Exhibit No.___ (EB-5)
Docket Nos. UE-111048/UG-111049
Witness: Ellen Blumenthal

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,	)	
Complainant,	)	
v.	)	Docket Nos. UE-111048/UG-111049 *(Consolidated)*
PUGET SOUND ENERGY, INC.,	)	
Respondent.	)	

EXHIBIT NO. ___ (EB-5)

STATEMENT OF MICHAEL J. GRAETZ

December 7, 2011

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**STATEMENT OF
MICHAEL J. GRAETZ
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES**

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the recent withdrawal of proposed regulations concerning the treatment under State ratemaking proceedings of consolidated tax savings under the normalization provisions of the Internal Revenue Code (the "Code"). These proposed regulations, which were published in November 1990 and withdrawn in April 1991, attempted to address the question whether the Internal Revenue Code should be interpreted to restrict the ability of State regulators to take into account certain tax savings realized by an affiliated group of corporations ("consolidated tax savings") in setting the rates that they permit public utilities to charge their customers.

Background

Public utility rates generally are set under State law to compensate the utility for the costs of providing utility services and to provide the utility's bondholders and shareholders with a fair return on the capital they invest in utility assets. The "cost of service" component of rates is based on the operating costs incurred by the utility during the year (such as fuel, salaries, postage, etc.), the depreciation of fixed assets during the year (generally allowed on a straight-line basis over a 25 to 40 year life), and Federal and State income tax expense for the year. The "return on capital" component of rates is based on the product of the "rate base"

(generally the regulatory book value of assets employed to provide utility services) and a weighted average rate of return on debt and equity capital that bondholders and shareholders have invested in those assets.

Since 1969 the Internal Revenue Code has conditioned a public utility's ability to use accelerated depreciation for public utility property on specified ratemaking treatment of the tax savings due to the utility's use of accelerated methods of depreciation or shortened depreciation lives. In general, the Code provides that a public utility may not use accelerated depreciation for public utility property in computing its Federal income tax liability unless the regulators use a "normalization method of accounting" in calculating the utility's tax expense for ratemaking purposes.

There are two general ways a utility regulatory commission can account for the benefits of accelerated depreciation, shorter depreciation lives, and investment credits for public utility property in setting utility rates. One way, flowthrough accounting, treats these benefits as a current reduction in Federal income tax expense in computing the utility's cost of service. Under this method, current operating expenses are reduced, and the Federal tax benefit is immediately flowed through to current utility customers. A second way, normalization accounting, treats these benefits as a reduction in the utility's capital costs.

In general, normalization accounting requires a utility to compute its tax expense in determining its cost of service for ratemaking purposes as though it used the same method and period of depreciation that it uses in calculating its depreciation expense for purposes of setting its rates. This typically will be the straight-line method over a much longer life than is used for tax purposes. Thus, under this method, which the Code requires for a utility to be able to use accelerated depreciation on public utility property, regulators must calculate the utility's cost of service in a manner that permits the utility to collect from customers an amount for tax expense that exceeds the utility's actual current tax liability by the amount of the tax savings from accelerated depreciation.

Under normalization accounting, however, regulators may treat the tax savings as cost-free capital. It is not a violation of the normalization rules of the Code for regulators to reduce a utility's "rate base" -- generally the total amount of capital invested in the utility on which stockholders and bondholders are allowed to earn a return -- by the cumulative tax savings from using accelerated depreciation. A utility using normalization accounting may be thought of as treating the reduction in its current tax liability that results from using accelerated depreciation as an interest-free loan from the Treasury; this is accomplished by treating the utility as though it were required to pay to the Treasury the tax that would be due

if accelerated depreciation were not allowed, and the Treasury loaned back to the utility -- without interest -- the excess of this amount over the utility's actual tax liability calculated using accelerated depreciation. In effect, normalization accounting operates to determine a utility's rate of return on a reduced rate base, thereby flowing through to customers over the service life of the asset the benefits of reduced capital expenses due to accelerated depreciation. The normalization rules are intended to ensure that the Federal tax savings provided through accelerated depreciation provide cost-free capital to utilities to promote investment and are not used to subsidize current consumption.

The History of the Normalization Requirement

A requirement that utilities use the normalization method of accounting was first added to the Internal Revenue Code in 1969. In 1964, Congress had foreshadowed the 1969 normalization rules by prohibiting Federal regulatory agencies from flowing through the 3 percent investment tax credit then available on public utility property more rapidly than ratably over the useful life of the asset and prohibiting Federal regulators from flowing through any part of the 7 percent investment credit on nonpublic utility property.[1] The Tax Reform Act of 1969 added section 167(l) to the Code to limit the use of flowthrough accounting, and, in general, to require utilities that claimed accelerated tax depreciation to use a normalization method of accounting.

Congress did not completely prohibit flowthrough accounting in 1969, however. At that time, about half of all State ratemaking authorities were requiring utilities to flow through to current customers the benefits of accelerated tax depreciation.[2] Congress was concerned about causing a widespread increase in rates paid by customers of those

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[1]Pub. L. No. 88-272, § 203(e) (1964). When Congress enacted a 7 percent investment tax credit (ITC) in 1962, regulated utilities were granted a credit of only 3 percent. The reduced rate was a compromise between those who argued that utilities should receive the same investment incentives as other businesses and those who argued that, because of their monopoly status, utilities did not need incentives to invest and that flowthrough accounting by ratemakers would defeat the purpose of making investment incentives available to utilities.

[2]Indeed, some ratemakers were insisting that utilities, such as the major telephone companies, which had been claiming straight-line depreciation, claim accelerated tax depreciation so that the Federal tax savings could be flowed through to ratepayers. Certain ratemakers were reducing rates by the available Federal tax savings even if a utility did not claim accelerated tax depreciation.

utilities, and the 1969 legislation was designed to stop the spread of flowthrough accounting to utilities not already using it; utilities using flowthrough were "grandfathered."

In structuring the 1969 prohibition, Congress did not attempt directly to prohibit State ratemaking authorities from using flowthrough accounting. Because of federalism concerns and suggestions that such a direct prohibition would raise constitutional issues, Congress instead conditioned a utility's ability to use accelerated depreciation on its use of normalization accounting.[3] The 1969 Act granted Treasury broad authority in section 167(l)(5) to issue regulations as needed to carry out the purposes of the normalization rules.

In 1971, Congress increased the investment tax credit on public utility property to 4 percent and required utilities to use a normalization method of accounting for the credit as a condition of claiming it with respect to public utility property.[4] In 1981, in connection with the adoption of the ACRS system of depreciation, Congress extended the normalization rules to all utilities by repealing the 1969 grandfather rules. In 1982, Congress expanded Treasury's regulatory authority to prevent the use of ratemaking techniques that are inconsistent

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[3]The 1969 normalization requirement grew out of H.R. 6659, which would have prohibited flowthrough accounting by State ratemakers. This direct prohibition was rejected in favor of imposing a loss of accelerated depreciation on utilities because the bill's opponents raised doubts about the constitutionality of prohibiting State regulators from using flowthrough accounting. See, e.g., Statement of Fred P. Morrissey, Commissioner, California Public Utilities Commission, before the Committee on Ways and Means on March 27, 1969, summarized in Summary of Testimony on Treatment of Tax Depreciation by Regulated Utilities, JCS 47-69 at 8 (July 11, 1969). The Treasury Department opined on May 5, 1969, that the direct prohibition was constitutional. See letter from Paul W. Eggers, General Counsel of the Treasury, submitted in response to a question from Congressman Utt to Assistant Secretary Cohen and reprinted in Hearings before the Committee on Ways and means, Ninety-first Congress, First Session on the Subject of Tax Reform, Part 15 of 15 at 5672 (April 24, 1969).

[4]Although the new ITC normalization rules in section 46(e) (which later became section 46(f)) allowed ratemakers to "share" part of the credit with current and future ratepayers, the rules were not identical to the section 167(l) normalization rules that were prescribed for accelerated depreciation in 1969. Under the 1971 rules, ratemakers were permitted to reduce the rate base by the amount of the investment tax credit or to flow through the credit over the life of the property.

with the statutory normalization requirement.[5] In 1986, Congress extended normalization accounting to cover the ratemaking treatment of the reduction in corporate income tax rates.[6] Notice 87-82, 1987-2 C.B. 389, 391, requires normalization of contributions in aid of construction (CIACs) received subsequent to the 1986 Act's changes in the method of tax accounting for most CIACs.[7]

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[5]The California regulatory commission had created a technique called the Average Annual Adjustment ("AAA") method, which creatively used certain "estimates and projections" to mimic the effects of a flowthrough method in a way that arguably did not violate the statutory normalization rules. In sections 168(e)(3)(C) (which later became section 168(i)(9)(B)) and 46(f)(10), Congress stated that the normalization requirements are not met if the taxpayer uses procedures and adjustments that are inconsistent with the normalization rules. Congress described the AAA method as one procedure or adjustment that violated the new statutory "consistency requirement," and authorized Treasury to prescribe by regulation other procedures and adjustments that would be treated as inconsistent with the normalization rules. See H.R. Rep. No. 97-827, 97th Cong. 2d Sess. at 7-10 (1982). The 1982 legislation also granted relief to eliminate the substantial tax liability of several California utilities that would have been assessed for prior years due to the disallowance of accelerated depreciation and investment credits on the grounds that the State regulatory commission's rules violated the Code's normalization requirements.

[6]By lowering the top marginal income tax rate for corporations from 46 percent to 34 percent, the 1986 Act produced an "excess deferred tax reserve" because the deferred tax reserve for accelerated depreciation that was set aside at a rate of 46 percent could now be paid back at the 34 percent rate. Section 203(e) of the 1986 Act provided that under a normalization method, the excess deferred tax reserve could not be flowed through to reduce the cost of service component of current rates more rapidly than over the remaining regulatory lives of the utility's assets. In 1987 and again in 1989, this Committee revisited the decision to require normalization of the effect of the 1986 change in income tax rates, and on both occasions Congress left in place its 1986 decision that the excess deferred tax reserves should be normalized.

[7]A typical CIAC is a utility line that a customer constructs and contributes to the utility, or pays the utility to construct, as a condition of receiving utility services. Prior to 1986, CIACs were generally excluded from the utility's income as nonshareholder contributions to capital under Code section 118(a). The 1986 Act added section 118(b), which provides that CIACs received from a customer or potential customer are not covered by section 118(a). Thus, these CIACs must be included currently in the utility's gross income under section 61.

In summary, Congress has enacted normalization requirements with respect to the regulatory treatment of three tax benefits: accelerated depreciation and investment tax credits claimed for public utility property and the 1986 reduction in corporate tax rates. Prior to the publication of the proposed regulations concerning consolidated tax savings -- which are the subject of this hearing -- the Internal Revenue had published normalization requirements for only one additional item: post-1986 CIACs.

Consolidated Tax Savings

In recent years, the Treasury and Internal Revenue Service have been asked whether the normalization requirements of the Code apply to restrict the regulatory treatment of the reduction in Federal income taxes resulting from utilities filing a consolidated return with unregulated affiliates. Utilities, like other corporate taxpayers, are permitted to file a consolidated tax return with other commonly controlled corporations. When a consolidated return is filed, the tax liability of the affiliated group generally is determined as if the members of the group were a single corporation. A utility, for example, may thereby shelter its income from current taxation by offsetting tax losses (or excess credits) of other affiliated corporations engaged in unregulated businesses (for example, leasing and gas exploration). If the affiliated corporations did not file a consolidated return, the losses of the unregulated companies generally would not be used to reduce taxes until the later years in which the loss companies become profitable.

State ratemaking authorities generally have used two different approaches to determine the tax expense of a utility that files a consolidated return. Under an "actual taxes paid" approach, the tax savings that result from filing a consolidated return are flowed through to utility customers through lower rates that result from including only the utility's share of actual taxes paid in the utility's cost of service. The United States Supreme Court upheld the Federal Power Commission's use of such an "actual taxes paid" approach in 1967, two years before the depreciation normalization rules were first added to the

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However, notwithstanding the 1986 change in the tax law, most utilities disregard the receipt of a CIAC for ratemaking purposes. Thus, the 1986 Act created a timing difference between ratemaking and tax accounting for CIACs, and Notice 87-82 required that difference to be normalized so that the prepayment of tax on CIACs would be shared between current and future ratepayers. The Notice requires a utility to increase its rate base by the amount of the CIAC or treat the CIAC as a loss of zero-cost capital in computing the return on capital component of current rates. We are not aware of any utilities or ratemakers who have complained about Notice 87-82.

Internal Revenue Code. Federal Power Commission v. United Gas Pipe Line Co., 386 U.S. 237 (1967).

Under an alternative "stand-alone" approach, the ratemaking authority determines the utility's tax expense for purposes of setting rates as if the utility had filed a separate return. Thus, for example, under stand-alone accounting, if a utility that has taxable income files a consolidated return with an affiliate whose losses completely shelter that income from current taxation, the utility's cost of service for ratemaking purposes reflects the tax that the utility would have paid if it had filed a separate return. The United States Court of Appeals for the District of Columbia Circuit upheld the Federal Energy Regulatory Commission's use of such an approach in City of Charlottesville v. Federal Energy Regulatory Commission, 774 F.2d 1205 (D.C. Cir. 1985), cert. denied, 475 U.S. 1108 (1986).[8]

In the 1980s, the Internal Revenue Service issued several private letter rulings holding that the normalization provisions of the Code require regulatory authorities to use a stand-alone approach. One of these rulings was issued to Contel, a utility doing business in Pennsylvania. Notwithstanding this ruling, the Pennsylvania Public Utility Commission set Contel's rates using an "actual taxes paid" approach. Contel then appealed the Commission's decision to the Commonwealth Court of Pennsylvania, which affirmed the Commission's position. Continental Telephone Company of Pennsylvania v. Pennsylvania Public Utility Commission, 548 A.2d 344 (Pa. Commw. 1988), appeal denied, 557 A.2d 345 (Pa. 1989). The Pennsylvania court rejected the conclusion of the private letter ruling that Contel would be in violation of the normalization rules if it followed the Commission's rate order.[9]

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[8]The Federal Power Commission (FERC's predecessor) decided in 1972 to abandon consolidated tax savings adjustments in favor of a stand-alone approach. Dismissing as dicta the Supreme Court's statements in United Gas Pipeline about FPC's "duty" to limit the cost of service component of rates to real expenses, Judge Scalia rejected Charlottesville's argument that the "actual taxes paid" doctrine prevented FERC from using a stand-alone method. 774 F. 2d at 1216. In essence, the court held that it was within FERC's ratemaking authority to require either a flowthrough or stand-alone method of accounting for consolidated tax savings.

[9]According to the Pennsylvania court, the letter ruling did not rest upon compelling law or logic, and "in itself cannot provide a legal basis for invalidation of a PUC order." 548 A.2d at 351. The court relied instead upon the holdings of the Pennsylvania Supreme Court in Barasch v. Pennsylvania Public Utility Commission, 493 A.2d 653 (Pa. 1985)(the commission was not entitled to include in rates "hypothetical" Federal and State income taxes that were not actually incurred), and in Barasch v.

Following the Pennsylvania Court's decision, decisionmakers at the Internal Revenue Service were forced to consider whether to maintain the position taken in the private letter ruling, which would have treated Contel as violating the normalization requirement, thereby requiring disallowance of accelerated depreciation on its public utility property that would produce large tax deficiencies against Contel. In May 1989, the Service published Notice 89-63, 1989-1 C.B. 720, to inform utilities and ratemakers that it was developing proposed regulations to address whether the use of consolidated tax adjustments violates the normalization requirements of the Code. At that time, the Service also withdrew two of the private rulings -- including the one issued to Contel -- that had addressed the issue.

Issuance and Withdrawal of Proposed Regulations

On November 27, 1990, the Service proposed regulations attempting to apply the general policies of the normalization method of accounting to consolidated tax savings. These proposed regulations would have prohibited current flowthrough of consolidated tax savings by denying a utility the use of accelerated depreciation on its public utility property -- the only sanction permissible under the statute -- unless the utility's tax expense in determining its cost of service for ratemaking purposes is determined on a stand-alone basis. Thus, the proposed regulations would have prohibited regulatory commissions from taking consolidated tax savings into account in computing ratemaking tax expense. However, the proposed regulations would not have prohibited a commission from adjusting the utility's rate base to treat the affiliated group's[14] tax savings from filing a consolidated return as cost-free capital until the loss affiliate becomes profitable.

This approach generally regards the taxable income generated by the utility as serving to permit current use of the offsetting losses (or credits) of unregulated affiliates and treats the benefits of filing a consolidated return as a deferral, rather than a permanent reduction, of tax liability. The normalization requirements of the proposed regulations were similar to those under the Code for the tax savings from accelerated depreciation. As with statutory normalization of accelerated depreciation, the proposed regulations would not have required ratemakers to adjust the rate base by a utility's share of the affiliated group's consolidated tax savings, but would have permitted them to do so. The proposed regulations specified a method, based on the

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Pennsylvania Public Utility Commission and Pennsylvania Power Co., 491 A.2d 94, 103 (Pa. 1985)("hypothetical" taxes could only be included in rates if the failure to normalize would result in the loss of accelerated depreciation deductions and leave current ratepayers even worse off than they are under normalization).

consolidated return regulations, for determining the utility's share of the affiliated group's consolidated tax savings.

Subject to specific exceptions for cases where consolidated tax savings had previously been flowed through to customers, the proposed regulations would not have permitted any tax savings from prior years to be flowed through to customers or to be treated by regulatory commissions as cost-free capital. These provisions were intended to minimize the effect of the proposed regulations by limiting any sudden changes in utility rates.

The Internal Revenue Service received about 100 written comments on the proposed regulations and held a public hearing on February 8, 1991, at which about 30 witnesses testified. Not one commenter endorsed the basic approach of the proposed regulations.

Representatives of public utility commissions argued that the Service lacked authority under the normalization rules to issue regulations to require use of a stand-alone approach in computing cost of service, because the normalization rules of the Code apply only to accelerated depreciation of public utility property. Ratemakers contended that the Service exceeded its regulatory authority by attempting to dictate the ratemaking treatment of an item, such as consolidated tax savings, that does not necessarily involve either accelerated depreciation or public utility assets. The ratemakers maintained that if Congress had intended to treat consolidated tax adjustments as a violation of normalization, it would have done so explicitly and would have adopted a different statutory penalty for violating normalization -- something other than the loss of accelerated depreciation on utility property. State regulatory authorities indicated that they intended to challenge in court the validity of the regulations if finalized.

Representatives of public utilities opposed the proposed regulations on the grounds that the normalization rules of the Code do not permit any reduction of rate base due to consolidated tax savings. They argued that any reduction of rate base inappropriately allows utility customers to enjoy the tax benefits associated with losses of an unregulated affiliate when the customers did not bear the burden of those losses.

On March 29, 1991, the Office of Management and Budget ("OMB") informed the Treasury Department that it had designated any final regulations in this area as a "major rule" under Executive order 12291. That designation requires the Department to submit the text of the final regulations, along with a Regulatory Impact Analysis of the costs and benefits of the rule and of any alternative regulatory approaches, for review by OMB

before the final rule can be published in the Federal Register.[10]

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[10]As provided in section 3(d) of Executive order 12291, the Analysis is required to contain the following information:

1. A description of the potential benefits of the rule, including any beneficial effects that cannot be quantified in monetary terms, and the identification of those likely to receive the benefits;

2. A description of the potential costs of the rule, including any adverse effects that cannot be quantified in monetary terms, and the identification of those likely to bear the costs;

3. A determination of the potential net benefits of the rule, including an evaluation of effects that cannot be quantified in monetary terms;

4. A description of alternative approaches that could substantially achieve the same regulatory goal at lower cost, together with an analysis of their potential benefits and costs and a brief explanation of the legal reasons why such alternatives, if proposed, could not be adopted; and

5. Unless covered by the description required under item 4. above, an explanation of any legal reason why the rule can not satisfy the requirements set forth in section 2 of the Executive order:

    - Administrative decisions shall be based on adequate information concerning the need for and consequences of regulatory action;

    - Regulatory action shall not be undertaken unless the potential benefits to society from the regulation outweigh the potential costs to society;

    - Regulatory objectives shall be chosen to maximize the net benefits to society;

    - Among alternative approaches to any given regulatory objective, the alternative involving the least net cost to society shall be chosen; and

    - Agencies shall set regulatory priorities with the aim of maximizing the aggregate net benefits to society, taking into account the condition of the particular industries affected, the condition of the national economy, and other regulatory actions contemplated for the future.

Furthermore, the designation of the final regulations as a "major rule" under Executive order 12291 automatically makes any final regulations a "significant regulatory action" under Executive order 12498. That designation would have required the final regulations to be described in the published Regulatory Program of the U.S. Government.[11]

The Treasury Department is not aware of another circumstance when OMB has designated a tax regulation as a "major rule" under Executive order 12291. Performing the kinds of cost-benefit analyses required by these Executive orders would be difficult in any circumstances, but in the instant context such analyses would be particularly forbidding. First, the factual variations are manifold. For example, tax savings resulting from the filing of consolidated tax returns by affiliated groups that include a regulated utility may or may not be due to the use of specific tax incentives, such as accelerated depreciation or deduction of intangible drilling costs, and may vary in their relationship to the provision of utility services. Second, the costs and benefits may be different in different sections of the country and will depend, at least in part, on the State regulatory process relating both to consolidated tax savings and other issues.[12] Third, this issue raises important issues of both Federal-State relations and utility ratemaking regulatory policy

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[11]That description must include:

1. An identification of the problem to be solved;

2. A statement of the need for a Federal solution to the problem;

3. A summary of the approach taken by the rule; and

4. A tabular presentation of the currently projected monetary costs and benefits of the rule, as well as that of potential alternative approaches to the rule, including transfer costs and benefits resulting from the rule. (OMB has indicated to the Treasury Department that a narrative description of costs and benefits associated with a final regulation might be acceptable in lieu of a tabular monetary analysis in certain cases.)

[12]As Emil Sunley, Deputy Assistant Secretary of Treasury, reported to this Committee more than a decade ago: "While the [normalization] tax rules prescribe accounting rules, they do not authorize an inquiry into the motivation for regulators choosing a particular rate of return. This means there are limits as to how far the tax rules can be enforced in the regulatory process." Hearings before the Subcommittee on Oversight of the House Committee on Ways and Means, 96th Cong., 1st Sess., 515 (March 28, 1979).

that are difficult, if not impossible, to quantify and about which the Internal Revenue Service and the Office of Tax Policy claim no special expertise. Finally, the adverse commentary on the proposed regulations made it clear that neither the State regulatory authorities nor the affected utilities approved of the approach of the regulations and for opposite reasons: The State commissions regarded the proposed regulations as overreaching and illegal, while the utilities complained that the proposed regulations did not sufficiently constrain the regulators' discretion. In these circumstances, we had little reason to believe that any cost-benefit analysis we performed would be convincing to the affected parties. On April 25, 1991, the Internal Revenue Service withdrew the proposed regulations pending congressional guidance.

Current State of the Law

Attached as an Appendix to this statement is a memorandum to me from Abraham N.M. Shashy, Jr., Chief Counsel, Internal Revenue Service, that describes the Service's current ruling policy concerning whether a consolidated tax adjustment by a regulated utility violates the normalization requirements of the Internal Revenue Code. It is the position of the Service that, in the absence of regulations specifically prohibiting consolidated tax adjustments, these adjustments can be made without violating the normalization requirements of the Code. Therefore, if requested in an appropriate circumstance, the Service would rule that these adjustments do not violate the normalization requirements of the Code, provided that the adjustments are applied only to the extent of current ratemaking tax expense and not to the deferred tax reserve applicable to accelerated depreciation on public utility property.

Conclusion

We did not view the proposed regulations as a complete or final product. We saw them as a general rule and a framework within which a number of more specific issues could be resolved. We had expected that as a result of comments by the affected parties, the proposed regulations might be revised. For example, comments suggested that the rules for determining the utility's deemed share of the consolidated tax savings of the affiliated group merited change, such as by taking into account, where appropriate, tax sharing arrangements among the regulated and unregulated affiliated corporations. The comments we received on the proposed regulations also identified other issues to be considered, such as situations where there are several unregulated affiliates and situations where regulated and unregulated activities are performed within a single corporation.

Notwithstanding contentions to the contrary in comments on the proposed regulations, the Internal Revenue Service and the

Treasury concluded that the Code authorizes, but does not require, the Service to issue regulations prohibiting ratemaking procedures -- such as adjusting tax expense to reflect consolidated tax savings -- that it finds to be inconsistent with the policies behind the normalization rules. Section 168(i)(9)(B)(iii) authorizes Treasury by regulations to "prescribe procedures and adjustments" that "are to be treated as inconsistent" with the normalization rules. See also Section 167(l)(5).[13] Thus, we determined that we had adequate legal authority to issue these regulations.

Obviously, the Treasury and the Internal Revenue Service also regarded the basic approach of the proposed regulations as appropriate as a matter of policy when they were issued. On balance, we decided to propose regulations that would limit regulators' discretion in accounting for consolidated tax savings, notwithstanding Congress's failure to address explicitly the issue of consolidated tax adjustments in 1969 or thereafter, and even though the Supreme Court in 1967 had approved such ratemaking offsets.

As I have indicated, the proposed regulations were designed to follow the general structure of normalization requirements for accelerated depreciation. In essence, this approach views consolidated tax savings resulting from the combination of losses of unregulated affiliates with the income of the regulated

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[13]Certain comments argued that the kind of rate base reduction permitted in the proposed regulations violates the statutory consistency rules of section 168(i)(9)(B)(i). That paragraph provides that the normalization requirements are not met "if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with" the requirements of section 168(i)(9)(A). In particular, these comments argued that rate base reduction effectively allows losses of affiliates to be taken into account for purposes of computing rate base when they are not taken into account in computing depreciation expense, tax expense, and deferred tax expense, and that this violates the "estimate or projection" consistency rule of section 168(i)(9)(B)(ii).

We do not find this reading of the statute persuasive. The practice of taking affiliates' losses into account does not involve an "estimate or projection" of rate base as Congress used those words in section 168(i)(9)(B)(ii). The term "estimate or projection" as used in the statute clearly was intended to be narrower than the term "procedure or adjustment," and to refer to assumed changes in a particular account or item between a test year and the subsequent years covered by a rate order. See S. Rep. No. 643,, 97th Cong., 2d Sess. 7 (1982). Indeed, there is no evidence that the enactment of the consistency rules in 1982 was intended to extend normalization requirements to consolidated tax savings.

utility as enabling the consolidated group to use the losses sooner than if the affiliate were to file its tax return on a stand-alone basis. This measure of the utility's contribution may be captured in a rate base adjustment, which provides the utility's ratepayers with a benefit reflecting the time value of the more rapid use of the unregulated affiliates' losses or excess credits made possible by the utility's taxable income or tax liability.[14] Under the proposed regulations, the unregulated affiliates would have been no worse off than they would be had the utility not been part of the consolidated group. Since the utility's cost of capital reflects the activities of its unregulated affiliates, there seemed to be no reason to allocate the benefits resulting from the accelerated use of their losses or excess credits entirely to the unregulated affiliates, as would be the result if rate base reductions were prohibited. Thus, we concluded that we should not attempt to prohibit regulatory commissions from permitting utility customers to share in the benefit produced by consolidated tax savings through a rate base adjustment. However, because the assets that generated the tax loss are not utility property, we concluded that the losses generated by those assets should not be used to adjust the utility's current tax expense. If they were so used, the shareholders would be subsidizing the cost of the service provided by the utility. For this reason, the proposed regulations held that the current tax expense of the utility should be calculated as if it had filed a separate return.

Even when the statutory language is directly applicable and congressional policy is clear, the normalization requirements of the Code have proved to be something of a blunt instrument. On the prior important occasion when a State regulatory authority refused to accede to the statutory structure, Congress ultimately was forced to legislate to clarify the rules and forgave over $2 billion in tax liability that would have been due had the Service disallowed accelerated depreciation deductions as contemplated by the statute.[15] In the current context, certain State regulatory commissions made clear their intention to challenge the validity of these regulations if finalized and may well have disregarded them in the interval. The Service's ability to sustain disallowances of accelerated depreciation deductions in circumstances where the State commissions refuse to adhere to the proposed regulations is far from certain, and the failure to do so might erode the Service's ability to enforce normalization

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[14]Even when the tax savings are generated from a transaction that does not automatically "reverse" (i.e., where the tax loss incurred by the unregulated affiliate does not simply represent a timing difference), the component of no-cost capital in the utility's rate base will be reduced when the unregulated affiliate earns income.

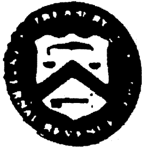
[15]<u>See</u> H. Rep. No. 97-987, 97th Cong., 2d Sess.(1982) and the discussion at note 5, supra.

requirements where the Code speaks clearly as to the congressional policy.

Finally, if Congress wishes to limit State regulatory commissions' discretion with respect to their treatment of consolidated tax losses by specifying normalization or other ratemaking treatment, disallowing the filing of a consolidated return by the utility would be a more focused and appropriate remedy than the only sanction available by regulation -- the disallowance of accelerated depreciation on public utility property. We are prepared to work with this Committee should it decide legislation is appropriate on the consolidated tax savings issue.

This concludes my prepared remarks. I will be happy to answer any questions that the Committee may have.

APPENDIX



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

SEP 09 1991

MEMORANDUM FOR: Michael Graetz
Deputy Assistant Secretary (Tax Policy)

FROM: Abraham N.M. Shashy, Jr.
Chief Counsel

SUBJECT: Internal Revenue Service Ruling Position on the Treatment of Consolidated Tax Adjustments Under the Normalization Rules

You have asked for a statement of the Internal Revenue Service ruling policy concerning whether a consolidated tax adjustment by a regulated utility violates the normalization requirements of the Internal Revenue Code. In the absence of regulations specifically prohibiting consolidated tax adjustments, it is the position of the Service that these adjustments can be made without violating the normalization requirements of the Code. Therefore, if requested in an appropriate circumstance, the Service would rule that these adjustments do not violate the normalization requirements of the Code.

Background

Over the last several years, the Service has faced the question of whether the calculation of ratemaking tax expense on a consolidated group basis is inconsistent under section 168(i)(9)(B)(i) with the normalization requirements, or, if not, whether it should be treated as inconsistent by exercise of the Service's broad regulatory authority under section 168(i)(9)(B)(iii) and former section 167(l)(5). When computed on a consolidated group basis, ratemaking tax expense is reduced to reflect the savings from filing a consolidated return with affiliated companies. These savings might arise, for example, from the credits, losses, or deferred transactions of affiliated companies.

Under one variation - the "consolidated tax savings adjustment" - the ratemaker first determines the utility's total tax expense on a separate return basis and then reduces it by the utility's share of the consolidated tax savings. Under another variation, the ratemaker computes an "effective tax rate" by dividing the tax liability of the group by the sum of the taxable

incomes of all members with positive taxable incomes. The ratemaker then applies this "effective tax rate" to the utility's taxable income to compute its current tax expense.

Between 1983 and 1988, the Service issued a series of private letter rulings holding that these practices ("consolidated tax savings adjustments" or "effective tax rates") violate the normalization requirements of Section 168(i)(9) and its predecessors. After the refusal of the Pennsylvania Public Utility Commission and the state courts to follow one of these rulings in 1988, the Service began to reexamine the issue. See Continental Telephone Co. of Pennsylvania v. Pennsylvania Public Utility Commission, 120 Pa. Commw. 25, 548 A.2d 344 (1988), appeal denied, 521 Pa. 613, 557 A.2d 345 (1989). In May 1989, the Service issued Notice 89-63, 1989-1 C.B. 720, announcing that regulations would be issued providing the extent to which consolidated tax adjustments violate the normalization rules and that these regulations generally would not provide that rate orders made final before July 1989 violate normalization merely because they involve such adjustments. Accordingly, several of the normalization rulings were revoked, including the one issued to Continental Telephone of Pennsylvania that was the subject of the litigation referred to above. On November 27, 1990, the Service published proposed regulations in the Federal Register addressing the issue. 55 Fed. Reg. 49294 (Nov. 27, 1990). Under the proposed regulations, a consolidated tax adjustment was treated as a violation of the Code's normalization requirements, pursuant to the authority of Section 168(i)(9)(B)(iii). On the other hand, an adjustment to rate base was permitted for tax amounts not actually paid to the federal government. Following public comment and a hearing, the proposed regulations were withdrawn in April 1991. 56 Fed. Reg. 19825 (Apr. 30, 1991).

We believe that existing law, as reflected in statutory language, legislative history, and current regulations, leads to the conclusion that consolidated tax adjustments do not violate normalization, provided that the adjustments are applied only to the extent of current ratemaking tax expense and not to the deferred tax reserve applicable to accelerated depreciation on public utility property. In the absence of a change in that law, our ruling policy must conform to that conclusion.

Analysis: Statutory Requirement of Section 168(i)(9)(A)

Section 168(i)(9)(A) requires that, in order to be eligible for accelerated depreciation on "public utility property" (as defined in section 168(i)(10)) a public utility must compute its

tax expense for ratemaking purposes using the same method and period for such property as it uses for computing its depreciation expense for ratemaking purposes. Under section 168(i)(9)(A)(ii), the difference between the tax expense so computed and the utility's actual current tax liability must be treated as a deferred tax expense, which is considered a cost-free source of capital. This cost-free capital may be used to reduce the rate base on which the utility is permitted to earn a return.

Section 168(i)(9)(A) does not impose any other restriction on the computation of tax expense for ratemaking purposes. Thus, if a utility computes its ratemaking tax expense on a consolidated basis, taking into account the losses of its affiliates (and thus taking into account the tax savings resulting from those losses), but also computes its tax expense as though it used its book method and period for determining depreciation deductions on public utility property, it would not be in violation of the literal requirements of section 168(i)(9)(A).

It has been argued that the statutory requirement that "the taxpayer must, in computing its tax expense . . ." necessarily contemplates determination of ratemaking tax expense on a "stand-alone" basis. We do not believe, however, that Congress intended to address this issue by using those words. At the time that the words were first added to the Code in 1969, consolidated tax adjustments (or equivalent procedures) were a widespread and accepted ratemaking practice and had been upheld by the Supreme Court as within the authority of the Federal Power Commission. See FPC v. United Gas Pipeline Co., 386 U.S. 237 (1967). We do not believe that it is plausible that Congress would have deliberately prohibited or discouraged such a widespread practice without a more explicit reference in the statute or legislative history.

Consistency Requirement of Section 168(i)(9)(B)

Section 168(i)(9)(B) prohibits (or authorizes Treasury to prohibit by regulation) ratemaking practices that undermine the purpose of the normalization rules while complying with their literal terms. This provision was enacted in 1982 in response to a specific ratemaking practice called the "averaged annual adjustment" or "AAA" method. See S. Rep. No. 1038, 96th Cong. 2d Sess. 11 (1980). The AAA method purported to comply with the literal statutory requirements of the normalization rules, while at the same time undermining the requirement to provide for

deferred taxes; the method did so by making an unreasonable adjustment to current tax expense, explainable only by an intent to circumvent the normalization rules.

Although the Service, in PLR 7838038 and PLR 7838048, ruled that the AAA method violated normalization, some utility commissions and courts refused to follow these rulings. In 1982, Congress concluded that the AAA method was inconsistent with normalization and that a clarifying statutory change was appropriate. Accordingly, section 168(i)(9)(B)(i) was enacted, providing that "[o]ne way in which the requirements of [section 168(i)(9)(A)] are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of [section 168(i)(9)(A)]." The phrase "inconsistent with the requirements" of normalization apparently was taken from regulations in effect at the time (section 1.167(l)-1(h)(4)(ii)), upon which the Service had relied in ruling that the AAA method violated normalization.

In order to make clear that the AAA method was "inconsistent with the requirements" of normalization, Congress also enacted section 168(i)(9)(B)(ii), which provided that "[t]he procedures and adjustments which are to be treated as inconsistent for purposes of [section 168(i)(9)(B)(i)] shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under [section 168(i)(9)(A)(ii)] unless such adjustment or projection is also used, for ratemaking purposes, with respect to the other 2 such items and with respect to the rate base."

PLR 8711050 (subsequently revoked) reasoned that section 168(i)(9)(B)(ii) prohibits consolidated tax adjustments because it requires that, if depreciation on property owned by an affiliate is not taken into account in setting rates (which it is not), the losses of that affiliate attributable to depreciation on such property cannot be taken into account in computing the utility's ratemaking tax expense.

We do not believe that this reasoning is persuasive for two reasons. First, the practice of taking affiliate losses into account does not involve an "estimate or projection" of tax expense as Congress used those words in section 168(i)(9)(B)(ii). The term "estimate or projection" as used in the statute clearly was intended to be more narrow than the term "procedure or adjustment", and it was intended to refer to assumed changes in a particular account or item between a test year and the subsequent

years covered by a rate order. See S. Rep. No. 643, 97th Cong., 2d Sess. 7 (1982); H.R. Rep. No. 827, 97th Cong. 2d Sess. 7 (1982). Therefore, we do not believe that consolidated tax adjustments constitute an "estimate or projection" of depreciation expense within the meaning of section 168(i)(9)(B)(ii).

Second, this reasoning implies that the normalization rules prohibit flow-through of the tax benefit of accelerated depreciation on any property if depreciation expense on that property is not taken into account in computing utility rates. The normalization provisions are, by their terms, limited to accelerated depreciation on public utility property. There is no evidence in the legislative history of section 168(i)(9)(B)(ii) indicating that Congress contemplated that this provision would have the effect of applying the normalization rules to non-public utility property.

In any event, even if the reasoning of this ruling were to be accepted, it would not support the view that no affiliate losses can be taken into account in computing ratemaking tax expense; it would only support the view that losses attributable to accelerated depreciation deductions on affiliate property can not be taken into account. Thus, this reasoning would not prohibit as being inconsistent with the normalization requirements the flow-through of affiliate losses attributable to intangible drilling costs, for example. In any case, we do not believe Congress intended the literal scope of the normalization requirements to extend beyond accelerated depreciation on public utility property.

These arguments do raise a concern that a consolidated tax adjustment might be used to offset a utility's deferred tax reserve from normalization or might be used to flow through the accelerated depreciation benefit of another regulated utility in the same consolidated group. These concerns are worthy of further study. Until they are resolved we can only say with confidence that consolidated tax adjustments do not violate normalization, provided that the adjustments are applied only to the extent of current ratemaking tax expense and not to the deferred tax reserve applicable to accelerated depreciation on public utility property, and provided that the taxable income of any other regulated utilities used in the calculation of the adjustments is computed on a normalized basis.

Regulatory Authority of Section 168(i)(9)(B)(iii)

In 1982, Congress also authorized Treasury to prohibit procedures and adjustments other than the AAA method by enacting the predecessor to section 168(i)(9)(B)(iii). It provides that the "Secretary may by regulations prescribe procedures and adjustments (in addition to those specified in [section 168(i)(9)(B)(ii)]) which are to be treated as inconsistent for purposes of [section 168(i)(9)(B)(i)]." The preamble to the now-withdrawn proposed regulations explicitly states that the regulations were issued pursuant to this authority. In the absence of such a regulatory provision, however, the normalization requirements do not prohibit consolidated tax adjustments as a general rule.

Therefore, it is the current ruling position of the Internal Revenue Service that consolidated tax adjustments, as a general rule, are not inconsistent with the normalization requirements of the Code. (Similarly, it is the current ruling position of the Internal Revenue Service, that, in the absence of any reduction of cost of service for consolidated tax savings, an appropriate reduction of rate base for consolidated tax savings is also not inconsistent with the normalization requirements of the Code.)