PUBLIC UTILITIES AND STATE REGULATION: ALTERNATIVES FOR TREATMENT OF THE INVESTMENT TAX CREDIT

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In every major rate case, the administrative body that regulates a state's utilities faces the same question: how to account for investment tax credit. For example, in September, 1977, the California Public Utilities Commission ordered Pacific Telephone and Telegraph Company to reduce its utility rates by $50 million and to refund $128.9 million to California consumers.[1] This decree was the result of a decision by the commission not to allow Pacific Telephone to include the credit on property investments it had earned for income tax purposes in its rate-making formula.[2] Typically, state regulatory bodies consider utility companies' federal income tax expense in determining a fair rate of return to the shareholders of the utility industry. The commission argued, however, that since the investment tax credit actually reduced Pacific's federal income tax liability, consumer utility bills should reflect this decrease in the utility's cost of providing telephone service. Pacific Telephone decried this treatment of the investment credit. It asserted that Congress would not have provided investment credit for utility companies if it could have foreseen that state commissions would flow through the benefits to the ratepayer rather than retain the revenues for the companies' use.

In the above case, and in every major rate case, the resolution of this regulatory dilemma is of no small import. Since utility companies are by nature capital-intensive, it can have a significant impact on consumers' monthly utility bills.[3] These credits take on an even greater importance in light of the accelerating demand and skyrocketing costs of all forms of energy production. As the large utility companies' annual capital budgets continue to grow well over a billion dollars,[4] the amount of investment tax credit naturally grows proportionately.[5]

This scenario presents a difficult situation for state regulatory bodies. Clearly, their purpose is to keep utility rates at the lowest possible level commensurate with a fair rate of return for the companies. Commissioners must allow rates generous enough to make the utility industry profitable, but at the same time they must keep a watchful eye on company-proposed additions

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1. Re Pacific Telephone and Telegraph Company, California Public Utilities Commission, No. 87838, (1977). This case is currently pending before the California Supreme Court. Supreme Court S.F. 23743, 23745 and 23746.
2. The commission's order dealt with the similar question of the treatment of accelerated depreciation tax benefits.
3. In fact, in a 1974 rate hearing involving Pacific Telephone, the commission indicated that the difference for one year (1973) between a rate passing tax benefits on to the consumer and one permitting the utilities to retain these benefits was approximately $23 million. Re Pacific Telephone & Telegraph Company, California Public Utilities Commission, No. 83162, slip opinion at 71 (1974).
4. Pacific Telephone pointed out in testimony before the commission that its annual capital budget for the year 1977 would be $1.35 billion.
5. An even greater impact is predicted for the future. The Carter administration's proposals for a 1978 revenue bill contemplate increasing the credit percentage to 12%.

to the rate base.[6] Each state commission has its own policy objectives which are determined by a myriad of political, economic, and sociological factors. The relative merits of these policy decisions have been argued at length elsewhere and are beyond the scope of this note. The purpose of this note is to present the available accounting alternatives to implement whichever policy decisions are considered of greatest importance by the state regulatory commissions. This presentation of accounting alternatives is necessary for state regulatory decision-makers due to the lack of a binding judicial determination of the appropriate accounting procedure for the investment tax credit (ITC). While this area is ripe for litigation, no federal court has as yet decided the issue. Until a final determination is made, each state must decide how it will account for the ITC. In order to facilitate effective decision-making in this area, the available alternatives must be evaluated in light of the relevant federal statutes and current state administrative practices.

INVESTMENT TAX CREDIT—HISTORY

1. The Internal Revenue Code

The investment tax credit was first enacted in the Revenue Act of 1962.[7] This act provided regulated utilities with a 3% credit against federal income tax for investment in certain depreciable property.[8] The Revenue Act of 1971 increased the credit to 4% for utility companies and added a new subsection (e) to Section 46 specifically dealing with regulated companies.[9] This new subsection provided three options for all public utilities. Under the first option, a utility could elect to have deferred ITC balances deducted from its rate base as long as the rate base was restored not less rapidly than ratably over the useful life of the asset.[10] This option also precluded any additional reduction of the cost of service by any portion of the credit.[11]

The second option provided for normalization and amortization of the investment credit over the useful life of the property by credits to cost of service, but did not allow the rate base to be reduced by any portion of the deferred credit. This option is commonly referred to as "service life flow through".[12]

The third option simply provided for an election whereby neither the first nor second option would apply. This option, in effect, allowed a regulatory body to treat the investment credit in any manner it deemed applicable (e.g., immediate flow through).[13] In the absence of any election by a utility, Option 1 was to apply to the credit.

The Tax Reduction Act of 1975 added a new subsection (f) retaining

6. Richard Morgan, *Phantom Taxes in Your Electric Bill* (1976) (Environmental Action Foundation of the National Consumer Information Center). Mr. Morgan was a member of the Electric Utilities Advisory Committee of the Federal Energy Administration.
7. The Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960; I.R.C. §38.
8. For articles discussing the breadth of property eligible for the investment credit under the pertinent code sections and rulings, *see:* Ron N. Bagley, "How to Maximize Investment Tax Credits: Planning Under the Cases and Rulings," 43 J. Tax. 154 (1975), and James L. Finefrock, "Opportunities for Increased Investment Credit Found in 1975 Transitional Rules,"45 J. Tax 168 (1975).
9. Revenue Act of 1971, Pub. L. No. 92-178, 85 Stat. 497; I.R.C. §46-50.
10. The term "ratably" referred to in these rules is determined by using the period of time used in computing depreciation expense for the purpose of reflecting operating results in the taxpayer's regulated books of account. I.R.C. §167(1)(2)(c); S. Rep. No. 437, 92d Cong., 1st Sess. 38 (1971).
11. I.R.C. §46(e)(1), Revenue Act of 1971.
12. I.R.C. §46(e)(2), Revenue Act of 1971.
13. I.R.C. §46(e)(3), Revenue Act of 1971.

word-for-word the provisions of the old subsection (e).[14] However, it raised the investment credit from 4% to 10% of qualified investment in property acquired and placed in service after January 21, 1975 and before January 1, 1977.[15] It also added a new paragraph (8) under subsection (f).[16] This paragraph represents the most important difference between the 1971 act and the 1975 act (other than the increase to 10%) for the purposes of state regulatory bodies. Code §46(f)(8) provides procedures for making a new and timely election under the 1975 act depending upon the company's previous election (or lack thereof) under the 1971 act. Paragraph (8) provides: (a) that in the absence of a prior Option 3 election under the 1971 act, a 1975 election for Option 3 shall apply only to the 4% of investment credit that was provided for under the 1971 act, and, (b) that a company which had made a timely 1971 election for Option 3 may elect to have Option 3 apply to the new 6% credit. However, if a company does not make a new Option 3 election, then Option 1 or Option 2 applies if either is specially applicable (e.g., by virtue of a temporary regulation by the Secretary of the Treasury).[17] If neither Option 1 nor Option 2 is applicable, Option 1 applies unless the company elects Option 2 in the manner the Secretary prescribes. Clearly, Congress intended to restrict the use of flow through accounting for the additional 6% of investment tax credit in the absence of an election for continued flow through by the company. In the case discussed *supra,* Pacific Telephone had timely elected Option 2 treatment pursuant to §46(f)(2) of the Internal Revenue Code. The commission, however, disregarded the election and proceeded to apply Option 3 treatment to the company's investment credit.

2. Legislative History

The legislative histories of the investment tax credit exhibit Congressional desire to implement two major policy objectives: stimulating the national economy and reducing the high unemployment rate. In addition, the 1971 report of the House Ways and Means Committee sets forth other policy considerations that would be achieved as a result of successful implementation of these objectives. These include relieving the hardship of inflation on lower income groups, providing tax incentives to modernize our national productive facilities, and increasing exports to improve the balance of payments.[18]

Stimulation of the economy was without question the primary objective of Congress in instituting the ITC in 1962 and re-enacting it in 1971. The utilities contend that Congress intended to implement this objective by providing tax credits that would increase cash flow and enable the industry to modernize its facilities. This is true of utilities providing essential public services such as water and telephone services and especially true of utilities engaged in the

14. Tax Reduction Act of 1975, §301, Pub. L. No. 94-12, 94th Cong., 1st Sess. (approved Mar. 29, 1975); I.R.C. §46 (1954), as amended.
15. Sec. 802(a) of the Tax Reform Act of 1976 extends the 10% credit for an additional four years to apply generally to property placed in service before Jan. 1, 1981. This applies to all taxable years beginning after Dec. 31, 1974.
16. Tax Reduction Act of 1975, I.R.C. §46(f)(8), added by §301(b)(3), Pub. L. No. 94-12, 94th Cong., 1st Sess., (approved Mar. 29, 1975), effective under §301(b)(4) of the same act for taxable years ending after Dec. 31, 1974.
17. Just such a situation confronted the West Virginia Public Service Commission in Re Huntington Water Corporation, Case No. 8666, in which the company contended that the language of temporary Treasury Reg. 9.1(b) precluded the necessity of an affirmative election in 1975 of Option 2, in order to be treated as an Option 2 company under their 1971 election.
18. Donald Sturm, "Revenue Act of 1971, Class Life System, and I.T.C.", 30 N.Y.U. Tax Inst. at 1603. Mr. Sturm discussed the report of the House Ways and Means Committee on Sept. 29, 1971.

production and distribution of energy. Since this country is facing actual shortages in almost all of our resources, the companies argue that it is of critical importance that the tax benefits be retained by the companies. These benefits would help update facilities which would in turn improve service. In this regard, a 1975 Senate report expressed concern that

> . . . the stimulation for the acquisition of productive facilities intended by the increase in the investment tax credit with respect to public utility property would be frustrated if any of the benefits were required to be flowed through immediately to consumers in the form of lower rates.[19]

Opponents of this view contend that the needs of the consuming public must be carefully guarded. Though public utilities encounter substantial difficulties in keeping their productive facilities modernized, the middle and lower class consumer cannot withstand utility rate increases that are higher than absolutely necessary. Utility bills will inevitably grow at a rapid rate as the law of supply and demand continues to make prices soar. Higher production costs, continued inflation and scarcity of resources will contribute to keeping utility bills at the highest tolerable level. Consumer advocates assert, therefore, that public capital requirements above that level should be weighed with the consumer's interest of controlling significance.[20] They would, accordingly, be in full agreement with the California Public Utilities Commission's decision in *Pacific Telephone* to flow through the investment credit to the consumer.

The other major purpose of the investment credit legislation was reducing the high rate of unemployment. In committee hearings, industry supporters contended that increased expenditures by the utilities would place more money in circulation and create work for those companies contracted to perform the modernization, thereby creating more jobs.[21] Flow through advocates assert, however, that there is a serious question whether modernization of equipment is likely to be job-producing. In fact, a study conducted at Northwestern University suggests that since these credits encourage investment in capital-intensive rather than labor-intensive areas, they may have a negative effect on employment.[22] Whatever the merits of these arguments, it is apparent that the legislative history does not settle the debate over the objectives of the investment credit legislation.

The same situation exists regarding the actual accounting procedures in ratemaking for regulated utilities. The wording of the Internal Revenue Code and the legislative histories of the 1971 and 1975 acts make it clear that Congress intended that the utilities retain the general benefit of the credit for economic reasons. But the committee reports are not specific in requiring a

19. S. Rep. No. 36, 94th Cong., 1st Sess. 44 (1975).
20. 3 General Tax Reform Panel Discussions, House Committee on Ways and Means, 93d Cong., 1st Sess. (1975) (Statement of Robert Eisner). Consumer advocates also point out that the investment credit does not apply to any form of intangible investment [I.R.C. §48(a)(1)]. This means that investment in research and development, which many economists believe is a major factor in producing growth, is left unrewarded. Thus, the companies invest large sums of money in facilities in order to qualify for the credit. Consumer advocates charge that the credit for these expenditures will often represent credit for modernizing facilities that would have been updated in any event, credit for expenditures that could have been more productively spent, or credit for expenditures made by reason of imprudent management decisions to modernize where it is not required. *See:* Robert Patinovich, "Memorandum: In Regard to the Substitution of a Gross Usage Tax for Federal Income Tax Levied Against Utilities" (April, 1977). Mr. Patinovich is president of the California Public Utilities Commission.
21. H.R. Rep. No. 19, 94th Cong., 1st Sess. (1975); S. Rep. No. 437, 92d Cong., 1st Sess. (1971); 1971 U.S. Cong. & Admin. News 1943.
22. Robert M. Coen, "Efficacy of the Investment Credit for Fiscal Purposes," 68 Proc. Nat'l. Tax Assn. - Tax Inst. Am. 33 (1976).

particular accounting method. The Senate Finance Committee Report in 1971 is a good example. It provides in part:

> To permit all the benefits of the credit to be flowed through to the consumer currently could have an impact on revenues which is twice that applicable in other cases. Moreover, the basic purpose of the investment credit is not an allocation of resources which will stimulate consumption of any particular type of product or service. For these reasons, as a general rule, the bill does not make this credit available where all of the benefit from it would be flowed through currently to the consumers . . . the credit is made available only where there is assurance that some of the benefit at least will go to the investors.[23]

Though the companies found support in this wording, that same Senate report went on to discuss the role of regulatory agencies:

> Although there are many different ways of treating the credit for rate-making purposes, the Committee, in general, believes that it is appropriate to permit the regulatory agencies, where they conclude it is necessary, to *divide* the benefits of the credit between the customers of the regulated industries and the investors in the regulated industries.[24]

The Finance Committee further stated that the intent of the 1971 Revenue Act was to " . . . permit regulatory agencies to *share* the benefits of the credit between investors and customers where appropriate . . . ."[25] Thus, it is clear that the utilities are to benefit from the investment credit. However, the statutes and legislative histories do not specifically restrict state commissions from dividing the benefits of the credit between investors and consumers.

3. Present Tensions

To further complicate this regulatory dilemma, the Internal Revenue Service (IRS) has warned that it will completely disallow the companies' credit in keeping with §46(f) of the code, if regulatory bodies require companies to flow through investment credit when the companies have in fact elected Option 1 or 2 treatment pursuant to the statute. The House Conference Committee put it this way:

> If after March 31, 1972, a company flows through to income an amount greater than that permitted under the option applicable to that company, or its rate base is adjusted by an amount greater than that permitted under its applicable option, then the company is to lose the investment credit with respect to its public utility property for all open years and all future years.[26]

If one considers orders handed down by commissions such as the California Public Utilities Commission, the confrontations between the commissions and the IRS result, as one writer put it, "in a giant game of 'chicken'".[27] The drafters of the statute apparently believed that no regulator would risk exposing the companies to excessive back taxes which would drain the companies of needed capital and earnings and eventually justify a need for substantial rate

23. S. Rep. No. 437, 92d Cong., 1st Sess. (1971); 1971 U.S. Cong. & Admin. News 1943.
24. S. Rep. No. 437, 92d Cong., 1st Sess. 36 (1971) [emphasis added].
25. [1977] 1 Fed. Taxes (P-H) Par. 5926 [emphasis added].
26. H.R. Rep. No. 708, 92d Cong., 1st Sess. 38 (1971).
27. *The Wall Street Journal*, Feb. 25, 1977, at 1, col. 6.

increases. The California commission, as well as other ratemaking bodies, have decided to take the risk. The IRS showed signs of backing up the statutory sanctions with action directed at the California commission. In *Re Southern California Gas Company,*[28] a case decided at approximately the same time as *Pacific Telephone,* the IRS condemned the commission's decision to flow through the benefits of investment tax credit, in an opinion letter by John Hatt, chief of the IRS Corporate Tax Division. The commission in this case had used a "reduction in risk" adjustment to the company's federal income tax that was tantamount to total flow through of the ITC. The IRS warned:

> . . . the CPUC [California Public Utilities Commission] did indirectly and by another name, what it could not do directly without causing Southern California to lose the benefits of the investment credit. Congress did not intend to allow the investment credit in such circumstances.
>
> The conclusion here is simply that the investment tax credit will not be available for Federal Income Tax purposes when the benefits to be otherwise derived therefrom are treated for ratemaking purposes in the manner provided in Decisions No. 85627 (as affirmed by Decision No. 86117).[29]

Many commissions, then, feel that it is within their jurisdiction to set utility rates for their states. Since the ITC often has an important impact on utility rate structures, they feel that they may control accounting methods of ITC for ratemaking purposes. Again in California, the state Supreme Court reviewed a decision by the Public Utilities Commission involving accounting for accelerated depreciation and investment tax credit.[30] In its opinion the court stated:

> The commission has the power to prevent a utility from passing on to the ratepayers unreasonable costs for materials and services by disallowing expenditures that the Commission finds unreasonable. The same rule applies where the utility resorts to accounting practices which result in unreasonably inflated tax expense . . . . The 1968 method of imputed accelerated depreciation and flow through is favorable to the ratepayer but harsh on Pacific. . . . The method adopted by the decision before us [service life flow through] is harsh on the ratepayer . . . but beneficial to Pacific . . . . The commission is not compelled to adopt one of the two extremes set forth above but may adopt a compromise striking a proper balance between the interests of the ratepayers and Pacific in light of the federal income tax statutes.[31]

The court permitted the state ratemaking body in this case to formulate what it considered to be an equitable approach to the problem. And until an interpretive federal decision specifies to the contrary, state regulatory agencies appear free to exercise discretion in dealing with investment tax credit in accordance with the agency's usual standards in light of the needs of the regulated industry. And, as discussed *supra,* despite indications of possible

28. Re Southern California Gas Company, California Public Utilities Commission, No. 85627 (affirmed by Decision No. 86117) 1977.
29. Letter by John Hatt, Chief, Corporate Tax Division, Internal Revenue Service (1977), cited in *The Wall Street Journal,* Feb. 25, 1977, at 1, col. 6.
30. City and County of San Francisco v. Public Util. Com'n, 98 Cal. Rptr. 286, 6 Cal. 3d 119, 490 P. 2d 798 (1971).
31. City and County of San Francisco v. Public Util. Com'n, 98 Cal. Rptr. 286, 6 Cal. 3d 119, 490 P. 2d 798 (1971). *See also:* City of Los Angeles v. Public Util. Com'n, 125 Cal. Rptr. 779, 15 Cal. 3d 680, 543 P. 2d 1371 (1975) where the court reaches a similar conclusion.

action by the IRS, up to the present time the IRS has not disallowed the credit for any company due to regulatory treatment by state commissions. Furthermore, the only situation in which the IRS has taken any preliminary action consists of commission attempts to immediately flow through *all* the benefits of the investment credit to the ratepayer. Commission determinations that have ordered a sharing of these benefits between the companies and consumers have not been actively opposed by the IRS.

ACCOUNTING ALTERNATIVES

1. Compliance With the Internal Revenue Code

If a state utility commission decides to follow the letter of the code, the choice of regulatory and accounting alternatives rests solely on the previous elections of the companies involved. If the utility timely elected Option 1 treatment pursuant to §46(f)(1) of the code, then the state agency may deduct deferred credit balances from the utility's rate base as long as the rate base is restored less rapidly than ratably over the useful life of the asset. The agency is precluded from any additional reduction of the cost of service by the ITC.

If the utility made a timely election for Option 2 treatment under §46(f)(2), then the agency may normalize and amortize the credit over the useful life of the property by credits to cost of service. The state agency may not allow the rate base to be reduced by any portion of the credit.

If the company elected Option 3 treatment pursuant to §46(f)(3) of the code, the state commission may account for the investment credit in any manner it deems applicable. This option would permit immediate flow through accounting procedures but solely under Option 3. For example, in the *Pacific Telephone* case, the company's Option 2 election was disregarded by the commission, which used flow through accounting procedures. Pacific Telephone wants the commission to comply with the code, which would preclude the use of flow through of the ITC in their case. Thus, for those state regulatory bodies which follow the letter of the code (unlike the California commission), the accounting procedures are clearly set out above.

In implementing Option 2 treatment above, there is a special disagreement between companies that have elected Option 2 treatment and state agencies which follow the Code and implement the companies' elections. The controversy centers around differing interpretations as to what constitutes a reduction in the rate base. §46(f)(2) provides that if a taxpayer or company makes an election for Option 2 treatment, no investment credit shall be allowed for that company if

> . . . the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by any portion of the credit allowable by §38 (determined without regard to this subsection).[32]

After providing for the current year's amortization of deferred ITC, a question remains as to how to treat the remaining unamortized balance. Since the statute provides that the rate base may not be reduced by any portion of the

32. I.R.C. §46(f)(2)(B).

credit, the utilities often request that the deferred ITC be reflected in the companies' cost of capital at the cost of equity.[33] In the case of most regulatory bodies, this balance is either not included at all in the capital structure, or it is treated as a zero-cost item.[34] The companies, however, point to the legislative history of the Revenue Act of 1971 to show that Congress would disapprove of this treatment. The Senate committee report stated in part:

> In determining whether and to what extent a credit has been used to reduce the rate base, reference is to be made to any accounting treatment that can affect the company's permitted profit on investment by treating the credit in any way other than as though it had been contributed by the company's common shareholders. For example, if the 'cost of capital' rate assigned to the credit is less than that assigned to common shareholders' investment, that would be treated as, in effect, a rate base adjustment.[35]

Many regulatory bodies and courts agree with the utilities that there is evidence of the intent of Congress to regard zero-cost capital treatment as equivalent to a rate base reduction. It does not necessarily follow, however, that the deferred ITC, if included in the capital structure, should be included at the cost of equity capital as the companies contend. The IRS recently promulgated Regulation 1.46-5, which speaks directly to this problem. It provides:

> 1.46-5 (a) (3) Rate Base
> . . . assigning a 'cost of capital' rate to the amount of such credit which is less than the permissible *overall* rate of return (determined without regard to the credit) would be treated as, in effect, a rate base adjustment. What is the overall rate of return depends upon the practice of the regulatory body. Thus, for example, an overall rate of return may be a rate determined on the basis of an average or weighted average of allowable rates of return on investments by common stockholders, preferred stockholders, and creditors.[36]

This regulation clearly rejects the zero-cost capital approach to the deferred investment credit. It clearly accepts, however, including the deferred balance in the capital structure at the *overall* cost of capital. This, of course, is the same procedure and has the same result as not including the investment credit in the capital structure at all.

Table I shows three approaches to the inclusion of the investment credit in the cost of capital. One can see from Table I that it makes a substanstial difference which method is used. Method A, the Zero-Cost Capital Method, yeilds an overall cost of capital of 9.4%, which is the lowest of the three methods. As previously discussed, however, this method is in direct opposition to Regulation 1.46-5. Method B, the Cost of Equity Method, yeilds an overall cost of capital of 10.0%, which is the highest of the three methods and the one most preferred by the utilities. Method C, the Overall Cost of Capital Method, yeilds an overall cost of capital of 9.89%. Under this method the actual cost of the deferred investment credit is calculated without regard to

33. Re Appalachian Power Company, Case No. 8182, testimony of company witness John F. Utley, received at the West Virginia Public Service Commission, Dec. 5, 1975.
34. Regulatory commissions that have used the latter approach include the Minnesota Public Service Commission. 8 P.U.R. 4th 75 (1974); the Arizona Corporation Commission, 8 P.U.R. 4th 547 (1975); the Massachusetts Department of Public Utilities, 11 P.U.R. 4th 270 (1975) and 11 P.U.R. 4th 297 (1975), and the Maryland Public Service Commission, 10 P.U.R. 4th 211 (1975).
35. [1977] 1 Fed. Taxes (p-H) Par. 5926.
36. Treasury Reg. 1.46-5, 771 C.C.H. Par. 587 DD [emphasis added].

the credit as required by the regulation. Therefore, the cost of debt and equity capital (4.0% + 5.4%) divided by their combined percentage of the total capital (95%) equals 9.89%, which is equal to the overall cost of capital if the remaining 5% is also assigned that cost rate. It follows that Method C would be most advantageous to consumers in thosejurisdictions where cost of capital is directly translated into a proper rate of return on rate base.[37]

TABLE I

INCLUDING THE INVESTMENT TAX CREDIT IN THE COST OF CAPITAL: THREE APPROACHES

Assume: Company X with $100,000 capital
$50,000 - debt capital at 8% cost
$45,000 - equity capital at 12% cost
$ 5,000 - investment tax credit

	Capitalization	*Actual Cost*	*Weighted Cost of Capital*
A. Zero-Cost Capital Method			
Debt	50%	8%	4.0%
Equity	45%	12%	5.4%
ITC	5%	0%	0%
	100%	**overall cost of capital:**	**9.4%**
B. ITC Deferrals at Cost of Equity Method			
Debt	50%	8%	4.0%
Equity	45%	12%	5.4%
ITC	5%	12%	.6%
	100%	**overall cost of capital:**	**10.0%**
C. Overall Cost of Capital Method			
Debt	50%	8%	4.0%
Equity	45%	12%	5.4%
ITC	5%	9.89%*	.49%
	100%	**overall cost of capital:**	**9.89%**

*Calculated "without regard to the credit" as required in Regulation 1.46-5.

37. The Georgia Public Service Commission has recently addressed this issue in Re Continental Telegraph Company of the South. The commission refused to permit the company to include investment tax credit in the capital structure. In its order dated Feb. 1, 1977, the commission stated:

> In this regard, the company's witness contended that in enacting the Revenue Act of 1971, Congress intended that the post-1970 unammortized deferred job development credits be treated as equity in the capital structure . . . . This Commission has a different interpretation of the intent of Congress. This Commission believes that it was the intent of Congress to prevent job development credit from being treated as capital supplied at no cost in the capital structure, and that if the job development credit were not included in the capital structure, the Commission would be within the intent of Congress since the credit would be priced at no less than the overall cost of capital determined without regard to the credit.

Re Continental Telephone Company of the South, 18 P.U.R. 4th 187 (1977).

2. Non-Compliance With the Internal Revenue Code

Rather than strict compliance with the elective options of the companies doing business within the state, an alternative policy for state regulatory bodies is one that allows the commission not to comply with the code in the interest of the regulated utility or the consuming public. As stated *supra,* until an interpretive federal court decision is handed down or until actual disallowance of the investment credit is practiced by the IRS, state commissions may exercise their discretionary ratemaking powers.

TABLE II

ALTERNATE ACCOUNTING PROCEDURES FOR THE INVESTMENT TAX CREDIT AS USED BY STATE REGULATORY COMMISSIONS

Company X - Assumptions
Asset Service Life = 20 years
Rate Base = $100,000
Rate of Return = 10%
ITC Earned = $5,000
Federal Income Tax
Utility Rate = 50%

	CHOICE I	CHOICE II	CHOICE III	CHOICE IV
	Option 1	*Option 2*	*Total Flow*	*Reduction of FIT*
	§46(f)(1)	*§46(f)(2)*	*Through*	*and Rate Base*
Depreciation	$ 5,000	$ 5,000	$ 5,000	$ 5,000
Operating Expense	5,000	5,000	5,000	5,000
Other Taxes	1,000	1,000	1,000	1,000
Return on Rate Base	9,500	10,000	10,000	9,525
Federal Income Tax	9,525	9,500	-0-	9,025
Revenue Paid by Ratepayer*	**$30,025**	**$30,500**	**$21,000**	**$29,550**

How FIT is Calculated for Ratemaking Purposes

Actual FIT before ITC**	$ 9,525	$ 9,750	$ 5,000	$ 9,275
ITC for Ratemaking	-0-	- 250	-5,000	- 250
FIT for Ratemaking	**$ 9,525**	**$ 9,500**	**$ -0-**	**$ 9,025**

Ratepayer Benefit Scale

Ratio			
1.000	Choice III	- Total Flow Through	$21,000
1.407	Choice IV	- Reduction of FIT and Rate	$29,500
1.429	Choice I	- Rate Base Reduction	$30,025
1.452	Choice II	- Amortization of FIT	$30,500

*Reflects revenue requirements for initial year
**Allowance for return + FIT = Net Taxable Income
Tax before ITC = .50 x Taxable Income

Since the enactment of the ITC in 1962, the state regulatory bodies have commonly applied four different methods of accounting for the credit. These

alternatives are shown in Table II. State commissions that decide not to follow the letter of the code are free to choose any of the methods of accounting for the ITC regardless of the company's prior election. Table II presents these alternatives as they would be applied to a utility company. Choices I and II in Table II follow the accounting procedures provided by Option 1 (reduction of rate base) and Option 2 (service life flow through) under §46(f) of the code. Choice III represents a total flow through treatment of the credit. Choice IV represents a treatment of the credit which combines the rate base reduction of Choice I with the amortization provision of Choice II.

Instead of reducing the FIT, Choice I provides for a reduction of the rate base with ratable restoration over the life of the asset.

Choice II provides for ratemaking treatment of ITC by ratable reduction of FIT over the service life of the asset. This choice offers the greatest benefit to the companies since only 1/20 of the ITC is flowed through to the consumer in any one year. Of course, at the end of the useful life of the asset, the entire ITC has flowed through to income. This approach has been accepted and applied by various state regulatory bodies.[38]

Choice III represents a total flow through treatment of ITC. This represents a substantial reduction of the burden on the ratepayer, but retains none of the credit earned for the utilities.

Choice IV represents a compromise among the other three choices. Under this normalization method, the ITC is amortized over the useful life of the asset, as in Choice II. But this ratable allocation is coupled with a deduction of the remaining unamortized balance from the rate base.

CONCLUSIONS

The foregoing analysis of the accounting procedures for investment tax credit suggest several conclusions.

First, state regulatory commissions must decide whether to comply with the accounting procedures outlined in §46(f) of the code with respect to timely elections by the regulated companies. If a commission decides to so comply, then the procedures are set out above.[39] The commission may not exercise its discretion in applying accounting procedures to the investment credit under §46(f) (1) and (2). And, as discussed *supra,* only if a company renewed its election of Option 3 after the 1975 act may the commission use its discretion in formulating proper accounting procedures. The only important decision would be the commission's treatment of cost of credit in the capital structure of an Option 2 company. This analysis shows that state commissions may adopt a policy of omitting the ITC from the utilities' capital structure. Table I suggests

38. Re Arkansas Louisiana Gas Company, Docket Nos. U-2338, U-2348, 96 P.U.R. 3d 209 (1972); Re Virginia Electric and Power Company, West Virginia Public Service Commission, Case No. 7515, October 22, 1974; Re Accounting Procedure for Investment Tax Credit, Docket No. 9883-PU, Order No. 4489, Jan. 6, 1969, 78 P.U.R. 3d 167 (1969).
39. The language of §46(f)(8) is such that even a dispute as to whether an election has been made at all results in a determination between Option 1 and Option 2 treatment of the additional 6% credit. Re Huntington Water Corporation, West Virginia Public Service Commission, Case No. 8666 (1976).

that such a policy would enable the consumer to escape the additional burden of paying a return to investors on the unamortized balance of ITC.[40]

Second, this analysis shows that, depending upon a commission's policy objectives, in many situations the commission may be able to treat the investment credit in a more effective manner by not following the letter of the code. Until a definitive federal court decision is handed down, commissions are free to treat the investment credit by any method they deem most applicable to the particular company and service area involved.

Table II presents the four accounting alternatives most used by state commissions. Each alternative requires the consuming public to supply different amounts of capital. Choice I requires the ratepayer to provide $30,025 in revenues. This choice is less beneficial to the consumer than either Choice III or IV, but of greater benefit than Choice II. The Ratepayer Benefit Scale in Table II shows that the capital requirements of Choice I are closest to the requirements of Choice IV. But since Choice I requires no immediate amortization of the investment credit, it requires approximately 2.2% more revenue from the consumer. Under this option the consumer would realize some of the initial benefit, since with a lower rate base the commission would justifiably find a lower revenue requirement and thereby lower rates. This choice is applicable to situations in which a state agency wishes to share the benefits of the credit (in keeping with the legislative history) between the companies and ratepayers while still allowing the utilities to retain most of the benefit.

Choice II in Table II is the alternative of greatest value to the companies. In essence, it permits the utility to retain the use of consumer-contributedfunds (the unamortized balance), and hold these funds as though they are a cost-free loan. It can reduce the need for companies to borrow money at market interest rates. Choice II requires 2.3% more revenue than Choice I, 4.5% more revenue than Choice IV, and a full 45% more revenue than Choice III. Therefore, this choice is applicable to situations in which a commission wishes to restrict the credit for the optimum use of the utility.

Choice III in Table II is by far the most advantageous accounting method from the consumer's standpoint. It requires far less consumer-contributed capital than the other alternatives. Choice III is applicable for situations in which the state agency (such as the California commission in *Pacific Telephone)* believes that all of the benefit of the credit should be immediately flowed through to the ratepayer, leaving no measurable benefit for the companies. It must be remembered, however, that this accounting method seems to fly in the face

40. In fact, one study indicates that faced with a common equity return on the unamortized investment credit balance, consumers are better off to forego the credit entirely. If immediate flow through is not available, the credit is better avoided altogether. J. Leslie Livingstone, David C. Ewert, Annis D. Sherali, "Treatment of Investment Tax Credit: A Regulatory Dilemma", (paper) (Mar. 1977). Mr. Livingstone is a professor of industrial management at Georgia Institute of Technology. Mr. Ewert is a professor of finance at Georgia State University. Mr. Sherali is project engineer with Southern Engineering Company, Atlanta, Georgia.

of congressional intent, and is the sole option likely to incur opposition from the IRS. Unless the company has renewed its election of Option 3 under §46(f)(3), immediate flow through could result in complete loss of the investment credit for the companies.

Choice IV in Table II requires less revenue from the consumer than Choice I or Choice II. It seems to be a viable alternative for both companies and consumers for several reasons. First, it comports with the congressional intent expressed in the legislative histories of the revenue acts. The reports expressed the desire that the credit be *shared* between the consumers and companies. Second, it is a middle ground of reasonable compromise, since it gives the utility company cost-free use of needed capital without requiring consumers to pay a return to utility stockholders on consumer contributed funds. It also provides for a return of contributed funds to the ratepayer through the annual reduction in federal income tax. Third, there is no evidence that the IRS will disallow the credit for a utility treated under Choice IV. While the IRS has initiated some opposition to total flow through, it has not done so where the state agency has continued to share the benefits of the credit. Thus, Choice IV would settle the " . . . confrontation between companies and consumers that may well end up with an extreme outcome either of immediate flow through or total disallowance by the IRS of the ITC. Neither alternative is desirable for utility companies who are striving to carry out construction programs with the benefits of ITC."[41] The purpose of the ITC would be fulfilled with as little burden as possible on the ratepayer.

Finally, this analysis suggests that each state commission must make its own decision regarding accounting procedures for the investment credit. The decision is an important one, for it has a substantial effect on the utility industry and the American consumer. By understanding these alternatives, state commissions may make an informed decision as to which accounting procedure will best implement the policy objectives it seeks to attain.

41. Livingstone *et al.*, "Treatment of Investment Tax Credit: A Regulatory Dilemma," *supra* note 40.