

ORIGINAL

Decision No. 26132

BEFORE THE RAILROAD COMMISSION OF THE STATE OF CALIFORNIA.

In the matter of the investigation on the Commission's own motion into certain accounting practices of the LOS ANGELES GAS AND ELECTRIC CORPORATION and into the propriety of certain entries shown in the 1930 annual report of said Company on file with this Commission.

Case No. 3445.

Herman Phleger and Paul Overton, for the Los Angeles Gas and Electric Corporation.

Erwin P. Werner and Frederick von Schrader, for the City Attorney's Office, City of Los Angeles.

F. F. Ball, for the Board of Public Utilities and Transportation of the City of Los Angeles.

Harold P. Hulse, City Attorney of the City of Pasadena, by Oscar L. Horn, for the City of Pasadena.

CARR, Commissioner:

O P I N I O N

In Re Los Angeles Gas and Electric Corporation, 35 C.R.C. 442, a rate case, (1) the Commission disallowed the company's claim that the historical cost rate base should be augmented by the amount of certain general expenses claimed not to have been charged to

1. The order in this case was attacked in the Federal court and there sustained (Los Angeles Gas & Elect. Corp. v. Railroad Commission, 58 Fed. (2nd) 256). The utility appealed from this decision to the United States Supreme Court which, on May 8th, affirmed the decision of the lower court. (Los Angeles Gas & Elect. Corp. v. Railroad Commission, 77 Law Ed. (Ad.Op.) 820.)

capital. (2) This claim of the utility, having been translated into formal entries in its permanent account books and reflected in its annual reports filed with the Commission commencing with its report for the year 1930 and resulting in an increase in its fixed capital of \$4,959,463.09, the Commission instituted this proceeding under its general authority and jurisdiction to supervise and regulate accounting methods and practices. (3)

Public hearings were had on January 4 and 5, and on February 25, 1933 argument was had before the Commission in bank.

2. Referring to the historical cost rate bases for the years 1928, 1929 and 1930, the Commission there said:

"These bases have not been raised as urged by the company because of the claimed omission of so-called overhead charges, allocated by the company from year to year and in the ordinary course of its accounting practice to operating expense. \* \* \* Either the responsible accounting officers of the company made these allocations in the exercise of their best judgment at the time when all of the facts were fresh in their minds or, for reasons presumably to the advantage of the company, deliberately undercharged capital and overcharged operation. \* \* \* There is no equity in the company's claim; and by its conduct and election it has created a quasi estoppel against now seeking to gain advantage by repudiating its own books and records as well as its position repeatedly taken before this Commission."

3. Section 29 of the Public Utilities Act provides that "Every public utility shall annually furnish to the Commission at such time and in such form as the Commission may require a report in which the utility shall specifically answer all questions propounded by the Commission upon or concerning which the Commission may desire information. \*\*\*\*\* All reports shall be under oath when required by the Commission."

Section 48 of the Act provides: "The Commission shall have power to establish a system of accounts to be kept by the public utilities subject to its jurisdiction, or to classify said public utilities and to establish a system of accounts for each class, and to prescribe the manner in which such accounts shall be kept." \*\*\*\*\* "The Commission may, after hearing had upon its own motion or upon complaint, prescribe by order the accounts in which particular outlays and receipts shall be entered, charged or credited."

Section 31 of the Act vests the Commission "with power and jurisdiction to supervise and regulate every public utility in the state and to do all things, whether herein specifically designated or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction."

A brief has been filed by the company. The case is now submitted and ready for decision.

As of January 1, 1930, the following journal entry was made by the utility:

Charged to fixed capital accounts.....	\$5,203,793.49
Credited to depreciation reserve.....	\$1,596,846.56
Credited to appropriations for add- itions and betterments.....	\$244,330.40
Credited to unappropriated surplus.....	3,362,616.53

"For the difference between the amount of construction overhead properly chargeable to our capital accounts up to January 1, 1929 (13.3 per cent) and the amount actually previously capitalized on account of such overhead (the correction of which accounting results in a credit to unappropriated surplus, as above shown, after making the proper adjustment in depreciation reserve to cover such additional capital, together with the item of \$244,330.40 immediately following)\$4,959,463.09;

"And for the transfer to appropriated surplus (C.R.C. account 'Donations in aid of construction') of the amount credited up to 1-1-30 to the capital account 'Gas services' on account of excess services paid for by customers, which amount is now charged back to such capital account \$244,330.40."

1. Of the \$4,959,463.09 added to capital, \$3,404,524.02 was charged to gas capital and the balance of \$1,554,939.07 to electric capital. This write-up was limited to capital installed after January 1, 1913. The \$4,959,463.09 was offset by a credit of \$1,521,870.84 to depreciation reserve and by a credit of \$3,437,592.25 to unappropriated surplus.

The annual reports of the company for the year 1930 and for subsequent years reflected this entry and the consequent charges made.

As succinctly stated by Mr. Walter W. Cooper, the Commission's Director of Research, when arguing the case before the full Commission:

"The entry in question, speaking now of the entry made on the books in 1930, to such extent as it may represent actual expenditure, attempts to transfer from the recorded operating expenses to fixed capital

almost \$5,000,000, exclusive of such portion as may be applicable to interest during construction. In other words, the Company now says that during the years involved the operating expenses were over-stated or charged with costs which should have gone to fixed capital. This, of course, resulted in an under-statement of the net sum available annually for return. Such under-statement of return varied from something less than \$12,000 in 1918 to approximately a million dollars in both 1922 and 1923, aside from the effect which such allocation currently made would have had in increasing Federal income taxes and depreciation annuity in the various years.

"The increase in fixed capital effected by these entries also serves to increase the amount to be set up annually for depreciation and included in annual operating expense, by approximately \$125,000. In other words, having initially obtained these sums through charges to operating expense, rate payers will again be asked to supply the funds necessary to renew or replace the funds they initially supplied, through future depreciation charges. Also, if these entries are permitted to remain in capital with the status of investment, an earning on them through current rates will no doubt be expected.\*\*\*\*\*

\*\*\*\*\*

"Through this entry the unappropriated surplus of the Company was increased \$3,362,616. It was not tagged or segregated in any manner and, therefore, becomes surplus available for the declaration of dividends or any other proper corporate purpose that the directing heads of the Corporation may select."

At an early date the Commission established uniform classifications of accounts for gas companies and for electric companies. These became effective on January 1, 1913. The 1913 classifications applicable to each under the caption of "Fixed Capital Accounts, Cost of Fixed Capital" provided:

"The term 'Cost' as used in the texts for fixed capital accounts means the original cost to the corporation. It includes not only the costs of labor, materials and supplies directly employed or consumed in the construction and installation of property classed as fixed capital, but also the cost of preliminary plans and surveys and such portion of the expenses for engineering and plant supervision and general expenses as may be chargeable to the fixed capital accounts under an equitable plan for the apportionment of such expenses."

Subsequently, the accounting rules for gas and electric companies were somewhat elaborated and, under general instructions for fixed capital accounts, it is provided:

"Tangible capital covers all physical property classed as fixed capital. Charges to specific accounts for tangible property cover direct labor and material costs up to and including the pay of the foreman or superintendent supervising the job; also assignable overhead construction costs."

The following also appears:

"The instructions contained in this section should not be interpreted as permitting, except in the case of interest, the addition to fixed capital of arbitrary percentages on amounts to cover assumed overhead costs, but only as requiring the assignment or apportionment to particular fixed capital accounts of actual and necessary overhead construction costs."

Commencing in 1913, this utility was required to, and did, file, under oath, an annual report verified by its appropriate officers.<sup>(4)</sup> These reports each year stated the amount of additions to fixed capital in the preceding year and stated in considerable detail the various operating expenses in such preceding year.

4. The following is the form of oath attached to the 1928 report of the utility and is typical of those attached to reports for other years:

"E. N. Simmons makes oath and says that he is Auditor and Assistant Secretary of Los Angeles Gas and Electric Corporation; that it is his duty to have supervision over the books of account of the corporation and to control the manner in which such books are kept; that he knows that such books have, during the period covered by the foregoing report, been kept in good faith in accordance with the accounting and other orders of the Railroad Commission, effective during the said period; that he has carefully examined the said report and to the best of his knowledge and belief the entries contained in the said report have, so far as they relate to matters of account, been accurately taken from the said books of account and are in exact accordance therewith; that he believes that all other statements of fact contained in the said report are true, and that the said report is a correct and complete statement of the business and affairs of the above-named corporation during the period of time from and including January 1, 1928 to and including December 31, 1928.

E. N. Simmons."

Also, a supplemental oath was attached, as follows:

"W. E. Houghton makes oath and says that he is Vice-President and Treasurer of Los Angeles Gas and Electric Corporation; that he has carefully examined the foregoing report; that he believes that all statements of fact contained in the said report are true, and that the said report is a correct and complete statement of the business and affairs of the above-named corporation during the period of time from and including January 1, 1928, to and including December 31, 1928.

W. E. Houghton."

Every annual report filed by this utility has carried the verification of W. E. Houghton, the present Vice-President and Treasurer, whose connections with the corporation run back for thirty-three years. From 1906 to 1917 he was Auditor; in 1917 he became Controller; in 1926 Vice-President and Treasurer. As a witness he was called upon to explain and to seek to justify the company's position.

The company's position was rather ingeniously stated by its counsel in examining Mr. Houghton as follows:

"Q. \*\* And am I correct in epitomizing your testimony to the extent that if at the time you made those entries you were possessed of the engineering and accounting experience and knowledge that you have you would not have made those entries but would have made entries approximating the result obtained by this correcting entry. A. That is correct.

"Q. And that the original entry, the error in it, was due to two causes, first, lack of detailed information as a result of not having made specific investigation at the time and, secondly, lack of technical knowledge and training with respect to the allocation of overhead construction items? A. That is the correct statement of the situation."

And the same counsel in his argument before the Commission further outlined the company's position in these words:

"Now, our position can be very briefly stated, and it is this: That errors were made in the keeping of those books; that, notwithstanding the good faith of the auditor who was striving to comply with the uniform classification of accounts, those errors were made. The record shows that they were made. That record is uncontradicted. And it was for the purpose of correcting those errors and complying with the uniform classification of accounts, that this corrective entry was made. The entry having been made and the books now being correct and in accordance with the uniform classification of accounts, we submit that there lies neither power nor, if there were power, should it be exercised in this case, to compel making now what is in effect an incorrect entry."

The facts as developed in the record disclose a situation varying from that thus plausibly suggested.

Prior to 1913, it seems, little or nothing was added to capital on account of overheads. About 1910 or 1911 Professor C. L. Cory was employed to make separate valuations of the gas and electric properties of the company. In these he assigned overheads to capital in larger amounts than were then being charged. Mr. Houghton saw these appraisals. Although Professor Cory added a substantial overhead, his valuations agreed approximately with the books, probably because in purchasing predecessor companies some allowance was made for overheads. About March, 1912, there was an adjustment upward in capital accounts. Mr. Houghton seemingly was skeptical of overheads as contained in valuation reports, for he testified "About the only thing I do recall, looking back on those old years, is seeing some terribly exaggerated claims of overhead in some valuation case." He says he paid very little attention to the early Cory appraisal, pointing out that "it was made for use in the rate case." He was familiar with the classification of accounts effective on January 1, 1913. Shortly after the Commission acquired jurisdiction over the rates of this utility it applied for an adjustment of rates. This resulted in a general rate order on August 21, 1917. (Re L.A. Gas & Elect. Co., 13 C.R.C. 725.) In the course of the proceedings in this case valuations were made by Professor Cory for the Company and by Commission engineers. The latter in their valuation allowed overheads at the average rate of 13.09 per cent. Mr. Houghton also appeared in this case as a witness and presented an exhibit displaying the cost of the company's gas properties and, separately, an additive amount for overheads. Referring to this, Mr. Houghton then testified "For the sake of making a showing regarding overhead included, we just assumed that 12 per cent might be a proper rate of overhead -- at least, that would be

probably the minimum." The company's books, he testified, did not show this overhead. This resulted, according to his testimony then, in an under statement of net earnings. The Commission in this early case did augment the rate base by adding larger overheads. The company, however, made no change in its basis of charging overheads to capital.

About the middle of the year 1927 the company established in a small way a valuation department. Rate proceedings were in progress in 1928 (See Re Los Angeles Gas & Elect. Co., 32 C.R.C. 379.) Studies made in 1928 and 1929 convinced the company's valuation engineers that insufficient overheads had been charged in the past. The matter was discussed amongst Messrs. Masser, Fitting, Evans, Simmons and Houghton and possibly Mr. Day, President of the company. Mr. Houghton was persuaded and he caused the correcting entry of January 1, 1930 to be made. This transaction, although its effect was to increase the company's fixed capital by nearly five million dollars and its surplus by over three and a half million dollars, was not the subject of any action by the Board of Directors.

It is thus perfectly clear that the company and Mr. Houghton, the chief accounting officer, at least as far back as 1913, were familiar with the nature of so-called overhead charges to capital. Mr. Houghton was familiar with the accounting rules to which the company was subject and knew that company expenditures pertaining both to operation and construction should be allocated "under an equitable plan" as between operation and capital. The plan adopted by him and by his company and consistently followed until new faces and new ideas came on the scene about 1928 and 1929 leaned toward the allocation of the general expenses of the company to operation rather than to capital. Mr. Houghton thought at the time he was making a fair allocation. The



plan he adopted may not have been the best one. It certainly was not in harmony with the plan the company's valuation engineers worked out for rate cases or the plan he himself presented in the company's first rate case before the Commission. However, it cannot be said on the whole to have been an inequitable one. Over a period and consistently followed, it certainly worked no injustice to the company. Expenditures by the company (except interest during construction) found lodgment in capital where presumably they would earn a return or in operation where they would currently be retired.<sup>(5)</sup> Under the plan followed the tendency was to hold down stated capital and to increase the stated amount of operating expense.

What the company, through Mr. Houghton, thus did over the long period from 1913 to 1929 cannot be said to have represented a mere "mistake" or "error." It falls rather within the category of a deliberate policy adopted with full knowledge of the facts upon which predicated and of the incidence and effect of such policy.

To change this policy and to let judgment lean towards building up capital and keeping down operating expenses when applied prospectively would work no inequity or prejudice to company or consumer. The vice of what the company has here sought to do lies in its attempt to give a retrospective effect to a change in policy where the relationships established under the superseded policy cannot all be effected consistently, for while capital is thus increased the benefit of lessened operating charges over the years can not be extended retroactively to the company's consumers.

5. At page 448 of the reported decision in Re L.A. Gas & Elect. Co., 35 C.R.C. 442 appears a table showing the earnings of the corporation in both of its departments over a long period of years. This table and the data supporting it were imported into the record. It appears therefrom that the company's earnings were ample to care for all stated costs of operation and yield a return on investment.

What the company has here sought to accomplish is entirely wanting in equity. If sanctioned, it would cast doubt and uncertainty upon the reliability of utility accounting developed over many years under public supervision. If fixed capital accounts may be thus surcharged now they may be revised again in the future. Ideas of overhead percentages vary widely and vary from time to time. The element of judgment enters into their determination. A variation of but 1% in the amount of these involves a large amount in the total of fixed capital. Should capital accounts be thus subject to change, energetic and astute valuation and other experts would ever be combing over utility accounts and effecting changes and revisions in the permanent records and fixed capital accounts would become as variable and shifting as the ideas of those in charge. In the complicated processes of regulation, involving not alone the fixation of rates but the supervision of security issues, it is highly important that permanent accounting records maintain a continuity and impart a reliability which would not exist if subject to revision and change whenever new faces appeared in positions of influence in the management.

Precedent and authority are not lacking for condemning and requiring to be undone what has here been attempted.

Under the broad powers over accounting and accounting practices vested in the Commission, its authority to make an appropriate and equitable order in the premises may hardly be questioned. (See Norfolk & West. Ry. Co. v. U.S., 77 Law Ed. (Ad.Op.) 54.)

Twenty-five years ago in a rate case, where the value concept is all important, the Supreme Court in Railroad Commission v. Cumberland Tel. & Tel. Co., 212 U. S. 414, voiced its disapprobation of collecting money for an operating expense and using it as capital

upon which to claim a return. Judge James in the majority opinion in Los Angeles Gas & Elect. Co. v. Railroad Commission, 58 Fed. (2nd) 256, a rate case, thought this Commission was justified in limiting overheads to the percentage actually used by the company. Judge Wilbur in his concurring opinion reached the same conclusion. The United States Supreme Court in affirming the decree of the lower court and upholding the Commission's order found it unnecessary to pass upon the point. In Natural Gas Co. v. Pub. Service Com. (W. Va.) 121 S.E. 716 it was said:

"No allowance for overhead should be made where they have already been paid by the public as operating expenses. The utility should not be permitted to capitalize such overhead charges and require the public to keep on paying a return on expenses already repaid the utility."

The Wisconsin Public Service Commission in a rate case (Re Mondovi Telephone Company, - decided on rehearing on Dec. 6, 1932) took a firm stand against plant expenditures absorbed as operating expenses being capitalized, it being said:

"Hence wherever and whenever plant expenditures have been absorbed in operating expenses, and these operating expenses have been reported under oath and relied upon by the Commission, these items are not to be added back to the plant account later in determining a rate base."

And the New York Public Service Commission in a capitalization case (Re Yonkers Electric Light & Power Co., decided on Nov. 16, 1932) speaking through its chairman, Mr. Maltbie, condemned in vigorous terms an attempt by the utility to revise and restate its accounts so as to augment its capital. Thus:

"If the transfer of items should now be permitted, it would mean that operating expenses in past years have been over-stated, that the net profits have been under-stated, and a hidden surplus built up of which the stockholders, the public and public authorities were not advised. No company ought to be permitted to profit by such methods."

All of which leads to the conclusion that not only does this Commission possess the authority but should exercise it to require this

utility to retrace its steps and to restore its permanent records to the condition they were in before it was launched upon its ill-advised adventure.

2. Involved in this proceeding is also the distribution of capital installed prior to 1913 to capital accounts prescribed by the uniform system of accounts for electrical corporations effective January 1, 1923 and by the uniform system of accounts for gas corporations effective January 1, 1924.

Account 397 of the uniform system of accounts for electrical corporations reads:

"Under this head shall be grouped for the purpose of reporting, until properly distributed to other accounts of this system of accounts, the balances in the fixed capital accounts as of December 31, 1922. The balances reported hereunder shall show the fixed capital installed prior to January 1, 1913 and the fixed capital installed from December 31, 1912, to and including December 31, 1922.

"All corporations must submit to the Commission for approval their proposed distribution of all or any of the balances in the fixed capital accounts as of December 31, 1922."

Account 397 of the uniform system of accounts for gas corporations reads as follows:

"Under this head shall be grouped for the purpose of reporting, until properly distributed to other accounts of this system of accounts, the balances in the fixed capital accounts as of December 31, 1923. The balances reported hereunder shall show the fixed capital installed prior to January 1, 1913 and the fixed capital installed from December 31, 1912 to and including December 31, 1923.

"All corporations must submit to the Commission for approval their proposed distribution of all or any of the balances in the fixed capital accounts as of December 31, 1923."

The company can not and did not plead ignorance of the requirement of Account 397. It did ask permission to distribute its electric capital installed from January 1, 1913 to December 31, 1922

and its gas capital installed from January 1, 1913 to December 31, 1923. The capital installed prior to 1913 was distributed in the 1930 annual report. At no time had the company asked permission to make such distribution. There is no reason why the company, if it desires to distribute the capital installed prior to 1913, should not proceed in the usual and ordinary way as required of all utilities.

3. In the journal entry shown above appears the sum of \$244,330.40 credited to appropriations for additions and betterments. This sum is said to represent "excess gas service" paid by consumers. By excess gas service is meant that portion of the gas service extensions which under the company's rules and regulations must be paid for by the consumers. On July 31, 1926, the company credited to capital a total of \$196,710.11, representing money collected from consumers for excess gas service from July 1, 1922 to July 31, 1926. From July 31, 1926 to December 31, 1929, it credited to capital a further sum of \$47,620.29. These two credit entries are readily distinguished from the attempted overhead "corrections." The company had reduced its charges to capital accounts by the sum of \$244,330.40. In restoring this sum to fixed capital the company did not credit surplus. On its books it credited appropriations for additions and betterments, while in the annual report filed with the Commission it shows ~~the~~ amount under "Donations in Aid of Construction-Credit," which is an account under the fixed capital accounts. There is no question but that the \$244,330.40 correction is appropriate and a reversal of this entry will not be required.

I recommend the following form of order:

O R D E R

Public hearings having been had herein and the matter having been submitted,

IT IS HEREBY ORDERED, that Los Angeles Gas and Electric Corporation be, and it is hereby, ordered and directed to reverse, within sixty (60) days after the effective date of this order, the journal entry of January 1, 1930, whereby it charged its fixed capital accounts with the sum of \$4,959,463.09 and credited depreciation reserve with the sum of \$1,521,870.84 and unappropriated surplus with the sum of \$3,437,592.25 and reverse the entry or entries by which fixed capital installed prior to January 1, 1913 was distributed to primary fixed capital accounts now in effect.

IT IS HEREBY FURTHER ORDERED, that Los Angeles Gas and Electric Corporation, within sixty(60) days after the effective date of this order, file with the Railroad Commission supplemental balance sheets, profit and loss, income account and operating expense statements for the year 1930, for the year 1931 and for the year 1932, indicating the manner in which the annual reports for those years should be changed to reflect the reversal of the entries to which reference is made in the preceding paragraph of this order.

This order shall become effective twenty(20) days after the date hereof.

The foregoing Opinion and Order are hereby approved and ordered filed as the Opinion and Order of the Railroad Commission of the State of California.

DATED at San Francisco, California, this \_\_\_\_\_ day of July, 1933.

W. A. Lacey  
Leon A. Whittell  
W. A. Lacey  
W. B. Harris  
W. A. Lacey  
Commissioners