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Administrative Law-Rate-Making-Authority of FPC to Limit Rate of Return on Tax Reserves Resulting From Liberalized Depreciation

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RECENT DECISIONS

ADMINISTRATIVE LAW—RATE-MAKING—AUTHORITY OF FPC TO LIMIT RATE OF RETURN ON TAX RESERVES RESULTING FROM USE OF LIBERALIZED DEPRECIATION—Plaintiff, a natural gas pipeline company, filed a petition for review of a Federal Power Commission ruling in a rate proceeding under section 4(e) of the Natural Gas Act.[1] Plaintiff argued that Congress did not intend tax deferrals arising from liberalized depreciation[2] to be shared by producers and consumers and that, consequently, accumulated tax reserves[3] should be included in the company's rate base at an ordinary rate of return.[4] The FPC ruled that the petitioner could include its tax reserves in the rate base, but that the rate of return on the reserves would be limited to one and one-half percent.[5] On review of the order, *held*, affirmed, by a five-to-four decision. The FPC may fix any rate of return on tax reserves so long as it gives the company an incentive to use liberalized depreciation.[6] *Panhandle E. Pipe Line Co. v. FPC*, 316 F.2d 659 (D.C. Cir.), *cert. denied*, 375 U.S. 881 (1963).

1 52 Stat. 822 (1938), as amended, 15 U.S.C. § 717c(e) (Supp. IV, 1963). Section 4 provides that any increase in previously authorized rates must first be filed with the Commission, which has the authority to investigate the reasonableness of new rates.

2 An example of the "liberalized depreciation" permitted by the Internal Revenue Code is the "declining-balance" method. It permits a uniform rate of deduction against the unrecovered basis of the depreciable property. The percentage or rate used may equal, but not exceed, twice the rate that would have been used under the "straight-line" method of depreciation. (Under the straight-line method of depreciation, the cost basis of the property, less its estimated salvage value, is deducted from gross income in equal installments over the period of the estimated useful life of the property.) INT. REV. CODE OF 1954, § 167. Thus, for a machine costing $10,000 with an expected useful life of ten years, the first year's depreciation deduction allowance will be 20% (twice the straight-line rate of 10%) of $10,000 (original cost), or $2,000; the second year's allowance will be 20% of $8,000 (the unrecovered cost), or $1,600; the third year's allowance will be 20% of $6,400, or $1,280; and so forth. The result is that 40 to 50% of the cost of a depreciable asset is written off in the first quater of the asset's life. S. REP. No. 1622, 83d Cong., 2d Sess. 25 (1954).

3 Reserves are generated by the accelerating effect of the "declining-balance" method of depreciation, which temporarily frees accumulations for taxes so that they may be channeled into capital investment. See note 2 *supra*. In theory, the resulting reserves are said to be "tax deferrals." El Paso Natural Gas Co. v. FPC, 281 F.2d 567, 573 (5th Cir. 1960), *cert. denied*, 366 U.S. 912 (1961).

4 The return is computed as the product of the rate base multiplied by a reasonable rate of return expressed as a percentage of that rate base. Francis, *Rate Regulation of Natural Gas Companies by the Federal Power Commission*, 19 LAW & CONTEMP. PROB. 413, 419 (1954).

5 See principal case at 660.

6 The dissent argued that the decision violated the plain mandate of Congress and defied established precedent. Principal case at 666. On February 2, 1964, the FPC held that a pipeline the value of whose depreciable assets was stable or increasing would no longer be permitted to normalize its taxes. Alabama-Tenn. Natural Gas Co., 32 U.S.L. WEEK 2402 (Feb. 2, 1964) (two commissioners dissenting). In light of the holding of the court in the principal case respecting the policy of INT. REV. CODE OF 1954, § 167 as to the encouragement of capital development, it may be doubted whether the *Alabama-Tenn. Natural* case will be affirmed on judicial review. In any event, the FPC was not the only federal agency that had embraced normalization. The CAB, for example, permits normalization

When the Natural Gas Act was passed in 1938, it gave the FPC broad powers to regulate the transportation and sale of natural gas in interstate commerce.[7] The Commission was empowered to fix "just and reasonable" rates for the sale of natural gas,[8] and to determine "proper and adequate rates of depreciation and amortization" for a natural gas company.[9] The Natural Gas Act was unquestionably passed with an intention of protecting the consumer,[10] and the courts have generally given the FPC free rein to regulate the industry in any way that it sees fit to achieve this goal.[11]

The Commission has usually regulated pipelines' rates by the traditional rate base cost-of-service method.[12] Generally, there are four necessary steps in the rate-making process.[13] First, the original cost of plant and equipment, less accrued depreciation, is added to working capital to determine the rate base.[14] Second, operating costs are calculated on the basis of costs incurred during an adjusted "test period."[15] Third, a fair rate of return is determined in the light of such factors as risk, interest and dividend rates, and costs associated with marketing securities and raising capital.[16] The rate base is multiplied by the rate of return, and to that product is added the operating cost; the sum thus arrived at is the gross income which must be earned by the pipeline. Fourth, rates are fixed so as to ensure a return which approximates the computed gross income.

With the passage of the liberalized depreciation and accelerated amortization provisions in sections 167 and 168 of the Internal Revenue Code of 1954,[17] the Commission was confronted with the problem of how to implement the intention of Congress as expressed in the new tax law[18] and still comply with the mandates of the Natural Gas Act. The initial

of taxes on the ground of effectuation of the congressional intent behind INT. REV. CODE OF 1954, §§ 167 and 168, though it does not allow the inclusion of reserves resulting from normalization in an airline's rate base. General Passenger Fare Investigation, Hearing Examiner's Initial Decision, Doc. 8008 *et al.*, CAB, May 27, 1959, at 155-62.

7 Natural Gas Act § 1, 52 Stat. 821 (1938), 15 U.S.C. § 717 (1958).

8 Natural Gas Act § 5, 52 Stat. 823 (1938), 15 U.S.C. § 717d (1958).

9 Natural Gas Act § 9(a), 52 Stat. 826 (1938), 15 U.S.C. § 717h(a) (1958).

10 See Natural Gas Act § 1(a), 52 Stat. 821 (1938), 15 U.S.C. § 717(a) (1958). See generally Douglas, *The Case for the Consumer of Natural Gas*, 44 GEO. L.J. 566 (1956).

11 "[W]hen the Commission's order is challenged in the courts, the question is whether that order 'viewed in its entirety' meets the requirements of the Act . . . . If the total effect of the rate order cannot be said to be unjust . . . judicial inquiry under the Act is at an end . . . . It is the product of expert judgment which carries a presumption of validity." FPC v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944).

12 See, *e.g.*, City of Lexington v. FPC, 295 F.2d 109 (4th Cir. 1961).

13 See generally BAUER, TRANSFORMING PUBLIC UTILITY REGULATION 3-115 (1950).

14 See Francis, *supra* note 4, at 420.

15 See *id.* at 418.

16 See CLEMENS, ECONOMICS AND PUBLIC UTILITIES 153, 218 (1950).

17 The provisions for accelerated amortization of emergency facilities in § 168 were adopted prior to 1954. Int. Rev. Code of 1939, § 124A.

18 Congress expressed two main purposes underlying the new depreciation policy:

solution to the problem came in 1954 when the FPC ruled that a pipeline could charge to operating expenses its "normalized taxes," and that accruals for taxes in excess of those actually paid were to be included in the rate base.[19] The normalization process permitted natural gas companies to use the straight-line method of depreciation in fixing rates, while using the declining-balance method in computing the amount of taxes to be paid.[20] The decision was reversed on other grounds in *City of Detroit v. FPC*,[21] but the court upheld the Commission's ruling with respect to normalization of taxes.[22] In a later decision,[23] the FPC accorded to liberalized depreciation under section 167 of the Code the same treatment which the *City of Detroit* case had given to accelerated amortization under section 168.

The inclusion of the liberalized depreciation provisions in the Internal Revenue Code caused some writers[24] to comment that section 167 would result in substantial "tax savings" to a business that had a rate of expansion which exceeded its rate of retirement of depreciable assets.[25] The FPC[26] and the courts[27] were forced to consider the problem, and both have consistently taken the position that the use of liberalized depreciation results in "tax deferrals" rather than "tax savings."[28] By using the tax deferral theory, the FPC has been able to justify its inclusion of tax reserves in the rate base. The Commission has ruled that normalization is simply an application of customary accrual accounting, with provision being made for higher tax expenses anticipated in the later life of a depreciable asset.[29] Dissenting in a leading FPC decision,[30] Commissioner Connolle criti-

(1) to create incentive to "maintain the present high level of investment in plant and equipment," in order to promote "economic growth, increased production, and a higher standard of living"; (2) to enact a method of depreciation which "results in a timing of allowances more in accord with the actual pattern of loss of economic usefulness." H.R. REP. No. 1337, 83d Cong., 2d Sess. 22-24 (1954).

19 Panhandle E. Pipe Line Co., 13 F.P.C. 53 (1954).

20 See, *e.g.*, Amere Gas Util. Co., 15 F.P.C. 760, 781-82 (1956).

21 230 F.2d 810 (D.C. Cir. 1955), *cert. denied*, 352 U.S. 829 (1956).

22 *Id.* at 821-22.

23 Amere Gas Util. Co., 15 F.P.C. 760 (1956).

24 See Brown, *The New Depreciation Policy Under the Income Tax: An Economic Analysis*, 8 NAT'L TAX J. 81 (1955); Eisner, *Depreciation Under the New Tax Law*, 33 HARV. BUS. REV. 66 (1955). *Contra*, Guercken, *Economic and Regulatory Aspects of Accelerated Depreciation*, 58 PUB. UTIL. FORT. 145 (1956).

25 See Eisner, *supra* note 24, at 67-69.

26 See, *e.g.*, Amere Gas Util. Co., 15 F.P.C. 760 (1956).

27 See City of Lexington v. FPC, 295 F.2d 109 (4th Cir. 1961); El Paso Natural Gas Co. v. FPC, 281 F.2d 567 (5th Cir. 1960).

28 The Fourth Circuit has held that the tax savings theory is based on speculative considerations and is too tenuous to be advanced seriously as factual reality. City of Lexington v. FPC, *supra* note 27, at 114. *But see* Alabama-Tenn. Natural Gas Co., 32 U.S.L. WEEK 2402 (FPC 1964).

29 Treatment of Federal Income Taxes as Affected by Accelerated Amortization, 12 F.P.C. 369 (1953).

30 Amere Gas Util. Co., 15 F.P.C. 760, 783 (1956) (dissenting opinion).

cized this view and argued that tax accruals would result in huge savings for the pipelines. Implicit in the argument made by Commissioner Connole was the assumption that the pipelines will continue to grow each year and that capital retirements will not exceed new capital investment.[31] Thus, given the foregoing assumption, where new depreciable assets are added each year in the same amount (or in successively increasing amounts), the yearly depreciation under any liberalized method will never be exceeded by the straight-line charge.[32] Consequently, actual taxes will always be lower than normalized taxes, and consumers will be charged higher rates to provide for so-called "deferred" taxes which will never materialize.[33]

Subsequently, as evidenced by *Northern Natural Gas Co.*,[34] the FPC apparently became convinced that "deferred taxes" might actually contain an element of tax savings. The Commission found that "accruals [for taxes] in the year 1959 by natural gas pipeline companies . . . aggregate[d] . . . $39,000,000; and total accruals . . . [in March 1961] approach[ed] $110,000,000."[35] Since this was the first time the Commission had seriously considered the problem of increasing tax reserves, it had no precedent to rely on. There were at least two alternatives available to the FPC: either to deduct the reserves from the rate base[36] or to limit the rate of return on the reserves. In light of the congressional pronouncements in the legislative history of section 167,[37] the Commission was undoubtedly reluctant to deduct the accrual for taxes from the rate base, and thereby prevent the pipeline from investing any of the funds held in reserve. However, the findings in the *Northern Natural Gas* case indicated that, if a full rate of return were allowed on the tax reserves, the consumer would be charged with additional taxes resulting from the earnings on the reserve.[38] The most effective way to allow the pipeline to reap the benefits of liberalized depreciation and still enforce the consumer-oriented mandates of the Natural Gas Act was to lower the rate of return on the tax reserves. In the principal case, the FPC allowed an over-all return of six and one-quarter percent on the total rate base, reflecting a rate of return of one and one-half

31 *Ibid.*

32 See Brown, *supra* note 24, at 85-86.

33 For an excellent comparison of the long-range effects of the declining balance method of depreciation and the straight-line method in cases where there is a continuous rate of capital expansion, see Eisner, *supra* note 24, at 68-71.

34 25 F.P.C. 431 (1961).

35 *Id.* at 434.

36 Some state commissions have in fact deducted tax reserves from the rate base. See, *e.g.*, City of Alton v. Commerce Comm'n, 19 Ill. 2d 76, 165 N.E.2d 513 (1960).

37 See note 18 *supra*.

38 The majority opinion argued: "[I]n the present case if the $8,376,740 in . . . [the] deferred tax account is neither deducted from the rate base nor included in the capital structure at less than 6¼ percent rate of return prescribed for Northern . . . it will . . . earn . . . approximately $523,500.00 . . . . [T]his will increase its actual Federal income taxes by $567,125.00. Since Northern is entitled to include its actual taxes in its cost of service, the ratepayer would be required to pay this additional sum . . . ." Northern Natural Gas Co., 25 F.P.C. 431, 437 (1961).

percent on investment from the tax reserve and 6.46 percent on other investment.[39] This clearly reaffirms the position taken by the Commission in the *Northern Natural Gas* case.

The *City of Detroit* opinion, which was relied on heavily by the minority in the principal case, appears to support the proposition that the tax deferrals are provided solely for the benefit of the pipelines and should be allowed a full rate of return.[40] However, in the same decision, the court speculated that the treatment of accelerated depreciation then propounded by the FPC would "not allow Panhandle for rate purposes more than a fair return over the long period . . . ."[41] In other words, the court was willing to allow a normal return on reserves so long as it proved to be "fair," and so long as it did not violate the rule "that the primary aim of the [Natural Gas Act] . . . is 'to protect consumers against exploitation at the hands of natural gas companies.' "[42] It became evident to the Commission in the *Northern Natural Gas* case that the tax benefits conferred by sections 167 and 168 of the Internal Revenue Code were creating real rate-making problems which were proving to be detrimental to the interests of consumers.[43]

There is nothing in the legislative history of section 167 of the Internal Revenue Code which would indicate that Congress intended to negate the otherwise clear mandates of the Natural Gas Act. The courts have continually recognized the authority of the FPC to consider all factors which are relevant to the determination of "just and reasonable" rates, and the Commission is statutorily and constitutionally free to use any rate-making formula it chooses, so long as the formula will allow the regulated company to maintain its financial integrity.[44] In spite of this broad grant of administrative power, the FPC has seen fit to give the pipelines a greater opportunity to benefit from the tax savings afforded by liberalized depreciation than have many of the state public utilities commissions.[45] It would seem that the FPC's view is the more realistic one, since there is no reason to deny pipelines the benefits of a tax law so long as the benefits received are not inconsistent with the consumers' interests.

In sanctioning the limit imposed on the rate of return on accrued tax

39 Principal case at 660-61.

40 *Id.* at 666 (dissenting opinion of Miller, J.).

41 230 F.2d 810, 821 (D.C. Cir. 1955).

42 *Id.* at 815.

43 See note 38 *supra.*

44 Cities Serv. Gas. Co. v. FPC, 155 F.2d 694 (10th Cir. 1946).

45 Many of the state commissions have advanced the argument that the utility should not be allowed to benefit from an interest-free loan from the rate-payers by getting a full return on tax reserves. *E.g.*, Central Maine Power Co. v. Public Util. Comm'n, 153 Me. 228, 136 A.2d 726 (1957). Some commissions, though permitting normalization of taxes, have refused to allow the regulated companies to include the reserves in the rate base, City of Alton v. Commerce Comm'n, 19 Ill. 2d 76, 165 N.E.2d 513 (1960), while others have allowed only actual taxes paid to be charged against income, Montana-Dakota Util. Co., 102 N.W.2d 329 (N.D. 1960).

reserves, the District of Columbia Circuit has given the FPC a flexible method for dealing with the rate-making problems caused by the tax law.[46] First, if liberalized depreciation does indeed result in "tax savings," the Commission is apparently best able to balance the consumer and pipeline interests by adjusting the rate of return on reserves. Second, if income tax rates were lowered in the future,[47] part of the tax reserve would never be written off and consumers would have been charged a full rate of return on "deferred taxes" which would never actually be paid. Third, by imposing a restricted rate of return on tax accruals, the Commission is able to control capital expenditures by the pipelines and prevent the build-up of excess capacity in plant and facilities. Since the enactment of the Natural Gas Act, the FPC has been empowered to make necessary adjustments in its rate-making process as they become warranted by new circumstances.[48] In light of the problems created by liberalized depreciation, it would seem that the FPC's decision to limit the rate of return on accumulated tax reserves, in an effort to protect the consumer interests, is the most satisfactory compromise solution.

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[46] The Fifth Circuit is apparently the only other court of appeals that has considered the problem of limiting the rate of return on tax reserves. In El Paso Natural Gas Co. v. FPC, 281 F.2d 567 (5th Cir. 1960), that court argued that, while full effect must be given to the congressional intent to make tax deferrals available under liberalized depreciation, this did not mean that these tax benefits were to be translated into additional earnings over and above a reasonable return on investment. *Id.* at 571.

[47] This consideration may be particularly pertinent in light of current attempts to reduce the existing level of federal income tax rates.

[48] See FPC v. Natural Gas Pipeline Co., 315 U.S. 575 (1942).