[JOINT COMMITTEE PRINT]

DESCRIPTION OF S. 232

RELATING TO

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

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE

ON SEPTEMBER 23, 1982

PREPARED FOR THE USE OF THE

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INTRODUCTION

This pamphlet is prepared by the staff of the Joint Committee on Taxation for the Committee on Finance Subcommittee on Taxation and Debt Management hearing scheduled for September 23, 1982, on S. 232 (relating to the tax consequences of the ratemaking accounting treatment of accelerated depreciation and investment credit for public utility property).

The first part of the pamphlet is a summary of present law and the bill scheduled for the hearing: S. 232 (introduced by Senators Hayakawa and Cranston). The second part of this pamphlet is a more detailed description of present law and the bill.

I. SUMMARY

For property placed in service after 1980, public utilities generally are allowed the investment credit and accelerated cost recovery only if the benefits of the investment credit and accelerated cost recovery are normalized for ratemaking purposes. For property placed in service before 1981, similar rules apply to investment credits and accelerated depreciation, but certain companies are exempted from the normalization requirement. Normalization generally requires that tax benefits be taken into account for ratemaking purposes over the service life of the asset that generates the benefits.

Subject to certain exceptions for grandfathered companies, normalization rules for accelerated depreciation were imposed in 1969. Subject to the same general grandfather exceptions, normalization rules for the investment credit were imposed in 1971. Except as provided in certain transition rules, the normalization rules were made mandatory and more comprehensive for property placed in service after 1980.

S. 232—Senators Hayakawa and Cranston

Normalization Requirements for Public Utility Property and Special Transition Rule

The bill would restate and make more specific the normalization rules relating to the investment credit (sec. 46(f) and accelerated depreciation (sec. 167(l)). It is anticipated that the bill will be amended to make corresponding amendments to the normalization rules for accelerated cost recovery (sec. 168(e)(3)). The bill would also give the Treasury Department specific authority to provide regulations setting fourth conditions under which ratemaking projections and adjustments are inconsistent with the normalization rules. The amendments generally would apply to taxable years beginning after December 31, 1979.

The bill would also provide a special transition rule. Under the special rule a ratemaking projection or adjustment that violated the normalization requirements would not result in a public utility's loss of eligibility for the investment credit or accelerated depreciation if the projection or adjustment (1) applied for a period ending before March 1, 1980, (2) was included in an order entered by a public service or public utility commission before March 13, 1980, and (3) was used to determine the amount of rates which were ordered to be collected or refunds which were ordered to be made.

In 1980, the Committee considered H.R. 6806 (96th Congress), which contained the same provisions as S. 232, and favorably reported H.R. 6806 but that bill was not acted on by the Senate in the 96th Congress.

On September 20, 1982, the House passed H.R. 1524, which contains the same provisions as S. 232 with certain technical amendments.

II. PRESENT LAW AND DESCRIPTION OF BILLS

A. Present Law

In general

Generally, utility regulatory commissions allow a utility to charge customers so that the utility can collect enough revenues to cover its cost of service. The cost of service includes annual operating expenses and annual capital expenses. Operating expenses include expenses such as labor, fuel, State and local taxes, and Federal income taxes. Capital expenses include an annual depreciation charge for operating assets and a rate of return on the utility's rate base (the basis of its operating assets).

Accelerated depreciation methods, accelerated cost recovery, and investment credits were enacted to encourage higher rates of investment in new and replacement property. By reducing the initial cost of equipment or permitting a more rapid recovery of capital, these investment incentives increase the estimated after-tax rate of return from the asset.

For investments in public utility property, there are two general ways a utility regulatory commission can account for the benefits of accelerated depreciation, accelerated cost recovery, and investment credits in setting utility rates. One way, flow-through accounting, treats these benefits as a current reduction in Federal income tax expense. Thus, current operating expenses are reduced and the benefit is flowed through to the current utility customers. A second way, normalization accounting, treats these benefits as a reduction in capital expenses. As a reduction in capital expense, the benefits are still flowed through to customers. However, because the benefits are flowed through as reduced depreciation charges or returns on reduced rate base, they are flowed through to customers over the service life of the asset that generated the tax benefit. Thus, under normalization accounting, the benefit of reduced capital expenses for a specific capital investment is enjoyed by all the utility customers who pay the capital expenses of the investment.

Accelerated depreciation and accelerated cost recovery

When accelerated depreciation was provided under the 1954 Code, there were no special provisions relating to the ratemaking treatment of accelerated depreciation for regulated utilities. The stated congressional intent was to stimulate the economy by fostering capital formation. However, because Federal income tax expense represents an element of cost of service for ratemaking purposes, some regulatory agencies treated the reduction in current tax liability resulting from accelerated depreciation as a current reduction in cost of service and therefore flowed it through to customers currently as lower rates. This practice, which is known as "flow-through" ratemaking, meant that accelerated depreciation would provide no investment incentive.

In response to what Congress saw as an undesirable trend toward flow-through ratemaking, Code section 167 was amended as part of the Tax Reform Act of 1969. Under Code section 167(l), a utility which had not previously used accelerated depreciation for Federal tax purposes could thereafter use accelerated depreciation only (1) if the utility used a "normalization" method of accounting in its books of account and (2) if the regulatory agency used a normalization method of setting rates.[1]

Code section 167(l)(3)(G) provides that:

> "In order to use a normalization method of accounting with respect to any public utility property—
>
> "(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and
>
> "(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

The Treasury Regulations (§ 1.167(l)–1(h)) interpret this section defining normalization to require that: (1) a utility's tax expense for ratemaking purposes must be computed as though straight-time depreciation were being used for tax purposes; (2) the full amount of the deferred taxes (i.e., the difference between tax expense computed first using accelerated and then using straight-line depreciation) must be reflected in a reserve and thus be available for capital investment; and (3) the regulatory agency may not exclude from the rate base an amount greater than the amount of the reserve for the period used in determining the tax expense as part of cost of service. The Treasury Regulations (§ 1.167(a)–11(b)(6)) also interpret section 167(l) as requiring that, in addition to the benefits of accelerated methods of depreciation, some or all of the benefits of shortened useful lives under the ADR system must be normalized.

Thus, a normalization method of accounting results in the benefits of the tax deferrals from accelerated depreciation being reflected in the rates charged to customers as a reduction in capital expenses over the period of tax deferral.

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[1] In general, these rules apply to public utility property used in a public utility activity. Property is public utility property if, during any period, it is used predominantly in a public utility activity. Public utility activities to which the depreciation method limitations apply means the trade or business of furnishing or selling:

(1) Electrical energy, water, or sewage disposal services;

(2) Gas or steam through a local distribution system;

(3) Telephone services;

(4) Other communication services (whether or not telephone services) if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701); or

(5) Transportation of gas or steam by pipeline, if the rates, for the furnishing or sale, are established or approved by certain regulatory bodies.

By allowing utilities to use accelerated depreciation only if normalization were followed, Congress had two principal objectives: first, to assure that the deferred taxes derived from accelerated depreciation would be available to the utilities as investment capital until paid to the Treasury and, second, to avoid the additional loss of Federal tax revenues that it believed would result because flow-through ratemaking would reduce utility profits.

When Congress enacted the accelerated cost recovery system (ACRS) in the Economic Recovery Tax Act of 1981 (ERTA), it decided that the full benefits of ACRS should be normalized by all public utilities. Therefore, except as provided in a special transition rule for rate orders issued before enactment of ERTA, all public utilities are required to normalize the tax benefits of ACRS accelerated depreciation, shortened useful lives, salvage value rules, and placed-in-service averaging conventions.

Investment tax credit

When Congress restored the investment tax credit in 1971, it provided that the investment credit for public utility property generally would not be available if the credit was flowed through to utility customers at a rate faster than that permitted under one of two optional normalization rules. However, utilities permitted to use flow-through accounting for the benefits of accelerated depreciation under the grandfather rules of the Tax Reform Act of 1969 were also permitted to use flow-through accounting for the investment tax credit if they made an affirmative election. In the Revenue Act of 1975, Congress increased the amount of the credit for public utility property that could be used to offset tax liability and increased the amount of the credit for public utility property from 4 percent to 10 percent. For this additional credit, flow-through accounting was not permitted to the grandfathered utilities unless the utility made a new affirmative election.

When Congress revised the investment tax credit provisions in the Economic Recovery Tax Act of 1981, it generally repealed the flow-through exception for all property placed in service after 1980. Thus, except as provided in a transition rule for rate orders issued before enactment of ERTA, all public utilities must use one of two normalization methods to account for investment credits for public utility property placed in service after 1980.

The two optional normalization rules of section 46(f) are known as the rate base reduction rule and the ratable flow-through rule. Both of these normalization rules permit some of the benefit of the investment tax credit to be flowed-through to utility customers as a reduction in capital expense. Taxpayers generally are subject to the rate base reduction rule unless they made an election in 1972 to be subject to the ratable flow-through rule or, if eligible, made an election to use flow-through accounting. For a limited group of utilities, gas pipeline companies, a special election also was available in 1972 that prohibited any flow-through of the credit, either as a reduction in current operating expense or a reduction in capital expense over the service life of the qualifying property.

Under the rate base reduction rule, some of the benefits of the investment tax credit may be flowed through to utility customers as a reduction to capital expense by excluding the credit from the utility's rate base. In this way, the utility customers are not required to pay a rate of return to the utility on the part of the cost of equipment that was paid for, in effect by the investment tax credit. However, under this rule, no other adjustment may be made to the operating expenses or capital expenses included in the utility's cost of service. Thus, no adjustment is permitted to be made, by reason of the credit, to the utility's Federal income tax expense or depreciation allowance included in its cost of service. The utility, therefore, is allowed to retain the use of the credit as capital and is allowed to include in its cost of service a depreciation allowance for the part of the equipment cost paid for, in effect, by the investment credit.

Under the ratable flow-through rule, the benefits of the investment tax credit may be shared with utility customers by denying any depreciation allowance in the utility's cost of service for the part of the equipment cost that was paid for, in effect, by the investment credit. Under this rule, no additional adjustment may be made by reason of the credit to the utility's operating expenses or capital expenses included in its cost of service. The utility, therefore, is allowed to retain the use of the credit as capital and is allowed to include in its cost of service a rate of return on the part of equipment cost paid for, in effect, by the investment credit.

Projections, estimates, and adjustments

The application of the depreciation and investment tax credit normalization rules has generated considerable controversy and uncertainty, due in part to the nature of the ratemaking process. In setting utility rates, it is customary to use a "test period" as a surrogate for the period when utility rates will actually be collected. Based on the experience of the test period (investment levels, operating expenses, etc.) appropriate rates are established. In some jurisdictions, adjustments are made to the test period experience to reflect expected changes in the future relationships between investments, expenses, and revenues. An example of such an adjustment would be a change in the Federal income tax rate to take effect after the close of the test period.

The proper application of the normalization rules with respect to the use of adjustments, estimates, and projections has been especially controversial in California. Prior to 1969, the California Public Utilities Commission generally required utilities under its jurisdicton to flow through the tax benefits of accelerated depreciation to customers immediately. However, in accordance with Code provisions making the use of accelerated depreciation elective, Pacific Telephone and Telegraph Company and General Telephone Company of California, the telephone companies under the Commission's jurisdiction, did not elect to take accelerated depreciation for Federal tax purposes. In a 1968 decision, the Commission found that it was imprudent for the companies to use straight-line depreciation for Federal tax purposes, and the Commission set rates as if accelerated depreciation had been elected and flowed through the tax benefits of this imputed accelerated depreciation to the customers. This 1968 decision was modified by the Commission in 1970 to allow the companies to elect accelerated depreciation with normalization as prescribed by the Code. However, in 1971 the California Supreme Court annulled the 1970 decision on the grounds that (1) the 1968 decision did not have to be modified because of the intervening passage of the Tax Reform Act of 1969 rules requiring that public utilities (other than public utilities which had previously used accelerated depreciation and flowed it through to their customers) could elect accelerated depreciation only if the benefits of such depreciation were normalized and (2) other methods of normalization should have been considered.

After protracted litigation (including three more decisions of the California Supreme Court and two unsuccessful petitions for certiorari to the U.S. Supreme Court), the Commission entered an order which requires the telephone companies to use certain methods of accounting to measure the amount of the benefits from accelerated depreciation and the investment credit that are to be shared with the utility customers.

The Internal Revenue Service has issued private letter rulings that take the position that these methods do not comply with the normalization requirements. The IRS has asserted deficiencies for some of the taxable years in issue. As a result, these telephone companies are faced with a situation in which they may be deemed ineligible to claim accelerated depreciation and the investment tax credit even though the allowance of these benefits has already been reflected in reduced rates or refunds to utility customers. Another California utility (Southern California Gas Company) apparently has a similar problem relating to the manner in which the investment tax credit may be taken into account in establishing a utility's rate of return.

It is understood that the California Public Utility Commission has not required the use of these controversial accounting methods for any period after March 1, 1980.

B. Issues

The principal issues raised by the bill are (1) whether it is appropriate to provide a transitional rule that would exempt utilities from the normalization requirements of present law for accounting periods that ended prior to March 1, 1980, if the utilities used accounting methods which were prescribed by order of a State or local government public service or utility commission and (2) whether it is appropriate to make the normalization rules more specific in a manner generally based on current Treasury regulations.

One subsidiary issue raised by the bill is whether the complete forgiveness of tax in the transition rule is appropriate or whether some sort of "penalty" should be imposed. Another subsidiary issue is whether the cut-off date in the transitional rule is appropriate.

C. Description of S. 232

Explanation of Provisions

The bill contains two amendments to the normalization rules which do not materially change the substance of present law as that law is interpreted by Treasury regulations. It also contains a special rule applicable to periods prior to March 1, 1980, and designed to benefit Pacific Telephone and Telegraph Company (a subsidiary of A.T. & T.), General Telephone Company of California (a subsidiary of General Telephone & Electronics Corporation), and Southern California Gas Company.

Accelerated depreciation and accelerated cost recovery

The bill would add a new provision (Code sec. 167(l)(3)(H)) which clarifies the present definition of the normalization method of accounting (in Code sec. 167(i)(3)(G)) for accelerated depreciation in a manner which generally follows the interpretation of this provision now contained in Treasury regulations.

This added provision generally provides that normalization is not complied with if, for ratemaking purposes, a procedure or adjustment is employed which uses estimates or projections of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes unless these estimates and projections are also used in determining the other two such items and the rate base.

The Treasury would also be given authority to prescribe regulations which define other procedures and adjustments which are inconsistent with normalization. This specific authority to prescribe regulations is not intended to limit the Treasury's normal authority to interpret, by regulations or otherwise, these new Code provisions or existing Code provisions relating to normalization.

This provision is intended to make it clear that California's so-called "Average Annual Adjustment" method (and any other similar method) of making adjustments for ratemaking purposes does not comply with the normalization requirements of Code section 167(l)(3)(G).

The new Code provision to be added by the bill (Code sec. 167(l)(3)(H)) specifies only one manner in which the normalization rules may be violated. Thus, compliance with this provision is a necessary but not exclusive condition for eligibility for accelerated depreciation.

It is anticipated that the bill will be amended to make corresponding amendments to the normalization rules for accelerated cost recovery (sec. 168(e)(3)).

Investment tax credit

The bill would add a new provision (Code sec. 46(f)(10)) to the rules relating to normalization of the investment tax credit. The new provision generally provides that the normalization rules are not complied with if a procedure or adjustment is employed which uses an estimate or projection of the taxpayer's qualified investment for purposes of the investment tax credit 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.

The Treasury Department would also be given authority to prescribe regulations which define other procedures and adjustments which are inconsistent with the requirements of the rate base method or the ratable flow-through method. This specific authority to prescribe regulations is not intended to limit the Treasury's normal authority to interpret, by regulations or otherwise, these new Code provisions or existing Code provisions relating to normalization.

This provision is intended to make it clear that California's so-called "Annual Adjustment" method (and any other similar method) of making adjustments for ratemaking purposes does not comply with the requirements of Code section 46(f).

The new Code provision to be added by the bill (new Code sec. 46(f)(10)) specifies only one manner in which the normalization rules may be violated. Thus, compliance with this provision is a necessary but not exclusive condition for eligibility for the investment tax credit.

Special rule for periods prior to March 1, 1980

The bill would provide that violations of the normalization requirements of present law (and of the bill) will not result in a public utility's loss of eligibility for the investment tax credit or accelerated depreciation if (a) such violations involved the use of estimates, projections or adjustments to the taxpayer's rate of return and (b) such estimates, projections, or adjustments only applied for any period ending prior to March 1, 1980, and were included in a qualified order. For purposes of this special rule, a qualified order is an order of a public utility commission—(1) which was entered before March 13, 1980, (2) which used the estimates, projections, or rate of return adjustments to determine the amount of the rates to be collected by the taxpayers or the amount of a refund with respect to rates previously collected, and (3) which ordered such rates to be collected or refunds to be made (whether or not such order actually was implemented or enforced). Since the special rule would apply to rates which were determined for periods prior to March 1, 1980, an order may be a qualified order even if it requires that refunds be paid after March 1, 1980, so long as such refunds are attributable to adjustments to rates charged prior to that date.

As indicated above, this transitional rule is designed to benefit Pacific Telephone and Telegraph Company, General Telephone Company of California, and Southern California Gas Company.

Effective Date

The provisions of the bill (other than the special rule) generally would apply to taxable years beginning after December 31, 1979. However, these provisions can be overridden by the special rule for periods prior to March 1, 1980.

The bill explicitly provides that, in applying the normalization rules (Code secs. 46(f) and 167(1)(3)) to taxable years beginning before January 1, 1980, no inference shall be drawn from the amendments to these rules (new Code secs. 46(f)(10) and 167(1)(3)(H)) or from the special rule. However, this no inference rule is not intended to limit the relief provided by the special rule.

Revenue Effect

The permanent changes made by the bill would have no revenue effect assuming that rate orders in effect for periods ending after March 1, 1980, are in compliance with the normalization rules as to be revised by the bill.

If the orders of the California Public Utilities Commission applicable prior to March 1, 1980, to the three utilities which would be benefitted by the special rule do *not* comply with the current normalization rules in the Code, the special rule in the bill would result in a revenue loss of approximately $2,200 million attributable to accounting periods prior to March 1, 1980. Approximately $117 million of this amount has been paid into the Treasury and may be the subject of claim for a refund. If the transitional rule is enacted, such amount would probably be repaid during fiscal year 1983. The remainder of the $2,200 million revenue loss generally would occur in the fiscal year or years in which determinations of tax liability for the affected companies would otherwise become final. Such losses would probably occur in fiscal years after 1987 because of the timing of the audit process and delays of presumed litigation.

If these orders do comply with the current normalization rules, the special rule in the bill would result in no revenue loss.

Prior Congressional Action

The provisions of S. 232 were considered by the committee in H.R. 6806 (96th Congress), which was reported favorably in 1980, but that bill was not acted on by the Senate in the 96th Congress.

On September 20, 1982, the House passed H.R. 1524, which contains the same provisions as S. 232 with certain technical amendments.

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