



DEPARTMENT OF JUSTICE
GENERAL COUNSEL DIVISION

MEMORANDUM

DATE: March 22, 2005

TO: Commissioner Baum
Commissioner Beyer
Commissioner Savage

FROM: Jason W. Jones, Assistant Attorney General
Regulated Utility & Business Section

SUBJECT: Reply to the Utility Reform Project's comments on tax treatment in utility ratemaking

In a previous memorandum, I discussed the applicable legal parameters if the Commission desires to change its current policy of calculating utility tax expenses on a stand-alone basis. In sum, I concluded that the Commission has the discretion to choose a policy, so long as the policy is rational, including taking into account the benefits and burdens of its policy, and meets minimum constitutional requirements. I also concluded that the *City of Charlottesville, Virginia v. FERC*, 249 U.S. App. D.C. 236, 774 F.2d 1205 (1985) (*City of Charlottesville*), while not binding authority, is persuasive and consistent with Oregon law and constitutional requirements. Thus, I advised you that it would be legally prudent to follow the benefits/burdens test.¹ For the reasons set forth below, I again conclude that, if the Commission wishes to change its policy, the legally prudent approach is to follow the benefits/burden approach as outlined in *City of Charlottesville*.

In response to my earlier memorandum, the Utility Reform Project filed additional comments ("URP Comments") that assert that my earlier memorandum "does not reflect with any accuracy the current state of relevant law." See URP Comments at 1. In support of its position, URP relies on *Federal Power Commission v. United Gas Pipe Line Company et al.*, 386 US 237, 87 S Ct. 1003, 18 L Ed2d 18 (1967) (*United Gas*) as a "leading relevant legal authority." See *Id.* I disagree. For reasons I will discuss in more detail below, *United Gas* is not current and its relevance, if any, is limited.

¹ I use the term benefits/burdens test to illustrate the type of consideration that should be implemented in calculating utilities tax expenses. The test could be described in many ways such as consistency or matching. However, the underlying rationale remains the same – to give ratepayers the benefits of consolidated tax savings if the customers bore the burden that generated those savings.

United Gas

In this case, United Gas Pipe Line Co. (“United”) was a member of a group which filed consolidated federal income tax returns. The Federal Power Commission (“FPC”), the predecessor to the Federal Energy Regulatory Commission, applied a formula that it had developed to calculate United’s tax allowance. The FPC formula first applies the losses of unregulated companies to the gains of other unregulated companies, then applies any remaining losses to reduce the taxes of the regulated companies, and finally allocates the consolidated taxes among the regulated companies in proportion to their taxable income. Applying its formula, the FPC lowered United’s tax allowance from the stand-alone 52% rate to a rate of 50.04%, which represented United’s proportionate share of the consolidated tax savings. In reality, the court did not limit cost of service to “real” expenses, but instead, upheld the FPC’s formula for calculating United’s tax allowance which took into consideration consolidated tax savings.

For example, consider a utility with revenue of \$900M that is part of a consolidated group that files consolidated tax filings. Under the formula at issue in the *United Gas* case, the regulator would first add the losses of the unregulated companies to the gains of the other unregulated companies. Thus, only if the combined unregulated companies of the consolidated group had a net revenue loss of, say, \$400M would the gains of the utility be used to lower the taxable income of the consolidated group. If there were unregulated losses and regulated gains, the utility’s tax allowance would be lowered proportionally² within the consolidated group. Therefore, if we assume in our hypothetical that there are six companies in the consolidated group and the effective tax rate is 35 percent, there are tax savings of \$140M ($\$400M \times .35\%$) to be shared proportionally among the six members of the consolidated group. Thus, for purposes of tax allowance in rates, the regulator would lower the utility’s tax expense by approximately \$23.3M³, which would represent its proportionate share of the consolidated tax savings.⁴ The FPC formula did not limit a utility’s tax allowance to expenses actually incurred, but only shared the consolidated tax savings proportionally with the consolidated group.

Is *United Gas* current and relevant law, which can be applied if the Commission desires to change its current tax policy?

United Gas is not current and, if relevant, is of very little use. *United Gas* was decided two years before the original normalization requirements of the Internal Revenue Code (“Code”) were promulgated. In fact, in the early 1970’s FERC opposed *United Gas* and adopted the position that stand-alone accounting should be used. See *Florida Gas Transmission Co.*, 47 F.P.C. 341, 362 (1972); *Southern California Edison Co.*, 59 F.P.C. (1972). It is correct that

² For ease of understanding, the hypothetical assumes that the utility’s proportional share is equal to the other companies in the consolidated group.

³ For illustration, if we assume the same effective tax rate for the utility with revenue of \$900M, the tax expense would be \$315M. Thus, the old FPC formula in this hypothetical would result in a tax expense of \$291.7M, which represents the difference between the utility’s stand-alone liability and its proportionate share of the consolidated tax savings. None of these approaches represents actual taxes paid, but instead are different methods of estimating tax expenses.

⁴ As discussed below, *Duquesne* underscores the constitutional concerns that are created when commissions arbitrarily pick and choose how to treat expenses. The FPC formula, which predates *Duquesne*, may create some of the constitutional concerns mentioned in *Duquesne* because the FPC formula only applies to consolidated savings.

during this time and the 1980's that states approached the issue inconsistently, but in *City of Charlottesville* the court upheld the stand-alone method and analyzed the benefits/burdens approach. Thus, *City of Charlottesville* can be viewed as a culmination of the differing views related to the appropriate method to calculate tax allowances. From that case, it is clear that regulators have discretion to use different methods of calculating tax allowances, but it is also true that whichever method is chosen it should be applied in a way that matches benefits and burdens.

It is also important to consider the limited issue before the court in *United Gas*, which was whether the FPC's approach was contrary to its statutory authority. See *United Gas*, 386 U.S. at 245. Because constitutional issues were not raised by the parties, the court did not consider the constitutional implications of the FPC decision. For example, the court declined to address whether the tax allowance formula erroneously failed to recognize and to take account of the fact that United had both jurisdictional and nonjurisdictional activities and income because the issue was not addressed by the Court of Appeals. See *United Gas*, 386 U.S. at 247. However, the failure to account and for jurisdictional and nonjurisdictional activities and income may raise serious constitutional implications related to unlawful takings.

Although *United Gas* did not address constitutional questions, the Supreme Court has since decided *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989) (*Duquesne*). As I discussed in my earlier memorandum, *Duquesne* highlights the constitutional concerns created when a utility commission picks and chooses in an arbitrary manner how it treats expenses and investments. See *Duquesne*, 488 U.S. at 315. *Duquesne* is important, not only because it was decided after *United Gas*, but because it considers constitutional concerns that were not presented or addressed in *United Gas*. URP's Comments only provide one part of the story. If this Commission wishes to change the method it uses to calculate tax expenses – as my earlier memorandum concludes, you have the discretion to do – it still must be done in a way that passes constitutional and administrative muster. The Supreme Court's decision in *Duquesne* and *City of Charlottesville* provide other, necessary chapters to the story if you choose to change the Commission's policy of calculating taxes.

Conclusion

United Gas stands for the limited point that the FPC had the statutory authority to apply a formula that considered a consolidated tax structure. The limited nature of *United Gas* becomes more apparent when combined with the rest of the story; that the original normalization requirements were added to the Code after *United Gas*, at which time the FPC quickly back-tracked from its previous position and determined that the stand-alone approach was more appropriate, and the Supreme Court issued a seminal case regarding constitutional concerns in ratemaking, which were not raised or addressed in *United Gas*.

United Gas could be viewed as starting the debate on whether state commissions could use an "actual taxes paid" doctrines to calculate utility tax expenses. Although the FPC quickly determined that the *United Gas* method should be discarded, the debate continued in some state courts. However, the debate culminated in *City of Charlottesville* where the court determined

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that state regulators had the discretion to choose actual taxes paid or stand-alone, so long as the policy was applied in a rational way that matched the benefits and burdens.

The conclusion that my earlier memorandum reached – that the Commission has the discretion to choose a policy so long as it is rational, takes into consideration the benefits and burdens of its policy, and passes constitutional muster – remains accurate.