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Decision No. 59925

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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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| In the Matter of the Investigation on the Commission's own motion concerning the proper treatment for rate making purposes, to be accorded accelerated amortization and accelerated depreciation. | ) ) ) ) ) ) | Case No. 6148 |

Appearances are listed in Appendix A.

## O P I N I O N

In order to assist the Commission in establishing a policy as to the proper treatment of Federal income taxes as a charge to the operating expense of public utilities for the purpose of ratefixing, as related to the provisions of Sections 167 and 168 of the Federal Internal Revenue Code, the Commission instituted the above-entitled investigation on its own motion.

Preliminary to a discussion of the issues involved herein, we desire to point out that this decision will not concern itself with the several rate decisions heretofore rendered by this Commission, where the subject of income taxes was treated for the purpose of ratefixing in such cases. Those decisions will be given special treatment by the Commission in each case, based upon the special facts and circumstances appertaining thereto. Special procedures will be devised for such cases. Neither will this decision treat with the subject of accelerated amortization, as authorized by Section 168 of said Federal Internal Revenue Code, for the reason that such subject lends itself to special treatment in each case and will be so administered by the Commission pursuant to special procedures devised for such purpose. Furthermore, the situation involving accelerated amortization is quite unlike the situation involving liberalized depreciation, which is provided for by

Section 167 of said Code. One of the important differentiating features of accelerated amortization, as contrasted to liberalized depreciation, is that accelerated amortization has a definite terminal date, free of any speculation, whereas liberalized depreciation is a continuing matter without any definite future terminal date.

Hereafter, we shall employ the term "liberalized depreciation" instead of the term "accelerated depreciation", when dealing with Section 167.

During the course of the above-entitled proceeding, the Commission held 45 days of public hearing and a very extensive record was constructed consisting of 6,031 pages of transcript, together with 74 exhibits. Many expert witnesses testified and presented varying and conflicting views on the subject of the proper treatment of Federal income taxes for the purpose of ratefixing.

Because of the broad scope of the testimony in this proceeding and the numerous views expressed, both by expert witnesses and by counsel, it is our opinion that no useful purpose would be served by taking the time to set out all of these matters in extenso. The record in this proceeding is a public one and is available to any person who desires to review it. We shall confine ourselves to the ultimate resolution of the issues presented.

A number of witnesses took the position that the provisions of Section 167 provide for a tax deferral or the deferment of tax liability which the taxpayer must respond to by the payment of higher taxes at some future date. Their position was that the tax differential which results from employing liberalized depreciation, as contrasted to straight-line depreciation, should be borne by present ratepayers by appropriate charges to operating expense just as though such amount had been paid by the utility. Such differential would be credited to a reserve for the payment of future income

taxes. The procedure advocated by these witnesses is denominated the "normalization" of income taxes for the purpose of ratefixing. Other witnesses took the contrary view and contended that there is no deferred tax liability and that the result flowing from the use of liberalized depreciation is actually a tax saving to the taxpayer. It may be conceded that there is logical argument to support the former view, if one looks at this matter purely from the standpoint of accounting theory. However, this is a subject which must be viewed as an over-all proposition. It is elementary that ratefixing is a practical and pragmatic procedure which demands the employment of judgment and opinion and which is surrounded with considerations that do not lend themselves to abstract theory or barren logic. These considerations must be given effect to reach the reasonable result which the law compels. Here, theory must give way to the facts of experience. In resolving these issues, we cannot close our eyes to the future and what reasonably the future will produce. Furthermore, it must be borne in mind that an income tax is not a tax on property. (Graves v. New York, 306 U.S. 466, 480-481, 83 L. ed. 927, 933.) Therefore, the argument which attempts to attach tax liability to specific items of depreciable property overlooks completely the fact that the tax we are here dealing with is an income tax which addresses itself to net income and not to property or any specific items of property.

The record in this proceeding is clear that public utilities, for the foreseeable future, will continue to construct new plant to an extent which will be sufficient to more than overcome retirements to such plant. In such circumstances, the theory of normalization, based upon the concept of a deferred tax liability, would not have an opportunity to operate. Here, regulatory

authority must be concerned with what reasonably will happen and not with that which theoretically might happen. The problem here concerned presents a practical, realistic situation which derives from experience and our dynamic economic growth, thus rendering theory to a large extent inoperative.

Based upon the record in this case, we find that, as applied to Section 167, there is created no income tax deferral and no deferred tax liability. The operation of said section provides a vehicle and a procedure whereby the taxpayer may reduce his taxes just as though the tax rate had been reduced. So far as tax liability may be concerned, the end result would be the same in each case. Should this Commission adopt the so-called normalization theory, we would be required to close our eyes to the obvious facts of the future which can reasonably be expected to result from California's tremendous economic growth. There is no duty incumbent upon this Commission to adopt a theory which is at war with the facts of experience and the reasonable expectations for the future.

While the record in this case amply justifies the findings and conclusions which we have just expressed, we desire to point out that judicial authority supports the conclusion at which we have arrived. Prior to the decision by the Supreme Court of the United States in the case of Galveston Electric Co. v. City of Galveston, 258 U.S. 388, 399, 66 L. ed. 678, 684, decided on April 10, 1922, there was no established rule, judicial or otherwise, that income taxes of a public utility be charged to operating expense. As a matter of fact, such taxes, as a general proposition, were not permitted to be charged to the operating expense of a public utility. In that particular decision, the Supreme Court, without the citation of any authority whatsoever, established the

rule that income taxes constituted a lawful charge to the operating expense of a public utility. A few years thereafter, the Supreme Court re-affirmed the rule which it established in the Galveston case by its decision in the case of Georgia Railway, etc. v. Railroad Commission, 262 U.S. 625, 633, 67 L. ed. 1144, 1148. Since that time, it has never been questioned that income taxes constituted a lawful charge to the operating expense of a public utility. However, the decisions in those two cases clearly reveal that only income taxes lawfully assessed by the taxing authority and paid by the public utility would constitute a lawful charge to the operating expense of a public utility. The decision in the Galveston case clearly reveals the strict construction which the Supreme Court placed upon that newly created rule. In our opinion, it would be a negation of the rule established by the Supreme Court in those two cases to hold that the ratepayers of a public utility could be required, in any event, to bear the burden of a charge to the operating expense of a public utility which represented more income taxes than the taxing authority lawfully assessed and were actually paid by the utility. We reject the contention that the operating expense of a public utility may be so burdened.

Wherever the matter of normalization of income taxes, based upon Section 167, has come before the courts, the normalization theory has been rejected. (City of Pittsburgh v. Pennsylvania Public Utility Commission, 17 P.U.R. (3d) 249, 128 Atl. (2d) 372; Central Maine Power Company v. Public Utility Commission, 21 P.U.R. (3d) 321, 136 Atl. (2d) 726; In re Plainfield Water Company, 154 Atl. (2d) 201, 212.) The foregoing cited decisions were rendered, respectively, by the Superior Court of Pennsylvania (an intermediate appellate court), affirmed by the Supreme Court of Pennsylvania; the Supreme Court of Maine; and the Appellate Division of the Superior

Court of New Jersey. Very recently, the Supreme Court of Illinois qualifiedly adopted the normalization theory but required the tax reserve to be deducted from the rate base of the utility. (City of Alton v. Illinois Commerce Commission, Docket No. 35242, decided March 30, 1960.) In taking this action, the court reversed the Illinois Commission which had allowed full normalization.

It must be remembered that a public utility is not in the same category, factually or legally, as an unregulated company. A public utility performs a function of the state and is created for public purposes. (Smyth v. Ames, 169 U.S. 466, 544, 42 L. ed. 819, 848; Western Canal Company v. Railroad Commission, 216 Cal. 639, 647.) A public utility exercises an extraordinary privilege granted to it by the state and it occupies a privileged position. (United Fuel Gas Co. v. Railroad Commission, 278 U.S. 300, 309, 73 L. ed. 390, 396.) Furthermore, a public utility devotes its property to the public use and, thereby, "grants to the public an interest in that use . . . ." (Munn v. Illinois, 94 U.S. 113, 126, 24 L. ed. 77,84; Southern California Edison Co. v. Railroad Commission, 6 Cal. (2d) 737, 754.) In essence, a public utility is charged with the administering of a public trust delegated to it by the state. (Acme Brick Co. v. Arkansas Public Service Commission (Supreme Court of Arkansas), 18 P.U.R. (3d) 13, 17.) In these circumstances, standards of public service are the guide, not the rule of the market place. Here, we have no room for any overreaching by a public utility, as regards the ratepayer. Such would be grossly out of character.

It is pertinent to point out that a regulated company enjoys a distinct protection which the unregulated company does not; that is, the regulated company may turn to public authority for the purpose of securing an increase in the price of its services or product, whereas the unregulated company must withstand the rigors of the law of competition. In many instances the public utility

enjoys a monopoly, and the rates which public authority permits it to enjoy must be paid by the consumer without his being aided in any way by the law of competition.

In this decision we do not reach the matter of the claimed duty of a public utility to avail itself of liberalized depreciation for the purpose of diminishing its income tax liability and thus lessening the burden upon its ratepayers. Surely, a reasonable argument in support of that contention could be made. As a general proposition, it is a matter to be determined in the first instance by the management of a public utility as to whether or not liberalized depreciation will be availed of or whether straight-line depreciation will be used.

Based upon the record in this case and the findings and conclusions in this opinion, we hold that a public utility is not lawfully entitled to charge to its operating expense any amount for income taxes in excess of the amount of such taxes which the taxing authority lawfully assesses and which the utility pays. It will be the order of this Commission that such treatment will be accorded income taxes for the purpose of ratefixing.

All motions and requests made during the course of this proceeding which are inconsistent with the action taken in this decision will be denied.

## O R D E R

Public hearing in the above-entitled proceeding having been held, evidence having been adduced, and the matter having been submitted for decision, the Commission enters its order herein based upon the foregoing findings and conclusions.

Therefore, IT IS HEREBY ORDERED that:

(1) For the purposes of ratefixing, the Commission will not allow a public utility to charge to its operating expense for income taxes any amount in excess of the amount of income taxes lawfully assessed by the taxing authority and paid by said public utility.

(2) All motions and requests made during the course of this proceeding which are inconsistent with the action taken in this decision are hereby denied.

The effective date of this decision shall be twenty days after the date hereof.

Dated at San Francisco, California, this 12th day of April, 1960.

President

Commissioners

I dissent. An opinion setting forth my reasons therefor will be filed later.

## LIST OF APPEARANCES

RESPONDENTS: Bacigalupi, Elkus & Salinger by Claude N. Rosenberg, for California Water & Telephone Company and West Coast Telephone Company of California; J. P. Bradley, for the Dominguez Water Corporation; Brobeck, Phleger & Harrison by Gordon E. Davis, for the California Oregon Power Company; Donald J. Carman, for California Electric Power Company; Chickering & Gregory, by Sherman Chickering, C. Hayden Ames and Angus G. MacDonald, for San Diego Gas & Electric Company; Noel Dyer and Emerson Bolz, for The Western Union Telegraph Company; Susie Donoghy, Donoghy Water Company, for self; Frank J. Gallagher, for Southern Pacific Company; John L. Holleran, Vice President, for Southwest Gas Corporation; C. J. McIntyre, Managing Partner, Indian Valley Light and Power Company; O'Melveny & Myers, Harry L. Dunn, John Robert Jones, and Albert M. Hart, on behalf of General Telephone Company of California; Orrick, Dahlquist, Herrington & Sutcliffe by Warren H. Palmer and James K. Haynes, for California Pacific Utilities Company, Citizens Utilities Company of California, Sierra Pacific Power Company, Western California Telephone Company, Central California Telephone Company, Kern Mutual Telephone Company, The Western California Telephone Company, Sunland-Tujunga Telephone Company; Frederick G. Pfrommer and Robert A. Thompson, for The Atchison, Topeka and Santa Fe Railway Company; Pillsbury, Madison & Sutro, by Arthur T. George and Francis N. Marshall, for The Pacific Telephone and Telegraph Company; T. J. Reynolds, H. P. Letton, Jr., and Milford Springer, for Southern California Gas Company; O. C. Sattinger, J. R. Elliott, and Milford Springer, for Pacific Lighting Gas Supply Company; F. T. Searls and John C. Morrissey, for Pacific Gas and Electric Company; John E. Skelton, for the San Gabriel Valley Water Company; Milford Springer, and Robert M. Olson, Jr., for Southern Counties Gas Company; W. E. Welman, for Southern California Water Company; Rollin E. Woodbury, Harry W. Sturges, Jr., by Rollin E. Woodbury, for Southern California Edison Company.

INTERESTED PARTIES: Robert T. Anderson, Assistant City Attorney, for the City of Berkeley; Roger Arnebergh, City Attorney, Alan G. Campbell, Assistant City Attorney for the City of Los Angeles, a Municipal Corporation; Glenn A. Baxter, for the Alameda Bureau of Electricity; Harold A. Berliner, District Attorney, for the County of Nevada; Stanley B. Christensen, for the City of Fullerton; Winslow Christian, District Attorney, for the County of Sierra; T. M. Chubb, Chief Engineer and General Manager, and M. Kroman, Department of Public Utilities and Transportation, for the City of Los Angeles; Robert G. Cockins, for the City of Santa Monica; Robert O. Curran, for City of National City; C. P. Decrevel, Chairman, State Legislative Committee, Brotherhood of Railway Clerks; J. F. DuPaul, City Attorney, by Frederick B. Holoboff, Deputy City Attorney, for the City of San Diego; William W. Eyers, for California Manufacturers Association;

LIST OF APPEARANCES

INTERESTED PARTIES (Continued): Enright, Elliott & Betz, for Monolith Portland Cement Company; Waldo A. Gillette, for Monolith Portland Cement Company; Everett M. Glenn, City Attorney, for the City of Sacramento; Neal C. Hasbrook, for California Independent Telephone Association; Dion R. Holm, City Attorney, by Orville I. Wright, Deputy City Attorney and Robert Laughead, Chief Valuation and Rate Engineer, for the City and County of San Francisco; Frederick B. Holoboff and Clarence A. Winder, for California Municipal Utilities Association; Walhfred Jacobson, City Attorney, by Leslie E. Still, Deputy City Attorney, for the City of Long Beach; Henry E. Jordan, Chief Engineer-Secretary, Bureau of Franchises and Public Utilities, for Bureau of Franchises and Public Utilities; J. C. Kaspar, A. D. Poe, and J. X. Quintrall, on behalf of the California Trucking Associations; William Knecht, Attorney, for California Farm Bureau Federation; Frank L. Kostlan, City Attorney, for the City of Pasadena; Louis Krainock, for California Farm Research and Legislative Committee; Sherrill D. Luke, Administrative Assistant to City Manager, for City of Richmond; W. D. MacKay, Commercial Utility Service, for Challenge Cream and Butter Association; J. H. Macomber, Jr., General Counsel, Frederick W. Denniston, Assistant General Counsel, and Clarence W. Hull, Regional Counsel, for General Services Administration, representing the Executive Agencies of the Federal Government; Grace McDonald, for California Farm Research and Legislative Committee; Robert E. Michalski, City Attorney, for the City of Beverly Hills; Chester N. Newell, Secretary. Public Service Commission of Nevada; Edward Neuner, on his own behalf; Julia Nye, for Consumer Groups; Charles A. O'Brien, for Stanley Mosk, Office of the Attorney General, for the State of California; L. F. Pratt, for Sacramento Municipal Utilities District; Arlo E. Rickett, Jr., City Attorney, by J. William Mortland, Deputy City Attorney, for the City of Pomona; James M. Shumway, County Counsel of Solano County, for the County of Solano; Alexander R. Tobin, Deputy County Counsel, for the County of San Bernardino; Preston Turner, for Cities of Anaheim, Azusa and Riverside; Melwood W. Van Scoyoc by Alexander E. Wiskup, for the Attorney General of California; Donald Vial, Economist, for California State Federation of Labor, C. J. Haggerty, Secretary-Treasurer, and California Industrial Union Council, John A. Despol, Secretary-Treasurer; Archie L. Walters, for the City of Burbank; Leonard M. Wickliffe, for California State Legislative Committee, Order of Railway Conductors and Brakemen; Clarence A. Winder, for the City of San Diego.

COMMISSION STAFF: Harold J. McCarthy.

OBSERVERS: Harold Gold, Reuben Lozner and Gerald Jones, Bureau of Yards and Docks, Navy Department, ror Department of Defense and all Executive Agencies of the U. S. Government.

I dissent.

The basic purpose of rate-making is to design reasonable rates which will produce revenues sufficient to cover future costs of operation so as to render adequate service to the consumer, plus a reasonable return to the utility. Such return should be adequate to compensate present investors in the business for the use of capital and to attract new capital from investors on favorable terms, as the occasion therefor arises. This concept of rate-making is the fundamental ground for my dissent.

The complexity of the problem of liberalized depreciation deeply reaches into the fields of finance, accounting, and economics, as well as into the field of law. It is my considered opinion that in reaching a determination in this matter the Commission should consider the subject of accelerated depreciation in all of its aspects, including its effect not only on immediate rate levels, but also on the longer range problem of financing the cost of expansion, capital structures, cost of money and related matters which are preeminently important when due consideration is given to the unprecedented, well-nigh explosive, growth in this State, and the heavy obligation placed upon all public utilities of raising huge sums of money in order to meet their obligations of rendering adequate service to the public.

Upon the basis of the record as developed in this matter, I am of the opinion that the Commission is warranted in approving modified normalization of income taxes for accounting purposes and for the fixing of rates. Such normalization would not result in any increase in rates, over existing rates, and would not result in making any additional sums available to the utilities for dividends on outstanding stock or in increasing the capital or earned surplus. The revenues to be exacted from the customers would not be increased by the approval of normalization procedures over that which prevails presently by the utilities computing their depreciation for tax purposes on a straight line basis. In this connection it should be noted that a number of the utilities have stated that they will use straight line depreciation for tax purposes in the event the Commission should decline to approve normalization.

In my opinion, it is adverse to the public interest to cause the utilities to refrain from using the liberalized depreciation provisions of the Internal Revenue Code. The internal funds that would be generated from the adoption of liberalized depreciation would reduce materially the large financing operations of utilities for expansion and replacement and, accordingly, would reduce their financial requirements and lower their cost of money and the resultant rate of return. This certainly would be to the advantage of the rate payers and in the public interest. In any future rate-making proceedings involving utilities that elect to use liberalized depreciation and normalization of income taxes, the Commission, in computing the cost of money on that portion of the capital structure which is represented by the deferred tax reserve should then only allow a return equal to the difference between the average interest rate on a particular utility's long term debt and the return which is otherwise found to be normal. Such a procedure would have the effect of requiring the utility to pay interest on the deferred tax reserve. Thus, benefits would be made available to the rate payers by reducing the utility's earning requirement, and at the same time allow the utility to participate in such savings as reasonable compensation for managing the properties, financed with funds provided through normalization, and for the resultant risk assumed.

The Commission is regulating a living, continuing, rather than a dying, industry and should base its findings on such a premise. Should a condition arise in the future in respect to the accumulated tax reserve resulting from normalization, other than the utilization of the tax reserve for the payment of higher taxes at a later date resulting from the use of liberalized depreciation, then the Commission through its continuing regulation could take such action as it deemed proper under the conditions then surrounding the particular case presented to it and, therefore, no windfall arising from such reserve could be given to the shareholders of the utility.

I am in accord with the salient observation of the Supreme Court of the

State of Illinois in the case of the City of Alton et al vs. the Commission, Docket No. 35242, decided March 30, 1960, wherein the Court said:

> "* * * At this time, we think it permissible for the Commission to safeguard the financial integrity of a utility by recognizing as present expenses those tax liabilities which are deferred by the use of accelerated depreciation for federal tax purposes."

Commissioner.

April 12, 1960.

C. 6148

I DISSENT:

The majority opinion ignores pertinent and indisputable facts established clearly in the voluminous record in these proceedings and leaves undetermined various important issues which should be settled. Because of these omissions, some of the deleted facts must be discussed in this dissent. While citing the contention of some that it is the "duty of a public utility to avail itself of liberalized depreciation", the majority opinion concedes that whether to take or reject liberalization is a prerogative of management; there is no compulsion on management to take liberalized depreciation on the terms prescribed.

It is significant that throughout these proceedings the Commission staff was split asunder on the issues herein involved. The Director of the Division of Finance and Accounts, who is the logical advisor to this Commission on such matters, advocated "normalization of Federal income taxes as a proper means of returning the greatest benefit to all concerned, both the utilities and their ratepayers, whereas the Commission engineering staff vigorously opposed "normalization", although admitting that "normalization" would not increase rates presently computed on the straight-line basis.

The majority opinion cites two series of court decisions in its effort to bolster its findings and conclusions. It cites decisions of the United States Supreme Court which set the precedent for and compelled State regulatory bodies to allow Federal income taxes paid by a utility as a legitimate expense in

rate-making procedures. The majority opinion reads into these decisions a limitation on the amount of Federal taxes that can be allowed in computing rates. This contention was advanced by opponents of "normalization" during the public hearings on this issue and was challenged by competent and experienced counsel well qualified to interpret the law and court decisions. Therefore I must reject the theory that should this Commission grant "normalization" it would be overriding decisions of the Supreme Court of the United States, which to date has not acted on this particular issue.

The majority might well have cited Federal Power Commission vs. Hope Natural Gas Company, 320 U.S. 591, at page 602, which stated:

> "Under the statutory standing of 'just and reasonable' it is the result reached(1) not the method employed which is controlling. . . . It is not theory but the impact of the rate order which counts." . . . .

The record in these proceedings, as will be discussed later, discloses the undisputable fact that "normalization" of Federal income taxes would not increase rates as presently computed in California and as, in all probability, they will be computed for the majority of California ratepayers in the foreseeable future. Thus the "results reached" insofar as rates are concerned would not be effected, in a majority of instances, by the authorization of "normalization".

The second series of decisions cited have to do with courts of other states, none of which have any jurisdiction over

(1) Emphasis added.

this Commission. On the contrary, it is a fact that no court having jurisdiction over this Commission has passed upon the right of this Commission to authorize "normalization" or the propriety of such an authorization.

Objective analysis and evaluation of the evidence presented in this record and of the issue herein, requires that two facts be kept clearly in mind: (1) the Federal Government and the Bureau of Internal Revenue prescribe the laws and regulations under which Federal income taxes are computed, while (2) the State of California and this Commission prescribe the laws and regulations under which are fixed the rates public utilities under the jurisdiction of this Commission are permitted to charge. The procedures followed by these two governmental agencies, i.e., the Federal Bureau of Internal Revenue and the California Public Utilities Commission vary markedly. One bears no legal relation to the other. To cite one example: the Bureau of Internal Revenue allows interest paid on long-term debt as a deductible expense in computing Federal income taxes due. This Commission does not allow such interest as an expense item in rate-fixing procedures. There are many other dissimilarities.

In rate-fixing procedures, the operating expenses of a utility, i.e., wages, costs of goods and materials, etc., state and local taxes and depreciation, are deducted from revenues before Federal income taxes are computed. Since the Federal Government takes 52 per cent of the net earnings of a corporation, when such revenues exceed $25,000 a year, the net before Federal

income taxes must be increased by approximately 2.2 times to determine the net after Federal income taxes, or the "take home" earning left to the utility. Since depreciation is a deductible expense in computing Federal income taxes, it follows that the greater the depreciation expense allowed for tax purposes, the less the amount subject to taxation will be and a reduction in taxes due will result. Conversely, the less the depreciation expense allowed, the greater will be the amount subject to tax and an increase in taxes will result.

Another fact, also, must be kept in mind: a facility may be depreciated not to exceed one hundred per cent of its cost, either for tax or rate-making purposes. It follows, therefore, that when depreciation allowances are increased for any purpose, the total allowable depreciation is used up more rapidly until the full one hundred per cent of the depreciation allowance may be used up years before the facility has worn out or has become obsolete. Public utilities in California are using many facilities that have been fully depreciated and for which no further depreciation is allowed either for tax or rate-making purposes.

This Commission, for more than a decade, has advocated the "straight-line remaining life" method of depreciation in rate making as being most equitable to a utility's ratepayers, present and future. By this method the useful life of a facility is estimated and the allowable depreciation computed on a percentage of cost determined by the years of useful life. Example: a facility is estimated to last thirty years, thus the

annual depreciation would be 3-1/3 per cent of the cost of the facility. This Commission adopted this method of depreciation for rate-making purposes because this method distributes equally over all ratepayers receiving the benefits of that plant, the cost thereof. The rates for California utilities, with a few exceptions, for some time have been, and presently are, determined by the "straight-line remaining life" method of depreciation.

Prior to enactment of Sections 167 and 168 (Section 168 is not herein considered) of the Internal Revenue Code of 1954, the depreciation allowances for tax purposes of California utilities was, in general, the same as the depreciation allowed as an expense in the rate-making process; thus the full Federal income tax which accrued on the "straight-line remaining life" method of depreciation was allowed as an expense item in the determination of proper rates. Section 167 of the Internal Revenue Code of 1954 permitted all corporations to increase, or accelerate, the depreciation charged to expense for the purpose of determining income tax payments for the tax year. The explicit purpose of Congress in enacting this statute, as stated plainly both in Congressional committee reports and in the Congressional Record, was to enable companies to generate internally additional funds with which to help pay the cost of new plants to meet rapidly expanding needs of production. Congress, in effect, said to corporations, "You may use up depreciation credits at a faster than normal rate in order to reduce current income tax payments in order to retain more money to help you meet expansion needs". It follows therefore, that, unless California utilities are

permitted to compute taxes for rate-making purposes on the "normal" method of "straight-line remaining life" depreciation while actually paying Federal income taxes on an accelerated depreciation basis, there will be no additional "internally generated funds" with which to help meet expansion needs. Denying California utilities the right thus to take advantage of this Federal statute, is to thwart the will of Congress in this particular.

The majority finding that "there is created no income tax deferral and no deferred tax liability" obscures fact with semantics. As stated above, a facility can be depreciated not to exceed one hundred per cent of its cost and that by taking liberalized depreciation a utility would be using up depreciation credit in advance of that credits actually becoming due. Thus if a large part of the depreciation credit is used up in the early years of a facility's useful life the charge to depreciation will decrease in the later years and as this depreciation allowance decreases the amount of a utility's revenues subject to Federal income tax will increase; thus the Federal income taxes will be higher in future years than they would have been had a utility adhered strictly to the straight-line depreciation method in computing Federal taxes. While this may not be classified as a "deferred liability" in the strict connotation of such term, it will result in higher future tax payments which the utility will be required to pay and will constitute a contingency which must be met at some future date. In this practical aspect, it does constitute a "deferred liability" and prudence requires that a reserve be established to meet it. In order to prepare for this

contingency, California utilities proposed to establish a reserve comprising the "temporary savings" on Federal income tax payments. The advantage to be gained by this procedure would be to provide California utilities with substantial amounts of interest-free money. This would reduce a utility's need for going to the open market to obtain additional funds and thus reduce its cost of money. This simple fact, standing alone, would have been to the advantage of a utility's ratepayers, because it would have reduced a utility's cost-of-money expense and thus have reduced the rates required to make a utility "whole". Utilities appearing in these proceedings, however, advocated a further sharing of benefits with ratepayers, in effect, by paying interest on the contingency fund, which interest would accrue to the ratepayers' benefit in determining future rates. This passing of benefits to ratepayers, as advocated by a number of utilities, would have been accomplished by crediting to income (or income taxes) an amount equal to the interest on the money in the Deferred Tax Contingency Fund.

The majority opinion cites the growth potential of the population and economy of California to support its contention that the addition of new facilities will outweigh the accelerated depreciation allowances authorized to the extent that the Deferred Tax Contingency Fund would continue to grow for the foreseeable future. This contention ignored the distinct possibility of recessions and depressions; that natural gas is a diminishing resource, and that Congress may rescind Section 167 of the Internal Revenue Code of 1954.

Even without repeal of the accelerated depreciation options or some other pertinent modification of the tax laws, the majority's assumption requires that in the foreseeable future plant additions will equal or exceed retirements. This is only speculation. History and the record in these proceedings show it to be unreliable. Although population continued to grow in California during a portion of the 1930's, utility plants shrank. Exhibit No. 59 shows that Southern California Edison Company had less plant in each of the years 1934, 1935, 1936 and 1937 than in 1933; that Southern California Gas Company had less plant in 1934, and 1935 than in 1933, and that Pacific Telephone had less plant in each of the years 1931, 1932, 1933 and 1934 than in 1930. As stated by one of the witnesses for the Southern California gas companies, there may be substantial fluctuations in a particular taxpayer's annual property replacements or additions due to: (1) extraordinarily large property additions in a single period; (2) a recession, or the contractions of the industry, or any event leading to a lean period for the taxpayer and a severe restriction on replacements and additions; (3) sharp changes in replacement cost which cause dollar fluctuations in periodic replacements even though physical amounts do not change materially; and (4) substantial differences in the average lives of replacements and additions from year to year. Even accepting the speculative computations of growth over long-term prosperity and ignoring the possibility of Section 167 being rescinded, the fears of the majority fall of their own weight, for the simple reason that the bigger the Deferred Tax Contingency Fund, the

greater the benefit of tax-free money available to California utilities and thus the greater and more lasting the benefit to be passed along to the ratepayers of said utilities.

While some utilities may take accelerated depreciation on the "flow through method" as prescribed in the majority opinion, the record indicates that the majority of major California utilities will reject it. Since the "flow through method" passes along to current ratepayers all benefits accruing from accelerated depreciation, there will be no funds with which to establish a Contingency Deferred Tax Reserve, unless such funds come from the stockholders. The majority opinion makes no provisions for the creation of such a Contingency Reserve. These utilities, in effect, will be borrowing depreciation credit from ratepayers of the future for the benefit of present ratepayers. Whether such utilities will be required to repay such borrowings from earnings normally accruing to stockholders or will be permitted to saddle this "deferred liability" upon future ratepayers through higher rates, will remain for this Commission to determine. In my opinion, any utility which elects to use up credits belonging to future ratepayers should be required to establish a compensating contingency fund out of stockholders' earnings.

It is an indisputable fact that rates would not be increased by permitting a utility to normalize its income taxes. Even witnesses opposing "normalization" admitted this fact, under oath, albeit, grudgingly.

Insofar as "normalization" of Federal income taxes is concerned, it must be pointed out that the entire rate-making procedure of this Commission involves "normalization". This is true not only in computing revenues but in estimating many expense items; therefore, it may be stated as a fact that "normalization" is an accepted theory and principle that has been followed by this Commission for many years.

By denying California utilities the right to normalize Federal income taxes for rate-making purposes, the Commission has denied the utilities of this state and the majority of ratepayers the advantages which, according to the records of Congress, Congress intended should accrue to such taxpaying corporations. In this regard, it is my opinion, despite the confusion generated by the voluminous and conflicting "evidence" recorded in these proceedings, that the majority opinion is adverse to the public interest.

C. LYN FOX
Commissioner