COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ADJUSTMENT OF THE GAS AND ELECTRIC RATES, TERMS AND CONDITIONS OF LOUISVILLE GAS AND ELECTRIC COMPANY	))))	CASE NO: 2003-00433

RECEIVED

AUG 0 2 2004

PUBLIC SERVICE COMMISSION

RESPONSE OF THE ATTORNEY GENERAL TO COMMISSION ORDER OF JULY 26, 2004

CERTIFICATE OF SERVICE AND NOTICE OF FILING

I hereby give notice that I have filed the original and ten copies of the Attorney General's Response to Commission Order of July 26, 2004 this the 2nd day of August, 2004, with the Executive Director of the Kentucky Public Service Commission at 211 Sower Boulevard, Frankfort, Kentucky, 40601 and further certify that this same day I have served the parties by mailing a true copy of same to the following:

Michael S. Beer
Vice President, Rates & Regulatory
Louisville Gas and Electric Company
220 W. Main Street
P. O. Box 32010
Louisville, KY 40232-2010

Kent W. Blake
Director, Regulatory Initiatives
Kentucky Utilities Company
c/o Louisville Gas & Electric Co.
P. O. Box 32010
Louisville, KY 40232

John Wolfram
Manager, Regulatory Policy/Strategy
Louisville Gas and Electric Company
220 W. Main Street
P. O. Box 32010
Louisville, KY 40232-2010

Honorable Linda S. Portasik
Senior Corporate Attorney
Louisville Gas and Electric Company
220 W. Main Street
P. O. Box 32010
Louisville, KY 40232-2010

Honorable David C. Brown, Esq.
Sites & Harbison, PLLC
1800 Aegon Center
400 West Market Street
Louisville, KY 40202

Honorable Joe F. Childers
201 West Short Street
Suite 310
Lexington, KY 40507
Honorable Lisa Kilkelly
Legal Aid Society
425 West Muhammad Ali Boulevard
Louisville, KY 40202

Honorable Michael L. Kurtz
Boehm, Kurtz & Lowry
36 East Seventh Street
Suite 2110
Cincinnati, OH 45202

Michael A. Laros
Managing Director/Co-President
Barrington-Wellesley Group, Inc.
2479 Lanam Ridge Road
Nashville, IN 47448
laros@bwgi.com

David A. McCormick
DAJA-RL 4118
901 N. Stuart Street, Room 700
Arlington, VA 22203-1837

Honorable Iris Skidmore
Office of Legal Services
Natural Resources and Environmental
Protection Cabinet
5th Floor, Capital Plaza Tower
500 Mero Street
Frankfort, KY 40601

Honorable Kendrick R. Riggs
Ogden, Newell & Welch, PLLC
1700 Citizens Plaza
500 West Jefferson Street
Louisville, KY 40202

Honorable Allyson K. Sturgeon
Attorney at Law
Ogden, Newell & Welch, PLLC
1700 Citizens Plaza
500 West Jefferson Street
Louisville, KY 40202

Honorable Robert M. Watt, III
Attorney At Law
Stoll, Keenon & Park, LLP
300 West Vine Street
Suite 2100
Lexington, KY 40507-1801

Response of the Attorney General
To Commission Order of July 26, 2004
Case No. 2003-00433

Witness Responding: Robert J. Henkes and Counsel

1. Is the AG aware of any state regulatory commission decision or court order discussing the use of an effective state income tax rate for rate-making purposes? If yes, provide copies or citations to the commission decisions or court orders.

Answer:

Mr. Henkes is aware of no other state using an effective state income tax rate. Research has shown the use of the effective income tax rate-making purposes in several venues for federal taxes. Copies of the Orders are attached.

Westlaw Attached Printing Summary Report for BLACKFORD, BETSY 3999927

Your Search:	EFFECTIVE TAX RATE
Date/Time of Request:	Wednesday, July 28, 2004 09:44:00 Eastern
Client Identifier:	ATTORNEY GENERAL
Database:	PUR
Citation Text:	57 P.U.R.4th 136
Lines:	1102
Documents:	1
Images:	0

57 P.U.R.4th 136
57 P.U.R.4th 136
(Publication page references are not available for this document.)

C

Re Caribou Water Works

Additional applicants: Eastport Water Company, Greenville Water Company, Mechanic Falls Water Company, and Millinocket Water Company

Intervenors: Towns of Caribou, Greenville, Mechanic Falls, and Millinocket et al.

Docket Nos. 83-29 et al.

Maine Public Utilities Commission

November 3, 1983

APPLICATION for authority to increase water rates; commission modifies prior policy regarding consolidated tax returns and disallows income tax expenses incurred because of corporate structure of water utility holding company.

P.U.R. Headnote and Classification

VALUATION

s290 -- Working capital -- Methodology.

Me.P.U.C. 1983

The commission adopted the Federal Energy Regulatory Commission formula for determining net revenue lag or lead in computing working capital, stating that the methodology chosen need not rely on the recommendation of a witness but was within the expertise of the commission and subject only to a test of reasonableness. [1]

Re Caribou Water Works

P.U.R. Headnote and Classification

VALUATION

s290 -- Working capital -- Deferred taxes and depreciation.

Me.P.U.C. 1983

Depreciation and deferred taxes should not be included in a working capital study, the commission decided, since the booking of these noncash expenses has no bearing on the need for cash. [2]

Re Caribou Water Works

P.U.R. Headnote and Classification

VALUATION

s25 -- Date of valuation.

Me.P.U.C. 1983

New capital equipment placed into service after the end of the test year may be added to the rate base where it is shown (1) that its addition had no impact on revenues or expenses and (2) that its addition was not merely part of ongoing, routine additions to retirements from rate base. [3]

Re Caribou Water Works

P.U.R. Headnote and Classification

VALUATION

s25 -- Date of valuation.

Me.P.U.C. 1983

Due to an accounting delay, items were listed on the books as construction work in progress, but, the commission allowed their inclusion in rate base because they were placed into service before the end of the test year. [4]

Re Caribou Water Works

P.U.R. Headnote and Classification

EXPENSES

s117 -- Income taxes -- Consolidated returns -- **Effective tax rate**.

Me.P.U.C. 1983

In determining the federal income **tax** expenses for individual utilities that filed a consolidated return as a controlled group, the commission used an **effective tax rate** derived from actual taxes paid and total positive taxable income by deducting losses from taxable incomes, computing the **tax** on that amount at the applicable **rate**, and then dividing the amount of **tax** by total taxable income. [5]

57 P.U.R.4th 136
57 P.U.R.4th 136
(Publication page references are not available for this document.)

Re Caribou Water Works

P.U.R. Headnote and Classification

EXPENSES

s117 -- Income taxes -- Subsidiary utility -- **Effect** of corporatestructure.

Me.P.U.C. 1983

The commission found that the income **tax** expense that was incurred solely because of the particular corporate structure of a controlled group of utilities was unreasonable where the utilities failed to show the benefits of the structure and substantial **tax** detriments existed. [6]

Re Caribou Water Works

P.U.R. Headnote and Classification

EXPENSES

s95 -- Salaries and wages.

Me.P.U.C. 1983

Operating and maintenance expenses were adjusted for a salary increase that would take effect after the end of the test year but would be in effect for the period of the approved rates. [7]

Re Caribou Water Works

P.U.R. Headnote and Classification

DEPRECIATION

s81-- Water utilities.

Me.P.U.C. 1983

An additional depreciation expense was allowed for items the commission added to the rate base for the test year. [8]

Re Caribou Water Works

Before Bradford, chairman, and Gelder and Harrington, commissioners.

57 P.U.R.4th 136

By the COMMISSION:

The five water companies named above are subsidiary corporations of General Waterworks Corporation (hereinafter 'GWC'). Each of these companies filed a proposed increase in rates with the commission on February 1, 1983. The effective dates were March 3, 1983. On February 28, 1983, the commission suspended the rates until June 3, 1983. On May 31, 1983, the rates were again suspended until November 3, 1983. The municipalities of Caribou, Greenville, Mechanic Falls, and Millinocket each were granted intervention in the rate case of the company serving those municipalities. Herbert B. Shipley, a ratepayer of the Mechanic Falls company, was also granted status as an intervenor. A joint hearing on all of the cases was held on September 26 and 27, 1983. Of the five intervenors, only the towns of Mechanci Falls and Millinocket participated in the hearing. However, the towns of Caribou and Greenville participated in partial stipulations described below.

The five water companies are wholly or almost wholly owned subsidiaries of GWC. Therefore, many issues are identical for all of the companies. Some of the issues which were identical, as well as many which were unique to each company, were stipulated by the commission staff, the companies, and the participating intervenors. The hearing was limited to those issues which were not stipulated. Testimony was presented by Richard P. Yeomans, region account rate analyst for General Waterworks management service company and Alan Baran, the Maine district accountant for GWC.

I. Stipulated Issues.

We find that the partial stipulations, described below, are reasonable and we hereby adopt them as part of this order.

A. Common Issues.

The parties have stipulated that for each of the five companies the rate of return should be 12.54 per cent. This is based on GWC's actual cost of debt of 10.63 per cent and the stipulated cost of equity of 14.75 per cent. The capital structure of GWC is 53.6 per cent debt and 46.37 per cent common stock. Weighting the costs by the capital structure, the overall rate of return is 12.54 per cent.

The parties have also stipulated in each case that the test year shall be 1982. The parties have used investment balances at the end of the year for determining the rate base. [FN1]

B. Caribou Water Works Corporation.

57 P.U.R.4th 136
(Publication page references are not available for this document.)

The commission staff, the city of Caribou, and Caribou Water Works Corporation have stipulated that the rate base for the test year should be a minimum of $1,099,431. In dispute, and discussed below, are two possible additions to rate base, a working capital allowance and a replacement main installed in 1983, after the end of the test year.

The parties have stipulated that the 1982 actual expenses for operation and maintenance (O&M) adjusted for known and measurable changes, are $339,726 (including an amount equal to $20 per customer for management and service fees, a reduction from the actual 1982 amount); for depreciation, $40,381; for uncollectible revenues, $4,037; for taxes other than income taxes, $87,214.

C. Eastport Water Company.

The commission staff and Eastport Water Company have stipulated that the rate base shall be $382,065 (subject to possible adjustment for a working capital allowance). The parties agree that testyear expenses for 1982, for operation and maintenance, adjusted for known and measurable changes, are $172,864 (including $20 per customer for management and services); $10,048 for depreciation; $1,446 for uncollectible revenues; $33,631 for taxes other than income taxes.

D. Greenville Water Company.

The commission staff, the town of Greenville, and the Greenville Water Company have stipulated that the rate base should be $230,637, subject to possible adjustment for a working capital allowance.

The test-year expenses, which are 1982 actual expenses, adjusted for known and measurable changes, are $71,043 for operation and maintenance (including $20 per customer for management and service fees); $8,055 for depreciation; $417 for uncollectible revenues; $8,004 for taxes other than income taxes.

E. Mechanic Falls Water Company.

The commission staff, the town of Mechanic Falls, and Mechanic Falls Water Company has stipulated that rate base shall be $208,919, subject to adjustment for working capital allowance.

The parties have stipulated that the test-year expenses, which are 1982 actual expenses adjusted for known and measurable changes, are $78,695 for operation and maintenance (including $20 per customer for management and service fees); $6,421 for depreciation; $335 for uncollectible revenues; $10,225 for taxes other than income taxes.

57 P.U.R.4th 136

F. Millinocket Water Company.

The commission staff, the town of Millinocket, and the Millinocket Water Company has stipulated only to the capital structure and rate of return (see above under Subpart A) and to the fact that the expenses for management and service fees should be an amount equal to $20 per customer. However, the evidence revealed that there is, in fact, no dispute as to most of the items that should be included in rate base. The disagreements center around the inclusion of a replacement for filter influent controllers, a $39,942 item which is expected to be placed in service shortly but which was not in service in the test year, 1982; the inclusion of $2,609 worth of property which was in service in late 1982 but which was not removed from the construction work in progress (CWIP) account until 1983; and the inclusion of a negative working capital allowance. Omitting those three amounts, there is agreement that the rate base otherwise would be $699,878. Including the items in service in 1982, the rate base, exclusive of negative working capital, is $702,487.

There is also disagreement over only one component of operation and maintenance expense. The staff and the company agree that there should be a $5,192 adjustment to test-year O&M because of a 'known and measurable' increase in 1984 wages and salaries. The town does not agree. The staff, the town, and the company agree that the range of depreciation expense is between $27,929 and $29,561, depending on whether the capital items described above are included in rate base. All parties also agree that taxes other than income should be $36,710 and that uncollectible revenues should be $887.

II. Rate Base Adjustment.

A. Working Capital.

The companies in this rate filing did not propose that a working capital allowance be included in the rate bases. However, the intervenor towns of Millinocket and Mechanic Falls each proposed a reduction of the rate bases for Millinocket and Mechanic Falls water companies to reflect a negative working capital requirement. The proposal was made because much of the billing for those companies (for metered minimums and for all fire service) is done in advance.

GWC states that it would be content with no working capital adjustment, positive or negative, for any of the five companies. However, it argues that if rate bases are reduced for those companies with a negative working capital requirement, than a positive working capital requirement ought to be reflected in the rate bases of the other companies.

Because of the computation method favored by the companies, the staff argues that rate bases should be reduced for Mechanic Falls Water Company and Millinocket Water Company, to reflect the negative working capital requirement, but that the rate bases of the other three companies should not be increased.

57 P.U.R.4th 136

The intervenors towns of Millinocket and Mechanic Falls of course take no position as to Caribou Water Works, Eastport Water Company, and Greenville Water Company.

[1] GWC's witness, Mr. Yeomans, testified that there are three 'generally accepted' methods of computing a working capital allowance. The first is a detailed lead-lag study. The second is the so-called FERC (Federal Energy Regulatory Commission) formula. The third is the 'balance sheet approach.' No party recommends the balance sheet approach. Mr. Yeomans testified that a lead-lag study had not been done for these cases and that GWC does not believe that the time and expense of doing a full lead-lag study is cost justified for companies as small as the five in this proceeding. No party appears to dispute this viewpoint. Therefore, GWC presented working capital computations based on the FERC formula (basically altering only time periods) although it recognized that the formula is, at best, inexact and based on many assumptions.

GWC argues that 'whichever method (if any) the commission decides is the proper one, it should be applied consistently to all five . . . companies, not just the one or ones in which working capital would be negative. . . .' Our problem is not with GWC's advocacy of consistent treatment, but with its further argument that use of the FERC formula, as modified for the companies' time periods by GWC, is a method which would provide that consistent treatment. In fact, the FERC formula would appear to be workable (if at all) only for those companies which had a revenue lag. It creates a substantial distortion in the case of companies with a revenue lead.

The staff argues that the major defect of the FERC formula is that it ignores expense lags, which all the parties, including the companies assume normally exist for utilities, including these companies. The staff therefore argues that the FERC formula, which assumes a revenue lag, will overstate the working capital requirement in the case of a company in the normal position of having both revenue and expense lags. However, the staff further argues that in the case of those companies which appear to have revenue leads, such as Millinocket and Mechanic Falls, the FERC formula's exclusive focus on revenue will only result in an understatement of negative working capital. (Of course, as pointed out by the town of Millinocket's brief, that is itself an overstatement of the working capital 'requirement.')

In the case of companies with a revenue lag, the staff argues that the FERC formula should not be used because the formula ignores expense lags. Because it is not clear to what extent expense lags offset revenue lags, the formula might produce a positive working capital requirement when the actual need may be zero or negative. However, the staff further argues that it is appropriate to use the FERC formula in the case of companies with a revenue lead because at worst the formula understates the amount of negative working capital. The staff views this latter approach as 'conservative.'

We cannot accept the staff's position. While we will not adopt use of the FERC formula for either revenue lag or revenue lead utilities, nevertheless we do not believe that the staff's characterization of the FERC formula is wholly accurate.

57 P.U.R.4th 136
(Publication page references are not available for this document.)

In fact, as is argued by the intervenor town of Millinocket, the FERC formula does not necessarily ignore expense lags nor make an assumption that there is either no expense lead or lag. The formula appears to be designed to account internally for the fact that a utility generally has an expense lag.

The formula indeed does assume a revenue lag. However, it applies that lag to only one category of expenses, operating and maintenance. Thus, as pointed out by the town of Millinocket, the fact that expense lags are apparently ignored (by assuming no net lead or lag) tends to be offset by the application of the revenue lag to only a portion of overall expenses. Failure to consider the expense lag necessarily overstates the working capital requirement. However, failure to apply the revenue lag to many of the expenses tends to understate the working capital requirement. Thus, as long as these two simplifications tend to offset each other, the FERC formula may give a reasonable estimate for working capital. See Re Lockhart Power Co. (1978) 26 P.U.R.4th 540, 544, 545, Opinion No. 29. However, even though there is some offsetting effect under the FERC formula, it is clear that it makes a basic assumption in favor of a positive working capital requirement. A utility having a revenue lag might actually have had an expense lag which exactly offsets the revenue lag. There would therefore be no working capital requirement. Nevertheless, application of the FERC formula would inaccurately produce a positive working capital requirement.

The greater problem with the FERC formula, however, is that it is designed only to apply to a company which has a revenue lag; i.e., billing and collection occur after the provision of service. If this formula is applied to a company with a revenue lead, as is claimed to be the case with Millinocket and Mechanic Falls water companies, there is no offsetting effect. On the contrary, the two simplifications tend to have an aggravating effect. Ignoring expense lag tends to overstate the working capital requirement; applying the revenue lead only to a certain category of expenses (O&M) also tends to overstate the working capital requirement. Where there is a revenue lead, the effect of the revenue lead and the expense lag run in the same direction and are cumulative. The revenue lead is added to the expense lag to produce a net revenue-expense lead, resulting in a negative working capital requirement. Thus, application of the FERC formula produces a substantial overstatement of the working capital requirement or, more precisely, a substantial understatement of negative working capital.

The towns of Millinocket and Mechanic Falls have proposed a simplified lead-lag study which incorporates the FERC formula methodology of determining the extent of both the revenue and expense leads or lags and applies the net result to a broader category of expenses than operation and maintenance.

Mr. Yeomans opposed the use of such a methodology in his testimony, apparently on the ground that such a procedure was not recognized and because he believed that the FERC formula took into account expense lags. As we have explained, however, if a company has a revenue lead, the expense lag is not only not taken into account but its effect appears to be doubly ignored.

We believe that the approach suggested by the intervenors is a reasonable one and, with certain modifications, we adopt it. That the only witness testifying in the case opposes this method does not preclude us from adopting what we believe to be a reasonable method. In Mars Hill & Blaine Water Co. v Maine Pub. Utilities Commission (Me Sup Jud Ct 1979) 397 A2d 570, 576, the law court stated:

'The methodology used by the commission in its rate-making determinations need not be suggested by any witness in the record. The methodology itself lies within the commission's expertise and discretion, and is subject only to a test of reasonableness.' [FN2]

Under this method we will use the FERC methodology for determining the net revenue lag or lead. We have used the method used in the companies' joint Exh 3 and in the intervenors' briefs. This exhibit computes: (1) the lead or lag of the time of the calculation and sending of bill, based on the average number of service days in the billing period and whether the billing is in advance or in arrears [FN3]; and (2) the billing and collecting period, which is assumed to be thirty days for all billing for all five companies. These two time periods (in some cases negative where there is advance billing), are added to determine a net lag or lead. Each of these periods are then weighted according to the percentage of total revenues which each reflects. These weighted amounts are then added to determine a net revenue lead or lag. A net lead, indicative of a negative working capital amount, is expressed in parentheses. Net lag, indicative of a positive working capital requirement, is expressed without parentheses.

We have made one substantial change from the computations provided by the companies in joint Exh 3 by towns of Millinocket and Mechanic Falls in their briefs. These parties have assumed that fire service for those two towns, as well as some private fire service in the case of Eastport Water Company, is billed semiannually in advance, but have also assumed 180 average service days. If billing is actually semiannual, the average number of service days should be ninety rather than 180. We have therefore corrected the time period and have recalculated the net revenue leads or lags.

The computation of the revenue lags or leads are shown as the upper portions of the tables attached to this order as Appendix A [omitted herein].

For the calculation of the expense lags or leads we have followed the approach used by the town of Millinocket with certain described modifications.

The towns of Millinocket and Mechanic Falls have computed the lag times for several expense categories in addition to operation and maintenance. They have also divided O&M into three categories: salaries and wages, purchased power, and other. Each has a different lag time.

For salaries and wages we will use an expense lag of 11.5 days. This is based on the testimony of Alan Baran, the Maine district accountant for GWC, that the companies have a two-week payroll which begins and ends on Saturdays. Employees generally receive their checks on the Wednesday or Thursday following the end of the payroll period. The mid-point of the payroll period is seven days. If payment is made either four or five days later the average payment time is 4.5 days. The expense lag is therefore 11.5 days.

Mr. Baran testified that all the companies are billed for power on a 30-day cycle

57 P.U.R.4th 136

and that the companies generally pay their bills in about twenty-five days. This results in an average expense lag of forty days.

Other operation and maintenance (the amount of which is computed by deducting the previous two categories from the stipulated O&M amounts for each company), is assumed to have an expense lag of forty-five days. There is no evidence in the case that the company has done any study of the lag for these expenses. However, Mr. Baran testified that prepaid expenses are minimal. We have assumed an average of fifteen days between the provision of goods and services to the companies and the billing for them by the suppliers. We have assumed another thirty days for the companies to pay these bills. We believe these assumptions are reasonable. However, we expect that when this formula is used in the future, there will be actual evidence of the amount of lag.

The town of Millinocket has urged the use of fifteen expense lag days for current federal and state income taxes 'based upon an assumption that taxes are paid to General Waterworks monthly in arrears.' There was no testimony as to when any of these payments were made.

We do not believe that the payment schedule of the companies of amounts for taxes is relevant in any event. None of the companies should be required to pay in advance of GWC's own schedule and, if they are, ratepayers should not have to bear the burden of that lead. We have calculated a 37.5-day lag for federal and state income taxes. We use the dates for payment of estimated taxes by the consolidated group pursuant to 26 USC §6154(B). [FN4] A consolidated group filing a consolidated return is governed by this section of the tax code. See IRS Reg § 1.1502-5. Use of the dates of the consolidated group's return was approved by the law court in Camden & Rockland Water Co. v Maine Pub. Utilities Commission (Me Sup Jud Ct 1981) 432 A2d 1284, 1289, 1290. In using the IRS payment schedule we have assumed that GWC pays on time and that its estimated tax payments are accurate. We have used the same computation for state income taxes. 36 MRSA §5230(1-A) requires payment of estimated taxes by corporations on the same schedule as for federal taxes.

The category shown in the Millinocket brief as 'taxes other than income' consists primarily of local property taxes, but also includes payroll taxes. For local property taxes we have used the service period of April 1st to April 1st of each year, as required by the law court decision in Camden & Rockland Water Co., supra, 432 A2d at pp. 1290-1292. For the payment time we have used the last day on which taxes are payable without penalty. We have taken official notice of these dates. [FN5]

For payroll taxes we have assumed a lag of thirty days. This is based on the rule under 26 USC §6302 that employers with over $500 liability per month (for both FICA and payroll combined, although the amounts in this lead-lag study are limited to the FICA taxes) must pay the accumulated liability by the fifteenth of the following month.

For interest expense, which the companies pay to GWC, we have used fifteen expense lag days based on Mr. Yeomans testimony that interest is paid monthly in arrears by the companies to GWC. As in the case of income taxes we believe that

57 P.U.R.4th 136

the lag is correctly measured by GWC's payment schedules rather than that of the companies, which have no debt of their own. In the absence of such evidence we will use the companies' own schedules of payments to GWC, recognizing that they are probably a very conservative estimate of the lag. It is probably fair to assume that most of GWC's debt is long term. Interest payments for long-term debt are often on a semiannual schedule.

[2] The town of Millinocket has proposed inclusion of depreciation and deferred income taxes notwithstanding our ruling in Re Bangor Hydro-Electric Co. (1982) 46 P.U.R.4th 503, 530 that they should not be included in a working capital study. Millinocket argues that the commission in Bangor Hydro-Electric 'did not address the issue in terms of whether an adjustment should properly need to reflect timing differences in the receipt of noninvestor supplied capital.' (Emphasis added.) The town argues that the company collects expenses from its ratepayers before those expenses are 'booked.' We believe this argument misses the point that these expenses do not require an expenditure of cash by the company and therefore do not require working capital. Working capital, positive or negative, is designed to compensate for cash-flow (or cash overabundance) problems. The timing of the booking of these noncash expenses has no bearing on the need for cash. We therefore exclude depreciation and deferred taxes from our working capital calculations.

The lower portions of the tables contained in Appendix A [omitted herein] show the dollar amounts of each expense category; the daily dollar amounts of each category (the annual amount divided by 360 days); the revenue lead or lag, carried forward from Table 1; the expense lag; the net lead or lag, derived by adding the net revenue lead or lag and the expense leads or lags. Finally, the working capital amount for each expense category is computed by multiplying the daily amount of each expense by the number of net lead or lag days. The total working capital requirement is shown by adding these amounts.

It is interesting to note that the working capital requirements produced by this formula are very close to those produced by GWC's modified FERC formula in the case of Caribou and moderately close in the case of Eastport. Both of those companies have a substantial number (forty-five to sixty) of revenue lag days. However, as expected, the differences were substantially greater in the case of Millinocket, which had 12.5 revenue lead days. Slightly more surprising is the fact that the two formulas resulted in disparities which were almost as great for the two companies with virtually no revenue lead or lag, Greenville and Mechanic Falls. Stated alternatively, if a company actually has a negative working capital requirement (as shown by our simplified lead-lag method) the FERC formula appears to understate the negative amount. If the FERC formula does produce relatively accurate results (a conclusion far from certain with this sample of two) it does so only in the case of companies with revenue lags and perhaps only those with large lags.

We believe that the use of this simplified lead-lag study has much to recommend it in the case of small utilities and that it has a greater potential for accuracy than the FERC formula if for no other reason than it considers expense lags.

However, we wish to emphasize that we do not consider it as a substitute for a true detailed lead-lag study. It has been this commission's general policy to require a detailed study for working capital and we will continue to do so in the case of all but the smallest utilities.

We also emphasize that in any future use of this formula, we expect lead or lag periods to be based on record evidence, including estimates, rather than purely on assumptions, however reasonable.

B. Inclusion in Rate Base of Items Not in Service Until After Test Year.

[3][4] The Caribou Water Works Corporation and the Millinocket Water Company each have argued that certain capital additions that were under construction in 1982 should be added to their rate bases for the adjusted test year. In Caribou the item is a replacement main installed on Bradley street at a cost of $11,899. The project was completed in January 1, 1983.

The project in Millinocket is the replacement of the filter influent controllers at the treatment plant. In addition, Millinocket Water Company seeks to include an amount of $2,609, reflecting various small projects which were actually in service at the end of the test year. These projects were not shown on the books as being in service as of that date but rather as construction work in progress (CWIP).

The staff opposes the inclusion of the

	A MPUC Simple Lead/Lag	B GWC Modified FERC	C Difference (B-A)	D Difference as Per Cent of Total Revenue
Caribou	$52,733	$56,598	$3,865	0.6
Eastport	18,490	25,973	7,483	2.9
Greenville	(7,689)	396	8,085	7.1
Mechanic Falls	(9,487)	0	9,487	9.1
Millinocket	(43,922)	(9,279)	34,643	9.0

Caribou main and the Millinocket filter influent controllers. It does not oppose inclusion of the Millinocket items which were in service prior to the end of 1982. The town of Millinocket opposes the inclusion of both the filter influent controllers and the small Millinocket projects in service at the end of 1982. The filter influent controllers were not in service at the time of the hearing in this case, on September 26 and 27, 1983, but were expected to be placed in service shortly.

We reject the inclusion of both the Millinocket filter influent controllers and the Caribou Waterworks Bradley street main. We will allow the inclusion of the Millinocket items which were in service at the end of 1982.

57 P.U.R.4th 136

The staff argues that the inclusion of new capital equipment items in rate base which were not in service during the test year should not be permitted, even though those items will be in service during the period of the approved rates. The staff claims that inclusion violates the fundamental basis of the test-year concept. The 'test-year concept matches revenues, expenses, and rate base in an attempt to ensure a consistent relationship for measuring an appropriate level of return that the utility can reasonably be expected to earn during a 12-month period.' New England Teleph. & Teleg. Co. v Maine Pub. Utilities Commission (Me Sup Jud Ct 1982) 448 A2d 272, 293. The addition of an item to rate base which was not actually in service during the test year--i.e., the same period during which revenues and expenses have been measured--has the clear potential for producing a mismatch on these three items.

The Millinocket and Caribou companies argue that inclusion of these items in rate base is an appropriate adjustment to test year because the purpose of an adjusted test year is to provide an accurate estimate of rate base, revenues, and expenses in the period during which the approved rates will be in effect. If the item in question will actually be serving the public, under this view, the utility should earn a return on it. [FN6]

The difficulty with the companies' argument is that it does violate the test-year concept by ignoring the interrelationships and the balance of investment, expenses, and revenues. If it is permissible to consider the inclusion of itmes in rate base which were not actually added until after the test year, it may be equally necessary to consider retirements, other changes in the depreciation reserve, and any changes in expenses and revenues during this same period as that of the addition to rate base. By then, there might as well be a new test year.

Nevertheless, we believe that in certain instances new capital equipment may be added to rate base when it is shown (1) that their addition had virtually no impact on revenues or expenses, and (2) they are not merely part of ongoing and routine additions and retirements from rate base; i.e., that their impact is substantial and not likely to be offset by other changes in investment. If the post-test-year additions are merely routine, the test year will already reflect such additions.

The Millinocket Water Company filter influent controllers fails to meet the first of these tests. The equipment is replacement equipment. Unlike a water main extension, for example, which will generate new customers, it will not produce new revenues. However, there is nothing in the record to indicate the effect that this equipment will have on expenses. It is possible that the replacement equipment was in such poor condition that no amount of maintenance would make it work and that there was therefore no associated maintenance expense. It is also possible that a filter does not need maintenance because it simply sits and filters until it wears out. However, it is also possible that the filter was operable but costing so much in maintenance expense that it was prudent to replace it, in which case there should be an adjustment for the reduction in maintenance expense. In the absence of evidence it is impossible to determine whether there is an offsetting expense reduction or not. It is the company's burden to justify the inclusion of an out-of-test-year item in rate base. We hold that it failed to meet that burden by failing to show the absence of a reduction in expenses.

57 P.U.R.4th 136
(Publication page references are not available for this document.)

We are not willing to accept the staff's argument on this issue. The staff has argued that the failure of the companies to apply for approval should, by itself, preclude use of an effective tax rate for GWC and require the continued use of the effective tax rate for I.U. International. The staff argues that this is 'a fair and logical consequence of the violation of §104.'

The failure to apply is, in itself, a purely procedural violation. Application of a sanction which in effect disallows a sale, without determining the extent of harm to the ratepayers or investors, is too sweeping. [FN15] It would be clearly disproportionate where the only defect is procedural and the reorganization clearly would have been approved.

On the other hand, effectively disapproving the sale (by requiring continued use of the I.U. International effective tax rate) may be appropriate if it were clear on the record that we would have not approved the sale in a proceeding under §104. However, it is simply impossible on this record to determine whether this sale would have been approved. The companies apparently are of the belief that approval was not required. The reason for this view is not known. There is no indication in the record that there was any notice to the company that the validity of the sale under §104 was an issue in this rate case. The first reference to the issue appears at T. B-45 in a question by the staff attorney. The issue simply was not litigated in this proceeding. We do not know and cannot know for sure (1) whether the company was actually required to apply and (2) whether approval would have been granted or denied. In particular, without full development of the issue, it is difficult to determine here whether we would have held that the negative tax consequences of the sales were or were not 'consistent with the interests of the utility's ratepayers and investors.' 35 MRSA § 104(3-A)(A). For that reason, we decline to adopt the hypothetical corporate structure advocated by the staff and will apply the **effective tax rate** of General Waterworks Corporation.

However, it is yet to be determined what **effective tax rate** should be applied to GWC. The staff argues in a third alternative that we should abandon our present policy that only chronic **tax** losses should be included in the calculation of the **effective tax rate** and that we should instead include all actual **tax** losses.

The explanation for not including nonchronic **tax** losses was stated in our decision in Re Mechanic Falls Water Co. (1976) 13 P.U.R.4th 347, and by the law court in the same case on appeal, Mechanic Falls Water Co. v Maine Pub. Utilities Commission (Me Sup Jud Ct 1977) 381 A2d 1080. If a subsidiary company were in fact independent (or if it filed an individual return even though it was part of a controlled group), it could use the occasional losses on a carry-forward or carry-back basis to offset taxable income in other years. By contrast, a chronic loss company could not use tax losses in other years because there would be no profit to offset. [FN16] In Mechanic Falls, we apparently adopted the view of the staff's expert that nonchronic tax loss companies should be 'compensated' by the system as a whole for the use of their tax losses to reduce the system's consolidated tax liability. Under that view, we have allowed 'collection of 'taxes' sufficient to pay both the federal government and nontax loss or recovery companies.' (13 P.U.R.4th at p. 353.) We adopted that policy, however, not without reservations; stating that

'We wish to go on record as noting, however, that we have reservations about permitting a rate enabling such recoveries. . . .. We feel that even this approach may prove too generous to the utility.' (13 P.U.R.4th at p. 353.)

We now are not able to perceive any valid distinction between chronic tax losses and nonchronic tax losses. While it is true that a company with chronic tax losses could never use them and a company with an occasional tax loss might use it on a carry-forward or a carry-back basis if the company were independent of the consolidated group, in reality, neither kind of loss can be used by a company individually as long as it is part of an affiliated group which files a consolidated tax return.

In Mechanic Falls Water Co. v Maine Pub. Utilities Commission, supra, the law court stated that a then recent study showed that a plurality of state commissions permitted utilities to recover from ratepayers only their proportionate share of the actual consolidated tax paid without compensation to nonchronic tax loss companies. No argument has been presented to us which requires 'compensation' to a company for its tax losses which it cannot use as long as it is part of an affiliated group filing a consolidated tax return. It is only if a consolidated return were not advantageous to the group as a whole that an affiliated group would return to filing separate returns. In the light of the long history of I.U. International and GWC's consolidated returns, such a possibility appears unlikely.

Therefore, in this case, having delayed the implementation of treating each company as if it were not part of a controlled group, we will adopt the alternative position of the staff and apply an effective tax rate for General Waterworks Corporation which uses all of the tax losses. Based on calculations provided by GWC's witness, the effective tax rate for the four-year period of 1979 through 1982 would be 40.41 per cent. [FN17]

B. 1984 Salary Increase for Millinocket Water Company.

[7] The five companies have proposed to adjust test-year operation and maintenance expenses for an increase in salaries which will be granted effective January 1, 1984. None of the parties oppose this adjustment except for the town of Millinocket in the case of Millinocket Water Company. The town argues that the salary increase is 'too speculative and premature.' In fact, the decision as to the amount of the wage increase was being formulated by GWC at the time of the hearings in this case on September 27, 1983. GWC's witness testified that the proposed wage increase was for 5.5 per cent and was subject to approval by GWC management. The companies late filed Joint Exh 4 establishes that the increases at that level were in fact granted. The increases therefore hardly seem 'speculative.' They will be in effect during all but an insubstantial portion of the effective period of the rates approved in this case. The town did agree to an adjustment for the 1983 salary increase and has not attempted to distinguish the 1983 increase from the 1984 increase. The 1984 increase has no effect on other expenses, revenues, or rate base. We find that it is an appropriate adjustment to the operating and maintenance expense for Millinocket Water Company as well as for the other four companies.

57 P.U.R.4th 136

57 P.U.R.4th 136

(Publication page references are not available for this document.)

C. Increases in Millinocket Depreciation Expense Because of Out-of-test-year Additions to Rate Base.

[8] Millinocket Water Company has also argued that its depreciation expense should be increased if we allowed the inclusion in rate base of the $2,609 worth of small items that did go into service during test year but which were not added to in-service plant until afterwards. Because we did approve their inclusion, see Part II, B, we also will allow an adjustment to depreciation expense to reflect the fact that these items will be depreciated during the period of the rates approved in this case.

IV. Conclusion.

The revised rate bases, expenses (including income taxes) and revenue requirements are shown in detail in the comparative income statement attached as Appendix B [omitted herein]. For Caribou Waterworks Corporation the revenue increase is $52,579, [FN18] or 8.5 per cent over 1982 (test-year) revenues. For Eastport Water Company the revenue increase is $26,497, or 10.2 per cent over 1982 revenues. For Greenville Water Company the revenue increase is $12,268, or 10.8 per cent over 1982 revenues. For Mechanic Falls Water Company the revenue increase is $24,858, or 23.7 per cent over 1982 revenues. For Millinocket Water Company the revenue increase is $63,651, or 16.6 per cent over 1982 revenues.

FN1 The commission wishes to express its preference for use of an average rate base for determining rate base because of its greater potential accuracy. The use of the average of the levels of investment at the end of thirteen months-- e.g., December 31st to December 31st--provides a picture of the rate base during the same period in which revenues and expenses are measured. We understand that in this case there was little difference between the method used and an average.

FN2 The methodology in question was the use of an average of several years' effective income tax rates to compute the effective rate used by the commission.

FN3 As in the FERC formula, the average (expressed as either the mean or the median) number of days in the billing period constitutes the number of days of lead or lag, depending on whether the billing is in advance or in arrears. Thus, if there is quarterly billing in advance of the ninety days of service provided, there is an average lead of forty-five days between the date of the bill and the provision of the service. All periods expressed in these computations are assumed to have 30-day months, 90-day quarters, and 360-day years.

FN4 Estimated taxes for the first quarter are due fifteen days after the end of the first quarter. Estimated taxes for the other three quarters are due fifteen days before the end of the quarter.

57 P.U.R.4th 136
(Publication page references are not available for this document.)

FN5 These dates are shown it [sic] certified copies of the tax warrants or ordinances which set the dates upon which taxes are due without penalty.

FN6 In the only authority cited to us which has allowed the inclusion of similar items in rate base the staff in each instance did not oppose inclusion.

FN7 Of course, if a 13-month average test year had been used, the effect of these actions would be truly de minimus rather than merely minor.

FN8 A 'consolidated return' may be filed by an 'affiliated' group. 26 USC §§ 1501 , 1504(a). The definitions of an 'affiliated group' and a 'controlled group' are similar. For purposes of this case they may be considered identical. GWC and its member companies are both an 'affiliated' and a 'controlled' group.

FN9 The effective rate is determined as follows. First, taxable losses are deducted from taxable incomes and the tax on that amount is computed at applicable rates. This amount is then divided by the total taxable income (not including the losses) to yield the effective tax rate.

The commission in the past has included only those companies with 'chronic' tax losses in the computation. See discussion of this policy under infra.

FN10 The company's witness and brief have both referred to the method which it has advocated as the 'stand-alone' method. Similarly, the staff has referred to its method as the 'stand-alone' method. Clearly, an argument may be made that each characterization is accurate. For a variation under this description, see Re Columbia Gulf Transmission Co. (FERC 1983) 54 P.U.R.4th 31, Opinion No. 173. Therefore, to avoid confusion, we will avoid use of this term.

FN11 If it were necessary in this case to determine whether GWC had met its burden of demonstrating benefits which wholly or partially offset the tax detriment of its structure, we would have to hold that it had not. That this burden would have belonged to the companies, rather than to the staff and intervenors, seems clear in this case.

The law court has stated that notice adequate to allow sufficient time for preparation for any evidentiary issue must be given 'where. . . the commission is contemplating a change in a long-standing policy which would adversely effect a utility. . . .' Mars Hill & Blaine Water Co. v Maine Pub. Utilities Commission (Me Sup Jud Ct 1979) 397 A2d 570; Mechanic Falls Water Co. v Maine Pub. Utilities Commission (Me Sup Jud Ct 1977) 381 A2d 1080.

The companies were informed of the staff's argument concerning this tax issue at least three weeks prior to the hearing. They did not object at the hearing to evidence relevant to this issue, nor have they claimed in their brief that they

57 P.U.R.4th 136

were in any way prejudiced by the amount of notice given to it by the staff and intervenors. Moreover, the commission has indicated possible future consideration of this policy in a decision involving GWC, Re Mars Hill & Blaine Water Co. (1977) 19 P.U.R.4th 380.

FN12 The authority supporting the staff's position is less than overwhelming. The staff has cited one case which has adopted its position and we have not been able to find any additional cases. Re Wakefield Water Co. (RI 1980) 32 P.U.R.4th 476. The Rhode Island commission, citing two of its own previous cases, noted (32 P.U.R.4th at p. 488)

'That the company chooses to do business in the form of a subsidiary of another company [General Waterworks] is a matter of choice, not necessity.'

The weight of this authority is somewhat diminished, however, by the fact that the commission evidently viewed its decision as a compromise of its own water division's argument that it should apply the Maine effective tax rate method, which apparently would have resulted in an even lower rate (9.2 per cent for I.U. International) than that resulting from treating each company as if it were not part of a controlled group. The water division's argument was rejected because the commission believed that there was insufficient evidence to make an accurate determination.

and, quoting one of the earlier cases, held that (32 P.U.R.4th at p. 488)

". . . the conglomerate status of its parent, grandparent, and great grandparent should not result in a disadvantage to the local ratepayers."

FN13 Neither intervenor town has made this argument in its brief.

FN14 35 MRSA §104(3-A) requires commission approval for any 'reorganization.' The applicant must establish that 'the reorganization is consistent with the interest of the utility's ratepayers and investors.'

A 'reorganization' is defined by §104(1)(B-1) as including '. . . transfer of ownership or control . . . of an affiliated interest. . . .'

I.U. International is an 'affiliated interest' of the utilities within the meaning of the statute. 'Affiliated interest' is defined by §104(1)(A)(1) as including 'any person [a 'person' includes a corporation, 35 MRSA § 104(1)(B)] who owns directly, indirectly or through a chain of successive ownership, 10 per cent or more of the voting securities of a public utility.'

FN15 35 MRSA §104(5) contains its own civil violation for failing to 'obtain consent as required by this section after notice by the commission of violation.' The violation is for failing to obtain consent rather than failing to apply. Nothing in this record indicates that any notice was provided. Of course, it does

57 P.U.R.4th 136
(Publication page references are not available for this document.)

not necessarily follow that this civil violation is the exclusive remedy or that it should be the only consequence for a violation of § 104.

FN16 In the Mechanic Falls case, the commission found that the only chronic loss companies were the holding companies themselves; i.e., I.U. International and GWC.

FN17 For 1979 the effective tax rate, including all tax losses, was 41.89 per cent; for 1980, 43.55 per cent; for 1981, 34.16 per cent; for 1982, 41.23 per cent.

The average of these four rates is 40.41 per cent, not 40.16 per cent as stated by Mr. Yeomans.

FN18 See footnote at Appendix B, p. 1 [omitted herein].

END OF DOCUMENT

57 P.U.R.4th 136

It is not necessary to consider whether the filter influent controllers, which amount to 5.38 per cent of the test-year rate base, meet the second test.

The replacement main on Bradley street in Caribou apparently satisfies the first of these two tests. Because it is a replacement main rather than an extension main, it does not create new revenues or new operating expenses. However, Caribou Waterworks has failed to show that this replacement is anything other than a part of routine program of retirement and replacement of water mains as they wear out. In this instance, the cost of the proposed addition to rate base is about 1.07 per cent of the 1982 rate base. We therefore will not allow the inclusion of the Bradley street main in the Caribou Waterworks rate base.

Finally, it is necessary to consider inclusion of the $2,609 worth of Millinocket Water Company small items that were actually in service in 1982 but listed on the books as CWIP at the end of the year because of an accounting delay. We will allow the inclusion of these items in rate base because they were actually in service during the test year, even though we believe that this is a close issue on this record. As in the case of routine additions and retirements from rate base outside of the test year, it is difficult to tell if the same accounting delay might have prevented timely booking of some retirements or other exclusions from rate base which should be considered along with the proposed inclusions. In the absence of any such evidence, however, we will assume that the Millinocket Water Company has accurately reported the delayed bookings. [FN7] The staff agrees that this was an 'unusual situation.'

III. Adjustments to Expenses.

A. Federal Income **Tax**.

[5][6] The commission staff and the intervenor towns of Millinocket and Mechanic Falls have argued that the commission should depart from the policy we have followed since 1977 of applying an '**effective tax rate**' to utilities which were part of an 'affiliated group' filing a consolidated **tax** return. The staff and intervenors argue that each individual company instead should be treated on a hypothetical basis, as if it were able to take advantage of the lower **tax** brackets for lower amounts of income.

General Waterworks Corporation argues that we should not adopt the proposed policy and, moreover, that we also should abandon the present '**effective tax rate**' policy and treat each member company of the 'controlled group' as if it actually filed an individual return and paid taxes at the **rate** which it would pay thereunder.

If each company did in fact file separately, it would be liable for taxes at close to the maximum **rate** of 46 per cent, because the companies would still be defined as 'controlled group' under federal **tax** law and would be allowed, as a group, to take advantage of the **tax rates** in the lower income bracket of 26 USC § 11(b) only once. 26 USC §§1561(a), 1563(a). No party disputes this fact.

57 P.U.R.4th 136

Under the staff's and intervenors' proposal, the commission, for **rate**-making purposes, would assume as an operative fact that the individual companies were not part of a 'controlled group.' If this assumption were true, each company would pay overall taxes well below the maximum federal corporate **tax rate** of 46 per cent. Under the federal corporate income **tax**, the first $25,000 of corporate profit is **taxed** at a **rate** of 15 per cent. Taxable income between $25,000 and $50,000 is **taxed** at a **rate** of 18 per cent. Income between $50,000 and $75,000 is **taxed** at 30 per cent and income between $75,000 and $100,000 at 40 per cent. Only income over $100,000 is **taxed** at the maximum of 46 per cent. See 26 USC §11(b).

This proposal does ignore the reality that none of the companies would actually pay these **rates** even if they filed separate returns. Because more than 80 per cent of each company is owned by the holding company, General Waterworks Corporation, the group is a 'controlled group' as defined by 26 USC § 1563(a). The lower rates applicable to the first $100,000 of taxable income in the four blocks of $25,000 are available only once to the controlled group as a whole, whether the group files a consolidated return [FN8] or whether each member files separately. The individual companies cannot each take advantage of these lower rates, regardless of filing method. As the staff admits in its brief at p. 12, 'There is no doubt that this approach understates the actual tax expense incurred.'

Since 1977 we have used the 'effective tax rate' for affiliated companies which file a consolidated return. See Mechanic Falls Water Co. v Maine Pub. Utilities Commission (Me Sup Jud Ct 1977) 381 A2d 1080; Mars Hill & Blaine Water Co. v Maine Pub. Utilities Commission (Me Sup Jud Ct 1979) 397 A2d 570. The tax advantages to a group filing a consolidated return include the ability to use the losses of some member companies (including the parent company) to offset taxable income of profit-making companies. Because the affiliated group is able to offset taxable income with losses, it does not pay the maximum (presently 46 per cent, formerly 48 per cent) corporate tax rate on the affiliated group's total taxable income.

If each company were to file separate returns, the companies with tax losses would pay no tax. Some of those companies (those without 'chronic' losses) might be able to use the losses on a carry-back or carry-forward basis to offset taxable income in other years. However, if each company filed separately, neither the affiliated group nor any other member of the group would be able to benefit from another company's **tax** losses.

The purpose behind this commission's **effective tax rate** policy is to ensure that the use of the losses by the affiliated group, to reduce the overall **tax** for the group, benefits ratepayers of companies which are members of the group. The policy is designed to prevent ratepayers from contributing more in taxes than the utility owes to the group proportionally. The **effective tax rate** is derived from the actual **tax** paid and the total positive taxable income. [FN9] The **effective tax rate** is then applied to the individual companies for **rate**-making purposes in order to determine each company's federal corporate income **tax** expense. Although the **effective tax rate** produces a lower **tax rate** than application of the maximum **tax rate**, it does not in any way tend to understate the actual **tax** liability of the consolidated group. Nor does it understate each company's fair proportionate burden of the overall **tax** liability of the group.

57 P.U.R.4th 136
(Publication page references are not available for this document.)

By contrast, GWC's approach overstates each company's share of the overall **tax** burden and the staff's proposal understates it.

GWC advocates calculation of each company's capital federal **tax** expense at the statutory maximum **rate** of 46 per cent on the ground that each company's **tax** is actually computed in ths manner. It is only as part of the consolidated return that the total **tax** due from all of the positive taxable income companies is combined with offsetting **tax** losses to reduce the **tax** owed by the affiliated group. GWC's viewpoint was expressed by its witness, Mr. Yeomans.

'There should be no subsidization of one company by another. There should be no mathematical manipulation games played to create a hypothetical lower income tax.' [FN10]

GWC alternatively has proposed, through Mr. Yeomans' testimony and in its brief, a minor variation of its basic position. Recognizing that the group as a whole is allowed one 'surtax exemption'--i.e., lower rates for the first $100,000 of taxable income--it has suggested that this tax savings be allocated among all of the approximately 50 GWC companies. This modification would, of course, produce little reduction of the maximum 46 per cent rate proposed by the company. If this benefit were divided equally by the number of companies, each company would receive a tax benefit of approximately $405.

In this case, it turns out that there is little quantitative difference between either of the approaches urged by GWC and the historic approach of this commission, because of a recent ownership change of GWC. Previously, the commission applied the effective tax rate of I.U. International Corporation, which had wholly owned General Waterworks Corporation. I.U. International filed a consolidated return, which included both GWC itself and its subsidiaries. However, effective October 14, 1982, I.U. sold 50 per cent of its interest in GWC to Lyonnaise American Holding, Inc., itself a wholly owned subsidiary of Societe Lyonnaise des Eaux et de L'Eclarage. The sales sale precludes I.U. from filing a consolidated tax return that would include GWC and its 80 per cent or more owned subsidiaries. Most of the companies with 'chronic' losses were apparently owned by I.U. International rather than by GWC. Thus, the effective tax rate for GWC, stated as an average of the four-year period of 1979-82, is 45.50 per cent.

It therefore makes little difference to these companies' ratepayers whether GWC's proposed method is used or whether the commission's historic **effective tax rate** method is used, at least if the **effective tax rate** which is used is GWC's, rather than I.U. International's, and if the commission continues to use only 'chronic' loss companies in computing the **effective tax rate**. Nevertheless, we reject both of GWC's proposals. Even though there may be little quantitative difference in this case between GWC's approach and our historic **effective tax rate** approach, we have long followed the principle that ratepayers should not pay in **rates** for taxes which are not actually paid and will not adopt a policy which might have that **effect** in future cases.

We must now consider the staff and intervenors' arguments.

In support of its proposal to treat each company as if it were not part of an

57 P.U.R.4th 136
(Publication page references are not available for this document.)

affiliated or controlled group and could use the lower rates that apply to taxable income of less than $100,000, the staff argues that a basic principle of utility regulation allows a utility regulatory body to ignore actual expenses and disallow them for rate-making purposes if they are unreasonable. It claims that the tax situation in this case presents an issue which is not significantly different from that of a utility with a corporate structure which results in too great a cost for the ratepayers; e.g., where the debt-equity ratio is too low. See Central Maine Power Co. v Maine Pub. Utilities Commission (Me Sup Jud Ct 1979) 405 A2d 153; Mars Hill & Blaine Water Co. v Maine Pub. Utilities Commission (Me Sup Jud Ct 1979) 397 A2d 570. The staff argues that the five General Waterworks companies in Maine are structured in such a way as to increase significantly utility tax expenses beyond what it would be if they were not part of the controlled group; that this structure is unreasonable; and that the resulting excess taxes should be disallowed for rate-making purposes.

The staff also appears to believe, however, that the excess tax expense might be allowed if the companies were able to demonstrate that there are offsetting benefits to their inclusion in a controlled group. The companies' witness, Mr. Yeomans, testified to several benefits resulting from the holding company structure. Among these are centralized management, including accounting, engineering, financing, and planning; the avoidance of the need to engage certain independent specialists when needed; lower insurance rates because of the price of the total insurance package; the purchase of equipment under lower national contract prices.

However, neither Mr. Yeomans or GWC made any attempt to quantify these benefits. Mr. Yeomans testified that they were extremely difficult to quantify, pointing out that it was particularly difficult to make comparisons with the costs of smaller companies which are not part of a holding company structure. [FN11]

Nevertheless, it is clear that there may be important actual or potential benefits to be realized from the holding company structure if greater efficiencies and better management may result from centralized accounting, purchasing and the raising of capital. Even though GWC's witness ws either unwilling or unable to quantify the benefits, they may well exist for this group of companies. No party disputes that these benefits may exist; the only claim that is made is that the companies failed to demonstrate their extent.

The staff and intervenors' argument appears to challenge the basic management decision of how this group of companies should be structured, despite the possibility of substantial benefits from the form of organization and even though no disadvantages have been shown aside from the application of higher federal corporate income tax rates. In other words, they appear to argue that GWC's decision to own these smaller water companies is unreasonable solely because of the negative tax consequences. If the issue were so framed, the decision to hold that the basic corporate structure is unreasonable might be more difficult.

However, the issue is not nearly so difficult. Nothing precludes these companies and GWC from having the benefits of both lower taxes and the centralized management available through the holding company structure. Under federal tax law, a 'controlled group' of corporations may take advantage of the lower tax

57 P.U.R.4th 136

brackets for the first $100,000 of income only once for the entire group. GWC and its subsidiaries are a parent-subsidiary controlled group. See testimony of Mr. Yeomans, B-25; USC §1563. A parent-subsidiary controlled group is defined as ownership of over 80 per cent of the stock of subsidiary by a parent company. 26 USC §1563(a). This definition is similar to that of an 'affiliated group' under 26 USC §1504(a), which may file a consolidated return. If GWC owned slightly less than 80 per cent of each of these companies, it could simultaneously maintain sufficient control of the companies that each of them could (or presumably, would be required to) take advantage of the assumed benefits of the managerial services of GWC.

In Re Mars Hill & Blaine Water Co. (1977) 19 P.U.R.4th 380, 383, affd (Me Sup Jud Ct 1979) 397 A2d 570, a case involving GWC, we stated:

'As we stated in [Re Mechanic Falls Water Co. (1976) 13 P.U.R.4th 347], a tax rate so computed 'is a very conservative effective tax rate [which] gives every benefit of the doubt to the companies. . . .' In fact, even this computation may yield a higher effective tax expense for a subsidiary company than it would be liable for if the subsidiary company filed an independent federal tax return. This is especially true in the case of companies with taxable income of less than $25,000, for whom the statutory rate would be 20 per cent if they filed independently, or for companies with taxable income between $25,000 and $50,000, for whom the taxable rate on income over $25,000 would be 22 per cent if they filed independently.

'As a matter of principle the commisson believes that no subsidiary company should be assessed an amount of federal income taxes by its parent organization in excess of the amount it would pay if it filed as an independent concern. Not only do the ratepayers not share in the benefits of a consolidated tax return in such instances, but they would be required to absorb a penalty charge for membership in the organization.'

General Waterworks Corporation has thus been on warning since at least 1977 that the commission has considered the approach now urged by the staff as a potentially reasonable policy. Nevertheless, it has continued to maintain the same form of ownership. It may be too speculative to assume that GWC has not attempted to reduce its ownership level in its subsidiaries to less than 80 per cent merely because regulatory bodies have allowed it to charge ratepayers tax expense on the basis of its actual controlled group ownership, rather than on the basis of a hypothetical form of ownership. Nevertheless, it is clear that there has been no regulatory incentive for it to reduce its ownership level.

Because the record fails to show that there are any benefits to the present GWC structure (of owning greater than 80 per cent of its subsidiaries rather than some lesser amount) and because there are substantial tax detriments, we find that the tax expense caused by the present corporate structure of GWC and its subsidiaries is unreasonable. [FN12]

We therefore place General Waterworks Company, as well as other companies which are controlled groups within the meaning of 26 USC §1563, that this commission considers this amount of tax expense unreasonable in the absence of substantial

57 P.U.R.4th 136
(Publication page references are not available for this document.)

justification and that excess taxes paid because of this form of ownership will be disallowed in future rate cases.

As stated previously, we do not believe that there has been any lack of notice to GWC or other utilities that the commission has been considering and might adopt this policy. Moreover, General Waterworks Corporation received specific notice from the commission staff and the intervenors that this policy would be advocated in this case.

Nevertheless, this policy does constitute a substantial departure from past practice and we believe that the most cautious approach is to implement it after a short delay. The policy difference is substantial, not in that it imposes a hypothetical tax: the effective tax rate did that. Rather, it is substantial in imputing to the subsidiary companies taxes which are in fact lower than their actual proportionate share of taxes paid by GWC. We are disallowing an expense which is a real cost for the company and which is required by federal law, albeit imposed because of the investors' unreasonable choice of ownership structure. We therefore believe that we should allow GWC an opportunity between now and its next rate case to alter its form of ownership so that it is no longer a controlled group for federal tax purposes. As we have pointed out previously, this does not mean that GWC's subsidiaries must forego the arguable benefits of the services provided by GWC.

The fact that this record does not contain any evidence concerning the ease or difficulty of such partial sales is a major reason for our view that caution should be exercised prior to actually imposing the policy which we have adopted.

Because we have delayed application of this new policy of disallowing excess taxes resulting from a controlled group structure, it is necessary to consider the alternative proposals concerning the treatment of taxes. The staff has argued in the alternative that the commission should continue to apply its present effective tax rate doctrine, but should use the effective rate for I.U. International rather than that of General Waterworks Corporation. [FN13] It makes this argument notwithstanding the sale by I.U. International of 50 per cent of its interest in GWC to Lyonnaise American Holding, Inc., because of the companies' failure to obtain the commission's approval for the sale pursuant to 35 MRSA §104. The sale by I.U. of 50 per cent of its interest in GWC precludes it from filing a consolidated tax return, and therefore precludes GWC's subsidiaries from taking advantage of the tax losses of subsidiaries of I.U. which are not subsidiaries of GWC.

There appears to be little doubt that this sale falls within the statutory definition under 35 MRSA §104 as one which literally requires the commission approval, unless the sale was within an exception contained in the statute. [FN14]

There is no evidence in the record or argument in the companies' brief which explains the reason for the failure of these companies to apply for or obtain approval of the sale by I.U. International of 50 per cent of its interest in GWC. Counsel for the companies stated on the record that GWC believed that approval was not required. However, the reason for this view was not stated.

13. Remaining tax benefits and costs of property previously on flow-through should be reviewed on a case-by-case basis.

14. Conventional normalization should be applied in compliance with the Economic Recovery Tax Act.

15. Since the subject matter of this investigation has been thoroughly explored in this and prior decisions, the OII should be terminated.

ORDER

IT IS ORDERED that:

1. Respondents shall prepare and present their next general rate filings in conformance with the policies and principles adopted in this decision.

2. OII 24 is closed.

This order becomes effective 30 days from today.

Dated May 2, 1984, at San Francisco, California.

VICTOR CALVO

PRISCILLA C. GREW

DONALD VIAL

WILLIAM T. BAGLEY

Commissioners

I dissent.
LEONARD M. GRIMES, JR., Commissioner

END OF DOCUMENT

Westlaw Attached Printing Summary Report for BLACKFORD, BETSY 3999927

Date/Time of Request:	Thursday, July 29, 2004 16:12:00 Eastern
Client Identifier:	ATTORNEY GENERAL
Database:	PUR
Citation Text:	13 P.U.R.4th 347
Lines:	805
Documents:	1
Images:	0

Westlaw.

13 P.U.R.4th 347
13 P.U.R.4th 347
(Publication page references are not available for this document.)

C

Re Mechanic Falls Water Company

Additional petitioners: Caribou Water Works Corporation, F.C. Nos. 2124 et al., Ellsworth Water Company, F.C. Nos. 2129 et al., Washburn Water Company, F.C. Nos. 2136 et al., Island Falls Water Company, F.C. Nos. 2142 et al., and Fort Kent Water Company, F.C. Nos. 2151 et al.
F.C. Nos. 2120 et al.

Maine Public Utilities Commission
January 26, 1976

COMPLAINT of various water companies alleging unjust and unreasonable rates; complaint sustained.

P.U.R. Headnote and Classification

DEPRECIATION

s16 -- Property subject to depreciation -- Contributed property.

Me.P.U.C. 1976

Where a water company had invested no funds in contributed property, it was not entitled to recover the original investment through depreciation. [7]

Re Mechanic Falls Water Co.

P.U.R. Headnote and Classification

EXPENSES

s114 -- Consolidated income tax -- Water company.

Me.P.U.C. 1976

A tax rate less than the statutory rate was used for rate-making purposes of a subsidiary water company which filed a consolidated income tax return with its affiliates where it was determined that the parent company could not use all the tax credits which were credited to it. [1]

13 P.U.R.4th 347
(Publication page references are not available for this document.)

Re Mechanic Falls Water Co.

P.U.R. Headnote and Classification

EXPENSES

s114 -- Income tax flow through -- Water company.

Me.P.U.C. 1976

An expense allowance for the income tax of a water company using accelerated depreciation should reflect a flow through of resulting tax savings to the ratepayers. [6]

Re Mechanic Falls Water Co.

P.U.R. Headnote and Classification

EXPENSES

s114 -- Federal income tax rate -- Water company.

Me.P.U.C. 1976

A federal income tax rate of 28 per cent was held to be reasonable for rate-making purposes of a water company which filed a consolidated income tax return with its affiliates. [2]

Re Mechanic Falls Water Co.

P.U.R. Headnote and Classification

RETURN

s26.2 -- Cost of debt -- Water company.

Me.P.U.C. 1976

A reasonable cost of debt for a water company was found to be 8.25 per cent. [3]

Re Mechanic Falls Water Co.

P.U.R. Headnote and Classification

RETURN

s26.4 -- Cost of equity -- Water company.

13 P.U.R.4th 347
(Publication page references are not available for this document.)

Me.P.U.C. 1976

A reasonable cost of equity for a water company was determined to be 12.6 per cent. [4]

Re Mechanic Falls Water Co.

P.U.R. Headnote and Classification

RETURN

s115 -- Water company.

Me.P.U.C. 1976

A 10 per cent rate of return was determined to be fair and reasonable for a water company. [5]

Re Mechanic Falls Water Co.

APPEARANCES: Roger A. Putnam, Portland, and William J. LeBuhn, Philadelphia, Pennsylvania, for the Mechanic Falls Water Company, Caribou Water Works Corporation, Ellsworth Water Company, Washburn Water Company, Island Falls Water Company, and Fort Kent Water Company; Stephen A. Canders, Presque Isle, for the town of Washburn; Thomas R. Gibbon, Augusta, for the public utilities commission staff.

By the COMMISSION:

The Mechanic Falls Water Company filed with this commission on April 8, 1975, to become effective May 8, 1975, its schedules of rates MPUC No. 5, consisting of Sheet No. 1--Seventh Revision; Sheet No. 2--Eighth Revision; and Sheet No. 4--Third Revision, thereby proposing an increase in rates to its customers. This petition carries the commission's docket designation of F.C. No. 2120.

After a summary investigation, the commission suspended the proposed rates for a period of three months from May 8, 1975, unless otherwise ordered, and subsequently suspended the proposed rates for a further period of five months from August 8, 1975, unless otherwise ordered.

The Mechanic Falls Water Company also filed with this commission on May 6, 1975, a petition against itself alleging unreasonable, unjust, inadequate, and unjustly discriminatory rates, tolls and charges. This petition carries the commission's docket designation of F.C. No. 2126.

The Mechanic Falls Water Company also filed with this commission on May 1, 1974, an application for approval of contract between itself and General Waterworks

Management and Service Company for the furnishing of certain services by General to petitioner. This application carries the commission's docket designation of C. No. 418.

Caribou Water Works Corporation filed with this commission on May 5, 1975, to become effective June 4, 1975, its schedule of rates MPUC No. 7, consisting of Sheet No. 1--Seventh Revision; Sheet No. 2--Fifteenth Revision; and Sheet No. 3--Fourth Revision, thereby proposing an increase in rates to its customers. This petition carries the commission's docket designation of F.C. No. 2124.

After a summary investigation, the commission suspended the proposed rates for a period of three months from June 4, 1975, unless otherwise ordered, and subsequently suspended the proposed rates for a further period of five months from September 4, 1975, unless otherwise ordered.

Caribou Water Works Corporation also filed with this commission on May 5, 1975, a petition against itself alleging unreasonable, unjust, inadequate, and unjustly discriminatory rates, tolls, and charges. This petition carries the commission's docket designation of F.C. No. 2125.

Caribou Water Works Corporation also filed with this commission on May 1, 1974, an application for approval of contract between itself and General Waterworks Management and Service Company for the furnishing of certain services by General to petitioner. This application carries the commission's docket designation of C. No. 409.

Ellsworth Water Company filed with this commission on May 28, 1975, to become effective June 27, 1975, its Schedule of Rates, MPUC No. 1, consisting of Sheet No. 1--Fifth Revision; Sheet No. 2--Fifth Revision; Sheet No. 3--Fifth Revision; and Sheet No. 4--Third Revision, thereby proposing an increase in rates to its customers. This petition carries the commission's docket designation of F.C. No. 2129.

After a summary investigation, the commission suspended the proposed rates for a period of three months from June 27, 1975, unless otherwise ordered, and subsequently suspended the proposed rates for a further period of five months from September 27, 1975, unless otherwise ordered.

Ellsworth Water Company also filed with this commission on May 28, 1975, a petition against itself alleging unreasonable, unjust, inadequate, and unjustly discriminatory rates, tolls, and charges. This petition carries the commission's docket designation of F.C. No. 2130.

Ellsworth Water Company also filed with this commission on May 1, 1974, an application for approval of contract between itself and General Waterworks Management and Service Company for the furnishing of certain services by General to petitioner. This application carries the commission's docket designation of C. No. 411.

Washburn Water Company filed with this commission on June 20, 1975, to become effective July 20, 1975, its schedule of rates MPUC No. 5 consisting of Sheet No.

13 P.U.R.4th 347

1--Second Revision; Sheet No. 2--Second Revision; Sheet No. 3--Second Revision; and Sheet No. 4--Second Revision, thereby proposing an increase in rates to its customers. This petition carries the commission's docket designation of F.C. No. 2136.

After a summary investigation, the commission suspended the proposed rates for a period of three months from July 20, 1975, unless otherwise ordered, and subsequently suspended the proposed rates for a further period of five months from October 20, 1975, unless otherwise ordered.

Washburn Water Company also filed with this commission on June 20, 1975, a petition against itself alleging unreasonable, unjust, inadequate, and unjustly discriminatory rates, tolls, and charges. This petition carries the commission's docket designation of F.C. No. 2137.

Washburn Water Company also filed with this commission on May 1, 1974, an application for approval of contract between itself and General Waterworks Management and Service Company for the furnishing of certain services by General to petitioner. This application carries the commission's docket designation of C. No. 426.

Island Falls Water Company filed with this commission on August 18, 1975, to become effective September 17, 1975, its schedule of rates MPUC No. 7, consisting of Sheet No. 1--First Revision; Sheet No. 2--First Revision; Sheet No. 3--Second Revision; and Sheet No. 4--Second Revision, thereby proposing an increase in rates to its customers. This petition carries the commission's docket designation of F.C. No. 2142.

After a summary investigation, the commission suspended the proposed rates for a period of three months from September 17, 1975, unless otherwise ordered, and subsequently suspended the proposed rates for a further period of five months from December 17, 1975, unless otherwise ordered.

Island Falls Water Company also filed with this commission on August 18, 1975, a petition against itself alleging unreasonable, unjust, inadequate, and unjustly discriminatory rates, tolls, and charges. This petition carries the commission's docket designation of F.C. No. 2143.

Island Falls Water Company also filed with this commission on May 1, 1974, an application for approval of contract between itself and General Waterworks Management and Service Company for the furnishing of certain services by General to petitioner. This application carries the commission's docket designation of C. No. 416.

Fort Kent Water Company filed with this commission on September 2, 1975, to become effective October 2, 1975, its schedule of rates MPUC No. 8, consisting of Sheet No. 1--Second Revision; Sheet No. 2--Fourth Revision; Sheet No. 3-- Third Revision; and Sheet No. 4--First Revision, thereby proposing an increase in rates to its customers. This petition carries the commission's docket designation of F.C. No. 2151.

After a summary investigation, the commission suspended the proposed rates for a period of three months from October 2, 1975, unless otherwise ordered, and subsequently suspended the proposed rates for a further period of five months from January 2, 1976, unless otherwise ordered.

Fort Kent Water Company also filed with this commission on September 2, 1975, a petition against itself alleging unreasonable, unjust, inadequate, and unjustly discriminatory rates, tolls, and charges. This petition carries the commission's docket designation of F.C. No. 2152.

Fort Kent Water Company also filed with this commission on May 1, 1974, an application for approval of contract between itself and General Waterworks Management and Service Company for the furnishing of certain services by General to petitioner. This application carries the commission's docket designation of C. No. 412.

After motions to consolidate were filed with this commission by the public utilities commission staff and by the companies listed above, this commission ordered, on November 6, 1975, that the above-entitled cases be consolidated for the purpose of trying and resolving together the issues of the proper fair rate of return, the proper federal income tax rate, the proper management and service contract expense to be used for rate-making purposes, the propriety of normalization of depreciation for tax purposes and the propriety of depreciation on contributed property, and whether the contracts filed in C. No. 418, C. No. 409, C. No. 411, C. No. 426, C. No. 416, and C. No. 412 are in the public interest.

The commission also ordered its Rule 4-A Alternate Hearings Procedure, to be applicable to the consolidated hearing.

The commission received two petitions to intervene from Stephen A. Canders, Esquire, representing the town of Washburn, and Ferris A. Freme, Esquire, representing the city of Caribou. The commission also received a notice of appearance from Thomas R. Gibbon, Esquire, representing the public utilities commission staff.

After appropriate notice, hearings were held on the consolidated issues on December 3-4, 1975, January 5, 1976, and January 12, 1976.

All of the above-entitled companies are owned by General Waterworks Corporation (GW) which is a holding and operating company owning approximately 60 subsidiaries. All the GW subsidiaries are serviced by General Waterworks Management and Service Company (G.W.M.&S. Co.) which is itself a subsidiary of G.W. General Waterworks Corporation is owned by I.U. North America Corporation which is a holding company owned by I.U. International Corporation (I. U.) which is an international conglomerate owning in excess of 200 corporations with interests from oil to mining to transportation services.

Consolidated Income Tax Return

13 P.U.R.4th 347

These six Maine subsidiaries of General Waterworks file an income tax return on a consolidated basis with I. U. International and approximately 200 of I. U. International's subsidiaries. All six Maine General Waterworks subsidiaries are seeking a federal income tax expense equal to 48 per cent of their test-year income.

It has been the practice of the I. U. system to collect from subsidiaries with positive taxable incomes an expense equal to 48 per cent of the positive taxable income and to pay to all subsidiaries with negative taxable incomes an amount equal to 48 per cent of the negative taxable income. In addition, all subsidiaries are given credit, dollar for dollar, for the value of tax credits which they contribute to the system.

In 1974, I. U., through its tax collection and payment policy, collected a total of $25,645,163 'federal income taxes' from its subsidiaries. In that same year, the I. U. system paid only $4,604,578 of federal income taxes to the federal government. That payment satisfied the I. U. system's tax liability in toto. In that same year, I. U. paid its tax loss companies and companies with large tax credits $19,269,061. The rest of the 'taxes' collected went to pay certain tax carryovers and nonutilized tax credits as more fully detailed on the reconciliation of 'taxes' paid and 'taxes' collected which was furnished by the six companies.

All witnesses agreed that if I. U. collected from its tax profit companies only that amount necessary to satisfy its obligation to the federal government, it could collect that amount by charging its tax profit companies at a rate less than 48 per cent. The witnesses for the six Maine subsidiaries testified that I. U.'s policy of collecting at the 48 per cent rate from the tax profit companies and paying loss companies 48 per cent of their tax losses was discretionary with I. U. and was not required by any federal law, rule, or regulation.

[1] The most basic issue before this commission is whether we should accept, for rate-making purposes, the I. U. policy of collecting 'taxes' to pay the loss and/or recovery companies. If we accept this policy, then 48 per cent is the proper rate to be used for rate-making purposes. If we reject the I. U. policy and conclude that Maine utilities should be able to collect only those amounts necessary to pay the federal government liability, then a tax rate substantially less than 48 per cent would be proper. A third possibility is to permit the collection of taxes necessary to pay the liability to the federal government and to pay some loss companies. This, in turn, would require some rationale for distinguishing among various types and sources of losses.

Mr. Green, the witness for the six Maine General Waterworks subsidiaries, contended that the I. U. tax collection policy of paying tax loss companies 48 per cent of the tax loss is reasonable because, as independent companies, the loss companies could use the loss under the carry-forward and carry-back provisions to reduce future or past income tax liabilities. Under consolidation, the loss is used immediately to reduce the system's taxable income and hence, so the argument goes, the individual company should receive consideration for the use of its loss.

Mr. Green's argument is based, in part, in the dissenting opinion in Federal

13 P.U.R.4th 347

Power Commission v United Gas Pipe Line Co. (1967) 386 US 237, 68 PUR3d 321, 18 L Ed 2d 18, 87 S Ct 1003. The majority opinion, in upholding a commission's right to allow a tax rate less than the statutory rate, did not accept this argument. Mr. Green's theory is clearly inapplicable to some of the holding companies in the I. U. system. The uncontradicted testimony indicates that these holding companies (except I. U. and General Waterworks) derive their income almost exclusively from tax exempt dividends. Since these holding companies have expenses, they will be in chronic tax loss positions and would be unable to use their losses under the carry-forward or carry-back provisions if they filed independently. Accordingly, the carry-forward or carry-back possibility provides no basis for 'tax' payments to these chronic loss companies. Similarly, although I. U. International Corporation has had positive taxable income on an independent basis, it is unlikely that I. U. could, on an independent basis, use all of the foreign tax credits which are credited to it.

In the rebuttal testimony, the six Maine General Waterworks subsidiaries introduced a new argument to rationalize their 'tax' payments to loss companies. Mr. Clougherty testified that it would be possible, through mergers, to eliminate all tax loss companies, including chronic tax loss companies while keeping the tax liability to the federal government the same.

Assuming that the liability would be the same, this argument does not answer the question of how the total tax liability would be allocated to the newly merged corporations of operating divisions. Mr. Clougherty testified that if all the Maine General Waterworks subsidiaries were merged, the newly merged company would be assessed by I. U. a tax expense equal to 48 per cent of the newly merged company's taxable income. Mr. Clougherty freely admitted that in order to meet the newly merged company's liability to I. U., it would not have to charge each of its profit-making divisions 48 per cent of their taxable income (assuming at least one tax loss division). He also admitted that divisions would not be able to carry-forward or carry-back losses since they would not be individual companies. It was unclear, however, how the divisions of the newly merged Maine company would be assessed the federal income tax liability and whether loss divisions would be paid at 48 per cent of their losses. Similarly, it was unclear from Mr. Clougherty's testimony whether the holding companies, when merged, would continue as divisions and be paid at 48 per cent of their losses. Thus, while it might be possible to eliminate tax loss companies without affecting the actual federal income tax liability, it is not the actual federal income tax liability which determines whether the new divisions would be charged at the rate of 48 per cent. Rather, it is I. U.'s method of collecting 'taxes' which determines whether or not the new divisions would be charged at the rate of 48 per cent.

A more serious defect to the argument that loss companies could be eliminated through merger is that realistically such mergers either would or could not take place. For one thing, there would be no advantage to I. U. from instituting such mergers. Mr. Clougherty testified that I. U. preferred to operate through a holding company structure and that various governmental agencies, loan agreements, or 'union problems' could prohibit the hypothetical mergers he has envisioned. Because of these potential obstacles to wholesale mergers, this commission feels that it must make its decision on the basis of the present corporate structure of I. U. On the basis, it is clear that the holding companies will be in a chronic

13 P.U.R.4th 347

tax recovery position because of their losses and/or tax credits.

Dr. Shipman testified that the whole system should benefit by the tax losses of chronic loss companies but that the tax savings resulting from the tax losses of other companies, particularly regulated companies, should probably accrue to the tax loss companies themselves (in the form of a 'tax' recovery from the system) if it could be shown that these companies were actually giving up a tax benefit by entering into the consolidated return. His effective tax rate (with the adjustments he accepted from Mr. Clougherty) would, in effect, result in a collection of 'taxes' sufficient to pay both the federal government and nonchronic tax loss or recovery companies.

For the purposes of this case, we will permit a tax rate sufficient to pay nonchronic tax loss companies at 48 per cent of their negative taxable income. We wish to go on record as noting, however, that we have reservations about permitting a rate enabling such recoveries. We do, however, emphatically agree with Dr. Shipman that the entire system should benefit from the reduction in taxes caused by the losses of the holding companies and their credits. Without the system's positive taxable income, no use could be made of the holding companies credits and losses. As Dr. Shipman said, 'Since in reality, nothing is being given up by these companies in entering into a consolidated return, the tax benefits due to consolidation properly belong to the whole system.' Accordingly, we will permit a tax rate which will reflect our belief that the holding companies should not be paid tax recoveries for their unusable credits and losses. We feel that even this approach may prove too generous to the utility.

If a Maine utility filed independently and sustained a tax loss, that tax loss could reduce taxes paid to the federal government. Yet if a utility always is granted a 48 per cent federal income tax rate for rate-making purposes, even after it has sustained a loss, the benefits of the tax loss are never passed on to the ratepayers. Furthermore, under the present tax laws, where certain expenses, like accelerated depreciation, are used for income tax purposes but not for rate-making purposes, the possibility of sustaining a tax loss, even when a utility is healthy, is substantial. This commission, of course, will continue to try to insure that Maine utilities have an opportunity to earn a fair rate of return and will try to prevent real losses resulting from unreasonably low rates. Nevertheless, if such a tax loss does occur, and taxes in the future will be reduced as a result of such a loss, we must recognize the reality of such a reduction. If, for example, these tax losses reflect genuine financial problems, then these problems will be reflected in the cost of equity which we allow. If the cost of equity is higher because of genuine financial problems, then any benefits, such as reduced taxes, should be considered when setting rates. Therefore, the mere fact that a corporation filing on an independent basis could use its loss to reduce taxes is not necessarily a valid basis for contending that all tax profit companies should be charged a rate of 48 per cent. As we have noted, in some circumstances, not present in the record in this case, the reduction of taxes through the carry-forward and carry-back provisions might be an appropriate reason for permitting a rate at less than 48 per cent.

In reaching our conclusion that the statutory rate is not appropriate, we note that the decision to file a consolidated return was voluntarily made by I. U. for

13 P.U.R.4th 347

its own reasons. Likewise, the present corporate structure of I. U. is a product of its objectives. The allocation of tax liability in the I. U. system is likewise a choice made by I. U. to further its own corporate objectives. This consolidated return, corporate structure, and tax allocation system, all chosen by I. U., result in large tax recoveries being paid to the holding companies of the I. U. system. We find no reason to permit the Maine General Waterworks subsidiaries to be charged, for rate-making purposes, a tax rate which will take substantial amounts of money that will be paid neither to the federal government nor to sister companies which have foregone usable future tax benefits. Amounts allowed for federal income taxes in rates should, to the extent permitted by law, be based upon the realistic expectation of the taxes actually to be paid to the federal government. The uncontested facts are that for each year from 1970 through 1974, I. U. has collected from its profitable subsidiaries far more in 'taxes' than it has paid to the federal government. Furthermore, the larger of the tax recoveries are paid to the holding companies of the I. U. system. In 1974, for example, more 'taxes' were paid to the holding companies than to the federal government. In fact, the witnesses for the General Waterworks subsidiaries admitted that even if the liability to the federal government were zero, I. U. would still charge its subsidiaries 48 per cent of their positive taxable income.

We note the following language of the United States Supreme Court which it used in United Gas Pipe Line Co., supra, in deciding to approve a method proposed by the FPC to flow through some of the savings of the consolidated return to the ratepayers:

'Respondents insist that in making the allocation the commission would violate the statute unless in every conceivable circumstance, including this one, United is allowed an amount for taxes equal to what it would have paid had it filed a separate return. In their view United should never share in the tax savings inherent in a consolidated return, even if on a consolidated basis system losses exceed system gains and neither the affiliated group nor any member in it has any tax liability. This is an untenable position and we reject it. Rates fixed on this basis would give the pipeline company and its stockholders not only the fair return to which they are entitled but also the full amount of an expense never in fact incurred. In such circumstances, the commission could properly disallow the hypothetical tax expense and hold that rates based on such an unreal cost of service would not be just and reasonable.' (Emphasis supplied.) (386 US at pp. 243, 244, 68 PUR3d 321.)

The court also made clear that the selection by the affiliated group of a particular method of collecting taxes benefiting tax loss companies is not binding on an agency which sets rates:

'But the commission is not responsible for the use of consolidated returns. It is the tax law which permits an election by an appropriate group to file on a consolidated basis. The members of a group, as in this case, themselves choose not to file separate returns and hence, for tax purposes, to mingle profits and losses of both regulated and unregulated concerns, apparently deeming it more desirable to attempt to turn the losses of some companies into immediate cash through tax savings rather than to count on the loss companies themselves having future profits against which prior losses could be applied. Such a private

13 P.U.R.4th 347

decision made by the affiliates, including the regulated number, has the practical and intended consequence of reducing the group's federal income taxes, perhaps to zero, as was true of one of the years involved in the Cities Service case. But when the out-of-pocket tax cost of the regulated affiliate is reduced, there is an immediate confrontation with the rate-making principle that limits cost of service to expenses actually incurred. Nothing in Colorado Interstate or Panhandle forbids the commission to recognize the actual tax saving impact of a private election to file consolidated returns. On the contrary, both cases support the power and the duty of the commission to limit cost of service to real expenses.' (386 US at pp. 244, 245, 68 PUR3d 321.)

While the method the court was discussing is different from the method which we approve in this case, we think the principles are similar.

[2] In this case, we will permit an effective tax rate of 28 per cent to be used for rate-making purposes. This rate, if applied to all I. U. subsidiaries, would be sufficient to pay the federal government and all loss companies, except the clearly identifiable chronic loss or recovery holding companies, the recoveries permitted by the I. U. tax system. While this rate remains higher than it would be if some of the operating subsidiaries were found to be in chronic loss positions, we conclude that the use of this rate will reasonably allocate to the Maine General Waterworks subsidiaries their fair share of the true federal income tax liability of the I. U. system.

This rate is based upon the method proposed by Dr. Shipman, using 1974 data, as adjusted to take some account of the accounting corrections of Mr. Clougherty. We do not think the conflicting 'Calkraft' adjustments were adequately supported or explained. In using this method, we have also disallowed tax payments to I. U. Transportation Services, Inc., whose status as a holding company came to light during the hearing. No party presented testimony concerning an effective tax rate for years other than 1974 and 1973. The only testimony concerning an effective tax rate for 1973 was a rough calculation without Mr. Clougherty's adjustments. Nevertheless, this rough calculation showed that an effective tax rate for 1973, using Dr. Shipman's method, would be close to that of 1974.

Using 1974 data the numerator of the fraction for the effective tax rate is composed of the following items [omitted herein].

We emphasize that, in our judgment, 28 per cent is a very conservative effective tax rate. The computation above gives every benefit of the doubt to the companies in this proceeding. For example, in our computation, we have assumed that the only chronic loss or recovery companies are I. U. International, I. U. North America, I. U. Investment Corporation, General Waterworks Corporation, and I. U. Transportation Services, Inc. While we do not have enough resources to examine each one of I. U.'s nearly 200 other subsidiaries, this assumption is probably too generous. We have also assumed that each of the tax loss companies, on an independent basis, would be able to use all of its investment tax credits. Again, this assumption is probably generous. We have also assumed that all of the foreign tax credits (except those of the parent, I. U. International, in excess of its 1974 tax liability) would be usable on an independent basis.

13 P.U.R.4th 347

Finally, we have not adjusted for the fact that the I. U. tax collection system converts tax losses into immediate cash, rather than waiting (in the carry-forward situation) for future profits against which prior losses could be applied. As the record indicates, a given sum of money in hand is worth more even than the virtual certainty of the same sum at some point in the future. Thus, the 28 per cent effective tax rate does not deprive the system of tax benefits it might have realized by filing separate returns for each of its subsidiaries. It serves only to share among the customers some of the benefits of the holding company arrangement.

Management and Service Fees

In 1974 General Waterworks Management and Service Company (G.W.M.&S. Co.) charged the six subsidiaries a total of $85,259 in management and service fees. Of this amount, $19,372 was capitalized. This amount was charged to the Maine subsidiaries pursuant to contracts between the subsidiaries and G.W.M. & S. Co. which are currently before this commission for approval. The issues before this commission are (i) whether the management and service fees are reasonable, and (ii) whether the contracts permitting the charging of such fees should be approved.

The staff presented evidence which showed that on a per customer basis the General Waterworks subsidiaries had higher expenses in Accounts 820 through 825 [FN1] in 1974 than other selected Maine independent water companies or other selected Maine water districts. The management and service expenses charged the General Waterworks subsidiaries are found in Account 824 of the subsidiaries, and represent the largest item in the total of Accounts 820 through 825. On the basis of this comparison, it was demonstrated that the nineteen General Waterworks subsidiaries had a per customer expense for Accounts 820-825 of $18.01; that eleven Maine Water Districts had a per customer cost of $6.96; that eight Maine subsidiaries of Consumers Water Company had a per customer cost of $11.28; and the seven other Maine independent water companies had a per customer cost of $6.75. It was on the basis of this comparison that Dr. Shipman, the staff's witness, recommended that this commission allow the General Waterworks subsidiaries no more than $10 per customer in expenses for Accounts 820-825.

Such a large difference between the General Waterworks subsidiaries per customer in Accounts 820-825 cost and other Maine water companies raises serious questions as to the reasonableness of General Waterworks management and service fees which represent approximately two-thirds of the $18.01 per customer cost shown in General Waterwork's Accounts 820-825.

The questions raised by this comparison became more serious in light of certain information brought out in the course of the hearings. G.W.M.&S. Co. is a wholly owned subsidiary of General Waterworks Corporation. It provides management services to the other subsidiaries of General Waterworks Corporation. While G.W.M.&S. Co. is a 'nonprofit' company, it flows through all of its 'expenses' to the subsidiaries it serves. Since General Waterworks Corporation owns both G.W.M.&S. Co. and the subsidiaries G.W.M.&S. Co. serves, it is clear that the subsidiaries do not bargain at arm's length over the terms of the contract by which the charges are made by G.W.M.&S. Co. The subsidiaries cannot refuse to be served by G.W.M.&S. Co. or seek alternative management services from competitors. That there was no arm's-length bargaining over the services rendered and the fees charged the subsidiaries, tends to support the conclusion reached by Dr. Shipman that the high cost per General Waterworks subsidiary customer is, in part, attributable to unreasonable management and service fees. When all the expenses of a service company can be automatically passed on to a captive subsidiary, there simply is not the incentive to charge competitive fees. When this lack of incentive is combined with a comparison showing that the service company's fees are higher than other management and service expenses for similar utilities, the inference of unreasonableness is especially strong.

An analysis of exactly how the G.W.M.&S. Co.'s management and service fees are calculated also supports the inference of unreasonableness. In 1974, G.W.M.&S. Co. had total expenses of about $1.5 million which it allocated to the General Waterworks subsidiaries. Of this $1.5 million which G.W.M.&S. Co. incurred as expenses, $737,000, or approximately one-half of the total expense, [FN2] resulted from a management and service fee which G.W.M.&S. Co. paid its ultimate parent, I. U. International Corporation. Testimony at the hearing indicated that this charge in 1974 was not based upon time sheets kept by I. U. International. There was very little evidence indicating what types of services I. U. International performed in return for this substantial fee. We believe that the existence of this charge also supports the conclusion that the management and service fees of G.W.M.&S. Co. are unreasonable. In effect, one-half of every management and supervision expense charge to the Maine General Waterworks subsidiaries is used to pay a management and service expense which I. U. International [FN3] charges its own subsidiary, G.W.M.&S. Co., another management company. Once again, a reasonable inference is that G.W.M.&S. Co. is a captive customer of I. U. International and is unable to reject the terms and charges made by I. U. International.

Other expenses incurred by G.W.M.&S. Co. and flowed through to General Waterworks subsidiaries are of concern to us. For example, in 1974, G.W.M.&S. Co. spent $71,000 for 'public relations.' Part of this money was devoted to a so-called 'less is more' campaign (including T-shirts emblazoned with this wisdon) which initially was a campaign for General Waterworks subsidiaries to save electricity. It did not affect customer use of water in Maine and is apparently not the motto of the rate department. Also included in the $71,000 was $25,000 for 'advertising and promotion,' an expense which the company's witness was unable to explain. The acceptance by the General Waterworks subsidiaries of a management and service company expense entitled 'advertising and promotion' and 'public relations' without knowing what these expenses represent is not second management practice.

Still further expenses came to light at the hearing which indicate that costcutting is not the top priority for G.W.M.&S. Co. There was a voucher for $603.20 for 'Pierre's' which could not be explained and tickets for the Multiple Sclerosis Society for $120 and a voucher to I. U. North America for $115,000 which might have been a 'clerical error.' There was an expense of $600 for the Crime Commission of Philadelphia.

The potential for abuse in the I. U.--G.W.M.&S. Co.--G. W. subsidiary combination

13 P.U.R.4th 347

is real. The commission is faced with a situation where the General Waterworks subsidiary is permitted to pass all its reasonable expenses on to the ratepayers. General Waterworks Management and Service Company, since it is without competition, is able to pass all of its expenses on to the General Waterworks subsidiaries. Finally, I. U., without competition, is able to pass all of its management services on to its subsidiaries, including G.W.M.&S. Co. From the evidence presented, a mere acceptance of the expenses is obviously not in order. We conclude that a reasonable way to meet this problem is to compare General Waterworks subsidiary management and service fees with other water company management and service fees. Where they are excessive, as they seem to be here, we will cut them back to a reasonable level.

It should be finally noted that G.W.M.&S. Co. could pinpoint only a very few dollars of expense, perhaps 3-4 per cent of the total expense charged to the Maine General Waterworks subsidiaries, which were directly incurred by the Maine General Waterworks subsidiaries. All the other expenses charged the Maine companies in 1974 were on an allocated basis. Thus there is no indication of how much time G.W.M.&S. Co. actually spent on the Maine companies in 1974. Of course, if the original expenses of G.W.M.&S. Co. are unreasonable, direct charges based on time spent will not cure the problem.

We find that comparisons made by the staff's witness are sufficient for this case, and with the supporting evidence, show that the G.W.M.&S. Co.'s charges are unreasonable. The supporting evidence, in summary, is the noncompetitive nature of G.W.M.&S. Co. and I. U. management fees, the large undetailed fee going to I. U. as a management fee, the promotional and advertising expenses, the few illustrative vouchers which show the tendency to be liberal to causes unconnected with managing Maine companies, and the fact that there is no indication of how much time was actually spent by G.W.M.&S. Co. on the Maine companies.

We will accept Dr. Shipman's conclusion. We note that other commissions have used the per customer approach in determining the reasonableness of G.W.M.&S. Co.'s service charges. Re Dunsmuir Water Corp. (Cal 1974) Decision No. 82484; Re Wilmington Suburban Water Corp. (Del 1975) Docket No. 793. To be absolutely sure that any imprecision in this calculation does not disadvantage the companies, we will raise the proposed ceiling to $11.50 per customer which is slightly above the ceiling for any of the comparison entities.

We find the management and service contracts are not adverse to the public interest and we will approve the contracts, as filed, subject to the limitations contained in petitioner's request for findings, No. 31.

Fair Rate of Return

In order to make a judgment on the fair rate of return, it is necessary to determine the proper capital structure, to determine the proper cost of debt, and the proper cost of equity.

Ordinarily the capital structure to be used for determining the fair rate of

13 P.U.R.4th 347

return is the capital structure of the company seeking the rate change. The equity of the General Waterworks subsidiaries, however, is nearly 100 per cent equity owned by General Waterworks. The subsidiaries have very little debt of their own outstanding. Both witnesses have agreed that the proper capital structure to be used is the capital structure of General Waterworks since General Waterworks supplies all the capital to its subsidiaries. We agree on the record made in this case that the General Waterworks capital structure is the appropriate structure to be inspected. We note, however, that since General Waterworks does not presently sell its equity in the marketplace, the examination of the General Waterworks capital structure necessarily means that a true market test of the General Waterworks cost of equity is problematical.

Cost of Debt

[3] The six companies are seeking a cost of debt of 8.5 per cent. The staff witness, Dr. Shipman, testified that the proper cost of debt to be used is 8.25 per cent. The difference between the 8.25 and 8.5 per cent is due to the fact that Mr. Mulle, the General Waterworks witness, omitted from his computations the debt of the subsidiaries of General Waterworks. Since we are permitting a pro forma financing involving $30 million of new debt and since relatively little of that $30 million is actually required by Maine subsidiaries, it seems equitable that the Maine subsidiaries should benefit from the outstanding debt of other General Waterworks subsidiaries.

Accordingly, we find 8.25 per cent to be the appropriate cost of debt in these proceedings.

Cost of Equity

The economic and legal standards used by commissions and courts to test the reasonableness of a utility's earnings on equity are most clearly set forth in two landmark cases, Bluefield Water Works & Improv. Co. v West Virginia Pub. Service Commission, 262 US 679, PUR1923D 11, 67 L Ed 1176, 43 S Ct 675, and Federal Power Commission v Hope Nat. Gas Co. (1944) 320 US 591, 51 PUR NS 193, 88 L Ed 333, 64 S Ct 281.

In the Hope case, commenting on what constitutes a reasonable return to the equity owner, the court stated (320 US at p. 603, 51 PUR NS 193):

'From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital cost of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.' [Citation omitted.]

13 P.U.R.4th 347
(Publication page references are not available for this document.)

These principles have been recognized by our supreme judicial court in Central Maine Power Co. v Maine Pub. Utilities Commission (1957) 153 Me 228, 21 PUR3d 321, 136 A2d 726.

With these principles in mind we turn to the evidence presented regarding the cost of equity. Mr. Mulle testified for the six Maine General Waterworks subsidiaries. Mr. Mulle is the director of rates for General Waterworks Management and Service Company, a subsidiary of General Waterworks. We note that Mr. Mulle is a General Waterworks employee with a consequent duty to maximize the return to the company's investors. We have considered this in evaluating his judgments.

Mr. Mulle decided that the cost of equity to General Waterworks should be used to determine the cost of equity to the subsidiaries, and he concluded that the cost of equity should be at least 14.5 per cent. Mr. Mulle used several methods in judging the cost of equity including the comparable earnings, earnings to market, and the DCF approaches. The comparable earnings approach and earnings to market approach were modified so that basic ratios were adjusted upwards for such factors as 'expectation of real growth in earnings,' 'inflation,' 'lag time,' and 'attrition.'

Dr. Shipman testified as the public utilities commission staff's witness. He declined to use a 'market' test in part because General Waterworks' stock is not sold on the open market. Dr. Shipman instead relied on the comparable earnings approach with an adjustment for regulatory lag. When using the comparable earnings approach, he disagreed with Mr. Mulle over what utilities were truly comparable and over the type and magnitude of the adjustments Mr. Mulle made.

On balance, it appears that Dr. Shipman's method is a more useful method in trying to judge the cost of equity for General Waterworks. While he made no market analysis, we think that the market tests used by Mr. Mulle are simply not that reliable or accurate. General Waterworks markets no stock itself and thus a 'market' test necessarily must rely on market prices of other companies. We generally agree with Dr. Shipman's critique of Mr. Mulle's market methods and note particularly that Mr. Mulle's DCF method gives dramatically different results depending upon the 'g' selected. Even Mr. Mulle said his DCF method was 'another guideline to test all other approaches for sanity.' (Emphasis his.)

Mr. Mulle's adjustments made to the 'raw data' are duplicative and not shown to be necessary. Furthermore these adjustments are inappropriate in that they do not consider the regulatory climate of the particular state. With these consolidated hearings, it is unlikely that many of the General Waterworks' Maine subsidiaries will have to wait the full nine months for rates. Additionally we have allowed, in this case, the pro forma cost of debt even before the subsidiaries have issued the debt. Finally, in Mechanic Falls we are permitting a rate of return on pro forma property in service, but not included in the test-year rate base, and we are permitting adjustments to test-year expenses based on more recent experience. While Dr. Shipman made an adjustment to his cost of equity to take into consideration the use of pro forma long-term debt, no similar adjustments were made by Mr. Mulle. His lag-inflation-debt costs adjustments remained the same.

13 P.U.R.4th 347

As we have said before in Guilford and Sangerville ([Me 1975] 10 PUR4th 8) F. C. No. 2079:

'In our judgment the average historical earnings of the water companies Mr. Mulle listed would give a more accurate reflection of the cost of equity.'

We continue to adhere to this position and thus find Dr. Shipman's reliance on water companies sound.

In the final analysis, the commission must exercise its judgment based on its expertise and the evidence in the record. As was stated by the California Public Utilities Commission in Re Pacific Teleph. & Teleg. Co. (Cal 1968) 77 PUR3d 1, 16:

'In the final analysis, it devolves upon the judgment of the commission, after weighing the evidence presented by all of the experts who, by their testimony, have sought to advise the commission, to determine and to set a fair and reasonable rate of return for the applicant. The testimony and exhibits presented by the rate of return witnesses are of aid to the commission in such determination even though the individual opinions of the witnesses, when standing alone, may be inconclusive.'

[4][5] Based on the extensive record in this case it is our opinion that the cost of equity for six General Waterworks subsidiaries is 12.6 per cent and that the fair rate of return is 10 per cent.

Liberalized Depreciation and Income Taxes

[6] The company seeks to 'normalize' all income taxes by normalizing all depreciation expense in the computation of income taxes. Federal law now prohibits the flow through of liberalized depreciation on post-1969 property, but permits flow through on pre-1970 property.

It has been prior commission policy to flow through to the ratepayers all the benefits of federal income tax law to the extent permitted by law. We see no reason to change that position. By flowing through the benefits of accelerated depreciation now, we guard against the possibility of having the future tax laws change so as to erase any benefits which we might otherwise have deferred.

Mr. Green contends that normalization of income taxes would increase the cash flow needed for construction. While this might be true, an increase in cash flow to the utility also increases the cash flow from the ratepayer. The concept that money is more valuable now than in the future is as applicable to the ratepayer as it is to the utility.

Depreciation of Contributed Property

[7] We see no reason to change the commission policy of eliminating depreciation

13 P.U.R.4th 347

on contributed property. Re Central Maine Power Co. (Me 1975) 8 PUR4th 227, 291. The purpose of depreciation is to recover the original investment in property over the life of the property. The purpose of depreciation is not to replace property. Since the company has invested to funds in contributed property, it is not entitled to recover the original investment through depreciation. Princess Anne Utilities Corp. v Virginia et al. State Corp. Commission (1971) 211 Va 620, 88 PUR3d 519, 179 SE2d 714. There is no conflict with our generally accepted accounting principles or our Uniform System of Accounts, for those systems have never been controlling for rate-making purposes.

FN1 Account 820--Salaries and Expenses of General Officers; Account 821--Salaries and Expenses of General Office Employees; Account 822--General Office Supplies and Expenses; Account 823--Management and Supervision Fees; Account 824--Management and Supervision Expenses; Account 825--Miscellaneous General Expenses.

FN2 The record was unclear as to what part of this $737,000 might have been capitalized.

FN3 The record is unclear whether the $737,000 management and service expense is paid to I. U. International or I. U. International Management and Service Company.

END OF DOCUMENT

Westlaw Attached Printing Summary Report for BLACKFORD, BETSY 3999927

Date/Time of Request:	Friday, July 30, 2004 11:06:00 Eastern
Client Identifier:	ATTORNEY GENERAL
Database:	SCT
Citation Text:	87 S.Ct. 1003
Lines:	705
Documents:	1
Images:	0

Supreme Court of the United States

FEDERAL POWER COMMISSION, Petitioner,
v.
UNITED GAS PIPE LINE COMPANY et al.
MEMPHIS LIGHT, GAS AND WATER DIVISION, Petitioner,
v.
UNITED GAS PIPE LINE COMPANY et al.

Nos. 127 and 128.

Argued Jan. 11, 1967.
Decided March 13, 1967.

Proceeding on petition to review orders of the Federal Power Commission. The Court of Appeals vacated and set aside the Commission's order, 5 Cir., 357 F.2d 230, and certiorari was granted. The Supreme Court, Mr. Justice White, held that method chosen by Federal Power Commission to allocate tax liability among group members who choose to exercise statutory privilege of filing consolidated income tax returns, under which net losses and net income of unregulated companies were first set off one against the other, resulting in savings made possible by losses of unregulated enterprises being first allocated to unregulated companies, and under which regulated company would be deemed to have enjoyed a reduction in taxes as a result of the consolidated return only if unregulated losses exceeded unregulated income, was not erroneous or contrary to statutory authority.

Reversed and remanded for further proceedings.

Mr. Justice Harlan, Mr. Justice Douglas and Mr. Justice Stewart dissented.

West Headnotes

[1] Gas ⟹14.4(1)
190k14.4(1) Most Cited Cases

One of Federal Power Commission's statutory duties is to determine just and reasonable rates which will be sufficient to permit a company to recover its costs of service and a reasonable return on its investment.

[2] Gas ⟹14.4(7)
190k14.4(7) Most Cited Cases

Determination of allowance to gas company for taxes, including federal income taxes, is within jurisdiction of Federal Power Commission since a proper allowance for taxes is included in company's cost of service.

[3] Gas ⟹14.4(7)
190k14.4(7) Most Cited Cases

Method chosen by Federal Power Commission to allocate tax liability among group members who choose to exercise statutory privilege of filing consolidated income tax returns, under which net losses and net income of unregulated companies were first set off one against the other, resulting in savings made possible by losses of unregulated enterprises being first allocated to unregulated companies, and under which regulated company would be deemed to have enjoyed a reduction in taxes as a result of the consolidated return only if unregulated losses exceeded unregulated income, was not erroneous or contrary to statutory authority. Natural Gas Act, § 4(e), 15 U.S.C.A. § 717c(e); 26 U.S.C.A. (I.R.C.1954) § 1501.

[4] Gas ⟹14.4(7)
190k14.4(7) Most Cited Cases

Pursuant to statute allowing affiliated group of corporations to file consolidated income tax returns, nothing in the decisions or statutes governing rate making activities of Federal Power Commission would dictate priority for state regulated company or would provide that jurisdictional company might share in tax savings made possible by filing consolidated returns only if the saving exceeded the separate return tax liability of the state regulated company. Natural Gas Act, § 4(e), 15 U.S.C.A. § 717c(e); 26 U.S.C.A. (I.R.C.1954) § 1501.

[5] Gas ⚷14.5(6)
190k14.5(6) Most Cited Cases

Where Congress fails to provide a formula for Federal Power Commission to follow, courts are not warranted in rejecting Commission's formula unless it plainly contravenes the statutory scheme of regulation.

[6] Gas ⚷14.5(6)
190k14.5(6) Most Cited Cases

If total effect of natural gas rates fixed by Federal Power Commission cannot be said to be unjust and unreasonable, traditional inquiry under Natural Gas Act is at an end. Natural Gas Act, § 4(e), 15 U.S.C.A. § 717c(e).
****1004 *237** Howard E. Wahrenbrock and Reuben Goldberg, Washington, D.C., for petitioners.

***238** Thomas Fletcher, Houston, Tex., and William W. Brackett, Chicago Ill., for respondents.

Mr. Justice WHITE delivered the opinion of the Court.

The question here is whether the Federal Power Commission, in the course of determining just and reasonable rates for United Gas Pipe Line Company (United) under s 4(e) of the Natural Gas Act, 52 Stat. 822, 15 U.S.C. s 717c(e), made a proper allowance for federal income taxes in calculating the company's cost of service. United claimed that in determining the cost of service its allowance for federal income taxes should be at the full 52% rate, or $12,751,454, for the test year. The Commission disagreed because United was a member of an affiliated group which during the five-year period of 1957--1961 had elected ****1005** to file consolidated returns for federal income tax purposes, [FN1] a fact which in the Commission's ***239** view required a reduced tax allowance in the company's cost of service. Had consolidated returns not been filed during the five-year period and had each company in the affiliated group instead filed separate returns, the total tax for the group would have been several million dollars more than was paid on a consolidated basis. This was so because on a consolidated basis consolidated losses serve to reduce consolidated income and because two members of the group, Union and Overseas, had net losses over the five-year period, thereby reducing taxes by $2,092,038 over those years.

FN1. The election was pursuant to the privilege granted in s 1501 of the Internal Revenue Code of 1954, 26 U.S.C. s 1501. The other members of the affiliated group are United Gas Corporation, which wholly owns United and which is a gas distribution company subject to state and local regulation, and two other wholly owned subsidiaries of United Gas Corporation--Union Producing Company (Union), a domestic oil and gas producer whose interstate sales of gas are subject to the jurisdiction of the Federal Power Commission, and United Overseas Production Company (Overseas) which engaged in oil exploration in foreign countries.

To determine what the Commission considered the proper tax allowance for United's rate base, it allocated the actual consolidated taxes paid during the five-year period among the members of the group in accordance with a formula it had developed in Cities Service Gas Co., 30 F.P.C. 158, the order in which was set aside after issuance of the order in the instant case, 337 F.2d 97. As so allocated, United's annual share of the consolidated tax was 50.04% of its taxable income. Using this rate, the Commission allowed United $9,940,892 for federal income taxes instead of the $12,751,454 claimed by United. 31 F.P.C. 1180, 1191.

The Court of Appeals, relying on the decision of the Court of Appeals for the Tenth Circuit in Cities Service Gas Co. v. FPC, 337 F.2d 97, held 'the tax allocation as made by the Commission's order was contrary to the requirements which Congress had imposed', 357 F.2d 230, 231, and hence vacated and set aside the order. We reverse and remand to the Court of Appeals for further proceedings.

*240 I.

In the Cities Service case the affiliated group filing the consolidated return was composed of both regulated and unregulated companies. Some of the unregulated companies had taxable income, others had even larger losses, and, therefore, as a group the unregulated companies showed a net loss over the representative years used by the Commission to forecast the future federal income tax element of cost of service. The regulated companies as a group, on the other hand, had taxable income in the same period. On an unconsolidated basis the individual members of the affiliated group would have paid a considerably larger total tax than was actually paid on the consolidated basis. The gas company whose tax allowance for rate purposes was being determined claimed that it was entitled to the full 52% of its own taxable income. Its position was that the Commission had no power at all to apply any of the losses of unregulated companies to reduce its tax allowance and hence its rates. The tax allowance was thus to be figured at 52% without regard to the taxes actually paid by the affiliated group on a consolidated basis, seemingly even if the group paid no tax at all.

For the Commission, however, the only real cost to the regulated company was related to the consolidated tax actually paid and incurred in connection with the other companies in the group. In the Commission's view, it was unacceptable **1006 to determine the cost of service on a hypothetical figure--to fix jurisdictional rates 'on the basis of converting a hypothetical tax payment into a prudent operating expense.' 30 F.P.C., at 162. It refused to accept the argument that 'Gas Company ratepayers should make Cities Service stockholders whole for *241 the tax losses of nonregulated enterprises even though this means an allowance for taxes over and beyond that which the consolidated system as a whole actually paid.' Ibid. The Commission's function, it said, was to fix just and reasonable rates, not to insure that other affiliates would be made whole for their tax losses out of income from regulated enterprises. Thus the task was 'to determine the proportion of the consolidated tax which is reasonably attributable to the Gas Company vis-a-vis the other Cities Service affiliates.' Ibid.

To make this determination, the Commission devised a formula which in effect applied the losses of unregulated companies first to the gains of other unregulated companies. [FN2] If a net taxable income remained in the unregulated *242 group, the regulated companies would not share in the savings from the consolidated return and would be deemed to have paid a tax at the full 52% rate. But if losses of the unregulated companies exceeded their net income and hence reduced the taxes of the regulated group below what they would have paid had they filed separate returns, the consolidated tax paid would be allocated among the regulated companies in proportion to their taxable income. As applied to the facts in the Cities Service case, the formula resulted in a tax allowance of $5,866,847 rather than the $7,055,981 claimed by the Cities Service Gas Company.

FN2. '(T)he proper method to be applied in computing the Federal income taxes to be included in the cost of service of a regulated company where that company has joined in a consolidated tax return with affiliates is (1) separate the companies into regulated and unregulated groups, (2) determine the net aggregate taxable income of each group, and (3) apportion the net total consolidated tax liability over a representative period of time between the two groups, and among the companies in the regulated group, on the basis of their respective taxable incomes; provided that the allowance so computed for the regulated company shall not exceed what its tax liability would be for rate making purposes, if computed on a separate return basis.' 30 F.P.C. 158, 164.
As the Commission noted, id., at 162, it could draw little from the experience of state and local regulatory bodies dealing with the question whether the losses of affiliates should be taken into account in determining the tax allowance for regulated enterprises since the state and local solutions had not been consistent. It does not appear that the Commission drew on its own experience, although with a single exception the Commission seems to have accounted for consolidated tax

savings in past ratemaking proceedings. See Penn-York Natural Gas Corp., 5 F.P.C. 33, 39 (1946); Hope Natural Gas Co., 10 F.P.C. 583, 612, aff'd, 10 F.P.C. 625 (1951); Atlantic Seaboard Corp., 11 F.P.C. 486, 515, aff'd, 11 F.P.C. 43, remanded on other grounds, 200 F.2d 108 (4 Cir., 1952); United Fuel Gas Co., 12 F.P.C. 251 (1953); Hope Natural Gas Co., 12 F.P.C. 342, 347 (1953); Home Gas Co., 13 F.P.C. 241, 246 (1954); United Fuel Gas Co., 23 F.P.C. 127, 134 (1960). But see Olin Gas Transmission Corp., 17 F.P.C. 685 (1956).

The Court of Appeals set aside the Commission's order. In its view, the addition of the gas company's income to the consolidated return cost the affiliated group exactly 52% of the taxable income of the gas company, either in taxes paid or in a reduction of loss carry-forwards or carrybacks. The Commission's formula as applied was therefore held to appropriate losses of unregulated companies and to exceed the Commission's 'jurisdictional limits which require an effective separation of regulated and nonregulated activities for the determination of ****1007** the ingredients of the rate base * * * mean(ing) a separation of profits and losses between regulated and nonregulated businesses in determining the tax allowance includible in the cost of service of the regulated company.' 337 F.2d 97, 101. Hence the court, relying on Colorado Interstate Gas Co. v. FPC, 324 U.S. 581, 65 S.Ct. 829, 89 L.Ed. 1206, and Panhandle Eastern Pipe Line Co. v. FPC, 324 U.S. 635, 65 S.Ct. 821, 89 L.Ed. 1241, set aside the Commission's order.

***243** II.

[1][2] In our view what the Commission did here did not exceed the powers granted to it by Congress. One of its statutory duties is to determine just and reasonable rates which will be sufficient to permit the company to recover its costs of service and a reasonable return on its investment. Cost of service is therefore a major focus of inquiry. Normally included as a cost of service is a proper allowance for taxes, including federal income taxes. The determination of this allowance, as a general proposition, is obviously within the jurisdiction of the Commission. Ratemaking is, of course subject to the rule that the income and expense of unregulated and regulated activities should be segregated. But there is no suggestion in these cases that in arriving at the net taxable income of United the Commission violated this rule. Nor did it in our view in determining the tax allowance. United had not filed its own separate tax return. Instead it had joined with others in the filing of a consolidated return which resulted in the affiliated group's paying a lower total tax than would have been due had the affiliates filed on a separate-return basis. The question for the Commission was what portion of the single consolidated tax liability belonged to United. Other members of the group should not be required to pay any part of United's tax, but neither should United pay the tax of others. A proper allocation had to be made by the Commission. Respondents insist that in making the allocation the Commission would violate the statute unless in every conceivable circumstance, including this one, United is allowed an amount for taxes equal to what it would have paid had it filed a separate return. In their view United should never share in the tax savings inherent in a consolidated return, even if on a consolidated basis system ***244** losses exceed system gains and neither the affiliated group nor any member in it has any tax liability. This is an untenable position and we reject it. Rates fixed on this basis would give the pipeline company and its stockholders not only the fair return to which they are entitled but also the full amount of an expense never in fact incurred. In such circumstances, the Commission could properly disallow the hypothetical tax expense and hold that rates based on such an unreal cost of service would not be just and reasonable.

It is true that the avoidance of tax and the reduction of the tax allowance are accomplished only by applying losses of unregulated companies to the income of the regulated entity. But the Commission is not responsible for the use of consolidated returns. It is the tax law which permits an election by an appropriate group to file on a consolidated basis. The members of a group, as in these cases, themselves chose not to file separate returns and hence, for tax purposes, to mingle profits and losses of both regulated and unregulated concerns, apparently deeming it more desirable to attempt to turn the losses of some companies into immediate cash through tax savings rather than to count on the loss companies themselves having future profits against which prior losses could be applied. Such a private decision made by the affiliates, including the regulated member, has the practical and intended consequence of reducing the group's federal income taxes, perhaps to zero, as was true of one of the years involved in the Cities Service case. But when the out-**1008 of-pocket tax cost of the regulated affiliate is reduced, there is an immediate confrontation with the ratemaking principle that limits cost of service to expenses actually incurred. Nothing in Colorado Interstate or Panhandle forbids the Commission to recognize the actual tax saving impact of a private election to file consolidated *245 returns. On the contrary, both cases support the power and the duty of the Commission to limit cost of service to real expenses. [FN3]

FN3. See Colorado Interstate Gas Co. v. FPC, 324 U.S. 581, 604-- 605, 65 S.Ct. 829, 840--841, 89 L.Ed. 1206; Panhandle Eastern Pipe Line Co. v. FPC, 324 U.S. 635, 648--649, 65 S.Ct. 821, 827--828, 89 L.Ed. 1241; El Paso Natural Gas Co. v. FPC, 5 Cir., 281 F.2d 567, 573, cert. denied sub nom. State of California v. FPC, 366 U.S. 912, 81 S.Ct. 1083, 6 L.Ed.2d 236; Alabama-Tennessee Natural Gas Co. v. FPC, 5 Cir., 359 F.2d 318, 331, cert. denied, 385 U.S. 847, 87 S.Ct. 69, 17 L.Ed.2d 78.

We think that in the proper circumstances the Commission has the power to reduce cost of service, and hence rates, based on the application of nonjurisdictional losses to jurisdictional income. Hence, the question becomes one of when and to what extent the tax savings flowing from the filing of a consolidated return are to be shared by the regulated company. Or, to put it in the Commission's words the issue is one of determining 'the proportion of the consolidated tax which is reasonably attributable to the Gas Company vis-a-vis (its) other * * * affiliates.' 30 F.P.C., at 162.

[3] Viewing these cases in this light, we cannot say that the method the Commission chose to allocate the tax liability among the group members was erroneous or contrary to its statutory authority. Under its formula, the net losses and net income of unregulated companies are first set off one against the other, and the tax savings made possible by losses of unregulated enterprises are thus first allocated to the unregulated companies. Only if 'unregulated' losses exceed 'unregulated' income is the regulated company deemed to have enjoyed a reduction in its taxes as a result of the consolidated return. If there is more than one regulated company in the group, they will share the tax liability or tax saving in proportion to their taxable income.

*246 [4][5][6] It is true that the Commission includes in the regulated group companies which are regulated not by it but by state or local authorities and that under the Commission's formula enterprises not subject to its jurisdiction may be required to share the tax saving with the federally regulated concern. But we know of nothing in the decisions or the statutes governing the ratemaking activities of the Commission which dictates priority for the state-regulated company or which provides that the jurisdictional company may share in the tax saving only if the saving exceeds the separate-return tax liability of the state-regulated company. One could as well argue that for ratemaking purposes the company subject to federal regulation should have the first benefit of the tax saving. The Commission's formula, of course, prefers neither concern but allocates the tax liability equitably between each regulated member, without regard to the source of the regulation. [FN4] 'When Congress, as here, fails to provide a formula for the Commission to follow courts are not warranted in rejecting the one which the Commission employs unless it plainly contravenes the statutory scheme of regulation.' Colorado Interstate Gas Co. v. FPC, 324 U.S. 581, 589, 65 S.Ct. 829, 833, 89 L.Ed. 1206. 'If the total effect of the rate order cannot be said to be **1009 unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.' FPC v. Hope Natural Gas Co., 320 U.S. 591, 602, 64 S.Ct. 281, 288, 88 L.Ed. 333.

FN4. That some sharing of the tax savings with nonfederally regulated companies was in order seems to have been recognized by the members of the affiliated group. Under the internal allocation formula employed by the group, the tax liability assigned to United represented an effective tax rate of 48.8%.

There is no frustration of the tax laws inherent in the Commission's action. The affiliated group may continue ***247** to file consolidated returns and through this mechanism set off system losses against system income, including United's fair return income. The tax law permits this, but it does not seek to control the amount of income which any affiliate will have. Nor does it attempt to set United's rates. This is the function of the Commission, a function performed here by rejecting that part of the claimed tax expense which was no expense at all, by reducing cost of service and therefore rates, and by allowing United only a fair return on its investment.

Nor did the Commission 'appropriate' or extinguish the losses of any member of the affiliated group, regulated or unregulated. Those losses may still be applied to system gains and thereby be turned into instant cash. United may, of course, have less income than it did. If so, this will correspondingly reduce the opportunity of the affiliated group to use the losses of unregulated companies to appropriate United's income for the benefit of nonjurisdictional activities because United's income will no longer offset the same amount of losses which it once did. But the losses of unregulated companies are in no way destroyed. They remain with the system, readily available to reduce the taxes of the profitable affiliates to the maximum extent allowed by the tax law.

Another matter deserves some comment. It is said here that the Commission, in applying its tax allowance formula, erroneously failed to recognize and to take account of the fact that United has both jurisdictional and nonjurisdictional activities and income. Although this is a matter which might affect the results achieved in application of the Commission's formula, it is one to which the Court of Appeals has not addressed itself, and we think it appropriate for the issue to be raised there if the parties are so inclined.

***248** For the reasons stated herein, the judgment of the Court of Appeals is reversed and the cases remanded for further proceedings consistent with this opinion.

It is so ordered.

Judgment of Court of Appeals reversed and case remanded.

MR. JUSTICE FORTAS took no part in the consideration or decision of these cases.

Mr. Justice HARLAN, whom Mr. Justice DOUGLAS and Mr. Justice STEWART join, dissenting.

My analysis of the elusive issue involved in these cases leads me to different conclusions from those reached by the Court and to agreement with the result reached by the Court of Appeals on the facts of these cases.

We are presented here with the problems of resolving an apparent conflict between the consolidated tax return provisions of the Internal Revenue Code, [FN1] which permit an affiliated group of corporations, in this instance having some activities within and some without the Federal Power Commission's jurisdiction, to be treated as a 'business entity' for tax purposes, [FN2] and the Natural Gas Act which imposes on the Commission the duty of observing 'the fundamental ****1010** rate making principle (that) * * * requires a separation between regulated and unregulated costs and revenues.' Cities Service Gas Co., 30 F.P.C. 158, 162. The Court holds that the FPC may resolve the apparent dilemma by working only with 'the single consolidated tax liability' and determining by allocation what portion should be attributed to United for ratemaking purposes. By filing a consolidated return the members of the affiliated group are said 'to mingle profits ***249** and losses of both regulated and unregulated concerns' and thus create the necessity for allocation. The only serious problem the Court sees is the resolution of the question 'when and to what extent the tax savings flowing from the filing of a consolidated return are to be shared by the regulated company.' And the Court attempts to sidestep sharp analysis of that problem by resorting to the principle that, in ratemaking, the end in effect justifies the means. [FN3]

FN1. 26 U.S.C. ss 1501--1505.

FN2. 'The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise.' S.Rep. No. 960, 70th Cong., 1st Sess., p. 14.

FN3. The Court's opinion seizes on the language of FPC v. Hope Natural Gas Co., 320 U.S. 591, 602, 64 S.Ct. 281, 288, 88 L.Ed. 333, for the proposition that judicial inquiry must be at an end when it is determined that a rate order 'cannot be said to be unjust and unreasonable'. But the problem before the Court in that case was an entirely different one. There it was argued that the Court was obligated to delve into the details of an initial ratemaking in order to determine whether certain rates were reasonable. The Court held that in an initial ratemaking the essential question was only whether the return actually allowed permitted the company to sustain itself in the market. The Court noted that it could not become involved in questions of 'fair value' because 'the value of the going enterprise depends on earnings under whatever rates may be anticipated.' Id., at 601, 64 S.Ct. at 287. Nothing in Hope Natural Gas suggests that courts are powerless to review a particular formula to determine whether it is based on rational criteria. A return which is 'just and reasonable' must reflect underlying congressional policies. Thus courts have not hesitated to review the underlying rationales of Commission decisions while giving due deference to the Commission's discretion. See, e.g., Tennessee Gas Transmission Co. v. FPC, 5 Cir., 293 F.2d 761; United Gas Imp. Co. v. FPC, 5 Cir., 290 F.2d 133; City of Detroit v. FPC, 97 U.S.App.D.C. 260, 230 F.2d 810.

As will be developed more fully below, I think that the Court's resolution of the jurisdictional issue, while possessing a certain surface plausibility, mistakes the operation of the tax laws and permits the Commission to place regulatory presure on entities and business decisions wholly outside its jurisdiction under the Natural Gas Act. I think also that the Commission's formula ***250** cannot be upheld even under the Court's jurisdictional analysis. The formula indefensibly undercuts the policy of the tax laws, and thus cannot be considered a means of reaching 'just and reasonable' rates. Cf. El Paso Natural Gas Co. v. FPC, 5 Cir., 281 F.2d 567.

I.

The Court's 'single consolidated tax liability' approach ignores the fact that what is consolidated is corporate taxable incomes rather than the underlying revenues and deductions. Thus what has happened in this case is not the imposition of a single tax liability on the activities, as a whole, of the affiliated corporate group, but the reduction of the sum of separate 52% corporate tax liabilities by the setoff of tax losses against taxable income. Certainly there can be no contention that United would be entitled to anything other than a 52% of taxable income tax expense for ratemaking purposes absent tax losses in the consolidated group. [FN4] The only question ****1011** that properly arises on this record is whether the Commission could consider any setoff to have been made against United's tax liability for ratemaking purposes when nonjurisdictional activities could have taken full advantage of the setoffs belonging to the group and the group desired to allocate them to those activities. [FN5]

FN4. Thus despite the Court's 'single consolidated tax liability' phraseology, I am certain that the Court does not mean to imply that the Commission may allocate by any criterion other than taxable incomes.

The Court cannot mean to suggest that, for example, the Commission is empowered to allocate by gross revenues and thus consider special deductions belonging to nonjurisdictional activities as allocable for ratemaking purposes when the nonjurisdictional activity is fully capable of using them.

FN5. In determining what it considered to be the properly allocated percentage of 'tax saving' for ratemaking purposes the Commission utilized a five-year average (1957--1961) to eliminate the effects of short-term fluctuation. During that period, the total tax losses of Union and Overseas were $3,893,980. The total taxable income of Gas Corporation, all of which was nonjurisdictional, was $9,024,170. Moreover, 56% of United's taxable income of $105,290,983 was nonjurisdictional. Thus even in the two years, 1960 and 1961, when the tax losses of Union and Overseas exceeded the taxable income of Gas Corporation, the group's nonjurisdictional taxable income was more than sufficient to offset all tax losses.
The Court notes the observation, made by the FPC in its brief, p. 26, that United reflected a 'tax saving' on its books. This statement is somewhat misleading since it is directed to the allocation made for earnings and profits tax purposes under 26 U.S.C. s 1552(a)(1) and that allocation bears no necessary relation to the actual allocation of liability for corporate purposes. Exhibit 14--1 reveals that, on the basis of allocated liability for corporate purposes, United had an average effective tax rate of 51.749% for the test years.
Moreover, the allocation of setoffs in the 1957--1961 period has no direct relevance to the issue in this case for the Commission was not engaged in analyzing rates for that period. The rates under scrutiny were those United proposed to charge in the future. If the Commission had found that United actually intended to allocate setoffs to its jurisdictional operation for corporate purposes while attempting to take a full 52% tax expense deduction for ratemaking purposes, the Commission might well have been justified in recognizing the setoffs for ratemaking purposes to the extent that United actually utilized them. On this record, it is clear that the Commission did not make any such finding.

251** The 'tax losses' belonging to the group arose almost exclusively from the excess of depletion allowances over revenues in the accounts of the nonjurisdictional activities of Union and Overseas. Such allowances belonged to Union and Overseas and those corporations were entitled to their exclusive use. By agreeing to the consolidated return [FN6] Union and Overseas agreed to deliver to the group, in any taxable year, whatever deductions they themselves could not then utilize in their own returns. The question how to allocate the benefit of those ***252** deductions among the members of the group would seem to be one for the group rather than the Commission when, as here, they do not arise from jurisdictional activities and can be used by group members to offset other nonjurisdictional gains. The courts have allowed good-faith business decisions to control such allocations for the vital purpose of determining which corporations shall pay the tax. See Case v. New York Central R. Co., 15 N.Y.2d 150, 256 N.Y.S.2d 607, 204 N.E.2d 643. And the tax Commissioner would permit the group to allocate for earnings and profits purposes in precisely the manner the group has chosen here. [FN7] Although these decisions cannot control for ratemaking purposes, they do make it clear that the Commission's assertion of jurisdiction to make an allocation amounts to an order that certain nonjurisdictional assets be delivered up to jurisdictional use since there is no other compulsion for such an allocation. The Court asserts that '(o)ne could as well argue that for ratemaking*1012** purposes the company subject to federal regulation should have the first benefit of the tax saving.' But no authority or reason is given in support of this assertion, and, in my opinion, none can be found. The Commission has no authority to control the disposition of nonjurisdictional assets or the revenues or losses arising therefrom.

FN6. 26 U.S.C. s 1501 requires that all of the affiliated corporations consent to the filing of the consolidated return.

FN7. Proposed Treas.Reg. s 1.1502--33 recently promulgated by the Commissioner of Internal Revenue makes this a permissible means of allocation. 31 Fed.Reg. 16788--16789.

A parallel example will make even clearer the jurisdictional violation arising from the Commission's action here. If Union or Overseas had found itself with an excess quantity of steel pipe useful to all members of the group and had to negotiate its sale at a discount, one could hardly 'as well argue that for ratemaking purposes' United should be credited with the discount purchase when the pipe had been sold to Gas Corporation and United had been forced to purchase pipe on the ***253** market. [FN8] And it could not be asserted that the Commission would have authority to order the transfer of the discount pipe to United. [FN9]

FN8. And this nonjurisdictional decision would seem outside the Commission's control even if it were influenced by the fact that United could benefit less from the lower price because the ratepayers would absorb the benefit. Union and Overseas have no duty to act for the benefit of United's ratepayers. And if United were to join in a group compact agreeing to this allocation of excess pipe with the proviso that the excess would be sold to United in the absence of other needs, the decision would seem perfectly justifiable. United's contingent benefit would be more than it would have outside the compact, and since United has no right to compel the nonjurisdictional corporations to deal with it, United would not have surrendered anything. See Case v. New York Central R. Co., 15 N.Y.2d 150, 256 N.Y.S.2d 607, 204 N.E.2d 643.

FN9. It should be noted as well that this example makes clear that it is entirely normal for United to be expected to pay for the acquisition of the asset, and thus some consideration should pass to Union and Overseas. This point is further developed in Part II of this opinion.

The far-reaching nonjurisdictional impact of the Commission's ruling gives further evidence that its action was one which Congress could not have contemplated and would not have condoned. As the dissenting Commissioners pointed out in the Cities Service Gas Co. proceeding, supra, 30 F.P.C., 175, the Commission has made jurisdictional rates turn on the corporate form assumed by nonjurisdictional activities. If, for example, the group had separately incorporated its nonjurisdictional operations, they would have shown taxable income in filing the consolidated return and no ratemaking allocation would be forthcoming. Similarly, since the Commission regulations themselves require separation of jurisdictional and nonjurisdictional operations within a single corporation, all the affiliates could merge into United and since nonjurisdictional activities would show a net taxable income, United would receive a 52% tax expense ***254** for ratemaking purposes. [FN10] The congressional purpose in allowing consolidated returns was to eliminate exactly this kind of dependence on corporate form and leave corporations free to continue business in whatever corporate form best suited them. See, e.g., S.Rep. No. 960, 70th Cong., 1st Sess., p. 14. The congressional purpose in passing the Natural Gas Act was to prevent exploitation of the natural gas consumer. It was not to prevent natural gas companies from fully developing their nonjurisdictional opportunities, nor to control in any way the form of those activities, nor to appropriate nonjurisdictional assets for the benefit of consumers. Colorado Interstate Gas Co. v. FPC, 324 U.S. 581, 593--594, 65 S.Ct. 829, 835--836, 89 L.Ed. 1206.

FN10. Title 18 CFR s 154.63(f) which deals with joint facilities requires allocation of expenses between jurisdictional and nonjurisdictional activities.

The Court focuses its analysis on a case, not presented here, in which there are net nonjurisdictional losses and the **1013 consolidated tax liability is thus less than 52% of the taxable income of the jurisdictional activity. In such a case it is clear that nonjurisdictional assets are being used for tax purposes by the jurisdictional activity and it would blink reality not to recognize this use for ratemaking purposes, just as it would be wholly improper not to recognize the lower cost of discount pipe when a jurisdictional activity actually purchased it from a nonjurisdictional affiliate. When the group's election to file consolidated returns, or its intercorporate arrangements, require that nonjurisdictional deductions be utilized to set off jurisdictional income then, and only then, can there, in my opinion, be allocation. [FN11] That, however, is *255 not the situation here where nonjurisdictional income was fully capable of absorbing all nonjurisdictional losses.

FN11. This formulation is, of course, very similar in form to that utilized by the Commission. The essential difference lies in the fact that the Commission substituted the concept of a 'regulated corporation' for that of a jurisdictional activity. The regulated-unregulated division made by the Commission has no basis in the Natural Gas Act.

II.

In a well-reasoned opinion in El Paso Natural Gas Co. v. FPC, 5 Cir., 281 F.2d 567, the court held that the Commission properly took account of depletion allowances arising from jurisdictional activities in fixing rates. The gas company there had argued that since Congress intended by the allowance to encourage exploration its benefit could not be passed on to the ratepayers. The court rejected that argument because it concluded that the proper place to reflect the congressional policy was in the ultimate rate of return allowed the company. It made explicit, however, that the Commission could not fail to take account of the congressional policy.

The Court's opinion departs from that sound analysis by sustaining a formula which allocates the entire 'tax saving' to the 'regulated' corporations and thus fails to take account of the congressional desire to benefit the loss corporations by allowing the profit corporations to retain earnings which could be passed on to them. The consolidated return is the horizontal equivalent of the vertical loss carry-forward and carryback provisions of the Internal Revenue Code. It allows the 'business unit' to recoup from the Government some of the loss which has been sustained and, in the words of Mr. Justice Jackson, 'it is probable that the intention * * * was to provide salvage for the loser * * *.' Western Pacific Railroad Case (Western Pacific R. Corp. v. Western Pacific R. Co.) 345 U.S. 247, 277, 73 S.Ct. 656, 671, 97 L.Ed. 986 (dissenting opinion). Any rate formula which does not provide a means of allocating benefit to the loss corporation cannot then be 'just and reasonable.' And if the group as a whole does not benefit from consolidation because the setoff advantages of losses are absorbed by the 'regulated' corporations and passed on to the ratepayers it is most *256 unlikely that the loss corporations will achieve the benefit Congress intended them to have. [FN12]

FN12. The Commission has argued that the intended benefit can be disregarded in this case because the loss corporations are in that category for tax purposes solely because of depletion allowances and are actually profitable in economic terms. While this argument might be thought to have some force, it is not for us to decide that the depletion allowances Congress has authorized are not real costs of carrying on the business.

The Court recognizes the adverse effect on the benefits flowing to the loss corporations, but contends there is no frustration of the tax laws because the losses 'remain with the system, readily available to reduce the taxes of the profitable affiliates * * *.' But this hypothetical 'availability' is meaningless **1014 for the 'instant cash' produced by the losses is passed on to the ratepayers rather than, as the tax laws intends, to the loss corporations. The fact that the group's tax payment is lower will not satisfy the intent behind the revenue provisions which was not to reduce government collections but to increase resources available to the business unit. [FN13]

FN13. The Commission, if not the Court, was aware of this problem. In its petition for certiorari, p. 10, n. 8, the Commission recognized that '(t)here may indeed be problems in the application of * * * a formula which may result in allocating the entire tax saving resulting from losses on unregulated activities to the regulated members of the consolidated group.' The Commission has not attempted to justify its formula to this Court.

III.

To summarize, I think, first, that no allocation whatever could be required by the Commission in these cases because nonjurisdictional income was more than sufficient to absorb all nonjurisdictional losses and there was no showing that jurisdictional activities would actually benefit from nonjurisdictional losses. To permit the FPC in such circumstances to allocate would in effect ***257** extend the Commission's jurisdiction to areas not encompassed within the authority given the Commission by the Natural Gas Act. While the basic purpose of the Act is, of course, to protect ratepayers, Congress has not carried that protection so far as to allow them to share in the benefits of the nonjurisdictional activities of a jurisdictional corporation or those of its corporate affiliates--a result which today's decision permits the Commission to achieve.

Second, in instances where the Commission may allocate, it seems to me that any allocation formula that does not take account of the underlying policy of the tax statute would 'plainly (contravene) the statutory scheme of regulation.' Colorado Interstate Gas Co. v. FPC, supra, 324 U.S. at 589, 65 S.Ct. at 833.

Third, while I thus agree with the Court of Appeals that United, on this record, is entitled to have its rates calculated on the premise of a full 52% tax liability, I cannot subscribe to such intimations as there may be in the opinion relied upon by that court that the Commission may never allocate in a consolidated tax situation.

I would affirm the judgment of the Court of Appeals. [FN14]

FN14. Since, in my view, no allocation is permissible in the circumstances of these cases, as a matter of law, a remand to the FPC is unnecessary. Under the Court's view, however, such a remand would appear to be the appropriate disposition. The Court's 'single consolidated tax liability' jurisdictional formulation is essentially the 'fused mass' theory proposed by the Commission staff and rejected by the Commission for jurisdictional reasons. Cities Service Gas Co., 30 F.P.C. 158, 160. The Commission should at least be required to re-examine the matter under the Court's jurisdictional premises. SEC v. Chenery Corp., 318 U.S. 80, 63 S.Ct. 454, 87 L.Ed. 626; Connecticut Light & Power Co. v. FPC, 324 U.S. 515, 534, 65 S.Ct. 749, 758, 89 L.Ed. 1150. In any event, I cannot understand the Court's remand to the Court of Appeals, the Commission's power to allocate and its allocation formula having already been upheld by this Court.

386 U.S. 237, 68 P.U.R.3d 321, 87 S.Ct. 1003, 18 L.Ed.2d 18, 19 A.F.T.R.2d 934

END OF DOCUMENT

2

Response of the Attorney General
To Commission Order of July 26, 2004
Case No. 2003-00433

Witness Responding: Michael J. Majoros, Jr.

2. Does the AG agree that the depreciation rates currently in effect were the result of a unanimous settlement agreement in Case Nos. 2001-00140 and 2001- 00141, entered into by LG&E, KU, the AG, and the Kentucky Industrial Utility Customers, Inc. and approved by the Commission in total on December 3, 2001?

Answer:

Yes, the parties did agree to these depreciation rates in those Dockets. However, that agreement was the product of a negotiated global settlement that encompassed many issues presented in several cases and specifically required a new study in 2004. The rates were remaining life rates based on December 31, 1999 plant and reserve balances. Those are old remaining life rates. Page 8 of the December 3, 2001 Order in those Dockets states, "KU and LG&E have committed to perform a new depreciation study no later than calendar year 2004 based on utility plant in service as of December 31, 2003. When completed, this study will be filed with the Commission." Obviously, Mr. Majoros' current study trumps the old 1999 study. Furthermore, having been involved with that study, Mr. Majoros recalls having discussed the pending aspects of SFAS No. 143.

3

Response of the Attorney General
To Commission Order of July 26, 2004
Case No. 2003-00433

Witness Responding: Michael J. Majoros, Jr.

3. Does the AG agree that the future net salvage being used in the current depreciation rates is the net salvage that was incorporated into the settlement depreciation rates approved in Case Nos. 2001-00140 and 2001-00141?

ANSWER:

Yes. The future net salvage used in the current depreciation rates was accepted in return for other concessions by the Companies in the global settlement for the anticipated term of the settlement.