

LEGAL ANALYSIS OR NON-ANALYSIS?

Additional Comments of Utility Reform Project the OPUC "White Paper" entitled Treatment of Income Taxes in Utility Ratemaking and Memorandum to Commissioners from Attorney General (February 18, 2005)

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Previous comments on the "White Paper" were due prior to the publication of the Attorney General's February 18, 2005, memorandum to the Commissioners. That memorandum is styled a legal analysis, but a bit of investigation shows that it does not reflect with any accuracy the current state of relevant law.

I. **ELIMINATING FROM RATES THE "COST" OF INCOME TAXES THAT THE UTILITY DOES NOT ACTUALLY PAY TO GOVERNMENT HAS BEEN CONSISTENTLY UPHELD BY ALL LEVELS OF COURTS.**

It is curious that neither the "White Paper" nor the AG Memorandum cite even a single court decision overturning a regulator's decision not to include in rates the phony "cost" of income taxes that the utility does not actually pay. The entire premise of the AG Memorandum is that doing so would be fraught with legal peril, yet not a single case involving such an adjustment for "tax expense" is cited.

Neither document even mentions the leading relevant legal authorities, which consistently uphold such regulatory adjustments (and which prominently stand out in even a cursory Westlaw search). In ***Federal Power Commission v. United Gas Pipe Line Company et al.***, 386 U.S. 237, 87 S.Ct. 1003, 18 L.Ed.2d 18 (1967), the United States Supreme Court ruled:

In our view what the Commission did here did not exceed the powers granted to it by Congress. One of its statutory duties is to determine just and reasonable rates which will be sufficient to permit the company to recover its costs of service and a reasonable return on its investment. Cost of service is therefore a major focus of inquiry. Normally included as a cost of service is a proper allowance for taxes, including federal income taxes. The determination of this allowance, as a general proposition, is obviously within the jurisdiction of the Commission. Ratemaking is, of course subject to the rule that the income and expense of unregulated and regulated activities should be segregated. But there is no suggestion in these cases that in arriving at the net taxable income of United the Commission violated this rule. Nor did it in our view in determining the tax allowance. United had not filed its own separate tax return. Instead it had joined with others in the filing of a consolidated return which resulted in the affiliated group's paying a

lower total tax than would have been due had the affiliates filed on a separate-return basis. The question for the Commission was what portion of the single consolidated tax liability belonged to United. Other members of the group should not be required to pay any part of United's tax, but neither should United pay the tax of others. A proper allocation had to be made by the Commission. Respondents insist that in making the allocation the Commission would violate the statute unless in every conceivable circumstance, including this one, United is allowed an amount for taxes equal to what it would have paid had it filed a separate return. In their view United should never share in the tax savings inherent in a consolidated return, even if on a consolidated basis system losses exceed system gains and neither the affiliated group nor any member in it has any tax liability. This is an untenable position and we reject it. **Rates fixed on this basis would give the pipeline company and its stockholders not only the fair return to which they are entitled but also the full amount of an expense never in fact incurred. In such circumstances, the Commission could properly disallow the hypothetical tax expense and hold that rates based on such an unreal cost of service would not be just and reasonable.**

It is true that the avoidance of tax and the reduction of the tax allowance are accomplished only by applying losses of unregulated companies to the income of the regulated entity. But the Commission is not responsible for the use of consolidated returns. It is the tax law which permits an election by an appropriate group to file on a consolidated basis. The members of a group, as in these cases, themselves chose not to file separate returns and hence, for tax purposes, to mingle profits and losses of both regulated and unregulated concerns, apparently deeming it more desirable to attempt to turn the losses of some companies into immediate cash through tax savings rather than to count on the loss companies themselves having future profits against which prior losses could be applied. **Such a private decision made by the affiliates, including the regulated member, has the practical and intended consequence of reducing the group's federal income taxes, perhaps to zero, as was true of one of the years involved in the *Cities Service* case. But when the out-of-pocket tax cost of the regulated affiliate is reduced, there is an immediate confrontation with the ratemaking principle that limits cost of service to expenses actually incurred. Nothing in *Colorado Interstate* or *Panhandle* forbids the Commission to recognize the actual tax saving impact of a private election to file consolidated returns. On the contrary, both cases support the power and the duty of the Commission to limit cost of service to real expenses.**

386 U.S. at 243-44. Thus, the highest court in the nation has upheld a regulator's decision to "limit cost of service to real expenses" by recognizing the fact that the utility was not actually paying income taxes. Note that there is utterly no mention of any "benefits and burdens" test.

This proposition is so unexceptional that it appears in a bland legal encyclopedia, CORPUS JURIS SECUNDUM in its Public Utilities topic (updated October 2004):

Public Utilities

IV. Rates and Rate Making

C. Reasonableness of Rates; Fair Return

2. Sufficiency of Rate of Return

b. Operating Expenses

(2). Taxes Paid by Utility

Rate-making authorities may consider the income tax consequences of a subsidiary corporation's dealings with its parent company. [FN1] Thus, where a utility and its parent corporation file a consolidated return for federal income tax purposes, the portion of the tax to be allowed in fixing rates for the subsidiary utility company is for the rate making authorities to determine. [FN2]

A public utility regulatory commission's discretion on the proper method for calculating a utility's tax savings, by virtue of the utility's participation in a consolidated tax return by its parent corporation, is limited. [FN3] Not only must all tax savings resulting from consolidation be recognized in ratemaking, but the only proper tax expense which a utility may pass on to its customers is its proportionate share, after the consolidated return is filed and the actual tax is paid. [FN4] It is not an abuse of the regulatory commission's discretion in the allocation of a federal income tax expense to a utility company on the basis of an average rate taken from a consolidated tax return of the utility company's parent company. [FN5]

[FN1]. N.Y.--Long Island Water Corp. v. Public Service Commission, 49 A.D.2d 392, 374 N.Y.S.2d 841 (3d Dep't 1975).

[FN2]. Pa.--Western Pennsylvania Water Co. v. Pennsylvania Public Utility Commission, 54 Pa. Commw. 187, 422 A.2d 906 (1980).

[FN3]. Pa.--Barasch v. Pennsylvania Public Utility Com'n, 120 Pa. Commw. 292, 548 A.2d 1310 (1988).

[FN4]. Pa.--Barasch v. Pennsylvania Public Utility Com'n, 120 Pa. Commw. 292, 548 A.2d 1310 (1988).

[FN5]. Ohio--Ohio Utilities Co. v. Public Utilities Commission, 58 Ohio St. 2d 153, 12 Ohio Op. 3d 167, 389 N.E.2d 483 (1979).

Again, no mention of any "benefits and burdens" test.

Other relevant cases not mentioned in the "White Paper" or in the AG Memorandum are legion. Not only do those cases approve regulatory decisions not allowing utilities to charge phony income taxes to ratepayers, they approve further **reducing** rates in the circumstance where it is the utility that is the money-losing subsidiary (because the utility should be compensated by the other subsidiaries for the valuable tax deductions the utility is providing to them). **Central Power & Light Co. v. Public Utility Commission of Texas**, 36 S.W.3d 547 (Tex. App. 2001). This is the opposite of the "benefits and burdens" scenario outlined in the AG Memorandum.

Further, these cases are not from the early 1980s, as the AG Memorandum (p. 6, n.9) asserts about all relevant cases except for Virginia.

In **Greeley Gas Co. v. State Corp. Com'n of State of Kansas**, 15 Kan.App.2d 285, 807 P.2d 167, (Kan.App. 1991), the court upheld a complete disallowance of alleged income tax expense, when actual taxes paid were not proven.

Even under the reasoning of **Suburban**, it was Greeley's burden to establish the income taxes actually paid by its shareholders on its behalf.

In the present case, had the KCC recognized the reasoning of **Suburban** and allowed the estimated income tax expense in Greeley's cost of service, it would have, in our opinion, been allowing an expense unsupported by substantial competent evidence.

Based on Greeley's lack of competent evidence to support its position, the KCC's disallowance of the income tax expense is affirmed.

807 P.2d at 170.

The Indiana Utility Regulatory Commission regularly refuses to allow utilities to charge phony income taxes to ratepayers. See, e.g., *Indiana Cities Water Corp*, Cause 38851, 1991 WL 503056 (Ind. URC). One reason is that the Indiana courts have reversed earlier agency decisions that did allow the charging of these phony taxes. In ***City of Muncie v. Indiana PSC***, 177 Ind.App. 155, 378 N.E.2d 896 (1978), the court stated:

The evidence in the case before us is uncontroverted: Petitioner did not file a separate federal income tax return and did not compute its taxes at a rate of 48%. Therefore, it was error for the Commission to arbitrarily allow petitioner's tax expense to be computed on that basis.

* * *

Just as the Commission in *Indiana Bell* could not arbitrarily disallow taxes actually paid under a capital structure which did not exist, in this case the Commission cannot arbitrarily allow a tax expense computed *159 on the basis of a separate tax return when such a return was not actually filed. This does not mean that the expenses and revenues of affiliated companies must be attributed to Petitioner for rate-making purposes. Rather, it means that some determination must be made as to the tax savings accruing To Petitioner as a result of its participation in the filing of a consolidated federal income tax return. In this manner, a more accurate computation of Petitioner's actual federal income tax liability can be made. * * *

We feel that by automatically assuming a tax rate of 48%, without any determination of the effective tax rate, and without any determination of the properly allowable income tax expense, the Commission is allowing an additional, hidden return on capital to the shareholders at the expense of the rate-payer. Furthermore, our research indicates that at least thirteen other jurisdictions have reached the same conclusion on this issue.[FN1]

FN1. *Long Island Water Corp. v. Public Service Commission* (1975), 49 A.D.2d 392, 374 N.Y.S.2d 841; *Pennsylvania Public Utility Commission v. South Pittsburgh Water Co.* (Penn. Public Utility Comm. 1970), 84 PUR.3d 487; *Re Jersey Central Power and Light Co.* (N.J. Board of Public Utility Commissioner 1973), 2 PUR.4th 70; *Re Salisbury Water Supply Co.* (Mass. Dept. of Public Utilities 1964), 54 PUR.3d 196; *Re Arkansas Louisiana Gas Co.* (Ark. Public Service Comm. 1974), 4 PUR.4th 265; *Re Central Vermont Public Service Corp.* (Vt. Public Ser. Bd. 1971), 89 PUR.3d 121; *Re City Water Co. of Chattanooga* (Tenn. Public Ser. Comm. 1970), 84 PUR.3d 264; *Re Davenport Water Co.* (Iowa State Commerce Comm. 1968), 76 PUR.3d 209; *Re Lexington Water Co.* (Ky. Public Ser. Comm. 1968), 72 PUR.3d 253; *Re Michigan Consolidated Gas Co.* (Mich. Public Ser. Comm. 1969), 79 PUR.3d 375; *Re Minneapolis Transit Co.* (Minn. Public Ser. Comm. 1969), 81 PUR.3d 232; *Re Potomac Edison Co. of W. Virginia* (W. Va. Public Serv. Comm. 1974), 6 PUR.4th 183; *Re Stamford Water Co.* (Conn. Public Utilities Comm. 1971), 89 PUR.3d 502.

378 N.E.2d at 898-99 (emphasis added).

In *Re New Jersey Natural Gas Company*, Docket Nos. GR89030335J -- Phase II, GR90080786J, 1991 WL 501940 (NJ BRC), the New Jersey Board of Regulatory Commissioners stated:

It has been the Board's long-time policy to adjust operating income to reflect savings resulting from the filing of a consolidated income tax return by

a utility's parent company. As early as 1952 the courts recognized that a utility attempting to establish its proper operating income level in a rate proceeding is "entitled to allowance for expense of actual taxes and not for higher taxes which it would have to pay if it filed on a separate basis." ***In re New Jersey Power & Light Co. v. P.U.C.***, 9 N.J. 498, 528, 95 PUR NS 467, 89 A.2d 26 (1952). In 1976, the Court affirmed a decision in which the Board indicated that such an adjustment was part of the Board's regular policy, which was made consistently for water and electric holding companies. ***New Jersey Bell Telephone Company v. New Jersey Dept. of Public Utilities***, 162 N.J. Super. 60 (Appl. Div. 1978).

This policy, which required that consolidated tax savings be passed along to consumers, has been both affirmed and mandated by the courts of this state. ***In re Lambertville***, 153 N.J. Super. 24, 378 A.2d 1158 (App.Div. 1977), reversed in part on other grounds, 79 N.J. 449, 401 A.2d 211 (1979). In ***Lambertville***, the Court stated that the utility was not entitled to the then statutory 48% rate merely because that was the amount paid to its parent as a result of inter-company policy or agreement. The Court stated:

If Lambertville is part of a conglomerate of regulated and unregulated companies which profits by consequential tax benefits from Lambertville's contributions, the utility consumers are entitled to have the computation of those benefits reflected in their utility rates.

It is only the real tax figure which should control rather than that which is purely hypothetical. See ***In re New Jersey Power and Light Co.***, 9 N.J. 498, 52 (1952). And the P.U.C. Commissioners therefore have the power and function to take into consideration the tax savings flowing from the filing of the consolidated tax return and determining what proportion of the consolidated tax is reasonable attributable to Lambertville. See ***FPC v. United Gas Pipe Line Co.***, 386 U.S. 237 (1967), 158 N.J. Super at 28.

How is it possible that the OPUC Staff and the AG both missed the situation in New Jersey? Neither lists New Jersey as among those states making a consolidated tax adjustment.

Only the lack of time prevents me from citing numerous other cases. So many cases. So little time.

II. THE ALLEGED THREAT OF LOSING ACCELERATED DEPRECIATION IS A COMPLETE MYTH.

In Application of Houston Lighting and Power Company for Authority to Change Rates, 1998 WL 395732 (Tex. PUC 1998), the Texas Commission applied a consolidated return adjustment, expressly rejecting the discredited notion that doing so would endanger accelerated depreciation treatment for the utility's assets, which leads to the next topic. The Texas PUC noted that the alleged threat of losing accelerated depreciation benefits was simply nonexistent **and had never happened**.

The evidence does not support HL&P's contention that the consolidated tax savings adjustment would violate the normalization provisions of the Internal Revenue Code. The relevant Code sections on the normalization of accelerated depreciation apply to deferred taxes, not to current taxes. Only current taxes are affected by the consolidated tax savings adjustment. Mr. Forcucci [utility witness] agreed that current and deferred taxes could be segregated. Tr. Vol. 46 at 7658-59.

* * *

Mr. Skirpan pointed out although other jurisdictions have imposed a consolidated tax adjustment, the IRS has not notified any utility that it has violated the normalization rules. Mr. Forcucci was not aware of any utility having lost its accelerated depreciation benefits because of a consolidated tax savings adjustment. Tr. Vol. 46 at 7659.

Application of Houston Lighting and Power Company for Authority to Change Rates, 1998 WL 395732 (Tex.P.U.C.). So the big threat of losing accelerated depreciation benefits, touted in the "White Paper" and in the AG Memorandum, is a complete myth.

Its mythical status was not a secret. The well-known industry publication, PUBLIC UTILITIES FORTNIGHTLY, Volume 128, Number 10 (November 15, 1991), presented a Special Report on the 1991 Utility Tax Conference, where utility lawyers lamented the fact that they were not going to get away with this threat. According to the author, James E. Norris:

Consolidated Tax Savings

Consolidated tax savings adjustments (CTAs) encompass a variety of ratemaking techniques for passing through to ratepayers tax savings realized when a utility files a consolidated income tax return. In the past, some ratemakers had been reluctant to employ CTAs for fear of violating the normalization requirements of the tax code while others declined to make such adjustments based on the segregation principle.

Now, "the normalization lever has been lost," according to Bradley M. Seltzer, a partner with the law firm of Sutherland, Asbill, Brennan and current chairman of the American Bar Association's Normalization Subcommittee of the Committee on Regulated Public Utilities, Section of Taxation.

Seltzer explained that the withdrawal of proposed IRS regulations on the applicability of normalization requirements to CTAs, together with a recent IRS memorandum on the subject, indicate that the IRS no longer views CTAs as violative of normalization requirements -- so long as the adjustments are not applied to the deferred tax reserve applicable to accelerated depreciation on public utility property. The industry has asked Congress for legislation to restrict CTAs, but Seltzer said he considers congressional action unlikely.

Is it possible that the OPUC Staff and AG has overlooked this?

The remainder of the AG Memorandum is not legal analysis but instead some economic policy analysis. Particularly troublesome is its assertion (p. 8) that failing to allow regulated monopoly utilities to charge phony income taxes to ratepayers would "place[] the utility and its affiliates at a competitive disadvantage in the marketplace"? What marketplace? The utility is a state-sanctioned and natural monopoly with no competitors. Also rather egregious is the AG Memorandum's claim that "PGE ratepayers did not assume any of the burdens of Enron's other business endeavors" or "take on any of the burdens [of Enron] that created the tax savings." In fact, PGE ratepayers are heavily burdened by Enron's other business endeavors, specifically its endeavor to manipulate west coast energy markets, which succeeded in raising wholesale power costs in California and the Northwest to astronomical levels and in engineering the largest electric rate increase in Oregon history--PGE's \$400 million rate increase, effective October 1, 2001.