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RECENT NATURAL RESOURCES CASES

Rate Regulation—Oil and Gas Pipeline Companies—Rejection of "Normalization" of Taxes*

The seemingly narrow holding of the Fifth Circuit Court of Appeals in its 1966 *Alabama-Tennessee Natural Gas Co.* decision[1] is this: In circumstances where there is a finding based on substantial evidence that the jurisdictional investment rate base of a pipeline using the accelerated depreciation alternatives to straight line depreciation,[2] as provided by the federal income tax laws, for the foreseeable future will continue to be sufficiently incremented by new, undepreciated investments to increase (or at least not diminish) the overall undepreciated rate base, the Federal Power Commission *may*, as a matter of administrative discretion, reject "normalization" of taxes for ratemaking purposes (accomplished by using a theoretical calculated straight line depreciation in the ratemaking computation[3]) and require flow-through of the accelerated depreciation tax advantage by limiting the tax element of allowable costs for ratemaking purposes to the income tax actually paid.

This case is but a way station along a road the Commission appears to be traveling. Since *Alabama-Tennessee*, the Commission has decided that a regulated pipeline company which elected to return to straight line depreciation, its undoubted right under the income tax laws,[4] may have imposed upon it a ratemaking in terms of theoretical calculated accelerated depreciation instead of taxes

* Alabama-Tennessee Natural Gas Co. v. FPC, 359 F.2d 318 (5th Cir. 1966), *cert. denied*, 385 U.S. 847 (1966).

1. Alabama-Tennessee Natural Gas Co. v. FPC, 359 F.2d 318 (5th Cir. 1966), *cert. denied*, 35 U.S.L. Week 3126 (U.S. Oct. 11, 1966). This appeal is from Alabama-Tennessee Natural Gas. Co., 31 F.P.C. 208 (1964), a proceeding arising under the Natural Gas Act §§ 4 (d) and (e), 52 Stat. 821 (1938), as amended, 15 U.S.C. §§ 717 (c) (d) and (e) (1964) dealing with requested rate increases.
2. Int. Rev. Code of 1954, § 167 (b).
3. 359 F.2d at 326-27.
4. Int. Rev. Code of 1954, § 167 (e).

actually paid.[5] This goes beyond the taxes-actually-paid rationale of *Alabama-Tennessee* and invites an ultimate disposition in which all regulated pipelines capable of accruing tax benefits through accelerated depreciation will be so treated for ratemaking purposes whether or not that alternative ever was elected for tax purposes. There is in progress a general rulemaking proceeding in which the Commission purposes to establish the means and extent whereby elimination of accelerated depreciation benefits generally shall be visited upon jurisdictional pipelines through modification of its uniform system of accounts.[6]

This Commission trend represents a radical reversal of an original 1956 position permitting normalization, with a full rate of return applied to the fund accumulated thereby and charged with the deferred future tax obligation,[7] which position was continued until 1961[8] when it was modified to reduce the rate of return permitted on the fund to less than that allowed upon the rest of the rate base.[9]

There is another case development of much greater potential significance now before the Supreme Court in which, if the Commission prevails, it may secure such absolute discretion in the ratemaking process as to swallow-up and make academic *Alabama-*

5. Midwestern Gas Transmission Co., F.P.C. No. 497 (1966).
6. F.P.C. Docket No. R-264 July 7, 1964.
7. Amere Gas Util. Co., 15 F.P.C. 760 (1956).
8. El Paso Natural Gas Co., 22 F.P.C. 260, 265-69 (1959); United Fuel Gas Co., 23 F.P.C. 127, 130-31 (1960); Phillips Petroleum Co., 24 F.P.C. 537, 570 (1960). This position was inferentially supported by City of Detroit v. FPC, 230 F.2d 810 (D.C. Cir. 1955), dealing with amortization of emergency facilities pursuant to Int. Rev. Code of 1954, § 168, and upheld in City of Lexington v. FPC, 295 F.2d 109 (4th Cir. 1961), and El Paso Natural Gas Co. v. FPC, 281 F.2d 567 (5th Cir. 1960), *cert. denied*, 366 U.S. 912 (1961). The last case cited invited the treatment of the normalization fund discussed in note 9 *infra*.

9. Northern Natural Gas Co., 25 F.P.C. 431 (1961), upheld by sharply divided court in Panhandle E. Pipe Line Co. v. FPC, 316 F.2d 659 (D.C. Cir. 1963), *cert. denied*, 375 U.S. 881 (1963). The majority did not attack the validity of normalization but did permit reduction of the return on the reserve fund it created to 1.5% instead of the 6.46% permitted on the general rate base. In a notably sharp dissent the minority, (316 F.2d at 663), convincingly demonstrates that this tactic *pro tanto* thwarted the Congessional purpose in granting the accelerated depreciation privilege and suggests that, far from being the product of greater administrative experience, was the result of an abrupt change in regulatory philosophy occasioned by the radical change in membership (shown in detail at 359 F.2d 325, n.9). The "Eisenhower-Kennedy commissions" dichotomy used in this and other regulatory areas as a shorthand means of expressing the reason for these abrupt changes of direction is distasteful, but is a reality of present administrative law which scarcely can be ignored by one who would understand the administrative process.

Tennessee. That issue is whether tax savings attributable to losses by non-jurisdictional companies, accomplished through consolidating their tax returns with profitable jurisdictional company activities, as permitted families of affiliated companies by the tax laws, may be assigned proportionately to the jurisdictional activities, thereby reducing rates.[10] The Commission's result can be superficially explained by the taxes-actually-paid rationale (a position from which the Commission since has felt free to digress, however, where lowered rates would result by compelling a straight line taxpayer to use theoretical calculated accelerated depreciation[11]). But when it is reflected that this advantage comes as a wholly fortuitious windfall to the cost of service ultimately to be borne by consumers, it becomes apparent the Commission probably can be upheld only by the fullest extension of the *Hope Natural rule*,[12] which taken literally forbids *any* judicial inquiry into the propriety of the elements considered by the Commission in establishing rates so long as the end result is not "unjust or unreasonable." This is how the issue was posed by the Tenth Circuit (and any such absolute extension rejected) in the leading case.[13] The formulation was adopted by the Fifth Circuit in its treatment of a subsequent case, which has now become the test case before the Supreme Court.[14]

Finally, before proceeding to specific discussion of the *Alabama-Tennessee* case, it should be noted there is no direct effect upon producers of gas. Their battle to keep the tax benefits of percentage depletion, a statutory substitute for depreciation that is permitted

10. For an explanation of the details of this process see Cities Serv. Gas. Co., 30 F.P.C. 159 (1963), followed in United Gas Pipe Line Co. v. FPC, 31 F.P.C. 1180 (1964), the test case presently before the Supreme Court for decision in its coming 1966-67 term. 357 F.2d 230 (5th Cir. 1966), *cert. granted*, 383 U.S. 924 (1966). The income tax law sections involved are Int. Rev. Code of 1954, §§ 1501, 1504.

11. See note 5 and accompanying text *supra*.

12. FPC v. Hope Natural Gas. Co., 320 U.S. 591, 602 (1944). The rule is no more than a dictum in the context of this case which was concerned with whether determining the rate base by depreciated actual legitimate cost was proper.

13. Cities Serv. Gas. Co. v. FPC, 337 F.2d 97, 100-01 (10th Cir. 1964).

14. United Gas Pipe Line Co. v. FPC, 357 F.2d 230 (5th Cir. 1966), *cert. granted*, 383 U.S. 924 (1966). The Supreme Court sometimes evades the formulations of the lower courts. *E.g.*, North Dakota v. FPC, 247 F.2d 173 (8th Cir. 1957); Amerada Petroleum Corp. v. FPC, 334 F.2d 404 (8th Cir. 1964); Lo-Vaca Gathering Co. v. FPC, 323 F.2d 190 (5th Cir. 1963), formulating the issue in commingling of jurisdictional with non-jurisdictional gas as one of resegregating fungible commodities in a meaningful manner. There is no recognition whatever of this formulation by the Supreme Court in California v. Lo-Vaca Gathering Co., 379 U.S. 366 (1965), reversing Lo-Vaca Gathering Co. v. FPC, *supra*.

producers of wasting natural resources, was lost more than five years ago, again in the Fifth Circuit.[15] The area rate methods now in process of application obscure this treatment because under them there are no longer individual producer ratemakings. But the consequence is very much present in continued refusal to permit calculated depletion equivalent to tax savings to be reflected in the area ratemaking process.[16] In a very real sense it may be said that rejection of normalization for the pipelines is no more than a parallel extension of the treatment already accorded producers of jurisdictional gas.

The Fifth Circuit's *Alabama-Tennessee* opinion rests on two bases: (1) A determination that the most reasonable reconciliation of the earlier Natural Gas Act with the later amendment of the tax laws permitting accelerated depreciation benefits is that Congress did not intend, by its later enactment, to restrict the usual ratemaking methods of the federal regulatory agencies. (2) Hence the Commission, in its discretion, may elect either to normalize or require flow-through of the accelerated depreciation tax benefit. Under the second point, however, there is confusion. On the one hand the court seems to hold the option exists only when there are specific findings, supported by substantial evidence, that a *particular* company, for the foreseeable future, will have an expanding (or at the very least stable) undepreciated rate base.[17] On the other hand, adverting to the *Hope Natural* rule, the court seems also to plant its decision on the impregnable citadel that the Commission can commit any error in structuring its ratemakings, and the detail cannot be inquired into so long as the resulting revenues are not "unjust or unreasonable"[18]—whatever that means.[19]

15. El Paso Natural Gas Co. v. FPC, 281 F.2d 567 (5th Cir. 1960), *cert. denied*, 366 U.S. 912 (1961). The income tax law section involved was Int. Rev. Code of 1954, § 613.

16. [Permian Basin] Area Rate Proceeding, F.P.C. No. 468 (1965). For a more detailed review of the reasoning underlying this treatment, see Phillips Petroleum Co., 24 F.P.C. 537, 568, 707-23 (1960). This is the leading individual producer ratemaking proceeding. In it, it was announced that individual ratemakings would be abandoned in favor of consolidated industrywide area ratemakings.

17. Alabama-Tennessee Natural Gas Co. v. FPC, 359 F.2d 318, 323, 328-30 (5th Cir. 1966), *cert. denied*, 35 U.S.L. Week 3126 (U.S. Oct. 11, 1966).

18. *Id.* at 331.

19. In New England Tel. & Tel. Co. v. State, 95 N.H. 353, 64 A.2d 9 (1949), the idea that the *Hope Natural* rule operated to free regulatory bodies from judicial review of the correctness of application of their methods once chosen is criticized by a state court. The Supreme Court has given no hint of any such view, however, in the

The court correctly states that the legislative histories underlying the problem contain no unmistakable congressional manifestation of intent one way or the other; also that the normal ratemaking treatment of expense items, including taxes, is in terms of costs actually incurred. Even so, discerning the congressional purpose is not the "unmalleable granite"[20] the court contends in reaching what the writer believes a wrong result. The court's construction, in the final analysis, is premised on the tactic of charging Congress with an obligation to speak affirmatively if it would avoid the consequence decreed.[21] This is unsound and, for a busy Congress, unreasonable.

The tax law permitting election of accelerated depreciation, while no more or less specific than the Natural Gas Act in the area of interest, is later in point of time, an important consideration in statutory construction.[22] Immediately after its passage the Commission, adhering to analogous principles developed with regard to Korean War tax amortization of emergency facilities (a treatment known to Congress), held itself *bound* to accord normalization.[23] Its treatment was upheld on appeal[24] and, when the line was *pro tanto* breached in 1961 to the extent of reducing the rate of return on the normalization fund, there was even to that treatment a strong dissent by a five-to-four divided District of Columbia Circuit.[25] Because it disliked what it believed the law required of it, the

more than twenty years since the *Hope Natural* rule was enunciated. It is at least likely that review of federal ratemakings will be confined to measuring results. The effect, assuming a regulatory decision that is not patently outrageous, means prompt review is rendered impossible. Whether a rate is unjust or unreasonable as a matter of result can be tested only in terms of future revenues generated and consequent effect upon the marketability of the regulated company's stocks and bonds. Not only this, but by the time adverse results become apparent, it can be anticipated the Commission will have shifted to a new regulatory method which will purport to ameliorate the situation. See the suggestion in *Alabama-Tennessee*, 359 F.2d at 339. This will precipitate a new waiting period, and if that attempt fails to produce desirable results again and again, this, in effect, will indefinitely insulate the ratemaking process from effective review by the courts.

20. 359 F.2d at 331.

21. *Ibid.*

22. Consider the dissenting opinion in Panhandle E. Pipeline Co. v. FPC, 316 F.2d 659, 663 (D.C. Cir. 1961), *cert. denied*, 375 U.S. 881 (1963).

23. See the Commission cases cited in notes 7 & 8 *supra*.

24. See the court cases cited in note 8 *supra*.

25. Panhandle E. Pipeline Co. v. FPC 316 F.2d 659 (D.C. Cir. 1961), *cert. denied*, 375 U.S. 881 (1963).

Commission encouraged Congress to consider remedial legislation.[26] Congress refused to vary the treatment.[27] As a matter of technical construction this should be enough to reach an opposite result.

But there is more. Accelerated depreciation[28] is a part of the Internal Revenue Code, a law of general application to all taxpayers, regulated and unregulated. If it be conceded that a jurisdictional company can elect straight line depreciation, pay taxes on that basis, and have its rates calculated on the taxes actually paid as a matter of right,[29] it must be recognized that the reserve fund derived from the accelerated depreciation alternatives (and held for eventual discharge of the future increased tax burden resulting from the acceleration) is no more than the economic equivalent of permitted straight line depreciation.

The argument that the tax can be indefinitely deferred is specious. It *cannot* be deferred as to the investment in any *particular facilities* after their installation beyond the relatively short period resulting from choosing accelerated depreciation *which the law permits*. Dislike of a gross overall effect through time, which most emphatically does favor an expanding company, should not be permitted to obscure this vital reality. The contrary view, here adopted by Commission and court, permits current consumers to avoid a cost of service burden properly theirs, and progressively thrust forward current costs upon consumers of the more remote future.

26. 1957 FPC Ann. Rep. 75; 1956 FPC Ann. Rep. 75. There can be no doubt the Congress was thoroughly aware of the mandatory interpretation while it was in effect. S. Rep. No. 1380, 85th Cong., 2d Sess. 3-6 (1958); S. 2113, H.R. 5824, 85th Cong., 1st Sess. (1957).

27. S. 2113, H.R. 5824, 85th Cong., 1st Sess. (1957). On the other hand, the Fifth Circuit points to a 1964 effort to make normalization unmistakably mandatory after the Commission had changed its position, which also was not enacted, apparently intending to cancel the effect of one effort by the other. 359 F.2d at 334. The shifts of political alignment which constantly occur from Congress to Congress are inescapable facts. But, to the extent subsequent Congressional inaction is relied upon to supply intent, the test closest to point of time to the passage of the statute should control. Here the first test was within three years of passage of the accelerated depreciation alternatives, when there would have been comparatively little change in membership and the memory of what was intended in a fairly recent enactment would have been fresh.

28. Int. Rev. Code of 1954, § 167 (b).

29. This seemingly obvious proposition is under challenge, however. See note 5 and accompanying text *supra*. When the Commission acts against the interest of a company actually using straight line depreciation, it should come into such total conflict with the congressional purpose to permit either that the Commission action could be upheld only by full extension of the *Hope Natural* rule. See notes 12, 19 *supra* for a discussion of this rule.

And it is not rational, however solemn the findings or well protected by the substantial evidence rule of review, to premise ratemaking procedures on findings, which can never be more than doubtful speculation, of *indefinite, unbroken* future growth.

Even this is not all. The strongest point remains. The court points to the specific 1964 congressional denial of authority to include the benefits of the investment tax credit advantage, first granted in 1962 in the ratemaking process, contrasting this with its case where there is no specific denial.[30] But consider this. The Commission openly moved to claim this credit both by decisional process[31] and by importuning Congress that the treatment be left to it[32] in this two-year interval. Congress, thus appraised of the Commission's purpose, then specifically directed the advantage was for the sole benefit of the taxpayer.[33]

The conference report attending the 1962 enactment of the investment tax credit states:

> [The purpose] in the case of both regulated and non-regulated industries is to encourage modernization and expansion of the Nation's productive facilities and to improve its economic potential by reducing the net cost of acquiring new equipment, thereby increasing the earnings of the new facilities over their productive lives.[34]

After hearing the importunings of the regulators, who had already moved to claim this benefit for consumers in the face of this language, Congress acted emphatically, stating that the Commissioner's view of the 1962 law was "clearly contrary to the intent of Congress," and "it was not . . . [the] intention [of Congress] that the Federal regulatory agencies require the benefit of the investment credit to 'flow through' in this manner."[35]

The stated congressional purpose of accelerated depreciation in 1954 was "to increase available working capital and materially aid growing business in the financing of expansion."[36] Apart from the specific reference to both regulated and non-regulated industries, which cannot reasonably be given more standing than redundancy

30. 359 F.2d at 331-34.
31. FPC Interim Order in Docket No. 232, January 23, 1964.
32. *Hearings on H.R. 8363 Before Senate Finance Committee*, 88th Cong. 1st Sess. 1797-1801 (1963).
33. Int. Rev. Act of 1964, § 203 (e).
34. H.R. Rep. No. 2508, 87th Cong., 2d Sess. 14 (1962).
35. H.R. Rep. No. 749, 88th Cong., 1st Sess. 37 (1963).
36. S. Rep. No. 1622, 83rd Cong., 2d Sess. 26 (1954).

when it is recalled that the subject matter was a tax law of general application, this writer can see no distinction except that, in the case of the investment tax credit, Congress was compelled by threatened Commission action *to make so explicit a reiteration of its original 1962 intent* as to raise a barrier insuperable to contrary interpretation. Certainly there is no satisfaction in the *ipsi dixit* of the Fifth Circuit, first advanced in the case which denied producers the usual benefits of percentage depletion, and now in *Alabama-Tennessee* to deny the usual benefits of accelerated depreciation:

> [These benefits] are available to regulated companies to make it so much easier for them, in competition with other fuels and in competition with other industries seeking the investor's dollar to earn a fair return. . . .[37]

Unless one is willing to attribute to Congress an incredible degree of sophistication, attended by incredible obscurity of expression, and then attempt to explain away the obvious fact that the unregulated competitor for investment dollars is very unequally advantaged, he must hold this attempted justification wholly inadequate. Where is the increase in working capital for the regulated company? By what authority are certain taxpayers singled out and so unequally treated? Why is not the same natural reading of one Congressional purpose applied to all?

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37. 359 F.2d at 329-30.

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