallas, Inc.*, 665 S.W.2d 446, 452 (Tex.1984). Furthermore, this court has consistently stated that appellate courts are "not [to] subject an agency's order to some 'hypertechnical standard of review'" concerning the sufficiency of findings of fact. *Goeke v. Houston Light-*

16. The "shall not consider" language was added to section 41(c)(3) in 1983 after the PUC had made the decision in *Public Util. Comm'n v. Houston Lighting & Power Co.* Prior to 1983, section 41(c)(3) provided only that the PUC had discretionary authority to "promulgate reasonable rules and regulations with respect to the allowance or disallowance of certain expenses for ratemaking purposes." In *Public Util. Comm'n v. Houston Lighting & Power Co.*, the PUC exercised "discretionary" authority over capital investment decisions to reduce HL & P's revenue requirements to reflect HL & P's imprudent investment and the resulting tax savings. Under the current version of section 41(c)(3), the PUC would no longer have such discretionary authority.

ing & Power Co., 797 S.W.2d 12, 15 (Tex. 1990); *State Banking Board v. Allied Bank Marble Falls*, 748 S.W.2d 447, 448–49 (Tex. 1988). "What is important is that the findings serve the overall purpose evident in the requirement that they be made—i.e., they should inform the parties and the courts of the basis for the agency's decision so that the parties may intelligently prepare an appeal and so that the courts may properly exercise their function of review." *Goeke v. Houston Lighting & Power Co.*, 797 S.W.2d at 15. *See Texas Health Facilities Comm'n v. Charter Medical–Dallas, Inc.*, 665 S.W.2d at 452. *See generally* Hume Cofer, *Judicial Review of Agency Law Decisions on Scope of Agency Authority*, 42 BAYLOR L.REV. 255, 283–85 (1990). "The reviewing court, in determining whether the administrative agency has adequately articulated its findings of fact and conclusions of law, is to give appropriate consideration to such statements in the reports that were adopted by the commission in its final order." *Public Util. Comm'n v. AT & T Communications*, 777 S.W.2d 363, 366 (Tex.1989).

[11] Although appellate courts do not have the authority to impose a precise form of findings of fact to be made by the PUC, the legislature does have such authority and it exercised that authority concerning payments to affiliated companies. In section 41(c)(1), the legislature required that each finding by the PUC that a payment to an affiliate is "reasonable and necessary for each item or class of items" must include specific findings (1) that each item or class of items allowed is reasonable and necessary and (2) that the price paid by the utility "is no higher than prices charged by the supplying affiliate to its other affiliates or divisions for the same items or class of items, or to unaffiliated persons or corporations." *See generally Railroad Comm'n v. Rio Grande Valley Gas Co.*, 683 S.W.2d 783, 785–87 (Tex. App.—Austin 1984, no writ).

A. GTE Service Corporation

[12] GTE Service Corporation is a subsidiary of GTE Corporation. Among other things, GTE Service Corporation provides planning, support and centralized service functions related to telephone operations and home-office functions for all GTE Corporation subsidiaries such as consolidation accounting, tax return filing and treasury functions. GTE pays GTE Service Corporation for these services. The PUC included GTE's payments to GTE Service Corporation in GTE's operating expenses. The PUC's final order included Finding of Fact 13 which stated:

> GTE Service Corp provides to GTE Southwest [GTE] the classes of services described in section III.D.3.a of the [Examiner's] Report.[17] The testimony of the GTE witnesses summarized in section III.D.3 of the Report established by a preponderance of the evidence that (1) the allocation formula properly reflects differences between the purchasing affiliates; (2) the prices charged for each class of service are reasonable relative to the cost of obtaining them from alternative sources; and (3) the services are reasonable and necessary for the provision of utility service. The testimony of Mr. Gillespie establishes that $258,000 should be deducted as a disallowance of legislative advocacy expenses and $268,000 should be deducted for Signaling System 7, which is related to services that are not being provided.

17. Section III.D.3.a of the Examiner's Report stated:

> a. Introduction.—Four GTE witnesses discussed the operations of GTE Service Corp and the allocation and direct billing of its expenses to GTE Southwest [GTE]. About $9,406,000 of GTE Service Corp expenses were allocated to GTE Southwest [GTE].
>
> As described by the witnesses, GTE Service Corp is divided into three groups: Telops, GTE Corporate Departments, and Products and Systems. Telops performs planning, support, and centralized service functions related to telephone operations. The corporate departments perform home-office functions for all GTE companies, such as consolidation accounting, tax return filing and treasury functions. The products and systems group supports nontelephone subsidiaries. In general, the expenses of corporate departments are allocable to all GTE subsidiaries, the expenses of telops are allocable only to telephone operating companies, and the expenses of products and systems are allocable only to nontelephone subsidiaries.

(Footnote added). Section III.D.3 of the Examiner's Report [18] stated in pertinent part:

d. *GTE Southwest's* [GTE's] *position.*—GTE witness Quentin Bredeweg, an employee of GTE Service Corp, explained the rationale for allocating the costs of GTE Service Corp to GTE Southwest [GTE] and the other GTE subsidiaries. In his opinion, the method based on the general allocation rule is nonarbitrary and consistently applied.

With respect to the different treatment for the nontelephone companies and the nondomestic telephone companies, Mr. Bredeweg testified that there are significant differences between the domestic telephone companies and the other companies, so it would not be proper to use the same rule for the other companies. For example, the nontelephone operating companies are too dissimilar to use the general application rule. By contrast, the domestic telephone companies are very homogeneous. Mr. Bredeweg noted also that for certain services, such as auditing, direct billing is more accurate than allocation, and for such services, the subsidiary companies are billed directly.

* * * * * *

GTE witness Thomas Flaherty, a partner in Touch[e] Ross & Co., testified about the cost studies he had conducted to assess the reasonableness of the GTE Service Corp costs allocated to GTE Southwest [GTE]. According to Mr. Flaherty, the vast majority of the functions performed by GTE Service Corp are nondiscretionary, fundamental activities for a large telecommunications company; they are therefore necessary. Mr. Flaherty's two major conclusions with respect to the reasonableness of the charges were: One, if GTE Southwest [GTE] performed the functions in-house, it would incur almost $40 million to accomplish what it obtains from GTE Service Corp for a total of $20.4 million (the amount includes charges related to GTE labs). Two, for the functions that could be performed by outside contractors, it would cost GTE Southwest [GTE] about $11.9 million to obtain them from the outside; GTE Southwest [GTE] could perform these functions in-house for about $6.1 million.

GTE witness Scott Hanle, financial vice president and treasurer for GTE Southwest [GTE], described the process by which the GTE telephone companies guide the activities and monitor the services of GTE Service Corp. The control is exerted both formally through management committees and informally through continual meetings and communications. In Mr. Hanle's opinion, GTE Southwest [GTE] adequately monitors and influences the GTE Service Corp services it receives and is billed for.

e. *Discussion and recommendation.*

* * * * * *

The ALJ [Administrative Law Judge] agrees with the GTE witnesses and believes that their testimony adequately supports the allocation method as required by the *Rio Grande* [*Railroad Comm'n v. Rio Grande Valley Gas Co.*, 683 S.W.2d 783 (Tex.App.—Austin 1984, no writ)] court. The court did not require that the same allocation rule be used for all affiliates, but rather that any differences be explained. Mr. Bredeweg['s] testimony more than adequately supports the differential treatment of the affiliates; indeed, his testimony demonstrates that under the circumstances, any allocation method that did not allow for the differences among the affiliates would be open to challenge. Accordingly, Mr. Bredeweg's testimony establishes that the prices charged to GTE Southwest [GTE] were no higher than prices charged to the other subsidiaries.

Mr. Flaherty's testimony established that the prices charged are reasonable relative to the cost of obtaining them from alternative sources. His testimony and that of Mr. Hanle established that the services obtained were necessary. Finally, Mr. Moffatt's audit determined that the

18. The PUC's final order stated that "[w]ith the exception of the findings and conclusions, the Examiner's Report is ADOPTED and incorporated by reference in this Order ... [subject to several modifications]."

allocated amounts reasonably approximate the actual costs of the services received.

There remains the testimony of Mr. Gillespie that the allocated amounts may include unallowable expenses and expenses that may be recovered when Signaling System 7 is placed in service. The ALJ therefore recommends that the Commission adopt Mr. Gillespie's alternative recommendation, which would allow the requested amount of GTE Service Corp expenses allocated to GTE Southwest [GTE], but would deduct $258,000 of legislative advocacy costs and $268,000 of Signaling System 7 costs....

Finding of Fact 13 and section III.D.3 of the Examiner's Report which was adopted and incorporated by reference in the PUC's final order state that (1) "the prices charged for each class of service are reasonable relative to the cost of obtaining them from alternative sources," (2) "the services are reasonable and necessary for the provision of utility service," (3) "the prices charged to GTE Southwest [GTE] were no higher than prices charged to the other subsidiaries," (4) "the prices charged are reasonable relative to the cost of obtaining them from alternative sources," (5) "the services obtained were necessary," and (6) "the allocated amounts reasonably approximate the actual costs of the services received." Although the finding of fact as supplemented by the Examiner's Report is not in the exact form stated in section 41(c)(1), it constitutes sufficient findings (1) that each item or class of items allowed is reasonable and necessary and (2) that the price paid by GTE "is no higher than prices charged by the supplying affiliate to its other affiliates or divisions for the same items or class of items, or to unaffiliated persons or corporations." Consequently, we conclude that the PUC's finding of fact as supplemented by the Examiner's Report was sufficient to support its determination that payments by GTE to GTE Service Corporation were reasonable and necessary operating expenses.

B. GTE Directories

[13] GTE Directories is a subsidiary of GTE Corporation. GTE Directories publishes and prints directories for the GTE telephone companies and unaffiliated telephone companies. Under a joint venture agreement between GTE and GTE Directories, GTE Directories publishes and prints GTE's subscriber directories for the right to sell yellow page advertising to the business subscribers and GTE provides the subscriber listings and bills and collects the yellow page advertising revenues. As payment for the listings, and the billing and collection, GTE retained 52.5% of the revenues it collects and GTE Directories received 47.5% of the revenues. The PUC included GTE's payments to GTE Directories of 47.5% of the revenues in GTE's operating expenses.[19] The PUC's final order included Finding of Fact 16 which stated:

> The testimony of GTE witness Keys refutes the conclusion that GTE Directories' agreement with GTE Southwest [GTE] is unfavorable in comparison with its other customers. It would not be appropriate to adjust GTE Directories' prices for return and tax components. Because the matching principle would require ignoring the revenues from the arrangement with GTE Directories if the expenses are not allowed, the customers benefit from recognizing the arrangement for rate-making purposes. Accordingly, expenses of $19,400,000 and revenues of $47,416,000 should be included in the cost of service.

Section III.D.6 of the Examiner's Report stated in pertinent part:

> e. *Discussion and recommendation.*— The ALJ [Administrative Law Judge] disagrees with the company's [GTE's] position [that payments to GTE Directories are not an expense subject section 41(c)(1)]; the expenses incurred as a result of the agreement with GTE Directories are subject to scrutiny as an affiliate transaction. The ALJ agrees with the General Counsel and staff, however, that the expenses should be allowed because disallowance would cause a net reduction

19. We assume, without deciding, that GTE's payments to GTE Directories of 47.5% of the revenues constitute payments to an affiliate which are subject to section 41(c)(1).

of revenues. Adopting Mr. Arndt's [a witness for Intervenors/Cities] recommendation of disallowing all the expense would require not recognizing the revenues.

The ALJ agrees with the direct and rebuttal testimony of GTE Southwest [GTE] witness Keys that Mr. Arndt's analysis does not demonstrate that GTE Directories' agreement with GTE Southwest [GTE] is unfavorable in comparison with its other customers. With respect to Mr. Allen's [a witness for Intervenor Office of Public Utility Counsel] recommendation, the ALJ is of the opinion that it is not appropriate to adjust an affiliate's prices for return and tax components on the basis of the assumption—made by Mr. Allen—that such components would be adjusted if the utility were providing the services for itself.

Accordingly, the ALJ recommends that the Commission allow in cost of service $19,940,000 of expenses associated with the directories; $47,416,000 of revenues should be recognized.

Finding of Fact 16 and section III.D.6 of the Examiner's Report which was adopted and incorporated by reference in the PUC's final order state that (1) the "testimony of GTE witness Keys refutes the conclusion that GTE Directories' agreement with GTE Southwest [GTE] is unfavorable in comparison with its other customers," (2) GTE's "customers benefit from recognizing the [joint venture] arrangement [between GTE and GTE Directories] for rate-making purposes" and (3) the "analysis [of a witness for Intervenors/Cities] does not demonstrate that GTE Directories' agreement with GTE Southwest [GTE] is unfavorable in comparison with its other customers." The finding of fact is missing at least one essential finding required by section 41(c)(1)—that each item or class of items allowed is reasonable and necessary. Consequently, we conclude that the PUC's finding of fact as supplemented by the Examiner's Report was not sufficient to support its determination that payments by GTE to GTE Directories were reasonable and necessary operating expenses.

V.

In summary, we conclude that under the circumstances present in this case, the PUC does not have the authority to make GTE's new rates effective on a date prior to the issuance of the final rate order, that the PUC was not compelled by section 41(c)(2) 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 resulting from the filing of a consolidated income tax return, that the PUC was not 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, that the PUC's finding of fact as supplemented by the Examiner's Report was sufficient to support its determination that payments by GTE to GTE Service Corporation were reasonable and necessary operating expenses and that the PUC's finding of fact as supplemented by the Examiner's Report was not sufficient to support its determination that payments by GTE to GTE Directories were reasonable and necessary operating expenses. Consequently, 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.[20]

20. The PUC also argues that the court of appeals erred in not considering and granting its point of error that the trial court erred in denying its pleas to the jurisdiction and motions to strike OPUC's intervention. After entry of the PUC's final order, GTE, AT & T Communications of the Southwest (AT & T), the Cities of Abilene et al. (the Cities) and the Office of Public Utility Counsel (OPUC) filed eleven total petitions in the trial court challenging the PUC's order. The PUC filed pleas to the jurisdiction concerning eight of the appeals filed by GTE, AT & T, the Cities and OPUC. However, the PUC did not contest jurisdiction in three separate appeals filed by GTE, AT & T and the Cities. Regardless of the propriety of the trial court's denial of the pleas to the jurisdiction, the three appeals filed by GTE, AT & T and the Cities were sufficient to vest jurisdiction in the trial court over those three appeals.

Concerning the motions to strike OPUC's intervention, regardless of the propriety of the trial court's denial of the motions, we agree with the

GONZALEZ, J., concurs in part and dissents in part and is joined by GAMMAGE, J.

SPECTOR, J., dissents.

GONZALEZ, Justice, joined by GAMMAGE, Justice, concurring in part and dissenting in part.

I concur with the Court's holding today that under the circumstances of this case the PUC lacked retroactive ratemaking authority. However, because the Court also approves a calculation of GTE's tax liability that may result in ratepayers reimbursing GTE for taxes that the utility will never actually pay, I dissent in part. In so doing, the Court misconstrues section 41(c)(2) of PURA [1] and our precedent. I thus concur in Parts I, II, and IV of the Court's opinion, and in the corresponding portion of Part V, but dissent from Part III.

The Court's opinion fairly states the facts giving rise to the issue of retroactive ratemaking. Additionally, however, the facts were that to determine GTE's reasonable and necessary operating expenses for ratemaking purposes, the PUC considered GTE's federal income tax liability. GTE Corporation is the parent company of the utility. GTE Corporation filed consolidated income tax returns for GTE and unregulated affiliated companies. When the affiliated entities lost money, the consolidated returns reflected the losses as tax deductions. Consequently, the consolidated returns showed a lower tax liability for GTE Corporation's companies than they would have had without the tax deductions due to losses. In determining GTE's reasonable and necessary operating expenses, the PUC did not consider these tax deductions when calculating GTE's "fair share" of income tax liability. In effect, the PUC calculated GTE's fair share of tax liability under the consolidated returns as if GTE had filed separate returns without any deductions. The trial court and a majority of this Court approve the PUC's approach in calculating GTE's tax liability. I disagree with this part of the Court's opinion. I think the court of appeals correctly held that the PUC erred in omitting consideration of the tax deductions in the consolidated returns when it calculated GTE's federal income tax liability. 833 S.W.2d 153, 163–69.

The PUC argues that it could ignore tax savings realized in consolidated returns filed by GTE Corporation and tax deductions that GTE took for expenses that section 41(c)(3) of PURA disallows from ratemaking. I disagree, and dissent from that part of the Court's opinion that approves the PUC's treatment of GTE's tax savings. This approach overlooks the language of section 41(c)(2) of PURA,[2] is contrary to *Public Util. Comm'n v. Houston Lighting & Power Co.*, 748 S.W.2d 439 (Tex.1987) (*HL & P*), *appeal dismissed*, 488 U.S. 805, 109 S.Ct. 36, 102 L.Ed.2d 16 (1988), and unfairly requires ratepayers to reimburse GTE for taxes it will never actually pay.

The PUC must balance two goals. It must ensure that GTE charges customers just and reasonable rates and that GTE's revenues generate a reasonable return for the utility above reasonable and necessary operating expenses. TEX.REV.CIV.STAT. art. 1446c, §§ 38, 39(a) (Vernon Supp.1995). PURA's formula for striking the balance is that a utility's expenses, plus a reasonable return, should equal a just and reasonable customer rate. This formula links the two concerns together. Therefore, customer service rates ought to reflect an increase or decrease in a utility's expenses. If GTE's expenses decrease, customer service rates should fall.

Customers must pay for a utility's tax liability as an expense. *HL & P*, 748 S.W.2d at 441. Section 41(c)(2) of PURA addresses the special situation when a utility files consolidated returns with its unregulated affiliated companies. The section states:

> If a public utility is a member of an affiliated group that is eligible to file a consolidat-

court of appeals that "[d]eciding the issue of Public Counsel's [OPUC's] right to intervene was not necessary to the Court's disposition because the Cities raised the same points of error that Public Counsel raised." 833 S.W.2d at 175 n. 24.

1. TEX.REV.CIV.STAT. art. 1446c, § 41(c)(2) (Vernon Supp.1995).

2. TEX.REV.CIV.STAT. art. 1446c, § 41(c)(3) (Vernon Supp.1995).

> ed income tax return, and if it is advantageous to the public utility to do so, income taxes shall be computed as though a consolidated return had been so filed and the utility had realized its fair share of the savings resulting from the consolidated return, unless it is shown to the satisfaction of the regulatory authority that it was reasonable to choose not to consolidate returns.

TEX.REV.CIV.STAT. art. 1446c, § 41(c)(2) (Vernon Supp.1995) (emphasis added). The PUC failed to apply this section properly when it calculated GTE's tax expense liability. The PUC computed the utility's income taxes as though GTE filed separate returns, and did not attempt to apportion to GTE its fair share of tax savings realized in GTE Corporation's consolidated returns.

The PUC did not correctly construe section 41(c)(2). The Court today defers to the PUC on the ground that the PUC has great discretion in the ratemaking process. Such reasoning is persuasive only as a basis to avoid analyzing the meaning of section 41(c)(2). The PUC has no greater expertise than this Court in construing statutory meaning. Section 41(c)(2) requires the PUC to fairly allocate to GTE the savings that result from filing consolidated returns with its affiliated companies. In fact, even if GTE did not file consolidated returns, the section would require the PUC to allocate theoretical savings. Section 41(c)(2) plainly states that a public utility should share in all savings realized from a consolidated return. Therefore, I construe section 41(c)(2) as requiring that the PUC determine the utility's fair share of the tax savings.

Subsection (3) of section 41(c) provides no basis for the PUC to exclude savings realized in the consolidated returns from its calculation of GTE's tax liability. That section directs the PUC to disallow four categories of expenses. *See* TEX.REV.CIV.STAT. art. 1446c, § 41(c)(3)(A)–(D) (Vernon Supp.1995). In other words, a utility cannot make customers pay for these expenses. None of the four categories disallow the PUC from considering savings that a utility realizes by filing consolidated returns.[3]

In addition, *HL & P* compels the PUC to determine the fair share of actual tax savings due to filing consolidated returns and due to tax deductions. *See* 748 S.W.2d at 441 & n. 1 (discussing *Federal Power Comm'n v. United Gas Pipe Line Co.*, 386 U.S. 237, 87 S.Ct. 1003, 18 L.Ed.2d 18 (1967)). *HL & P* held that a "utility's rates must reflect the tax liability actually incurred." *Id.* at 442. In the usual ratemaking context, this statement means that the PUC must evaluate historical data on a utility's actual tax liability when it sets the future rates. The PUC did not follow this rule. By not considering the savings GTE realized by filing consolidated returns, the PUC measured the expense of GTE's tax liability as if GTE had filed separate returns. Likewise, by not considering GTE's tax deductions for lobbying, advertising, and other expenses disallowed for ratemaking purposes by section 41(c)(3) of PURA,[4] the PUC measured GTE's tax liability as if GTE had not taken these deductions. Although the PUC must disallow these expenses in calculating the rate base, it does not follow that the PUC can overlook the tax deductions that GTE takes for them. *HL & P* makes this point:

> [R]atepayers can be held accountable only for those tax expenses that are actually incurred by a utility. Accordingly, when a utility claims federal income tax deductions ... the resulting tax savings will necessarily reduce the utility's actual federal income tax expense. This will be the effect whether the expenses are allowed or disallowed in the calculation of a new rate.

3. The contrary argument is that expenditures by GTE's affiliated companies are "expenses not in the public interest," and thus in a category disallowed from the PUC's ratemaking consideration. *See id.* § 41(c)(3)(D). Whether section 41(c)(3)(D) of PURA disallows an expense from ratemaking consideration, however, is irrelevant to the PUC's calculation of a utility's tax expense. Section 41(c)(2) directs the PUC to consider the fair share of all savings resulting from consolidated returns.

4. *See* TEX.REV.CIV.STAT. art. 1446c, § 41(c)(3) (Vernon Supp.1995). The effect of section 41(c)(3) is that a utility cannot force consumers to pay for lobbying, advertising, civil penalties or fines, and other expenses that do not benefit the public.

748 S.W.2d at 442. The PUC's approach violates *HL & P*'s directive. As a result, GTE is passing on to consumers a hypothetical tax expense. The PUC should not require ratepayers to pay phantom taxes in lieu of a reasonable estimate of actual tax expense based on past years' data. *See id.* at 441 n. 1 (summarizing *Federal Power*, 386 U.S. at 246–47, 87 S.Ct. at 1008–09); *Washington Gas Light Co. v. Public Serv. Comm'n*, 450 A.2d 1187, 1234–35 (D.C.1982)) (approving a utility commission's rate calculation in which it halved the utility's tax liability expense estimate, based on savings in the consolidated tax return due to losses at an unregulated subsidiary company).

The majority's attempt to distinguish *HL & P*, a ratemaking case, from the present ratemaking case is unpersuasive. The majority says the rate order under review differs from that in *HL & P* because the PUC must base GTE's rates on test year results, estimated income tax calculations, and hypothetical returns. The majority's distinction is illusory. After we remanded in *HL & P*, the PUC likely used the same kind of information to set Houston Lighting & Power's service rates. Furthermore, the difficulty of prospective ratemaking is not a sufficient reason to omit a portion of the analysis, for example, inquiry into a utility's fair share of tax savings under consolidated returns or its tax deductions. It is the PUC's role to handle these complexities. The amounts of GTE's fair share of tax savings and GTE's tax deductions are questions of fact for the PUC's determination. In calculating GTE's expenses for ratemaking purposes, *HL & P* requires that the PUC take into account the tax savings realized in the consolidated returns and tax deductions, including those taken for expenses disallowed by section 41(c)(3). I stand by our holding in *HL & P*, that actual tax savings "should inure to the benefit of the ratepayers." 748 S.W.2d at 442.

Given the directives of section 41(c)(2) and *HL & P*, 748 S.W.2d at 441–42, the PUC erred by failing to allocate to GTE a fair share of the tax savings realized in the consolidated returns when it calculated the service rates, and excluding tax deductions that GTE took in its income tax returns. As a result, the PUC's estimate of GTE's tax liability is artificially high. No longer is there a balance between customers' rates and GTE's reasonable return above actual operating expenses. To charge ratepayers for a tax expense that may be more than GTE actually ever will pay is not just and reasonable. By contrast, allocating a fair share of tax savings to GTE and recognizing GTE's tax deductions would benefit consumers in the form of lower rates without reducing the net return for GTE or its investors. To put it in terms of PURA's formula, GTE's lower expenses due to actual reductions in tax liability, plus an unaltered reasonable rate of return, should equal a lower customer rate.

For these reasons, I concur in the Court's disapproval of the PUC's retroactive ratemaking under the facts of this case. However, I dissent from the Court's approval of the PUC's treatment of GTE's tax liability. On the latter issue, I would affirm the judgment of the court of appeals, 833 S.W.2d at 168–69, and hold that a regulatory agency must consider actual tax liability that results when a utility files consolidated income tax returns and takes tax deductions.

SPECTOR, Justice, dissenting.

I disagree with the majority's holdings that allow utilities to unjustly charge consumers for "phantom taxes." For the reasons stated in Justice Gonzalez's concurring and dissenting opinion, I would adhere to this Court's opinion in *Public Utility Commission v. Houston Lighting & Power Co.*, 748 S.W.2d 439 (Tex.1987), as well as the other decisions the majority today overturns: *City of Somerville v. Public Utility Commission*, 865 S.W.2d 557 (Tex.App.—Austin 1993, no writ) and *Southern Union Gas Co. v. Railroad Commission*, 701 S.W.2d 277 (Tex.App.—Austin 1985, writ ref'd n.r.e.). I would thus hold that the Public Utility Commission erred by failing to account for (1) GTE's pro-rata share of the savings resulting from its parent's filing a consolidated tax return; and (2) the income tax deductions taken for expenses that were disallowed from inclusion in rate base.

I also differ with the majority's curtailment of the Commission's authority to set the effective date of its ratemaking order. This Court has squarely held that the Commission has considerable discretion in this regard:

> The courts of this state have provided that in order to compensate for 'regulatory lag,' the Commission in its discretion may make the new rates effective at any date prior to the issuance of the order but following the attachment of the agency's discretion.

Railroad Comm'n v. Lone Star Gas Co., 656 S.W.2d 421, 426 (1983). I do not believe this writing is "distinguishable," as the majority declares, *supra* at 408. The *Lone Star* opinion addresses the present issue fully, discussing authority from other jurisdictions as well as Texas, and unambiguously concludes that the Commission has discretion to make its new rates effective at a date prior to the issuance of its final order. 656 S.W.2d at 425–26.

The majority's holding is also inconsistent with the Court's more recent writing in this area. In *State v. Public Utility Commission*, 883 S.W.2d 190, 195–96 (Tex.1994), this Court held that the Commission has broad discretion to provide remedies for regulatory lag other than those provided in section 43, because that section is simply "a component of the overall scheme provided by PURA for regulating utilities and assuring that rates are just and reasonable." Today, however—when the Commission's exercise of its discretion benefits *consumers* rather than utilities—the majority holds that the Commission has no such discretion at all, because section 43 already "provides a detailed procedure to avoid regulatory lag." *Supra* at 408.

While I disagreed with much of the Court's writing in *State v. PUC*, I recognize that it is now the law. Thus, under both *Lone Star* and *State v. PUC*, I would hold that the Commission acted within its discretion when it provided consumers some relief from regulatory lag "in order to do equity in light of [GTE's] dilatory tactics ... in this case." By overturning this exercise of discretion, the majority allows GTE to retain a windfall of some $140 million in overcharges.[1]

I would affirm the judgment of the court of appeals in all respects except with regard to the effective date of the Commission's order. Accordingly, I dissent.

Holland ST. JOHN, M.D., Petitioner,

v.

Marty Howard POPE and Sally Bates Pope, Respondents.

No. D–4603.

Supreme Court of Texas.

Argued Oct. 18, 1994.

Decided June 8, 1995.

Rehearing Overruled Aug. 1, 1995.

Patient who developed several permanent disabilities from meningitis brought medical malpractice action against emergency room physician, hospital, and on-call physician. The 126th Judicial District Court, Travis County, Joseph H. Hart, J., entered summary judgment for on-call physician. Plaintiffs appealed. The Court of Appeals, 862 S.W.2d 657, reversed and remanded. On application for writ of error, the Supreme Court, Gonzalez, J., held that on-call physician, consulted by emergency room physician over telephone, did not form physician-patient relationship by expressing his opinion

1. As explained in the court of appeals' opinion, 833 S.W.2d at 170, this windfall resulted after the Texas Legislature excluded telecommunication services from the gross-receipts tax and included them within the scope of the sales tax. GTE thereupon levied a "surcharge" on consumers to collect the sales tax; but it failed to reduce its rates to adjust for the exemption from the gross receipts tax. Thus, consumers continued to pay GTE for the gross-receipts tax, even though GTE was no longer paying the tax.

FIGURE RWH-R11

Gulf States V. PUC, 947 S.W. 2d 887 (Tex. 1997)

947 S.W.2d 887
Util. L. Rep. P 26,594, 40 Tex. Sup. Ct. J. 269
(Cite as: 947 S.W.2d 887)

H

Supreme Court of Texas.

GULF STATES UTILITIES COMPANY,
Petitioner,
v.
PUBLIC UTILITY COMMISSION OF TEXAS et al., Respondents.

No. 94-1229.

Argued March 19, 1996.
Decided Jan. 31, 1997.
Rehearing Overruled July 31, 1997.

Electric utility, cities, Office of Public Utility Counsel (OPUC), industrial energy entity, and State petitioned for judicial review of Public Utility Commission (PUC) order in utility rate case purportedly deferring issue of whether certain portion of utility's costs in constructing nuclear power plant should be included in utility's rate base. The 250th Judicial District Court, Travis County, Paul R. Davis, Jr., J., reversed and remanded. Commission, OPUC, and utility appealed. The Austin Court of Appeals, Bea Ann Smith, J., 883 S.W.2d 739, affirmed in part, reversed in part, and rendered. Utility appealed. The Supreme Court, Hecht, J., held that: (1) Commission prejudiced utility's substantial rights by attempting, in excess of its statutory authority, to defer ruling on whether to include certain portion of costs of constructing plant in utility's rate base, and rate case would be remanded to Commission, and (2) it would remand to Commission determination of federal income tax expense which should be included in utility's rate base.

Reversed and remanded.

West Headnotes

[1] Electricity ⇐11.3(7)
145k11.3(7) Most Cited Cases

Public Utility Commission (PUC) prejudiced electric utility's substantial rights by attempting in utility rate case, in excess of its statutory authority, to defer ruling on whether to include certain portion of costs of constructing nuclear power plant in utility's rate base, and rate case would be remanded to Commission, despite contention that Commission had reached conclusions tantamount to excluding costs portion from utility's rate base; one could not read record of proceedings and Commission's order and conclude that Commission would have excluded entire portion of costs from utility's rate base had it known that it could not defer ruling on issue. V.T.C.A., Government Code § 2001.174(2)(B); Vernon's Ann.Texas Civ.St. art. 1446c-0, § 1.301.

[2] Electricity ⇐11.3(7)
145k11.3(7) Most Cited Cases

On appeal in Public Utility Commission (PUC) electric utility rate case, Supreme Court would remand to Commission determination of federal income tax expense which should be included in utility's rate base, in light of intervening Supreme Court decision holding that, in determining utility's federal income tax liability, Commission cannot consider deductions for disallowed expenses, but has discretion to consider savings resulting from filing of consolidated tax return, where Commission had used "actual-taxes- paid" method for determining how much federal income tax expense should be included in utility's rate base. V.T.C.A., Government Code § 2001.174.

*887 Cecil R. Johnson, Beaumont, C. Robert Heath , Thomas M. Pollan, Barry K. Bishop, John F. Williams, Shannon H. Ratliff, Austin, for Petitioner.

Don R. Butler, Barbara Day, Geoffrey M. Gay, James G. Boyle, Mark W. Smith, Austin, Peter Brickfield, Washington, DC, Bryan L. Baker, Suzi Ray McClellan, Walter Washington, Susan Bergen Schultz, Dan Morales, Rupaco T. Gonzalez, Stephen Fogel, Steven Baron, Scott Sawyer, Austin, Rex D. VanMiddlesworth, Jonathan Day, Frederick D. Junkin, Houston, for Respondents.

947 S.W.2d 887
Util. L. Rep. P 26,594, 40 Tex. Sup. Ct. J. 269
(Cite as: 947 S.W.2d 887)

HECHT, Justice, delivered the opinion of the Court.

In Docket 7195, the Public Utility Commission considered but refused to decide whether Gulf States Utilities Company was entitled to include in its rate base $1.453 billion in costs to construct the River Bend Nuclear Generating Plant, even though the issue was fully litigated. Instead, having allowed some *888 of GSU's costs, the PUC attempted to defer the issue to a subsequent proceeding. In *Coalition of Cities for Affordable Utility Rates v. Public Utility Commission,* 798 S.W.2d 560 (Tex.1990), *cert. denied,* 499 U.S. 983, 111 S.Ct. 1641, 113 L.Ed.2d 736 (1991), we held that res judicata and collateral estoppel barred relitigation of the issue. The question now before us, not present in *Coalition of Cities,* is whether the PUC erred in refusing to decide the issue in Docket 7195 so that its final order must be reversed. The district court and court of appeals concluded that the PUC did not err. 883 S.W.2d 739. We disagree.

I

GSU, an electric utility serving customers in southeastern Texas and south central Louisiana, announced its plans to construct River Bend in 1971. The plant was completed at a total cost of nearly $4.5 billion and began commercial operation in 1986. GSU owns a seventy percent interest in the plant.

GSU applied to the PUC to include some $3 billion of its River Bend construction costs in its cost of service and to increase its rates accordingly. In this proceeding, Docket 7195, after hearing testimony from over 100 witnesses for 132 days, the examiners issued a 395-page report recommending to the PUC that only nine percent--about $274 million--of GSU's costs "should be excluded from GSU's rate base as invested capital not used and useful in rendering service to the public". There was extensive evidence supporting inclusion of all GSU's costs in its rate base and extensive contrary evidence that most of those costs should be excluded.

The PUC did not adopt the examiners' report. The Commission agreed that $2.273 billion of River Bend construction costs were reasonably and prudently incurred, and that GSU's seventy-percent share of those costs, $1.591 billion, should be included in its rate base. But the Commission found that "[t]he evidence is inadequate to support a finding of either prudence or imprudence with regard to construction costs in excess of $2.273 billion [with two minor exceptions]." Despite GSU's failure of proof, the Commission expressly refused to exclude the balance of GSU's costs from its rate base. The Commission also apparently rejected the possibility of remanding the case to the examiners, 16 Tex. Admin. Code § 22.262(c) (West 1996), after GSU's counsel indicated that a remand was "unnecessary". Instead, the Commission believed it could defer ruling until a later proceeding.

Accordingly, the PUC in its final order found that "GSU's share of all River Bend capital costs in excess of $2.273 billion"--$1.453 billion--"should be excluded from plant in service *at this time* for lack of sufficient evidence as to the prudence and reasonableness of those costs." (Emphasis added.) The PUC concluded: "[T]he Commission may reexamine on rehearing or in a subsequent proceeding the prudence and reasonableness of those River Bend construction costs regarding which the evidence is inadequate to support a finding of either prudence or imprudence." Chairman Thomas dissented from the Commission's decision "to hold in abeyance $1.453 billion of the investment in the River Bend Nuclear Power Plant, to allow the Company an opportunity to prove construction prudence on rehearing." Chairman Thomas would have disallowed $459 million of excess costs and excluded $495 million in costs for excess capacity until that capacity became used and useful.

Three things are clear about the PUC's final order in Docket 7195. First, the PUC intended that the order would end the proceeding, except for any motions for rehearing. Second, the PUC intended not to decide whether $1.453 billion of River Bend costs should be included in GSU's rate base. The Commissioners took particular care that no comment during the public hearing be construed as implying a disallowance of the $1.453 billion, rather than a deferral. Third, the PUC contemplated that GSU could initiate a separate proceeding to determine treatment of the $1.453 billion of costs.

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GSU and other parties filed motions for rehearing, which were overruled by operation of law when the time expired for the PUC to rule on them. The following parties then sought judicial review in the district court: GSU; Coalition of Cities for Affordable Utility Rates ("CAUR"); the Office of *889 Public Utility Counsel ("OPC"); Cities of Beaumont, et al. ("Cities"); Texas Industrial Energy Consumers ("TIEC"); and the State of Texas. The district court consolidated all the petitions for judicial review.

While those petitions were pending, GSU initiated a new proceeding in the PUC, Docket 8702, to include in its rate base the $1.453 billion costs "held in abeyance" in Docket 7195. When the PUC indicated that it intended to proceed in Docket 8702, CAUR, OPC, and Cities petitioned the district court for declaratory and injunctive relief. The district court declared that res judicata and collateral estoppel barred relitigation of the issues GSU raised in Docket 8702 and enjoined the PUC from going forward in that proceeding.

GSU and the PUC appealed. The PUC argued:

> Since the Commission has clearly expressed its reservation of the prudence determination of $1.45 billion of River Bend's costs, the district court's attempt to construe the Commission's order otherwise is an impermissible substitution of its judgment for that of the Commission. The district court is itself essentially determining that $1.45 billion of GSU's investment in River Bend are permanently disallowed from rate base. It is well settled that a court may not substitute its judgment for that of the administrative agency. As shown above, the Commission's final order does not state such a finding nor does it operate to permanently exclude $1.45 billion from rate base. The Commission's conclusion that GSU did not meet its burden of proving that the $1.45 billion were prudent cannot be interpreted as a final determination of the issue. Too many contingencies are left when that conclusion is read alongside other parts of the order.
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> * * * * * *
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> The myriad of possibilities as to the amount the Commission would have included in or excluded from rate base had it decided not to defer part of River Bend's costs precludes the court's and Appellees' conjectures as to the possible final outcome.

(Citations and footnotes omitted.) CAUR, OPC, and Cities argued that the PUC's finding that GSU had failed to meet its burden of proof amounted to an adjudication of the issue regardless of the PUC's attempt to defer ruling. The court of appeals agreed with GSU and the PUC, reversed the judgment of the district court and dissolved the injunction, thereby allowing Docket 8702 to proceed. *Public Util. Comm'n v. Coalition of Cities for Affordable Util. Rates,* 777 S.W.2d 814 (Tex.App.--Austin 1989).

We reversed the court of appeals. *Coalition of Cities for Affordable Util. Rates v. Public Util. Comm'n,* 798 S.W.2d 560 (Tex.1990). We reasoned that "the PUC order [in Docket 7195] must be considered final unless the PUC has the statutory power to defer and reconsider such critical issues." *Id.* at 564. Finding no such authority, we concluded that "the PUC was powerless to defer its decision to a future proceeding." *Id.* Inasmuch as the treatment of the $1.453 billion of costs was litigated in Docket 7195 and the PUC's final order did not include it in GSU's rate base, "the PUC *effectively* disallowed that amount from the rate base." *Id.* (emphasis added). Thus, we held, the doctrines of res judicata and collateral estoppel applied to preclude GSU from relitigating the issue in Docket 8702. *Id.* at 565.

By saying that the PUC *effectively* disallowed the $1.453 billion we did not suggest that the PUC *actually* made that decision. The PUC's intention not to do so, but rather to defer the decision, could not have been plainer. The PUC's intention was reflected not only in its own record and order but in its briefing on appeal. Our holding was solely that the legal effect of the PUC's final order was to bar relitigation of issues squarely presented in that proceeding, whether the PUC refused to decide them or not. Without severing the issue of the $1.453 billion from Docket 7195, *see* 16 Tex. Admin. Code § 22.34(b) (West 1996), the PUC could not render a final order that did not have the effect of adjudicating the issue.

Furthermore, we did not decide whether the PUC's order in Docket 7195 was correct; that issue had not yet been addressed by the district court in the consolidated cases for *890 judicial review. In response to the dissent's contention that "[t]he effect

of this decision is to assess a $1.453 billion penalty (permanent disallowance) on GSU all in the name of res judicata and collateral estoppel", 798 S.W.2d at 568 (Gonzalez, J., dissenting), the Court clearly stated:

> All issues relating to the merits of the administrative order, including the prudence of all elements of construction costs, remain to be addressed by the trial court where the consolidated appeals of the parties are pending.... In [that] proceeding the burden is upon GSU to show that the PUC's order is not supported by substantial evidence. The claim of the dissent that we have at this point 'assess[ed] a $1.453 billion penalty (permanent disallowance) on GSU' ... is incorrect.

Id. at 565 n. 7. With regard to the $1.453 billion, the issue remaining for judicial review was whether the PUC could effectively deny inclusion of those costs in GSU's rate base the way it did.

Following *Coalition of Cities*, the PUC altered its position. In the judicial review proceeding it joined CAUR, OPC, Cities and others in arguing that the $1.453 billion was properly excluded from GSU's rate base. GSU contended that disallowance of the $1.453 billion did not meet the statutory substantial evidence standard of review because it was arbitrary and capricious and violated the regulatory statute, the prudent investor test, and GSU's constitutional due process rights. The parties also addressed other issues, including the PUC's treatment of GSU's federal income tax expense. The district court rejected GSU's arguments, found relatively minor errors in the PUC's order, and reversed and remanded the case to the PUC solely to address those errors.

The PUC, OPC, and GSU appealed. The court of appeals, by a divided vote, reversed the district court to the extent that court reversed the PUC, thereby in effect approving the PUC's order in its entirety. 883 S.W.2d 739. Only GSU appealed to this Court. The PUC, OPC, Cities, TIEC, and North Star Steel Company have appeared as respondents.

II

"Any party to a proceeding before the [PUC] is entitled to judicial review under the substantial evidence rule." Public Utility Regulatory Act of 1995, TEX.REV.CIV. STAT. art. 1446c-0, § 1.301 (Vernon Supp.1996), formerly Public Utility Regulatory Act, Tex.Rev.Civ. Stat. Ann. art. 1446c, § 69 (Vernon 1980), Act of June 2, 1975, 64th Leg., R.S., ch. 721, § 69, 1975 Tex. Gen. Laws 2327, 2349. We therefore apply the substantial evidence rule in this case. The rule is prescribed by statute:

> If the law authorizes review of a decision in a contested case under the substantial evidence rule ..., *a court* may not substitute its judgment for the judgment of the state agency on the weight of the evidence on questions committed to agency discretion but:
> (1) may affirm the agency decision in whole or in part; and
> (2) *shall reverse or remand the case for further proceedings if substantial rights of the appellant have been prejudiced because the administrative findings, inferences, conclusions, or decisions are:*
> (A) in violation of a constitutional or statutory provision;
> (B) *in excess of the agency's statutory authority;*
> (C) made through unlawful procedure;
> (D) affected by other error of law;
> (E) not reasonably supported by substantial evidence considering the reliable and probative evidence in the record as a whole; or
> (F) arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion.

Administrative Procedure Act, Tex. Gov't Code § 2001.174, formerly Administrative Procedure and Texas Register Act, Tex.Rev.Civ. Stat. Ann. art. 6252-13a, § 19(e), Act of April 8, 1975, 64th Leg., R.S., ch. 61, § 19(e), 1975 Tex. Gen. Laws 136, 147 (emphasis added). Although GSU argues that the PUC's order is covered by several parts of subparagraph (2), we focus on part (B) and the italicized language.

*891 In *Coalition of Cities* we held that the PUC acted in excess of its statutory authority: "There is no language in [the Public Utility Regulatory Act] that allows the PUC to bifurcate into multiple proceedings the issue of a single investment's prudence." 798 S.W.2d at 564. Even when an agency has exceeded its authority, however, the substantial evidence rule requires reversal only when a party's substantial rights are prejudiced. GSU's right-- to include $1.453 billion costs in its rate base if reasonably and prudently incurred--is

unquestionably substantial. The issue, then, is prejudice: that is, did the PUC's decision to defer its ruling prejudice inclusion of the $1.453 billion in GSU's rate base?

[1] Respondents argue that GSU was not prejudiced by the PUC's attempt to defer its ruling because, despite that error, the PUC reached conclusions tantamount to excluding the $1.453 billion from GSU's rate base. Specifically, the PUC concluded that those costs "should not be included in GSU's rate base" because "GSU has not met its burden of proving that [those costs] were reasonably and prudently incurred." GSU points out the logical fallacy of this argument: if the PUC had concluded that the $1.453 billion should not be included in GSU's rate base, why defer the decision? Why not simply rule and be done with it? GSU argues that the PUC structured its findings and conclusions on the premise that it could defer ruling on the $1.453 billion.

The court of appeals rejected GSU's argument:

> Gulf States suggests that the Commission would have altered its findings of facts based on the evidence presented had it known it could not grant the utility a second chance to present more persuasive evidence. However, the Commission is not permitted to determine a just and reasonable rate and then "back into" the required findings of fact. A basic purpose of requiring findings of fact is to ensure that an agency's decision comes *after*, not *before*, a careful consideration of the evidence. Agency conclusions should follow from its serious appraisal of the facts. Gulf States here suggests that if the Commission had known its decision would be final, it would have reshaped its findings of fact to "back into" a decision more favorable to the utility. We reject this cynical view of the administrative process.

883 S.W.2d at 750. This "cynical view" is the very one the PUC itself expressed in its brief to the same court of appeals in appealing from the district court's declaratory judgment and injunction:

> The Commission's conclusion that GSU did not meet its burden of proving that the $1.45 billion were prudent cannot be interpreted as a final determination of the issue. Too many contingencies are left when that conclusion is read alongside other parts of the order.
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> * * * * * *
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> The myriad of possibilities as to the amount the Commission would have included in or excluded from rate base had it decided not to defer part of River Bend's costs precludes the court's and Appellees' conjectures as to the possible final outcome.

(Citations and footnotes omitted.) While the PUC has altered its position since it made this argument, one simply cannot read the record of proceedings in the PUC and the PUC's order and conclude that the Commission would have excluded the $1.453 billion from GSU's rate base had it known that it could not defer ruling on the issue. As Commissioner Greytok emphasized: "We have a portion of that plant [River Bend] held in abeyance, but we do not have a disallowed portion of that plant." For the PUC to depart now from its position reiterated in the past is disingenuous.

The PUC and the other respondents argue that GSU's position is foreclosed by *Coalition of Cities*. As noted above, however, we expressly stated in *Coalition of Cities* that "the prudence of all elements of construction costs ... remain to be addressed". 798 S.W.2d at 565 n. 7. The court of appeals characterized our decision this way:

> By its decision in the collateral attack [that is, *Coalition of Cities*], the supreme court did not intend to bar Gulf States' legal right to a fair adjudication of the *892 prudence issue or to restrict the scope of judicial review of that adjudication.

883 S.W.2d at 745. In *Coalition of Cities* we stated: "All parties were entitled to a straightforward decision from the PUC the first time that this case was presented." 798 S.W.2d at 565. They did not get it, and we are still not sure, given the PUC's equivocation, what the decision would be.

Accordingly, we conclude that the PUC prejudiced Gulf States' substantial rights by attempting to defer ruling on the proper treatment of the $1.453 billion. We therefore reverse the PUC's order and remand the case to the PUC for further proceedings. We leave to the PUC to determine whether the case should be remanded to the examiners for further evidence or whether the remaining issues can be decided on the evidence previously received in Docket 7195.

III

[2] There is one additional issue. The PUC used the "actual-taxes-paid" method for determining how much federal income tax expense should be included in GSU's rate base. The court of appeals affirmed that portion of the PUC's order. 883 S.W.2d at 756. The order and the court of appeals' opinion preceded our decision in *Public Utility Commission v. GTE-Southwest, Inc.*, 901 S.W.2d 401 (Tex.1995), in which we concluded that the court of appeals erred in imposing the "actual-taxes-paid" method on the PUC. We explained that in determining a utility's federal income tax liability, the PUC cannot consider deductions for disallowed expenses, *id.* at 411-412, but has discretion to consider the savings resulting from the filing of a consolidated tax return, *id.* at 409-411. While *GTE-Southwest* involved available deductions for disallowed noncapital expenses, as opposed to capital costs, we have since held that the same reasoning applied equally to disallowed capital costs, at least to the extent that those costs will never be allowed in rate base. *Public Util. Comm'n v. Texas Util. Elec. Co.*, 935 S.W.2d 109, 110 (Tex.1996) (per curiam). The determination of what tax expense should be included in GSU's rate base must, therefore, be remanded to the PUC for further consideration in light of *GTE-Southwest* and *Texas Utilities.*

* * * * * *

The judgment of the court of appeals is reversed, the order of the PUC in Docket 7195 is reversed, and the case is remanded to the PUC for further proceedings consistent with this opinion.

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FIGURE RWH-R12
Internal Revenue Code Section 46(f)

i paragraph shall not apply to any
ss than 6 months (determined under

\PPLY.—Subparagraph (A) shall not
in section 593 if such organization
e years the amount of the deduction
basis of actual experience. Any such
:d in substantially similar activities

RAL.—In the case of—
ation to which section 593 applies,
ed investment company or a real estate
subject to taxation under subchapter M
owing), and
ative organization described in section

investment and the $25,000 amount
subparagraphs (A) and (B) of subsection
such person's ratable share of such items."

6(b)(2), (c):
Sec. 46(e)(2) to read as above, effective
nding after October 31, 1978. Before
section read:

SHARE.—For purposes of paragraph (1),
of any person for any taxable year of the
.erein shall be—
ise of an organization referred to in
50 percent thereof,
of a regulated investment company or a
nent trust; the ratio (i) the numerator of
ble income and (ii) the denominator of
e income computed without regard to the
lividends paid provided by section
7(b)(2)(B), as the case may be, and
if a cooperative organization, the ratio (i)
which is its taxable income and (ii) the
hich is its taxable income increased by
section 1382(b) or (c) applies and similar
reatment of which is determined without
er T (sec. 1381 and following).

paragraph (B) of the preceding sentence,
.ncome" means in the case of a regulated
any its investment company taxable
: meaning of section 852(b)(2)), and in
estate investment trust its real estate
axable income (within the meaning of
determined without regard to any
al gains dividends (as defined in section
y excluding any net capital gain."

2(b)(4), 1607(b)(1)(B):
12(b)(4) substituted "subsection (a)(3)"
2)" in paragraph (1) of Code Sec. 46(e),
e years beginning after December 31,

07(b)(1)(B) amended Code Sec. 46(e)(2)
7(b)(2)(B)" for "857(b)(2)(C)" in sub-
d by inserting "determined without
action for capital gains dividends (as
57(b)(3)(C)) and by excluding any net
diately before the period at the end of
he amendments apply to taxable years
r 4, 1976, except that in the case of a
a net operating loss (as defined in Code
taxable year ending after October 4,
provisions of part II of subchapter M of
A of the Code apply to such taxpayer,
a net operating loss carryback under
ny taxable year ending on or before

P.L. 94-12, § 302(a):
Redesignated Sec. 46(d) as 46(e).

P.L. 92-178, § 108(a):
Added paragraph (3) to Code Sec. 46(d). Applicable to leases entered into after September 22, 1971.

[Sec. 46(f)]

[1] (f) LIMITATION IN CASE OF CERTAIN REGULATED COMPANIES.—

[1] Taxpayers who are subject to the provisions of Code Sec. 46(f) are not covered by Sec. 101(c) of the Revenue Act of 1971 or by Sec. 203(e) of the Revenue Act of 1964. See the amendatory notes following Code Sec. 46(f).—CCH.

(1) GENERAL RULE.—Except as otherwise provided in this subsection, no credit determined under subsection (a) shall be allowed by section 38 with respect to any property described in section 50 (as in effect before its repeal by the Revenue Act of 1978) which is public utility property (as defined in paragraph (5)) of the taxpayer—

(A) COST OF SERVICE REDUCTION.—If the taxpayer's cost of service for ratemaking purposes is reduced by reason of any portion of the credit determined under subsection (a) and allowable by section 38 (determined without regard to this subsection); or

(B) RATE BASE REDUCTION.—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 credit determined under subsection (a) and allowable by section 38 (determined without regard to this subsection).

Subparagraph (B) shall not apply if the reduction in the rate base is restored not less rapidly than ratably. If the taxpayer makes an election under this sentence within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, the immediately preceding sentence shall not apply to property described in paragraph (5)(B) if any agency or instrumentality of the United States having jurisdiction for ratemaking purposes with respect to such taxpayer's trade or business referred to in paragraph (5)(B) determines that the natural domestic supply of the product furnished by the taxpayer in the course of such trade or business is insufficient to meet the present and future requirements of the domestic economy.

(2) SPECIAL RULE FOR RATABLE FLOW-THROUGH.—If the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, paragraph (1) shall not apply, but no credit determined under subsection (a) shall be allowed by section 38 with respect to any property described in section 50 (as in effect before its repeal by the Revenue Act of 1978) which is public utility property (as defined in paragraph (5)) of the taxpayer—

(A) COST OF SERVICE REDUCTION.—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 credit determined under subsection (a) and allowable by section 38 (determined without regard to this subsection), or

(B) RATE BASE REDUCTION.—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 credit determined under subsection (a) and allowable by section 38 (determined without regard to this subsection).

(3) SPECIAL RULE FOR IMMEDIATE FLOW-THROUGH IN CERTAIN CASES.—In the case of property to which section 167(l)(2)(C) applies, if the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, paragraphs (1) and (2) shall not apply to such property.

(4) LIMITATION.—

(A) IN GENERAL.—The requirements of paragraphs (1), (2), and (9) regarding cost of service and rate base adjustments shall not be applied to public utility property of the taxpayer to disallow the credit with respect to such property before the first final determination which is inconsistent with paragraph (1), (2), or (9) (as the case may be) is put into effect with respect to public utility property (to which this subsection applies) of the taxpayer. Thereupon, paragraph (1), (2), or (9) shall apply to disallow the credit with respect to public utility property (to which this subsection applies) placed in service by the taxpayer—

(i) before the date that the first final determination, or a subsequent determination, which is inconsistent with paragraph (1), (2), or (9) (as the case may be) is put into effect, and

(ii) on or after the date that a determination referred to in clause (i) is put into effect and before the date that a subsequent determination thereafter which is consistent with paragraph (1), (2), or (9) (as the case may be) is put into effect.

(B) DETERMINATIONS.—For purposes of this paragraph, a determination is a determination made with respect to public utility property (to which this subsection applies) by a governmental unit, agency, instrumentality, or commission or similar body described in subsection (c)(3)(B) which determines the effect of the credit determined under subsection (a) and allowed by section 38 (determined without regard to this subsection)—

(i) on the taxpayer's cost of service or rate base for ratemaking purposes, or

(ii) in the case of a taxpayer which made an election under paragraph (2) or the election described in paragraph (9), on the taxpayer's cost of service for ratemaking purposes or in its regulated books of account or rate base for ratemaking purposes.

(C) SPECIAL RULES.—For purposes of this paragraph—

(i) a determination is final if all rights to appeal or to request a review, a rehearing, or a redetermination, have been exhausted or have lapsed,

(ii) the first final determination is the first final determination made after the date of the enactment of this subsection, and

(iii) a subsequent determination is a determination subsequent to a final determination.

(5) PUBLIC UTILITY PROPERTY.—For purposes of this subsection, the term "public utility property" means—

(A) property which is public utility property within the meaning of subsection (c)(3)B), and

(B) property used predominantly in the trade or business of the furnishing or sale of (i) steam through a local distribution system or (ii) the transportation of gas or steam by pipeline, if the rates for such furnishing or sale are established or approved by a governmental unit, agency, instrumentality, or commission described in subsection (c)(3)(B).

(6) RATABLE PORTION.—For purposes of determining ratable restorations to base under paragraph (1) and for purposes of determining ratable portions under paragraph (2)(A), 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.

(7) REORGANIZATIONS, ASSETS ACQUISITIONS, ETC.—If by reason of a corporate reorganization, by reason of any other acquisition of the assets of one taxpayer by another taxpayer, by reason of the fact that any trade or business of the taxpayer is subject to ratemaking by more than one body, or by reason of other circumstances, the application of any provisions of this subsection to any public utility property does not carry out the purposes of this subsection, the Secretary shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection.

(8) PROHIBITION OF IMMEDIATE FLOWTHROUGH.—An election made under paragraph (3) shall apply only to the amount of the credit determined under subsection (a) and allowable under section 38 with respect to public utility property (within the meaning of the first sentence of subsection (c)(3)(B)) determined as if the Tax Reduction Act of 1975, the Tax Reform Act of 1976, the Energy Act of 1978, and the Revenue Act of 1978 had not been enacted. Any taxpayer who had timely made an election under paragraph (3) may, at his own option and without regard to any requirement imposed by an agency described in subsection (c)(3)(B), elect within 90 days after the date of the enactment of the Tax Reduction Act of 1975 (in such manner as the Secretary shall prescribe) to have the provisions of paragraph (3) apply with respect to the amount of the credit determined under subsection (a) and allowable under section 38 with respect to such property which is in excess of the amount determined under the preceding sentence. If such taxpayer does not make such an election, paragraph (1) or (2) (whichever paragraph is applicable without regard to this paragraph) shall apply to such excess credit, except that if neither paragraph (1) nor (2) is applicable (without regard to this paragraph), paragraph (1) shall apply unless the taxpayer elects (in such manner as the Secretary shall prescribe) within 90 days after the date of the enactment of the Tax Reduction Act of 1975 to have the provisions of paragraph (2) apply. The provisions of

Figure RWH-R12

mination, or a subsequent determination, (9) (as the case may be) is put into effect,

1 referred to in clause (i) is put into effect ation thereafter which is consistent with put into effect.

his paragraph, a determination is a operty (to which this subsection applies) commission or similar body described in e credit determined under subsection (a) to this subsection)—

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an election under paragraph (2) or the :payer's cost of service for ratemaking te base for ratemaking purposes.

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ig ratable restorations to base under ons under paragraph (2)(A), the period s of reflecting operating results in the

:TC.—If by reason of a corporate : assets of one taxpayer by another the taxpayer is subject to ratemaking :, the application of any provisions of ut the purposes of this subsection, the uch provisions in a manner consistent

in election made under paragraph (3) er subsection (a) and allowable under he meaning of the first sentence of of 1975, the Tax Reform Act of 1976, been enacted. Any taxpayer who had vn option and without regard to any (3)(B), elect within 90 days after the such manner as the Secretary shall t respect to the amount of the credit n 38 with respect to such property ding sentence. If such taxpayer does ragraph is applicable without regard at if neither paragraph (1) nor (2) is hall apply unless the taxpayer elects ys after the date of the enactment of agraph (2) apply. The provisions of

this paragraph shall not be applied to disallow such excess credit before the first final determination which is inconsistent with such requirements is made, determined in the same manner as under paragraph (4).

(9) SPECIAL RULE FOR ADDITIONAL CREDIT.—If the taxpayer makes an election under subparagraph (E) of subsection (a)(2), for a taxable year beginning after December 31, 1975, then, notwithstanding the prior paragraphs of this subsection, no credit shall be allowed by section 38 in excess of the amount which would be allowed without regard to the provisions of subparagraph (E) of subsection (a)(2) if—

(A) the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by reason of any portion of such credit which results from the transfer of employer securities or cash to a tax credit employee stock ownership plan which meets the requirements of section 409A;

(B) the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of such credit which results from a transfer described in subparagraph (A) to such employee stock ownership plan; or

(C) any portion of the amount of such credit which results from a transfer described in subparagraph (A) to such employee stock ownership plan is treated for ratemaking purposes in any way other than as though it had been contributed by the taxpayer's common shareholders.

(10) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS, ETC., FOR PURPOSES OF PARAGRAPHS (1) AND (2).—

(A) IN GENERAL.—One way in which the requirements of paragraph (1) or (2) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of paragraph (1) or paragraph (2), as the case may be.

(B) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS.—The procedures and adjustments which are to be treated as inconsistent for purposes of subparagraph (A) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's qualified investment for purposes of the credit allowable by section 38 unless such estimate or projection is consistent with the estimates and projections of property which are used, for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

(C) REGULATORY AUTHORITY.—The Secretary may be regulations prescribe procedures and adjustments (in addition to those specified in subparagraph (B)) which are to be treated as inconsistent for purposes of subparagraph (A).

Amendments:	Sec. as amended effective:
P.L. 98-369, § 474(o)(4), (5) ...	.....
P.L. 97-424, § 541(b)	.....
P.L. 96-222, § 101(a)(7)(A)	.....
P.L. 96-222, § 103(a)(2)(A)	.....
P.L. 96-222, § 107(a)(3)(A)	.....
P.L. 95-600, § § 311(c)(2), 312(c)(2), (d), 703(a)(1), (r)	.....
P.L. 95-618, § 301(a)(2)(B)	.....
P.L. 94-455, 1906(b)(13)(A) ... . 803(a), (b)(1), 1906(b)(13)(A)	.....
P.L. 94-12, § § 301(b)(3), 302(a)	.....
P.L. 92-178, § 105(c)	.....

P.L. 98-369, § 474(o)(4), (5):

Act Sec. 474(o)(4)(A) amended Code Sec. 46(f)(1) and (2) by striking out "no credit shall be allowed by section 38" and inserting in lieu thereof "no credit determined under subsection (a) shall be allowed by section 38".

Act Sec. 474(o)(4)(B) amended Code Sec. 46(f)(1) and (2) by striking out "the credit allowable by section 38" each place it appeared and inserting in lieu thereof "the credit determined under subsection (a) and allowable by section 38".

Act Sec. 474(o)(4)(C) amended Code Sec. 46(f)(4)(B) by striking out "the credit allowed by section 38" and inserting in lieu thereof "the credit determined under subsection (a) and allowed by section 38".

Act Sec. (o)(5)(A) and (B) amended Code Sec. 46(f)(8) by striking out "the credit allowable under section 38" each place it appeared and inserting in lieu thereof "the credit determined under subsection (a) and allowable under section 38", and by striking out "(within the meaning of subsection (a)(7)(C))" and inserting in lieu thereof "(within the meaning of the first sentence of subsection (c)(3)(B))".

The above amendments apply to tax years beginning after December 31, 1983, and to carrybacks from such years, but shall not be construed as reducing the amount of any credit allowable for qualified investment in taxable years beginning before January 1, 1984.

P.L. 97-424, § 541(b):

Added Code Sec. 46(f)(10), above. Applicable to tax years beginning after December 31, 1979, except that the following special rules are provided in Act Sec. 541(c)(2)-(5):

(2) SPECIAL RULE FOR PERIODS BEGINNING BEFORE MARCH 1, 1980.—

(A) IN GENERAL.—Subject to the provisions of paragraphs (3) and (4), notwithstanding the provisions of

sections 167(l) and 46(f) of the Internal Revenue Code of 1954 and of any regulations prescribed by the Secretary of the Treasury (or his delegate) under such sections, the use for ratemaking purposes or for reflecting operating results in the taxpayer's regulated books of account, for any period before March 1, 1980, of—

(i) any estimates or projections relating to the amounts of the taxpayer's tax expense, depreciation expense, deferred tax reserve, credit allowable under section 38 of such code, or rate base, or

(ii) any adjustments to the taxpayer's rate of return,

shall not be treated as inconsistent with the requirements of subparagraph (G) of such section 167(l)(3) nor inconsistent with the requirements of paragraph (1) or (2) of such section 46(f), where such estimates or projections, or such rate of return adjustments, were included in a qualified order.

(B) QUALIFIED ORDER DEFINED.—For purposes of this subsection, the term "qualified order" means an order—

(i) by a public utility commission which was entered before March 13, 1980,

(ii) which used the estimates, projections, or rate of return adjustments referred to in subparagraph (A) to determine the amount of the rates to be collected by the taxpayer or the amount of a refund with respect to rates previously collected, and

(iii) which ordered such rates to be collected or refunds to be made (whether or not such order actually was implemented or enforced).

(3) LIMITATIONS ON APPLICATION OF PARAGRAPH (2).—

(A) PARAGRAPH (2) NOT TO APPLY TO AMOUNTS ACTUALLY FLOWED THROUGH.—Paragraph (2) shall not apply to the amount of any—

(i) rate reduction, or

(ii) refund,

which was actually made pursuant to a qualified order.

(B) TAXPAYER MUST ENTER INTO CLOSING AGREEMENT BEFORE PARAGRAPH (2) APPLIES.—Paragraph (2) shall not apply to any taxpayer unless, before the later of—

(i) July 1, 1983, or

(ii) 6 months after the refunds or rate reductions are actually made pursuant to a qualified order,

the taxpayer enters into a closing agreement (within the meaning of section 7121 of the Internal Revenue Code of 1954) which provides for the payment by the taxpayer of the amount of which paragraph (2) does not apply by reason of subparagraph (A).

(4) SPECIAL RULES RELATING TO PAYMENT OF REFUNDS OR INTEREST BY THE UNITED STATES OR THE TAXPAYER.—

(A) REFUND DEFINED.—For purposes of this subsection, the term "refund" shall include any credit allowed by the taxpayer under a qualified order but shall not include interest payable with respect to any refund (or credit) under such order.

(B) NO INTEREST PAYABLE BY UNITED STATES.—No interest shall be payable under section 6611 of the Internal Revenue Code of 1954 on any overpayment of tax which is attributable to the application of paragraph (2).

(C) PAYMENTS MAY BE MADE IN TWO EQUAL INSTALLMENTS.—

(i) IN GENERAL.—The taxpayer may make any payment required by reason of paragraph (3) in 2 equal installments, the first installment being due on the last date on which a taxpayer may enter into a closing agreement under paragraph (3)(B), and the second payment being due 1 year after the last date for the first payment.

(ii) INTEREST PAYMENTS.—For purposes of section 6601 of such Code, the last date prescribed for payment with respect to any payment required by reason of paragraph (3) shall be the last due date on which such payment is due under clause (i).

(5) NO INFERENCE.—The application of subparagraph (G) of section 167(l)(3) of the Internal Revenue Code of 1954, and the application of paragraphs (1) and (2) of section 46(f) of such Code, to taxable years beginning before January 1, 1980, shall be determined without any inference drawn from the amendments made by subsections (a) and (b) of this section or from the rules contained in paragraphs (2), (3), and (4). Nothing in the preceding sentence shall be construed to limit the relief provided by paragraphs (2), (3), and (4).

P.L. 97-34, § 209(d)(2) provides the following transitional rule applicable to public utilities.

(2) TRANSITIONAL RULE FOR REQUIREMENTS OF SECTION 46(f).—If, by the terms of the applicable rate order last entered before the date of the enactment of this Act by a regulatory commission having appropriate jurisdiction, a regulated public utility would (but for this provision) fail to meet the requirements of paragraph (1) or (2) of section 46(f) of the Internal Revenue Code of 1954 with respect to property for an accounting period ending after December 31, 1980, such regulated public utility shall not fail to meet such requirements if, by the terms of its first rate order determining cost of service with respect to such property which becomes effective after the date of the enactment of this Act and on or before January 1, 1983, such regulated public utility meets such requirements. This provision shall not apply to any rate order which, under the rules in effect before the date of the enactment of this Act, was inconsistent with the requirements of paragraph (1) or (2) of section 46(f) of such Code (whichever would have been applicable).

P.L. 96-222, § 101(a)(7)(A):

Amended Code Sec. 46(f)(9)(A) by changing "an employee stock ownership plan which meets the requirements of section 301(d) of the Tax Reduction Act of 1975" to "a tax credit employee stock ownership plan which meets the requirements of section 409A". Amended Code Sec. 46(f)(9) by changing "subparagraph (B) of subsection (a)(2)" each place it appears to "subparagraph (E) of subsection (a)(2)". The amendments are effective for stock acquired after December 31, 1979.

P.L. 96-222, § 103(a)(2)(A):

Amended Act Sec. 312(c)(2) of the Revenue Act of 1978 to read as follows.

(2) Paragraphs (1) and (2) of section 46(f) and subparagraph (B) of section 48(a)(7) are each amended by striking out "described in section 50" and inserting in lieu thereof "described in section 50 (as in effect before its repeal by the Revenue Act of 1978)."

P.L. 96-222, § 107(a)(3)(A):

Amended Code Sec. 46(f)(8) by changing "subsection (a)(7)(D)" to "subsection (a)(7)(C)", effective on November 10, 1978.

P.L. 95-600, § 312(c)(2), (d):

Amended paragraphs (1) and (2) of Code Sec. 46(f), effective for tax years ending after December 31, 1978, by striking out "described in section 50" after "with respect to any property".

P.L. 95-600, § 311(c)(2):

Amended in first sentence of Code Sec. 46(f)(8), effective on November 7, 1978, by inserting "the Energy Tax Act of 1978, and the Revenue Act of 1978" in place of "and the Energy Tax Act of 1978". [Note: Congress apparently intended the above amendment to apply after the amendment made by P.L. 95-618, § 301(a)(2)(B), see the amendment note after such law section, below.] Before the above amendment, but after amendments made by P.L.

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respect to public utility pro
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Figure RWH-R12

FIGURE RWH-R13
1986 Tax Reform Act Section 203(e)

TAX REFORM ACT OF 1986

1986-3 C.B. Vol. 1 1

(C) FACILITIES.—In the case of an inducement resolution or other comparable preliminary approval adopted by an issuing authority before March 2, 1986, for purposes of subparagraphs (A) and (B)(ii) with respect to obligations described in such resolution, the term "facilities" means the facilities described in such resolution.

(D) SIGNIFICANT EXPENDITURES.—For purposes of this paragraph, the term "significant expenditures" means expenditures greater than 10 percent of the reasonably anticipated cost of the construction, reconstruction, or rehabilitation of the facility involved.

(d) MID-QUARTER CONVENTION.—In the case of any taxable year in which property to which the amendments made by section 201 do not apply is placed in service, such property shall be taken into account in determining whether section 168(d)(3) of the Internal Revenue Code of 1986 (as added by section 201) applies for such taxable year to property to which such amendments apply.

(e) NORMALIZATION REQUIREMENTS.—

(1) IN GENERAL.—A normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of section 167 or 168 of the Internal Revenue Code of 1986 if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method.

(2) DEFINITIONS.—For purposes of this subsection—

(A) EXCESS TAX RESERVE.—The term "excess tax reserve" means the excess of—

(i) the reserve for deferred taxes (as described in section 167(l)(3)(G)(ii) or 168(e)(3)(B)(ii) of the Internal Revenue Code of 1954 as in effect on the day before the date of the enactment of this Act), over

(ii) the amount which would be the balance in such reserve if the amount of such reserve were determined by assuming that the corporate rate reductions provided in this Act were in effect for all prior periods.

(B) AVERAGE RATE ASSUMPTION METHOD.—The average rate assumption method is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its regulated books of account which gave rise to the reserve for deferred taxes. Under such method, if timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying—

(i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by

(ii) the amount of the timing differences which reverse during such period.

SEC. 204. ADDITIONAL TRANSITIONAL RULES.

(a) OTHER TRANSITIONAL RULES.—

(1) URBAN RENOVATION PROJECTS.—

Figure RWH-R13 3

FIGURE RWH-R14
PLR 8730013

Figure RWH-R14

C

Internal Revenue Service (I.R.S.)

Private Letter Ruling

April 21, 1987

Section 46 -- Amount of Credit

46.00-00 Amount of Credit

46.07-00 Alternative Limitations

46.07-02 Certain Utilities

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

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

CC:C:2:6

LEGEND:

Taxpayer or Company: * * *

State A: * * *

State B: * * *

State C: * * *

State D: * * *

State E: * * *

State F: * * *

State G: * * *

State H: * * *

State I: * * *

State J: * * *

Affiliates: * * *

M: * * *

N: * * *

O: * * *

P: * * *

Q: * * *

District Director: * * *

Dear * * *

This is in reply to your request for ruling dated November 21, 1985, as amended by submissions dated February 10, 1986, and letters dated April 16 and December 2, 1986, from your representatives, concerning the treatment of the deferred tax reserves and the accumulated deferred investment tax credits (ADITC's) attributable to assets that have been deregulated. You ask that we rule on the following questions:

1. Since certain public utility property must be removed from Affiliates' regulatory books of account as the result of deregulation legislation by States A through J, must the deferred tax reserves attributable to such property, accumulated pursuant to sections 167(l) and 168(e)(3) of the Internal Revenue Code , [FNa1] be removed from such regulatory books, or may these reserves be used, directly or indirectly, to reduce rate base or cost of service (or be treated as no-cost capital)?

2. Similarly, may the ADITC's attributable to such property, accumulated pursuant to section 46(f) of the Code, be used, directly or indirectly, to reduce cost of service or rate base?

Taxpayer was incorporated in * * * under the laws of State B and has its principal place of business at * * * Taxpayer's affiliated group is engaged in furnishing exchange telecommunications and exchange access service in several states. The common stock of Taxpayer is widely held and publicly traded.

Taxpayer is the common parent of a group of affiliated corporations which file a consolidated federal income tax return under section 1501 of the Code. The books of account of Taxpayer and Affiliates are maintained on a calendar year basis, and their income is reported for federal income tax purposes under the accrual method.

Affiliates have been active in providing local communications exchange service, exchange access service, and intraLATA toll service, and continue to be subject to rate regulation at the federal and state level.

With respect to certain services provided by Affiliates M through Q, technological advances and increases in competition have made cost-related rate

regulation inappropriate. Accordingly, as the result of either legislative or administrative action initiated in whole or in part by these Affiliates, cost-related methods of rate regulation of such services under the jurisdiction of a number of regulatory bodies will be terminated or are proposed to be terminated. The effect of these terminations on the deferred tax reserves and the ADITC's is the matter addressed in the above ruling request.

For example, in * * * legislation enabling deregulation of all services except two-way switch voice grade circuits (i.e., normal telephone dial-up service) was enacted in State E. Among the services deregulated or permitted to be deregulated are one-way video, cellular services, radio paging/mobile services, custom calling features, * * *, rotary lines, alarm services, two- point dedicated lines (no dialing necessary), high speed data transmission and special access services.

The proposals regarding deregulation vary in the number of affected services and the manner of implementation. In State D, for example, where legislation was enacted in * * * allowing deregulation if an administrative determination can be made that a particular service is competitive, * * * coin telephone service, and certain other special services have been deregulated, and consideration is now being given to deregulation of message telephone service. In States G and I, legislation permits deregulation to proceed on a service-by- service basis through administrative action.

The termination of a cost-related method of rate regulation for a particular service typically results in the removal of the cost of property used in providing the service from the regulatory rate base and of book depreciation with respect to such property from the calculation or determination of cost of service used in computing the permitted rates for regulated services. In situations where property is used jointly for regulated and deregulated services, a portion of the property is removed from the regulated rate base as well as the cost of service calculation.

In connection with the deregulation of a service, property related to the service which is removed from regulation may in some instances be transferred to a newly-created member of Taxpayer's group which will, in turn, carry on the newly-deregulated activity.

In the regulatory period immediately preceding the removal from the regulatory books of the portion of an Affiliate's property used in a newly- deregulated service, such property will still be included in the computation of rate base or cost of service and classified as public utility property. The deferred tax reserves relating to such property will be subject to the normalization requirements of sections 167(l) and 168(e)(3) of the Code. Similarly, the ADITC's relating to such property will be subject to the limitations imposed by section 46(f).

After the deregulated property is removed from the Affiliate's regulatory books, the deferred tax reserves for depreciation and the ADITC's attributable to such property will not continue to be subject to such regulation.

Sections 46(f)(1) and (2) provide limitations on the treatment of the investment credit for ratemaking purposes and for purposes of the taxpayers regulated books of account. Under the provisions of 46(f)(1) the credit, in certain instances, may be used to reduce rate base provided that it is restored to the rate base not less

rapidly than ratably. If an election is made under section 46(f)(2), the credit may be flowed-through to income but not more rapidly than ratably.

Section 46(f)(6) of the Code provides, in part, that for purposes of determining ratable flow through under section 46(f), the regulatory life used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulatory books of account shall be used.

Section 168(e)(3) of the Code expands the limitations of section 167(1) and provides a special rule for public utilities wishing to utilize the benefits of the Accelerated Cost Recovery System (ACRS) with respect to public utility property. Basically, it requires normalization by stating --

(A) IN GENERAL. --

The term 'recovery property' does not include public utility property (within the meaning of section 167(l)(3)(A)) if the taxpayer does not use a normalization method of accounting.

(B) USE OF NORMALIZATION METHOD DEFINED. --

For purposes of subparagraph (A), in order to use a normalization method of accounting with respect to any public utility property --

(i) 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 not shorter than, the method and period used to compute its depreciation expense for such purposes; and

(ii) if the amount allowable as a deduction under this section with respect to such property differs from the amount that would be allowable as a deduction under section 167 (determined without regard to section 167(l)) using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under subparagraph (B)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such differences.

(C) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS, ETC. --

(i) IN GENERAL. -- One way in which the requirements of subparagraph (B) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (B).

(ii) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS. --

The procedure and adjustments which are to be treated as inconsistent for purposes of clause (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 under subparagraph (B)(ii)

unless such estimate or projection is also used, for ratemaking purposes, with respect to the other two such items and with respect to the rate base.

Section 167(l)(3)(A) of the Code provides, in part, that the term 'public utility property' means property used predominantly in the trade or business of the furnishing of telephone services, or other communication services if the rates for such furnishing 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.

Section 167(l)(3)(G) of the Code provides, with minor exceptions, the same definition for the normalization method of accounting as found in section 168(e)(3)(B) above.

Section 1.167(l)-1(a)(l) of the Income Tax Regulations in describing the scope of section 167(l) of the Code states, in part, the following:

The normalization requirements of section 167(l) with respect to public utility property defined in section (l)(3)(A) pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation under section 167 and the use of the straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account.

Under normalization accounting for ratemaking purposes the utility does not fully take into account the actual federal tax benefits in the year in which the utility receives the benefits. This is accomplished by allowing the utility to reduce its payable taxes at a rate different from that allowable for ratemaking purposes. Thus, the utility claims accelerated depreciation on its federal income tax return; however, on its regulated books of account the depreciation is claimed on a straight-line method of depreciation over the useful life used for regulatory purposes. Similarly, for federal income tax purposes the utility claims the full amount of the investment credit in the year the property is placed in service; however, the investment credit is flowed through to the ratepayers ratably over the regulatory life of the asset.

The Service does not determine such purely regulatory questions as whether the proposals of a commission will produce just and equitable rates, nor does it discuss the relative merits of 'stand-alone' or other methods of regulatory accounting. The Service in this ruling request will determine only whether the deferred tax reserves and the ADITC's with respect to the deregulated property should be removed from the regulatory books of account for purposes of the normalization rules when the respective property becomes deregulated.

The normalization requirements of section 168(e)(3) of the Code are similar to the normalization requirements in section 167(l) and interrelate with section 46(f). If a proposed method of accounting does not meet the normalization requirements of section 167(l) it will not meet the requirements of section 168(e)(3).

The normalization rules would be violated if the deferred tax reserves and the ADITC's were left on the utility's regulatory books of account and flowed through

to the ratepayers after the property to which they relate becomes deregulated. The normalization rules contemplate that the ADITC's will be flowed through ratably over the regulatory life of the assets to which they relate, and the deferred tax incrementally over the regulatory life of the assets. Once property is deregulated it ceases to be public utility property as defined in section 167(l)(3)(A) of the Code. Said property is no longer depreciable for regulatory purposes and the tax reserves should be removed from the regulatory books of account. If the deferred tax reserves relating to property that was no longer regulated were to remain on the regulated books of account it would result in a procedure that is considered inconsistent under section 168(e)(3)(C) and therefore would not meet the normalization requirements of sections 167(l) and 168(e)(3)(B). Similarly, if the ADITC's relating to property that was deregulated were to remain on the regulatory books of account it would result in a violation of the requirements of section 46(f). If tax credits were accounted for under the provisions of section 46(f)(1) the rate base would be reduced by an amount larger than credits related to the assets included in rate base and upon which the depreciation expense was based. If the credits were accounted for under the provisions of section 46(f)(2), the amount used to reduce cost of service would include amounts attributable to assets that were no longer included in the rate base, therefore, the credits would be flowed-through to income more rapidly than ratably.

Therefore, based on the above represented facts and our legal analysis, we rule that:

1. Where, as the result of deregulation legislation in States A through J, public utility property is removed from Affiliates' regulatory books of account, the deferred tax reserve attributable to such property must also be removed from the regulatory books, and no final regulatory order may be used, directly or indirectly, to reduce Affiliates' rate base or cost of service (or treat it as no cost capital.).

2. Where, as the result of deregulation legislation in States A through J, public utility property is removed from Affiliates' regulatory books of account, the balance of the ADITC's accumulated under the provisions of section 46(f) of the Code attributable to such property must also be removed from the regulatory books, and no final regulatory authority order may be used, directly or indirectly, to reduce the Affiliates' cost of service or rate base.

No attempt is made in this ruling to address any situations other than those involving the requirements of a regulatory authority in connection with the removal of property with or without the removal of services from cost-related rate regulation.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by adoption of temporary or final regulations, to the extent the regulations are inconsistent with any conclusions in the ruling. See section 16.04 of Rev. Proc. 87-1 I.R.B. 7, 17. However, when the criteria in section 16.05 of Rev. Proc. 87-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

A copy of this ruling letter should be filed with the income tax return for the taxable year or years in which the transaction covered by this ruling is

consummated.

Pursuant to the power of attorney on file with this request a copy of this ruling is being sent to your designated representative.

Sincerely yours,

Anthony Manzanares

Acting Director

Corporation Tax Division

FNa1. Although all Code references are to the Internal Revenue Code of 1954, the principles of this ruling are also generally applicable to the normalization rules under the depreciation provisions added by the Tax Reform act of 1986.

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

PLR 8730013, 1987 WL 421152 (IRS PLR)

END OF DOCUMENT

FIGURE RWH-R15
PLR 9852030

PLR 9852030
1998 WL 894991 (IRS PLR)

C

Internal Revenue Service (I.R.S.)

Private Letter Ruling

Issue: December 25, 1998
September 29, 1998

Section 167--Depreciation

167.00-00 Depreciation

167.22-00 Public Utility Property

167.22-01 Normalization Rules

CC:DOM:P&SI:6 / PLR-117173-97

Legend:

Taxpayer =

Parent =

District =

Commission A =

Commission B =

Plant =

State X =

Intervenor =

Decision A =

Decision B =

Law =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

Dear ***

This responds to your request of September 12, 1997, and additional material, filed on behalf of the Taxpayer. Taxpayer requests four rulings as to whether certain actions of Commission A and State X related to utility restructuring are in compliance with the normalization requirements of sections 46(f)(2), 46(f)(10), and 168(i)(9)(B) of the Internal Revenue Code.

FACTS

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. The Parent files a consolidated return with its affiliated companies on a calendar year basis using the accrual method of accounting. The District Director's office in District has examination jurisdiction over the Parent's tax returns.

Taxpayer owns an a percent interest in Plant A. Taxpayer is subject to the rate making jurisdiction of the Commissions. The jurisdictional factor used by Commission A in setting rates is b.

On c, Taxpayer filed its d test year rate application which included cost of service rate recovery for operating and maintenance expenses, capital expenditures and administrative expenses associated with Plant A.

On e, Commission A issued Decision A which established rates for other Plant owners in a general rate case. Included in this Decision was approval of an agreement between the Taxpayer, the Intervenor and other owners of Plant A that would enable the Taxpayer to recover its remaining net book investment in Plant A by f. Pursuant to this decision, deferred investment tax credits would be returned to customers over the new remaining 8-year period if such action complies with the normalization requirements of section 46(f)(2).

On g, Commission A issued Decision B, which reaffirmed the 8-year recovery period and established a rate cap. Thus, under the approved pricing mechanism and rate cap, if the revenue requirement associated with the 8-year sunk cost amortization of Plant A exceeded previously approved ratemaking amounts, recovery of such excess would be deferred to the following year. To the extent that depreciation is excluded from cost of service due to this deferral, the investment tax credit attributable to the excluded portion of the property would also be deferred.

On h, State X adopted the Law which provided that sunk costs relating to generation-related assets shall be subject to recovery from all customers on a nonbypassable basis. The Law froze rates effective k, and provided that the recovery of these costs shall not extend beyond i. A special provision in the Law allowed recovery of incremental costs for Plant A through f. Because of the Law, the 8-year recovery period of Decision B was further accelerated commencing j, so that amortization of the sunk costs, including investment tax credits, will be complete by i.

REQUESTED RULINGS

Taxpayer has requested four rulings. First, Taxpayer has requested a ruling that the ratable amortization of its remaining investment tax credits for Plant A over a new 9-year (subsequently shortened to 5-years) regulatory period instead of over the previous period of 16 years, complies with the normalization provisions of section 46(f) of the Code. Second, Taxpayer requests a ruling that a one-time catch-up adjustment that includes the incremental difference in amortization from the effective dates of the Decisions to the date of this ruling complies with section 46(f). Third, Taxpayer requests a ruling that if at the end of the revised regulatory lives of the Plants, all of the sunk cost and the associated investment tax credit has not been reflected in rates due to the rate cap, the remaining credit may accrue to the benefit of its shareholders without violating the normalization rules. Fourth, Taxpayer requests a ruling that if the rate cap allows a depreciation recovery more rapid than anticipated, the investment tax credit may be flowed through to rates based on the new anticipated depreciable period without violating the normalization rules (if depreciation is deferred due to the rate cap, then the investment tax credit will also be deferred).

LAW AND ANALYSIS

Prior to the enactment of the Tax Reform Act of 1986 (Act), section 38 of the Code provided an investment tax credit for investments in certain depreciable

property. Sections 46(f)(1) and 46(f)(2) imposed limitations on the use of investment tax credits by regulated public utility companies. Section 46(f)(1) applied generally except as to taxpayers that elect the application of section 46(f)(2).

Section 46(f)(2) of the Code provided that no investment tax credit 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 credit, 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 credit.

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. Section 1.46-6(g) of the regulations provides that the investment tax credit amortization period must be no shorter than the one used to calculate ratemaking depreciation expense.

Furthermore, 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. In addition, if there is a revision for purposes of computing regulated depreciation expense beginning with a particular accounting period, the computation of ratable portion of investment tax credit must also be revised beginning with such period.

Section 46(f)(2) of the Code states that a taxpayer satisfies the normalization requirements if the cost of service is reduced by no more than the ratable portion of the investment tax credit. Ratable is determined under section 1.46-6(g)(2) of the regulations by reference to the period of time actually used in computing a taxpayer's regulated depreciation expense for the property for which the credit is allowed. Accordingly, as long as the investment tax credit is amortized no more rapidly than over the period actually used for regulated depreciation purposes, the ratemaking treatment of the credit will comply with the normalization requirements. In the facts set forth above, the Taxpayer's investment tax credit amount will always be ratable by reference to the related asset's regulated depreciation period. This will be true whether the depreciable basis is recovered over the anticipated 8-year or 5-year periods, or whether the depreciable basis recovery is deferred or accelerated due to the rate cap. So long as the amortization of the investment tax credit is deferred or accelerated ratably on the same basis as the recovery of the depreciable basis, there will be no violation of the normalization rules.

Taxpayer has requested a one-time catch-up adjustment that includes the incremental difference in amortization from the effective dates of the Decisions to the date of this ruling. Under the method described above, the period of time over which the investment tax credit is amortized is linked to the rate recovery period actually used in computing the Taxpayer's regulated depreciation expense. As in the previous analysis, there will be no violation of the normalization rules so long as at no time does the cumulative amount of the investment tax credit reduce cost of service more rapidly than ratably.

If there is unamortized investment tax credit at the end of the rate freeze period, the Taxpayer proposes to retain the remaining investment tax credit for the benefit of its shareholders. This action will not constitute a reduction in the Taxpayer's cost of service for ratemaking purposes or on its regulated books of account within the meaning of section 46(f)(2)(A) of the Code, nor a reduction of the base to which the rate of return for ratemaking purposes is applied under section 46(f)(2)(B). Thus, there is no normalization violation for the Taxpayer's retention of the remaining investment tax credit under the facts presented.

CONCLUSIONS

1. The ratable amortization of the Taxpayer's remaining investment tax credits

for Plants A over a new 8-year (or 5-year as subsequently shortened) regulatory period instead of over the previous period of 16 years, complies with the normalization provisions of section 46(f) of the Code.

2. A one-time catch-up adjustment that includes the incremental difference in amortization from the effective dates of the Decisions to the date of this ruling complies with section 46(f).

3. If at the end of the revised regulatory lives of the Plants, all of the sunk cost and the associated investment tax credit has not been reflected in rates due to the rate cap, the remaining credit may accrue to the benefit of its shareholders without violating the normalization rules.

4. If the rate cap allows a depreciation recovery more rapid than anticipated, the investment tax credit may be flowed through to rates based on the new anticipated depreciable period without violating the normalization rules. If depreciation is deferred due to the rate cap, then the investment tax credit must also be deferred.

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 in this office, a copy of this letter is being sent to your authorized legal representatives. In addition, a copy of this letter is being sent to the District Director of the District.

Sincerely yours,

CHARLES B. RAMSEY

Chief, Branch 6

Office of the Assistant Chief Counsel

(Passthroughs and Special Industries)

PLR 9852030, 1998 WL 894991 (IRS PLR)

END OF DOCUMENT

FIGURE RWH-R16
PLR 9852028

Westlaw.

C

Internal Revenue Service (I.R.S.)

Private Letter Ruling

Issue: December 25, 1998
September 29, 1998

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

46.06-03 Special Rule for Immediate Flow-Through

Section 167--Depreciation

167.00-00 Depreciation

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

168.09-00 Public Utility Property

168.09-01 Normalization Rules

CC:DOM:P&SI:6 / PLR-117178-97

Legend:

Taxpayer =

Parent =

District =

Commission A =

Commission B =

Plant A =

Plant B =

State X =

Intervenor =

Decision A =

Decision B =

Decision C =

Law =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

m =

n =

Dear ***

This responds to your request of September 12, 1997, and additional material, filed on behalf of the Taxpayer. Taxpayer requests four rulings as to whether certain actions of Commission A and State X related to utility restructuring are in compliance with the normalization requirements of sections 46(f)(2), 46(f)(10), and 168(i)(9)(B) of the Internal Revenue Code.

FACTS

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. The Parent files a consolidated return with its affiliated companies on a calendar year basis using the accrual method of accounting. The District Director's office in District has examination jurisdiction over the Parent's tax returns.

Taxpayer owns an a percent interest in Plant A and a 1 percent interest in Plant B. Taxpayer is subject to the rate making jurisdiction of the Commissions. The jurisdictional factor used by Commission A in setting rates is b.

On c, Taxpayer filed its d test year rate application which included cost of service rate recovery for operating and maintenance expenses, capital expenditures and administrative expenses associated with Plant A.

On e, Commission A issued Decision A which established rates for the Taxpayer's general rate case. Included in this Decision was approval of an agreement between the Taxpayer, the Intervenor and other owners of Plant A that would enable the Taxpayer to recover its remaining net book investment in Plant A by f. Pursuant to this decision, deferred investment tax credits would be returned to customers over the new remaining 8-year period if such action complies with the normalization requirements of section 46(f)(2).

On g, Commission A issued Decision B, which reaffirmed the 8-year recovery period and established a rate cap. Thus, under the approved pricing mechanism and rate cap, if the revenue requirement associated with the 8-year sunk cost amortization of Plant A exceeded previously approved ratemaking amounts, recovery of such excess would be deferred to the following year. To the extent that depreciation is excluded from cost of service due to this deferral, the investment tax credit attributable to the excluded portion of the property would also be deferred.

On h, State X adopted the Law which provided that sunk costs relating to generation-related assets shall be subject to recovery from all customers on a nonbypassable basis. The Law froze rates effective k, and provided that the recovery of these costs shall not extend beyond i. A special provision in the Law allowed recovery of incremental costs for Plant A through f. Because of the Law, the 8-year recovery period of Decision B was further accelerated commencing j, so

that amortization of the sunk costs, including investment tax credits, will be complete by i.

On m, the Commission adopted Decision C which adopted the final terms for the Taxpayer's ratemaking treatment for Plant B. The ratemaking treatment is similar to that adopted in Decision B with respect to Plant A, except that the recovery of investment will begin on n and end on i.

REQUESTED RULINGS

Taxpayer has requested four rulings. First, Taxpayer has requested a ruling that the ratable amortization of its remaining investment tax credits for Plants A and B over a new 5-year regulatory period instead of over the previous periods of 16 and 28 years, respectively, complies with the normalization provisions of section 46(f) of the Code. Second, Taxpayer requests a ruling that a one-time catch-up adjustment that includes the incremental difference in amortization from the effective dates of the Decisions to the date of this ruling complies with section 46(f). Third, Taxpayer requests a ruling that if at the end of the revised regulatory lives of the Plants, all of the sunk cost and the associated investment tax credit has not been reflected in rates due to the rate cap, the remaining credit may accrue to the benefit of its shareholders without violating the normalization rules. Fourth, Taxpayer requests a ruling that if the rate cap allows a depreciation recovery more rapid than anticipated, the investment tax credit may be flowed through to rates based on the new anticipated depreciable period without violating the normalization rules (if depreciation is deferred due to the rate cap, then the investment tax credit will also be deferred).

LAW AND ANALYSIS

Prior to the enactment of the Tax Reform Act of 1986 (Act), section 38 of the Code provided an investment tax credit for investments in certain depreciable property. Sections 46(f)(1) and 46(f)(2) imposed limitations on the use of investment tax credits by regulated public utility companies. Section 46(f)(1) applied generally except as to taxpayers that elect the application of section 46(f)(2).

Section 46(f)(2) of the Code provided that no investment tax credit 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 credit, 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 credit.

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.