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CASE 27513 - Generic Proceeding Concerning the Impact of the Reduced Corporate Income Tax Rate on the Deferred Tax Account.

STATEMENT OF POLICY

(Issued December 28, 1979)

On April 2, 1979, we issued a Notice requesting comments on the proper treatment of excess amounts which might exist in the accumulated Deferred Tax Accounts kept by New York State utilities subject to the Uniform System of Accounts caused by the reduction in the corporate Federal Income Tax rate from 48% to 46%. In the Notice we suggested three possible methods of returning to the utilities' ratepayers excess amounts in the deferred tax accounts caused by the change in tax rates:

1. Making no present change in these accounts, relying on the apparent current utility practice of reversing the deferred amounts at the rate at which they were deferred,1/ thus returning any surplus to consumers over the life of the depreciated plant.

1/We note from the comments filed that four utilities--Brooklyn Union, Central Hudson, Rochester and St. Lawrence--apparently do not have a current practice for amortizing of any excesses in these accounts.

2. Reducing the amounts in the deferred accounts now and, through each utility's next rate case, returning the amount deferred in excess of what is required if current tax rates were to remain in effect indefinitely to the ratepayers over a specified amortization period.

3. Accruing no new amounts in the deferred tax accounts until the amount in the account is correct under the new tax rate.

Comments were received from New York Telephone Company (NYT), National Fuel Gas Distribution Corporation (National Fuel), Rochester Telephone Corporation, New York State Electric & Gas Corporation, Continental Telephone Corporation (Continental), Orange and Rockland Utilities, Inc., St. Lawrence Gas Company, Inc., Long Island Lighting Company, Pennsylvania Electric Company (Penelec), Brooklyn Union Gas Company, Central Hudson Gas & Electric Corporation, Mid-Continent Telephone Corporation, Niagara Mohawk Power Corporation, Consolidated Edison Company of New York, Inc., Long Island Water Corporation, and Staff. New York Telephone also submitted a copy of a request for an IRS ruling on the matter by its parent, American Telephone & Telegraph Company.

DISCUSSION

Tax normalization is required under the Internal Revenue Code for several of the utilities under our jurisdiction that use accelerated depreciation under § 167 of the Internal Revenue Code. They include NYT, Continental, Penelec (a small portion of whose operations are in New York State), Sylvan Lake Telephone Company and a portion of National Fuel. These companies must normalize for ratemaking purposes in order to receive the benefits of accelerated depreciation. The other utilities involved (including the major gas and electric utilities) are not required to normalize by the Internal Revenue Code, but were permitted, pursuant to our 1972 Statement of Policy, to normalize a portion of the asset depreciation range (ADR).[1/] Differing considerations apply to each group because the latter group does not risk the loss of its right to liberalized depreciation for violation of the Code's rules with respect to tax normalization, while the former group may. The question we face is whether any of the methods for returning any surplus in the deferred tax accounts used by the utilities violate the provisions of the Internal Revenue Code and, presuming they do not, which is the fairest method.

This issue arose in the recently concluded New York Telephone Company rate case (Case 27469 - Opinion No. 79-22, issued November 9, 1979). In that case we noted that the company has received a letter from the IRS indicating that its regulations do not prescribe treatment of the excess created in the deferred tax account when a corporate tax decrease takes place. We recognized, as the telephone company contended in that case, that it was possible that a future adverse IRS ruling could be applied retroactively to reject the company's tax benefit. We found, however, that for this to occur the IRS would have to take the position that the existing statute, § 167(l) of the Internal Revenue Code, required at all times whatever treatment is prescribed at any time by the IRS through its interpretive regulations. We were persuaded that the risk of this occuring was so remote that it would be wrong to delay returning to consumers the excess accumulation solely on that basis. We determined

1/ Statement of Policy on Rate Treatment of Investment Tax Credits and Tax Benefits of Asset Depreciation Range System, 12 NY PSC 121-R (1972).

there that the excess in the reserve should be amortized over a five-year period, in part to give needed flexibility in case the IRS should, at some future date, determine that the procedure we ordered was unacceptable.[1/]

It remains to be determined which of the three methods suggested in our Notice should be followed for returning the excess in the accumulated tax reserve to the consumers in other cases.

All parties, with the exception of Staff, recommend that we adopt the first alternative. For the most part, these parties claim that, under their current practice, deferred amounts would reverse at the tax rate at which they were accrued or a weighted average thereof, so that any excesses in the deferred tax accounts would be returned to the ratepayers over the life of the plant. They cite Opinion No. 11 of the Accounting Principles Board (APB), which rejects the second alternative and basically adopts the first alternative as part of "generally accepted accounting principles." It must be remembered, however, that we are not bound in our rate treatment by the opinions of the Accounting Principles Board. We are thus free to accept or reject either alternative. Several of the respondents oppose a one-time adjustment to the reserve on the ground that if an adjustment is made for a decrease in the tax rate, a similar adjustment would have to be made to increase the deferred tax accounts should there be an increase in the tax rate at a future time. They point out also that ratepayers currently are receiving a return on the amounts in the deferred tax accounts since these amounts are deductions from rate base. To that extent, then, the pertinent issue

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1/In Case 27469, we reduced the amount to be amortized by $8.997 million to reflect additional income which New York Telephone Company was entitled to receive under a redetermination of a revenue requirement in a previous case. (See p. 28 of Opinion No. 79-22 and p. 9 of Opinion No. 79-23, issued November 9, 1979 in Case 27100.)

is whether the benefits of the tax rate reduction belong more properly to today's customers or future customers.

Staff prefers the second alternative, and NYT states that it would be amenable to that procedure if prior approval were given by the IRS. Staff suggests it would be preferable to choose the method that returns the surplus to the ratepayers the soonest, and Staff thus recommends a current reduction returned over a controlled period of years starting with each company's pending or next rate case. No party responding recommended the third alternative--reduction of current deferrals until the reserve is accurate. Moreover, it appears that reducing current deferrals would be directly contrary to the Internal Revenue Code's explicit directions for deferring tax amounts and, hence, would probably be illegal.

We conclude that, in general, the resolution adopted and the policy established in the New York Telephone case should be applied to excess amounts in deferred tax accounts attributed to accelerated depreciation and all other tax timing differences, including, but not limited to, taxes related to amortization of bond discount expenses and the gain on the reacquisition of a company's securities, where the period of reversal is related generally to the composite life of utility plant. We agree with Staff that the fairest method for returning surpluses in the deferred tax account is the one which returns it to the ratepayers the soonest over a controlled period of years and we find that such an adjustment is not contrary to the Internal Revenue Code. We recognize, as Staff and some of the utility respondents point out, that particularly in the case of the companies who normalize ADR pursuant to our 1972 Policy Statement, the financial conditions which caused us to authorize normalization (i.e., interest coverage problems, poor cash flow provisions) would militate against immediate refund of the surplus in the deferred tax account. We will thus proceed on a case by case basis, starting with each company's pending or next rate case, to evaluate whether such adverse financial conditions exist and what amortization period would be appropriate if an adjustment to the reserve is to be made. No company should reduce the balances in its deferred tax amounts pursuant to this Statement of Policy until a determination to that effect has been made in a rate case.

Moreover, we will exempt from this policy excess tax accruals related to timing differences for amounts which will reverse in a relatively short period of time. This would include, but is not limited to, the taxes related to normal operating expenses incurred in a given year prior to 1979 and amortized over a relatively short period of time that is not related to the life of the plant but has been determined by the Commission to be proper.