Decision No. 62585

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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 shown in Appendix A)

We are here concerned with the decision to be rendered on rehearing of Decision No. 61711.

General Background

This proceeding was instituted by the Commission in 1958 to consider the subject of the so-called "liberalized depreciation" which was authorized in 1954 for federal income tax purposes. On April 12, 1960, in Decision No. 59926, it was decided that "for the purposes of rate fixing," 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 and paid. The Commission based its decision on two major propositions: (1) the alleged deferred tax liability resulting from liberalized depreciation will not as a practical matter materialize, and (2) rates should be determined on the basis of the tax which a utility actually pays. Petitions for rehearing were denied. No judicial review was sought.

In Decision No. 59926, the Commission did not discontinue this proceeding, and on May 3, 1960 Decision No. 60018 was issued. Decision No. 60018 was a supplemental order concerning the accumulations for "deferred taxes" which a number of utilities had accrued pending the Commission's consideration of liberalized depreciation. It was therein ordered that, without further action of the Commission, no disposition might be made of such accumulations other than for the purpose for which they were created. (These accumulations will hereinafter be referred to as "tax reserves.")

On March 21, 1961, the Commission issued a further supplemental order, Decision No. 61711. Its purpose was twofold: (1) to direct a specific disposition

of these accumulated tax reserves, and (2) to guard against certain utilities' obtaining unjust enrichment from the fact that their rates had been fixed on the basis of straight line depreciation for taxes whereas they are actually reducing their current tax expense through the use of liberalized depreciation.

Petitions for rehearing of Decision No. 61711 were filed by several utilities, and on May 9, 1961 its effective date was ordered stayed. On May 22, 1961 a rehearing was granted. Hearings thereon were held before Commissioner George G. Grover and Examiner James F. Haley in San Francisco on June 12 and July 6, 7, 10, 24, and 31, 1961. On July 31, 1961, the matter of the rehearing of Decision No. 61711 was submitted, subject to the filing of concurrent briefs within ten days thereafter; such briefs have now been filed.

Tax Reserves

Ordering Paragraph 1 of Decision No. 61711 directed that tax reserves accumulated as a result of liberalized depreciation should be transferred to the depreciation reserve.

At the rehearing, certain parties argued that depreciation is an inherently improper account in which to record the tax savings (or tax deferrals) resulting from liberalized depreciation. On the other hand, there was evidence that at least one State (Wisconsin) requires such use of the depreciation accounts and that many leading accounting experts approve of it. We also note that the Securities and Exchange Commission, after extensive consideration, has found the practice acceptable. (Securities and Exchange Commission, Accounting Series Release No. 85, February 29, 1960, effective April 30, 1960; see also Accounting Research Bulletin No. 44 (revised) of the Committee on Accounting Procedure of the American Institute of Certified Public Accountants, July 1958.) It is unnecessary to consider these conflicting views in detail, for we have concluded that use of the depreciation reserve for recording these accumulations should be made permissive rather than compulsory. Ordering Paragraph 1 of Decision No. 61711 will be modified accordingly.

Modification of Ordering Paragraph 1 is not prompted by any recognition of the claimed accounting technicalities above referred to but results rather from the showing that in certain cases mandatory transfer to the depreciation accounts would result in substantial prejudice or inconvenience. For example, San Diego Gas & Electric

Company pointed out that it no longer takes liberalized depreciation for tax purposes[1/] and therefore does now pay higher taxes as a consequence of the reduction in taxes which it obtained while it was using liberalized depreciation; those current tax increases are met by charges to the tax reserve.[2/] The company argues that to transfer the tax reserve to the depreciation reserve under these circumstances would require the utility to meet such tax increases out of its profit. Several other utilities which no longer use liberalized depreciation might be similarly affected.[3/]

Compulsory transfer to the depreciation reserve might also cause difficulties for companies under the jurisdiction of certain Federal regulatory agencies which require deferred tax accounting for liberalized depreciation. Although separate accounting for Federal and State purposes is sometimes necessary, we believe that in this case accounting convenience might be defeated rather than served by an order which required inconsistent accounting methods for interstate and intrastate operations. A similar problem appears to exist for at least one company (Sierra Pacific Power Company) having substantial intrastate operations in California and Nevada; the Nevada Public Service Commission has not prescribed the use of depreciation accounts for deferred tax accounting.

These special cases indicate that there are instances where it may not be appropriate to transfer tax reserves to depreciation reserves. We are not to be understood as deciding that such transfer on a compulsory basis is never proper,

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1/ As stated in the order granting rehearing of Decision No. 61711, we are not here considering the claimed duty of a utility to take advantage of liberalized depreciation.

2/ On August 22, 1961, subsequent to submission of this matter, we issued Decision No. 62446 in Application No. 42887, in which we expressly recognized such use of San Diego Gas & Electric Company's tax reserve, and, for test year purposes, we correspondingly reduced its tax expense.

3/ Of course, under the straight-line remaining life method, an addition to depreciation reserve would lead to a decrease in depreciation expense, thus tending to compensate for the tax increases; but the two results would not necessarily be exactly offsetting. Certain utilities also argue that another effect of the proposed transfer to depreciation reserve would be a reduction in the total depreciation recoverable on the assets affected.

but we do find that a universal requirement to that effect is not desirable at this time. The various proposals for disposition of these reserves (submitted in response to the Commission's inquiries) will be handled on an individual basis.

It bears emphasis that in rate proceedings we will continue: (1) to deduct from rate base the tax reserves resulting from liberalized depreciation and accelerated amortization, and (2) to reduce test year tax expense by the amount of any charge to such reserves. Decision No. 60018, except as modified by orders of the Commission issued subsequently thereto, will remain in full force and effect.

Continuing Tax Differentials

Ordering Paragraph 2 of Decision No. 61711 did not deal with accumulated tax reserves as such but with the tax reductions that continue to result from use of liberalized depreciation.

Pending the Commission's consideration of liberalized depreciation, a number of utilities whose rates had been fixed on the basis of straight line depreciation for taxes, but who were taking advantage of liberalized depreciation, credited to tax reserves the amount by which their tax expense was thus reduced. The then effective uniform systems of accounts did not provide for such reserves, and the applications of certain utilities for permission to establish them were not acted upon by the Commission. Nevertheless, the Commission acquiesced in this practice. Various accounting devices were used to accommodate to the fact that deferred tax reserve accounts, such as those now authorized, did not then exist. For example, restricted surplus was used by some utilities, until rejected by the Securities and Exchange Commission. (Securities and Exchange Commission, Accounting Series Release No. 85, February 29, 1960, effective April 30, 1960.) The accrued taxes account was also used, notwithstanding the fact that it was designed for current accruals only and not for deferrals extending over many years; however, that method was ultimately disapproved by the Federal Power Commission, which insisted upon the use of true deferred tax accounts.

Following Decision No. 59926, some of the utilities who had credited their tax reductions to reserves (and who had unsuccessfully argued that their rates should continue to be fixed with an allowance for such credits) discontinued such credits and thereby increased their net profits. Ordering Paragraph 2 of Decision No. 61711 dealt with this situation; it required that so long as a particular

utility's rates continued to be based on straight line depreciation for taxes, then the amount by which taxes are reduced by liberalized depreciation should be credited to a reserve. As in the case of Ordering Paragraph 1, Ordering Paragraph 2 contemplated a credit to depreciation reserve rather than to a deferred tax reserve. 4/

The question presented is whether or not a utility whose existing rates have been fixed on the basis of straight line depreciation for taxes should be required to credit to a reserve the amount by which its taxes are reduced through use of liberalized depreciation. The Commission has been divided concerning the proper answer to be given to that question. On the one hand it was argued that the basis for credits to a reserve has been eliminated by the finding in Decision No. 59926 that no deferred tax liability results from the use of liberalized depreciation. On the other hand, since the rates of the affected companies have been fixed on the assumption that such credits would be made, it was reasoned that unjust enrichment might result if the tax savings were to be reflected in higher profits rather than in a reserve.

It has become unnecessary to resolve these conflicting views on a theoretical basis. Under any theory, the ultimate and vital question is the reasonableness of the rates and rates of return of the various utilities. We are now in a position to satisfy ourselves that no unjust enrichment will in fact result from discontinuation of the credits to reserve, and therefore we do not reach the question of how we might deal with such enrichment if it did occur. The two largest utilities affected (Southern California Edison Company and Pacific Gas and Electric Company) presented evidence at the rehearing to the effect that their present rates and rates of return are not unreasonable even though credits to a tax reserve be no longer made. Similar determinations may be made with respect to the other companies involved on the basis of investigation by the Commission staff. Accordingly, this case will be discontinued.

4/ Ordering Paragraph 2 was made operative as of January 1, 1960, because some utilities, following Decision No. 59926, had discontinued deferred tax accounting for liberalized depreciation as of that date.

the two named companies will be authorized to discontinue deferred tax accounting for liberalized depreciation as of January 1, 1961, and the remaining companies will be authorized to make individual letter applications for confirmation of their present accounting treatment of these tax reductions.

Southern California Edison Company

Following Decision No. 59926 Southern California Edison Company discontinued credits to the tax reserve for liberalized depreciation as of January 1, 1960. An officer of the company testified, however, that prior to the issuance of Decision No. 61711 the company had advised the Commission that, in order to resolve the problems which had developed with respect to liberalized depreciation, the company would be willing to transfer from surplus to the deferred tax reserve the amount of the tax reduction resulting from use of liberalized depreciation for 1960, provided the company were permitted by appropriate Commission action to reflect such tax savings in earnings beginning in 1961. He added that the company would still be willing to do so.

The evidence presented at the rehearing established that the company's rate of return for 1960, adjusted in accordance with methods currently followed by the Commission staff (which methods we hereby find to be reasonable), [5/] was 6.43%, on the assumption that credits to the tax reserve for liberalized depreciation be discontinued as of January 1, 1960. The estimated rate of return for 1961, similarly adjusted, would be 6.35%. If the tax savings had been credited to the reserve throughout 1960, the rate of return for 1960, similarly adjusted, would have been 5.90%. The last rate of return found reasonable for this company was 6.25%. The company's evidence was presented by sworn testimony, was subjected to cross-examination, and has been reviewed by the Commission staff. From the evidence it appears,

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5/ At the time of the latest rate case affecting this company (see Decision No. 55703 in Application No. 38382, October 15, 1957, 55 Cal. P.U.C. 743), the Commission was commencing its consideration of the subject of liberalized depreciation, and the company's tax reserves were not deducted from rate base. In later years, such deduction has uniformly been made, both for liberalized depreciation and accelerated amortization. These deductions constitute the only difference between the staff methods here found to be reasonable and the methods used in Decision No. 55703.

and we hereby find, that the company's proposal will eliminate the possibility of unjust enrichment as a result of its use of liberalized depreciation in 1960. We also find that the company's present rates and rate of return are not unreasonable for the future and that discontinuance of credits to the tax reserve for liberalized depreciation, beginning in 1961, will not result in unjust enrichment.

Since the company was required to file its federal income tax return for 1960 on September 15, 1961, it requested that we issue a decision herein by that date. Accordingly, we issued an interim opinion and order (Decision No. 62571) on September 15, 1961, directed solely to that company. We hereby reaffirm Decision No. 62571.

Pacific Gas & Electric Company

Pacific Gas & Electric Company introduced evidence showing that the rate of return for its electric department, estimated for 1961 in accordance with the staff methods hereinabove found to be reasonable, would be 6.25% on the assumption that no credits to a reserve be made because of liberalized depreciation. The company also pointed out that following issuance of Decision No. 59926, it had continued throughout 1960 to accrue to a reserve the tax savings resulting from liberalized depreciation and, with Commission approval, had transferred its entire tax reserve for liberalized depreciation (amounting to more than $35,000,000) to the depreciation reserve as of December 31, 1960. The evidence also shows that since the company's latest approved rate of return was fixed at 5.75% in 1952 it has experienced increased financing costs and other expenses. The Commission allowed a rate of return of 6.25% for the company's gas department earlier this year.

We hereby find that the company's present rates and rate of return are not unreasonable for the future and that no unjust enrichment will result from its discontinuation of deferred tax accounting for liberalized depreciation as of January 1, 1961.

Commissioner Mitchell is at present necessarily absent in connection with his duties as President of the National Association of Railroad and Utilities Commissioners and therefore has not had the opportunity to read this decision. Before his departure he reserved the right to file a dissent.

O R D E R

GOOD CAUSE APPEARING, it is hereby ordered that:

1. Ordering Paragraph 1 of Decision No. 61711 is modified to read as follows:

That every public utility under the jurisdiction of the Commission which now has accumulated tax reserves resulting from the use of liberalized depreciation methods in computing federal income taxes, except those utilities which prior to the date of this order have been authorized to dispose of such tax reserves, may transfer the balances in such tax reserve accounts to depreciation reserve accounts and report such transfers to the Commission within ten days thereafter.

2. Ordering Paragraph 2 of Decision No. 61711 is vacated.

3. Ordering Paragraph 3 of Decision No. 61711 is modified to read as follows:

Every public utility (other than Southern California Edison Company and Pacific Gas & Electric Company) which has transferred or proposes to transfer or carry to any surplus account any tax reductions resulting from use of liberalized depreciation shall forthwith apply by letter to the Commission for authority to reflect such reductions in surplus.

4. Ordering Paragraph 4 of Decision No. 61711 is affirmed.

5. If Pacific Gas & Electric Company utilizes liberalized depreciation in computing its federal income taxes for 1961 and subsequent years, it need not accrue to a reserve the amounts by which said taxes are thus reduced.

6. The motions to strike testimony and exhibits relating to results of operations are denied.

7. Case No. 6148 is discontinued.

The effective date of this order shall be twenty (20) days from the date hereof.

Dated at San Francisco, California, this 20th day of September, 1961.

Everett C. McKeage
President.
C. Lyn Fox
George G. Grover
Frederick B. Holoboff
Commissioners

Commissioner Peter E. Mitchell, being necessarily absent, did not participate in the disposition of this proceeding.