TREATMENT OF TAX BENEFITS UNDER CONSOLIDATED RETURNS

1637-7

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-NINTH CONGRESS

FIRST SESSION

ON

Senate Amendment 426 to H.R. 7502

INTRODUCED BY SENATOR EVERETT DIRKSEN OF ILLINOIS, RELATING TO THE TREATMENT FOR TAX AND REGULATORY PURPOSES OF THE TAX BENEFITS DERIVED BY A GROUP OF CORPORATIONS WHO FILE CONSOLIDATED RETURNS

AUGUST 31 AND SEPTEMBER 1, 1965

Printed for the use of the Committee on Finance

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TREATMENT OF TAX BENEFITS UNDER CONSOLIDATED RETURNS

TUESDAY, AUGUST 31, 1965

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m., in room 2221, New Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

Present: Senators Byrd, Long, Anderson, Douglas, Ribicoff, Williams, Bennett, Carlson, Morton, and Dirksen.

Also present: Elizabeth B. Springer, chief clerk; Thomas Vail, professional staff member; and Laurence N. Woodworth, chief of staff, Joint Committee on Internal Revenue Taxation.

The CHAIRMAN. The hearing will come to order.

This hearing has been called for the purpose of receiving testimony on amendment 426, which replaces amendment 418, to H.R. 7502. This amendment is proposed by Senator Dirksen, of Illinois. It relates to the treatment for tax and regulatory purposes of the tax benefits derived by a group of corporations who file consolidated returns.

(The amendment referred to follows:)

89TH CONGRESS
1ST SESSION

H.R. 7502

IN THE SENATE OF THE UNITED STATES

AUGUST 30, 1965

Referred to the Committee on Finance and ordered to be printed

AMENDMENT

Intended to be proposed by Mr. DIRKSEN to H.R. 7502, an Act relating to the income tax treatment of certain casualty losses attributable to major disasters, viz: At the appropriate place in the bill, insert the following new section:

SEC. . (a) Section 1552 of the Internal Revenue Code of 1954 (relating to earnings and profits) is amended by adding at the end thereof the following new subsection:

"(c) TRANSFERS IN RESPECT OF TAX LIABILITY.—

"(1) REDUCTIONS AND INCREASES IN EARNINGS AND PROFITS OF MEMBERS.—If each member of an affiliated group is bound for the taxable year by a consolidated return agreement described in paragraph (2), the earnings and profits of each member of such group for such year shall be determined by—

"(A) allocating the tax liability of such group for such year in the manner provided by subsection (a), and

"(B) reducing the earnings and profits of a member who transfers funds to another member or members in accordance with such agreement in the amount of such transfer, and increasing the earnings and

profits of a member who receives funds from another member or members in accordance with such agreement in the amount of such receipt. Transfers and receipts to which the preceding sentence applies (and transfers and receipts made prior to the date of the enactment of this subsection, whether or not made under an agreement of the type described in paragraph (2), to the extent made pursuant to a consistent practice having a similar purpose and effect as such an agreement) shall be treated as payments, or refunds, of Federal income tax, as the case may be, by all Federal agencies or instrumentalities for the purposes of establishing the cost of service, of determining the overall rate of return, and of determining the net income from the regulated activities or services of a member of such affiliated group.

"(2) CONSOLIDATED RETURN AGREEMENT.—For purposes of this subsection, a consolidated return agreement is an agreement among members of an affiliated group with respect to the use of deductions or credits in a consolidated return which provides for transfers of funds—

"(A) from those members whose inclusion in such group with respect to any taxable year increases the consolidated tax liability (or reduces the net operating loss) of the group to those members whose deductions or credits reduce the consolidated tax liability (or increases the net operating loss) of the group,

"(B) in amounts consistently determined by a formula under which the funds transferred by any member approximate 100 percent of the amount by which such member's tax liability for the taxable year, computed on a separate return basis (determined without regard to carrybacks to such year and without regard to dividends received from other members of such group), exceeds such member's allocable portion of the tax liability of the group computed under subsection (a), and

"(C) no later than thirty days after the date prescribed for the filing of the consolidated return for the taxable year (determined with regard to any extension of time for filing) or, in the case of a deficiency or overpayment, no later than thirty days after such deficiency has been paid or such overpayment has been credited or refunded,

which is binding with respect to each taxable year, on each corporation which is a member of the group for such year, so long as a consolidated return is filed by the common parent corporation and any other corporation, and in which each member of the group consents to the application of this subsection.

"(3) LIMITATION ON REDUCTION OF EARNINGS AND PROFITS OF PARENT CORPORATIONS.—If for any taxable year—

"(A) there would (but for this paragraph) be a net reduction, by reason of the application of paragraph (1)(B), of the earnings and profits of the common parent corporation of an affiliated group, and

"(B) the common parent corporation's pro rata share of the net earnings and profits of all the other members of such group exceeds the dividends received during such year by the common parent corporation from all such other members,

the earnings and profits of the common parent corporation for such year (after the application of paragraph (1) of this subsection) shall be increased (and the earnings and profits of such other members shall be properly reduced) by an amount equal to the amount of the excess described in subparagraph (B), or by the amount of the net reduction described in subparagraph (A), whichever is smaller, except that such earnings and profits shall not be increased to an amount greater than the earnings and profits of the common parent corporation for such year determined under subsection (a).

"(4) NET EARNINGS AND PROFITS.—For purposes of paragraph (3), the net earnings and profits of all of the other members of the group shall be the greater of—

"(A) the net earnings and profits of such members for their taxable years ending with the common parent corporation's taxable year (hereinafter referred to as the current taxable year), or

"(B) the net earnings and profits of such members accumulated in taxable years beginning after December 31, 1964, reduced by any dividend distributions made in such years (other than the current taxable year) by such other members out of earnings and profits accumulated prior to such years.

For purposes of subparagraphs (A) and (B), the net earnings and profits of such members for the current taxable year shall be determined as of the

close of such year after application of paragraph (1) but without regard to paragraph (3), and determined without regard to distributions paid by such members, or received by such members from other members, during such year."

(b) The first sentence of paragraph (1), so much of paragraph (2) as relates to such first sentence, and paragraphs (3) and (4) of section 1552(c) of the Internal Revenue Code of 1954 (as added by subsection (a)) shall apply to taxable years beginning on or after January 1, 1965.

The CHAIRMAN. Because of the regulatory impact of the amendment, we are hearing this morning from the Chairman of the Federal Power Commission and the Chairman of the Federal Communications Commission. Because of tax consequences, we are also hearing a a representative from the Treasury Department.

The committee has received departmental reports on amendment 418 from the Federal Power Commission the Federal Communications Commission, General Services Administration, Justice Department, and Securities and Exchange Commission. Without objection these reports will be made a part of the record.

(The documents referred to follow:)

FEDERAL COMMUNICATIONS COMMISSION,
Washington, D.C., August 23, 1965.

Hon. HARRY FLOOD BYRD,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The Commission has been furnished with a copy of a rider which Senators Dirksen and Long indicate they intend to present to H.R. 7502 which has already passed the House of Representatives. It appears that under this rider companies in an affiliated group which files a consolidated income tax return would compute the amount of Federal income taxes they would pay as if each of them filed a separate return. The intracompany tax liability for each individual member of the group would then be determined by an allocation method agreed upon by members of the group possibly subject only to approval by the Treasury Department. All Federal agencies or instrumentalities would, under the rider, be required to treat the allocated portions as Federal income taxes actually paid for the purpose of establishing the cost of service, for determining the overall rate of return or for determining the net income from regulated activities or services of a member of the affiliated group, for ratemaking purposes.

If the rider were to be enacted into law, regulatory agencies would, therefore, no longer be able to consider actual taxes paid in fixing rates of return or in determining net income. It would leave affiliated groups free to fix by internal agreement the allocable tax liability of individual members of the group in such fashion as to overstate the actual tax liability of regulated members of the group and understate the tax liability of unregulated members.

The Commission recognizes that such agreements may be subject to the approval of the Treasury Department. However, it is pertinent to note that even if this were the case, the concern of the Treasury Department with respect to such agreements would relate to the overall tax consequences rather than to the effect on charges to the public for utility services.

While the Commission does not feel that all such agreements would necessarily be improper, it is definitely of the view that, in particular instances, after an analysis of all of the pertinent data the regulatory commission should have the discretion to review the allocations made by an affiliated group and to require such adjustments as may be necessary to serve the public interest and to safeguard rate payers from the need to pay charges in excess of those actually required to allow the regulated member to earn a fair and reasonable return. This Commission has regulatory responsibility with respect to communication common carriers, some of whose operating revenues exceed $3 billion per year. Many such carriers are members of affiliated groups consisting of entities which are not subject to regulation, as well as those which are subject to regulation. While there has not been time to make a thorough analysis of the potential effect of the rider upon the revenue requirements of communication carriers and service, a quick survey indicates that under specific circumstances and with appropriate allocations the total communications bills of the users of common carrier service

subject to regulation by this Commission could be affected by many millions of dollars per annum. Furthermore, it appears to us that enactment of the rider might result in actual returns to the carriers substantially above those found to be fair and reasonable by the Commission and thus undermine one of the basic reasons for the establishment of regulatory agencies and the delegation to them of the responsibility to fix fair and reasonable rates to the public.

There is one other possible effect of the rider which the Commission feels merits serious attention. This results from the fact that in many instances manufacturing affiliates of a group furnish major portions of the physical equipment and supplies to their regulated affiliates, used to furnish common carrier service. The prices charged for such equipments and supplies include an element for the payment of Federal income taxes. At present, we understand that in many instances adjustments are made periodically to eliminate from costs of service the tax effect of intrasystem sales of capital equipment. However, while the Commission has not had an opportunity to analyze the effect of the rider upon such intrasystem sales and the income tax treatment which would be required if the rider were to become law, it is pertinent to point out that in one case at least sales run into the many hundreds of millions of dollars per year and the potential effect on a cumulative basis could be to increase the computed revenue requirements for ratemaking purposes of regulated common carriers very substantially.

You will appreciate that the matter did not come to the Commission's attention until very recently. Accordingly, in view of this fact and in view of the foregoing considerations, it is respectfully suggested that the Commission be given a reasonable opportunity to make a detailed study of its potential effects and to advise your committee with respect thereto before action is taken on this rider.

We have been advised by the Bureau of the Budget that adoption of the above described sections in the rider to H.R. 7502 would not be consistent with the administration's objectives.

Yours sincerely,

ROSEL H. HYDE, *Acting Chairman.*

FEDERAL POWER COMMISSION,
Washington, D.C., August 25, 1965.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This is the Federal Power Commission's formal report on amendment No. 418 (Senator Dirksen, August 24, 1965) to H.R. 7502, a bill relating to the income tax treatment of certain casualty losses attributable to major disasters. Public hearings on the amendment have been scheduled for August 31 and September 1, 1965, at which time the Commission will be prepared to present a further statement in response to the invitation of the committee.

The amendment would require the Federal regulatory agencies to accept as a tax payment for ratemaking purposes any payment to an affiliate classified by the companies as a reimbursement for contributed tax savings; that is to say, accounting transfers among the affiliated companies of moneys retained by them as a group would be treated for both tax and rate purposes as though the moneys had been paid to the Treasury.

The amendment includes a provision which would withdraw the present responsibility of Federal regulatory agencies to allocate to each regulated utility as a cost of doing business, a fair share of the actual taxes paid pursuant to a consolidated tax return in which the utility participates. The amendment would bind the regulatory agencies, including the Federal Power Commission, to accept the allocation made by the companies themselves. In consequence, the amendment could require customers of the utilities to pay millions of dollars in excess of the "just and reasonable" rate level under which the utilities have prospered in the past. The amendment would even eliminate the authority of Federal regulatory agencies to insure utilities do not discriminate against one utility and its customers to the unfair advantage of the other utility and its customers. Retroactive features of the amendment could prejudice a pending court case involving $2.8 million claimed by one utility in excess of rates fixed by the Commission. The Federal Power Commission believes that these provisions of the amendment are contrary to the public interest and recommends against enactment.

The proposed amendment is similar to amendment No. 337 (Senator Dirksen, December 3, 1963), to H.R. 8363 (88th Cong., 1st sess.), but the present proposal

delegates even greater allocation discretion to the regulated utilities themselves. Amendment No. 337, which was not reported out by the Finance Committee (and which the Commission opposed), would have prohibited Federal regulatory agencies from using the income deductions and credits which arise from "the nonregulated activities" of a taxpayer to reduce the regulated utility's Federal income tax for cost of service purposes. The present proposal, however, also controls Federal regulatory allocations between two fully regulated affiliates and, rather than prescribing the regulatory treatment, leaves the precise allocation up to the discretion of the regulated companies. Moreover, the former amendment No. 337, in contrast to the present proposal, would have left to the agencies the independent responsibility to determine which deductions and credits in fact arose from nonregulated activities.

The proposed amendment would, among other things, require "all Federal agencies or instrumentalities" to treat certain payments made by one regulated company which participates in a consolidated income tax return to one or more other companies (regulated or not) participating in that return as a "Federal income tax * * * for the purposes of establishing the cost of service, * * * and of determining the net income from the regulated activities or services of a member of such affiliated group." Specifically, where the Federal Power Commission regulates natural gas pipeline companies and electric public utilities on a cost-of-service basis, the proposed amendment would require the Commission to allow as the tax cost of each member of a group of companies filing a consolidated tax return the sum of the following two items:

(A) The portion of the actual consolidated tax allocated to the regulated company by one of the three methods approved in subsection 1552(a) of the Internal Revenue Code of 1954 or by "any other method selected by the group with the approval of the Secretary" of the Treasury; plus

(B) Any payment by the regulated company to other members of the consolidated tax group made pursuant to a formula designed to transfer to other group members approximately the difference between the actual consolidated tax allocated to the regulated company and the higher tax which it would have paid had it filed a separate tax return. (The formula may be altered from year to year.)

In practice the amendment would require the Federal Power Commission, and other Federal regulatory agencies, to allow regulated utilities to charge their customers an amount equal to the taxes they would have paid had they filed a separate return, thereby denying to customers of the regulated companies any share in the benefits derived from the consolidated tax return.

The Commission has not had time to undertake an exhaustive study of the impact of the proposed amendment on regulated utilities subject to its jurisdiction. Available data (tables 1 and 2, attached) pertain only to some of the utilities and 1 or 2 tax years. More important, statistics based on the past can only begin to suggest the impact on the consumer which the amendment may work, since they reflect company operations at a time when the rule of equitable regulatory allocation prevailed. Should the rule of company discretion to assess consumers with hypothetical taxes be established by statute, it would be possible for the regulated companies to increase the use of devices which deny to the customer of the regulated utility any of the tax benefits accruing from the consolidated return.

The total consolidated taxes paid by the utilities include tens of millions of dollars (see examples in table 3, attached), which must be allocated fairly and carefully between the regulated and unregulated affiliates on the one hand, and among the regulated affiliates on the other hand. In the past, relatively few utilities have had occasion to undertake the kind of bookkeeping transfers between affiliates which the amendment would declare to be a payment of income taxes. Enactment of the amendment would create an incentive for utilities to undertake interaffiliate transfers of funds, develop tax-loss affiliates, and otherwise rearrange their business dealings to take advantage of the amendment by shifting more of the benefits of the consolidated tax return from their customers to their stockholders.

The limited data at hand show the magnitude of the past benefits which the amendment would have affected; namely, the difference between the tax allocated to particular utilities in a consolidated return and the tax which each utility would have had to pay had it filed a separate return. A Commission staff study of the annual reports filed by 18 of the natural gas pipelines shows a total difference of $5.5 million in 1964. (Details appear in table 1, attached.) Data reported by by 28 of the electric public utilities show a total increment of $3,040,000 in the same

year. (Details appear in table 2, attached.) The foregoing data for 1 year are not necessarily typical of other years, and the precise increments could vary depending upon the allocations adopted by the Commission for a particular company upon consideration of all the evidence in a rate case.

A few examples will show the magnitude of the problems which the amendment would introduce to the proper exercise of the Commission's regulatory responsibilities under the Natural Gas Act and the Federal Power Act. The regulated operating companies in a number of holding company systems file a consolidated tax return with the nonutility parent company. The consolidated return takes advantage of deductions contributed by both parent and subsidiary companies. Thus, where the parent company issues the bonds for the system it contributes deductions such as interest expense to the consolidated return, whereas the subsidiary utilities contribute operating expense deductions. The interest expense deduction is universally recognized as fully allocable among all the consolidated return companies. Nonetheless, the amendment would often permit operating utilities to transfer funds to the parent company, in return for "tax savings" due to the interest deduction contributed by the parent and would require Federal regulatory agencies to allow such interaffiliate transfers "as payments * * * of Federal income tax", which the ratepayers must bear as part of the cost of doing business. Under the amendment, the holding company device could deny the ratepayers a fair share of the tax saving due to interest on long-term debt even though the ratepayers supply all the cash to pay the interest.

The impact of the amendment on a single holding company system, the Columbia Gas System, Inc., illustrates its potential effect on consumers throughout the country. Commission staff studies show that the difference between staff's allocation of the actual consolidated income tax of the entire system and the amount of tax which each utility could have claimed under the proposed amendment was $3 million in 1964 and $4.4 million in 1963. The data for each of the companies are set forth below:

Name of company	Excess of hypothetical tax (allowed by proposed amendment) above actual tax as allocated by FPC staff	
	1963	1964
Atlantic Seaboard Corp.	$392,961	$298,186
Columbia Gulf Transmission Co.	1,033,520	957,279
Cumberland & Allegheny Gas Co.	64,865	64,960
Home Gas Co.	82,883	57,164
Kentucky Gas Transmission Co.	79,833	54,927
Manufacturers Light & Heat Co.	579,970	368,893
Ohio Fuel Gas Co.	1,440,402	594,981
United Fuel Gas Co.	804,787	630,612

NOTE.—Similar data for other holding company systems are set forth in tables 1 and 2.

The possible adverse impact of the proposed amendment upon consumers may arise immediately because it includes a retroactive requirement upon the regulatory agencies which might control the outcome of pending cases. One of the cases involves a claim by the utility for $2.8 million in excess of the consolidated Federal income tax allocated by the Commission and for commensurately higher rates. *United Gas Pipe Line Company v. Federal Power Commission* (U.S. Court of Appeals for the Fifth Circuit Nos. 21872 et al., reviewing FPC Opinion No. 428, 31 FPC 1180, 1190–91). Another case involves a difference of $300,000 in accounting treatment of consolidated taxes. *Florida Gas Transmission Company v. Federal Power Commission* (U.S. Court of Appeals for the Fifth Circuit, Nos. 21957, et al., reviewing FPC Opinion No. 431, 31 FPC 1402). These complex questions have not yet come before the Supreme Court.

The Commission believes that the present system of administrative allocations, subject to the safeguards of judicial review are best adapted to the proper disposition of these complicated matters. The amendment goes counter to the purpose of creating regulatory agencies which are entrusted with the duty of arriving at rate decisions in light of a specialized and detailed knowledge of the economics, prospects, and changing circumstances of the utility industry.

If the amendment should become law it will be faithfully administered by this Commission, but we believe that it is not in the interest of gas and electric consumers, that it is not required for the protection of the legitimate interests of regulated gas and electric companies, and that it erodes the regulatory process by freezing into the law grants to some of the utilities to earn large amounts in excess of allowances under present ratemaking standards.

Commissioner O'Connor has requested me to advise you of his disagreement with the views expressed herein. His comments will be forwarded to the committee in a separate letter.

The Bureau of the Budget advises that enactment of the provisions discussed above would not be consistent with administration's objectives.

Sincerely,

DAVID S. BLACK,
Acting Chairman.

TABLE 1.—*Consolidated tax savings of 19 natural gas pipeline companies, 1963 and 1964* [1]

Company name	1963 savings	1964 savings
Atlantic Seaboard Corp.	$302,961	$298,188
Columbia Gulf Transmission Co.	1,033,529	967,279
Cumberland & Allegheny Gas Co.	64,865	64,960
East Tennessee Natural Gas Co.	None	13,872
Home Gas Co.	82,883	57,164
Hope Natural Gas Co.	288,272	(2)
Iroquois Gas Corp.	462,020	410,978
Kentucky Gas Transmission Corp.	79,838	54,927
Manufacturers Light & Heat Co.	579,970	306,898
Midwestern Gas Transmission Co.	None	53,726
New York State Natural Gas Corp.	8,578	641,828
Ohio Fuel Gas Co.	1,440,402	594,981
Pennsylvania Gas Co.	155,184	149,872
Tennessee Gas Transmission Co.	None	880,630
Union Light Heat & Power	1,574	3,477
United Fuel Gas Co.	804,737	630,612
United Gas Pipe Line Co.	None	532,041
United Natural Gas Co.	263,035	327,395
Valley Gas Co.	3,735	9,796
Total	5,661,578	5,537,914

[1] Computed by FPC staff without regard to flow through of deferred taxes; 1963 savings at 52 percent tax rate; 1964 savings at 48 percent rate.

[2] Included in New York State Natural Gas Corp. in 1964. Companies were subsidiaries of Consolidated Natural Gas Co., and have been merged into 1 company.

TABLE 2.—*Class A and B privately owned electric companies—1964 company Federal income tax liability on individual basis and as share of consolidated liability, for companies showing both amounts in annual report FPC form 1, and showing consolidated savings*

Company	Subsidiary of—	Federal income tax on individual basis	Federal income tax on consolidated basis
Alabama Power Co.	Southern Co.	$19,684,707	$19,594,707
Gulf Power Co.	do.	4,344,080	4,269,080
Georgia Power Co.	do.	23,955,042	23,715,042
Union Light, Heat & Power Co.	Cincinnati Gas & Electric Co.	1,708,351	1,645,583
Brockton Edison Co.	Eastern Utilities Association	1,203,103	1,097,843
Cambridge Electric Light Co.	New England Gas & Electric Association.	708,000	622,623
Cape & Vineyard Electric Co.	do.	585,000	550,989
Fall River Electric Light Co.	Eastern Utilities Association	620,594	558,577
Montaup Electric Co.	do.	1,204,657	1,148,917
New Bedford Gas & Edison Light Co.	New England Gas & Electric Association.	1,125,000	1,044,699
Plymouth County Electric Co.	do.	250,000	232,083
Mississippi Power Co.	Southern Co.	4,081,460	4,011,460
Missouri Power & Light Co.	Union Electric Co.	1,459,000	1,450,000
Jersey Central Power & Light Co.	General Public Utilities Corp.	4,091,145	3,857,145
New Jersey Power & Light Co.	do.	1,529,198	1,447,198
Public Service Co. of Oklahoma	Central & South West Corp.	9,897,195	9,483,000
Metropolitan Edison Co.	General Public Utilities Corp.	6,723,600	6,381,600
Pennsylvania Electric Co.	do.	10,017,700	9,504,700
West Penn Power Co.	Allegheny Power System.	16,142,820	15,951,820
Blackstone Valley Gas & Electric Co.	Eastern Utilities Association	1,549,850	1,548,182
Central Power & Light Co.	Central & South West Corp.	11,287,970	11,210,000
Southwestern Electric Power Co.	do.	7,207,000	7,188,000
Texas Electric Service Co.	Texas Utilities Co.	19,095,095	19,065,817
Texas Power & Light Co.	do.	20,433,000	20,405,000
West Texas Utilities Co.	Central & South West Corp.	5,424,411	5,223,823
Monongahela Power Co.	Allegheny Power System.	6,236,069	6,165,600
Potomac Light & Power Co.	do.	1,125,100	1,118,100
Northern States Power Co. (Wisconsin).	Northern States Power Co. (Minnesota).	19,361,648	19,350,000
Total		200,891,295	197,840,988
Difference between totals		3,050,307	

TABLE 3.—*Actual consolidated Federal income taxes paid by major gas company groups filing consolidated return, 1963 (unallocated)*[1]

Company filing return:	*Total tax paid by consolidated group, 1963*
Columbia Gas System, Inc.	$40,045,000
Peoples Gas Light & Coke Co.	29,299,000
Equitable Gas Co.	2,174,000
El Paso Natural Gas Co.	13,737,000
Tennessee Gas Transmission Co.	17,242,600
Consolidated Natural Gas Co.	21,200,000
National Fuel Gas Co.	8,019,363
Lone Star Gas Co.	12,719,589
American Natural Gas Co.	27,387,000
Panhandle Eastern Pipe Line Co.	25,306,700
Texas Eastern Transmission Corp.	24,137,000
Texas Gas Transmission Corp.	8,278,000
Cincinnati Gas & Electric Co.	16,585,826
Houston Natural Gas Corp.	4,478,000

[1] Moody's, Public Utilities 1964.

FEDERAL POWER COMMISSION,
Washington, August 25, 1965.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: A majority of the Federal Power Commission has forwarded to you their views recommending against enactment of the recently proposed amendment to H.R. 7502 with respect to the regulatory treatment to be accorded by Federal agencies to settlements between affiliates filing a consolidated tax return. As indicated in the closing paragraph of that letter, my comments recommending enactment of the proposed amendment were to be forwarded separately. I appreciate the opportunity at this time to express my position.

It is my opinion that the proposed amendment should be enacted for it expresses a legitimate concern on the part of Congress that the national economy should be accelerated by permitting financially sound corporations to diversify and expand their operations. Companies subject to this Commission's regulatory jurisdiction should not be denied a right to participate in this commendable purpose, particularly since there is no adverse impact on consumers by so permitting them to operate. Subject to specific authority in this Commission to determine whether the rules and regulations of another Federal agency accurately reflect the congressional intent, I support the proposed legislation.

At the outset it must be emphasized that Congress has already attempted to realize the purposes set forth in the proposed amendment. The acknowledged intent of Congress in granting the privilege of a consolidated return to an affiliated corporate group was to encourage companies to expand their overall operations for the betterment of the national and international economy and to eliminate any tax disadvantages that might result from operating through affiliates. There is no basis in law for segregating from the benefits of that legislation those companies that are regulated, particularly since such segregation is not of substantial economic consequence to the consumer; he would incur the same rates if the regulated company chose to operate as a single entity.

For these reasons, among others, I dissented in an opinion with the late Commissioner Woodward, in the Commission's leading decision on the issue of consolidated taxes. (See *Cities Service Gas Co.*, 30 FPC 158 (1963).) It is not without significance that the majority opinion was reversed by the Court of Appeals for the 10th Circuit in a unanimous opinion issued on October 9, 1964. (See 337 F. 2d 97.) Stating that the Commission's opinion made the tax allowance of the jurisdictional company depend upon the profits or losses of the nonregulated companies, the court concluded that this apportionment of total tax liability among the regulated companies "fails to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the act."

Although the Commission's failure to seek certiorari in that case cannot be construed as acquiescence in the court's holding, it is significant that the facts of that proceeding established that the inclusion of the regulated affiliate in the consolidated return increased the consolidated tax liability by 52 percent of the regulated affiliate's taxable income, and thereby no "tax savings" resulted. These compelling factual considerations indicate the difficulties that can be expected in dictating apportionment for regulatory purposes of the benefits of consolidated tax reporting.

First, the interests of a regulatory agency in protecting consumers are not realized by the fears expressed in the majority report. It is an exercise in futility for the majority to assume that consumers benefit by the allocations of taxes between regulated and nonregulated operations of affiliated companies, simply because the regulated company will cease to utilize the consolidated return, and will thereby have to charge its consumers for the same tax costs as it would without consolidating. The report of the majority can only be predicated upon a determination to require that affiliated companies must compute their tax liability on the basis of consolidated returns while at the same time denying effectuation to the congressional intention. Interestingly, discretion would not be permitted to management; it would be relegated to the regulators. The small benefits in rates to be realized by consumers by imposing this regulatory compulsion is more than outweighed by the congressional determination to proceed with an overriding policy. The figures here are particularly revealing. For electric companies the additional benefit to consumers is one two-hundredth of 1 percent of the total rates to consumers. For natural gas companies that additional benefit is less than one-tenth of 1 percent. For each ratepayer this amounts

to less than 10 cents a year. However, these benefits are in actuality taxes that the Federal Government has foregone for the expressed purpose of increased economic incentive and expanded financial activity.

Second, the policy of the consolidated tax returns of encouraging companies to expand their overall business for the betterment of the Nation's economy was not as much a declaration that such allocation as might be necessary between regulated and nonregulated companies was to be left to management; instead, this permissiveness was the congressional emphasis to allow management to accommodate as it saw fit to the dictates of the economy. Management is certainly not given any right to manipulate its tax returns; instead, Congress has, for overriding policy considerations, given to management a privilege in foregoing tax revenues. Of course, regulatory efforts upsetting management's privilege must also frustrate the congressional intendment.

Third, the majority report emphasizes the greater interest of natural gas companies in the proposed amendment. This is entirely proper since those companies do not have, under the Federal regulatory scheme, certain characteristics that would otherwise make them a "public utility," as that term is generally understood. The two major distinctions are that transmission companies do not have any guarantee under the Natural Gas Act to a franchised service area (see sec. 7(g)); and transmission companies cannot have an obligation to provide further service for they transport and sell a depletable commodity. Thus, they engage in a business that includes risks over and above those borne by most public utilities. Natural gas companies, denied many of the privileges of regulation, should not be discouraged from expanding into other economic sectors.

There is one feature of the proposed amendment that should not be enacted. It is the section which would apparently inhibit a regulatory commission in its inquiring into the tax allocations between regulated affiliates that are recognized under the rules and regulations of another regulatory agency. It is my opinion that such administrative determinations could conceivably compromise the congressional purpose, and this commission should have full authority to determine whether apportionments authorized by one Federal agency are justifiable under the law for the regulatory purposes of another agency.

With the above reservation, I commend to the Senate Committee on Finance the proposed amendment to H.R. 7502. It reflects a policy of expanded economic activity that redounds to the benefit of all persons; it permits regulated companies to participate in the benefits accorded nonregulated companies; it does not in the least infringe upon the consumer interest in just and reasonable rates; and, to the extent inequitable apportionments would be precluded, it does not infringe upon the legitimate regulatory interests of this Commission.

For purposes of consideration by the committee, I enclose a copy of the Commission's opinion, including the dissenting opinion of Commissioner Woodward and myself. I also enclose a copy of the unanimous decision of the tenth circuit setting aside the majority opinion.

Sincerely yours,

L. J. O'CONNOR, Jr.,
Commissioner.

FEDERAL POWER COMMISSION

OPINION NO. 396

CITIES SERVICE GAS COMPANY, DOCKET NO. G-18799

OPINION AND ORDER DETERMINING TAX ALLOWANCE, DISALLOWING RATES AND REQUIRING REFUND

(Issued July 15, 1963)*

Commissioner Morgan *concurring.*

Commissioner Woodward *dissenting,* joined by Commissioner O'Connor.

Harry S. Littman, Jack Werner, Conrad C. Mount, Henry L. O'Brien and *Richard Littell* for Cities Service Gas Company.

Charles B. McGee, James D. McKinney, Jr. and *R. B. Christiansen* for Missouri Public Service Company and The Gas Service Company.

Irvin Fane, Arthur J. Doyle and *Lowell L. Smithson* for Kansas City Power & Light Company.

Donald W. Steward for Union Gas System, Inc.

J. David Mann, Jr., William W. Ross, Robert D. Youle and *Stanley C. Whiteaker* for Midwest Industrial & Commercial Gas Users Association.

Robert D. Youle, Richard S. Righter, J. David Mann, Jr. and *William W. Ross* for Sheffield Steel, Division Armco Steel Corp.

William Carl Zimmerman for City of Topeka, Kansas.

Charles S. Rhyne, J. Weston Miller, Herzel H. E. Plaine, Benjamin M. Powers and *John F. Thice* for The Municipal Group.

Glenn D. Evans for Missouri Public Service Commission.

John F. Thice for Missouri Portland Cement Company.

J. Weston Miller, Charles S. Rhyne and *Herzel H. E. Plaine* for City of Springfield and City Utilities of Springfield.

John F. Thice for the City of Independence, Missouri.

Leo E. Forquer and *Cyril S. Wofsy* for the Staff of the Federal Power Commission.

Before Commissioners: Joseph C. Swidler, Chairman; Howard Morgan, L. J. O'Connor, Jr., Charles R. Ross, and Harold C. Woodward.

Ross, *Commissioner:*

This proceeding is before us on the single question of the proper tax allowance to be included in the cost of service of Cities Service Gas Company (Gas Company) and to be reflected in its rates after our approval on March 27, 1961, 25 FPC 582, of a rate settlement agreement between Gas Company and customers representing almost the entire volume of gas sold by it.[1] The settlement cost of service included federal income taxes in the amount of $7,055,981, calculated at the statutory rate of 52 percent upon Gas Company's return after mak-

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[1] This proceeding involves a locked-in period because Gas Company made a further filing increasing its rates in Docket No. RP62-1, which rates became effective on December 28, 1961, except for Rate Schedules I-1 and I-2 which became effective July 23, 1961.

ing all deductions applicable to Gas Company as a separate corporate entity but the Settlement Agreement specifically reserved for future determination the issue of the proper amount of federal income taxes to be allowed Gas Company in this proceeding and provided for refunds as a result of a final order on the tax question.

Gas Company is a member of the Cities Service system. The parent corporation is Cities Service Company, which, through its wholly owned subsidiary, Empire Gas and Fuel Company, owns all the outstanding stock of Gas Company and, altogether, directly or indirectly owns the stock of 87 corporations. Among these Gas Company is the only company engaged in the interstate transportation and sale of natural gas. The other subsidiaries are engaged in a wide range of petroleum activities. Subsidiaries explore for and produce oil and natural gas, not only domestically in Oklahoma, Louisiana, Texas, Illinois, Kansas, Mississippi and New Mexico, but also in the offshore areas of the Gulf of Mexico. Other subsidiaries produce petroleum products in Canada, Columbia, Venezuela, Peru, Arabia and the French Sahara. Still other subsidiaries own and operate refineries, oceangoing oil tankers, railroad tank cars, and an office building.

The parent has filed a consolidated tax return for a number of years and Gas Company has been included in the consolidated return except for the years 1950, 1951 and 1952. Under the Internal Revenue Code (Sections 1501–1504) when a consolidated return is filed, all corporations whose stock is owned 80 percent or more by the Parent Company, must be joined in the consolidated return. In the return the losses of any company can be set off against the taxable income of other companies in the group. A net loss in any year can be carried back to the three preceding years or carried forward to the succeeding five years (Sections 172 of the Code). The tax rate on the consolidated return is 54 percent, instead of the usual 52 percent for a separate corporate income tax return, but the 2 percent penalty applies only to the amount of the consolidated taxable income which exceeds the taxable income that is derived from a utility, such as Gas Company (Section 1503 of the Internal Revenue Code).

The Parent Company has allocated the burden of the consolidated tax payments among the various subsidiaries on the following basis. The regulated companies, such as the Gas Company, were charged 52 percent of their net taxable income while the remainder of the consolidated tax, if any, was then allocated among the nonregulated subsidiaries showing a profit in proportion to their respective taxable incomes. Their intrasystem methods of allocation, of course, cannot be the basis of determining the amount allowable to Gas Company as an operating expense in a rate case.

The staff argues that in computing an allowance for federal income tax to be included in the cost of service the Commission should adhere to its interpretation of the doctrine of actual taxes payable. When any company participates in the filing of a consolidated tax return, it should also participate in any saving generated whichever company is responsible for the saving. The important fact, the staff says, is that Gas Company joins in the Parent Company's consolidated tax returns, so that the taxable income or loss becomes a "fused mass" in which each dollar is indistinguishable from any other dollar. The filing of the consolidated tax return, the staff adds, does not produce any separate income tax liability on the taxable income of the Gas Company, but instead, produces a tax liability for the whole group.

As a result of these views the staff did not apply the statutory rate to Gas Company's taxable income, but rather employed a consolidated effective tax rate of 10.53 percent for the purpose of determining the proper allowance for federal income taxes in Gas Company's cost of service. This tax rate was de-

rived, in essence, by dividing the consolidated tax paid by the Cities Service system by the total taxable income of all the profit making affiliates computed separately for the years 1957, 1958 and 1959.[8] By this method the staff computed an effective tax rate of 23.92 percent for 1957, 0 percent for 1958 (where there was a consolidated tax loss), and 7.67 percent for 1959. It averaged these three figures to obtain its effective tax rate of 10.53 percent which it applied to the Gas Company's income in the test year 1958 to obtain a tax allowance of $785,565.

Cities Service argues that the tax rate actually payable on the Gas Company's stipulated return is 52 percent. It says that taking into account the carry-back of losses, there are no tax savings which can be attributed to the Gas Company's inclusion in the consolidated return. Furthermore, it contends that it is the Gas Company's rates which are in issue here not the rates for the oil, or gasoline, or petro-chemicals, or the other products produced and sold by the companies in the Cities Service system. It says that where rates are being set for a utility operation, the costs applicable to that operation are germane, not the costs of the unrelated non-utility operations. It adds that if there is any saving from the non-utility operations they belong to the stockholder who incurred the losses and not to the ratepayer, who has paid no obligation of the non-jurisdictional subsidiaries and has not contributed to their losses. The staff's proposal, the companies say, would take away from the investors a portion of the incentive provided by Congress to encourage exploration for oil, domestically and abroad, would put the company at a competitive disadvantage with other oil companies, and would penalize the Parent Company for its own form of corporate organization. Cities Service claims that the staff's consolidated effective tax rate is a clear deprivation of property without due process of law, because it takes the benefits of the large tax deductions from the non-jurisdictional companies and passes them along to the gas customers in the form of rate reductions.

In his decision issued April 23, 1962, the Examiner agrees with Cities Service. He holds that the staff's position is basically wrong because it would thwart the true congressional intent of the tax law permitting the filing of a consolidated return, which was to encourage holding companies to expand their overall businesses for the betterment of the national and international economy. He cannot see the justice of permitting Gas Company's customers to receive what he considers a windfall from losses occurring in businesses unrelated to that of the regulated natural gas company merely because Gas Company and the corporations having the losses happen to have a common corporate owner. The Examiner adds that the regulated businesses should not have the right to take away from the non-regulated entity any part of the losses it utilizes for tax purposes. The Examiner thinks that, if driven to it, the Parent Company could rearrange its system of corporations in such manner as to eliminate tax losses, and there would then be no tax saving to allot to the gain companies, including Gas Company. Exceptions were filed by the staff and a large Municipal Group[9] which had intervened and the issue is before us for decision.

The authorities do not give us a clear answer to the question of whether the tax allowance for the regulated company should take into account the losses

[8] Since the test year 1958 showed a consolidated loss, the staff used the three year period in order to reach a more representative result.

[9] Consisting of the Kansas Cities of Altamont, Atchison, Chanute, Cherryvale, Downs, Erie, Gerard, Grenola, Howard, Iola, Melvern, Meriden, Osage City, and Perry; the Missouri Cities of Carl Junction, Carrollton, Carthage, Clinton, Independence, Joplin, Kansas City, Marshall, Neosho, Nevada, Oronogo, Pierce, Platte City, Springfield, St. Joseph, Waverly and Webb City; and City Utilities of Springfield, Missouri.

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of affiliates. Some authorities appear to support the "actual taxes" concept as advanced here by the staff. *City of Pittsburgh* v. *Pennsylvania PUC*, 128 A. 2d 372, 385–387 (Pa. Super. Ct. 1956); *Re New Jersey Power & Light Co.*, 9 N.J. 498, 89 A. 2d 26, 41 (1952). Other authorities eliminate the losses of affiliated companies or of separable operations of the same company. *Southern Union Gas Co.* v. *New Mexico PSC*, No. 31074 (D. Santa Fe County, June 9, 1961); "Rates and Rate Structure," 29 PUR (N.S.) 301, 481–842 (N.Y.P.S.C., 1938).

The starting point in resolving the consolidated tax issue is the amount of the consolidated tax payment. This is the only real cost which was incurred by Gas Company in conjunction with the other Cities Service affiliates. The task is then to determine the proportion of the consolidated tax which is reasonably attributable to the Gas Company *vis-a-vis* the other Cities Service affiliates. The basic error in the position of Cities Service is that it ignores this point and claims an amount of Federal income taxes in Gas Company's cost of service on the basis of a hypothetical figure which Gas Company would have paid if it were a separate company. The simple truth of the matter is that Gas Company paid no separate Federal income tax but participated in the filing of a consolidated return with the other Cities Service affiliates. To accept Cities Service's position would be to approve fixing of jurisdictional rates on the basis of converting a hypothetical tax payment into a prudent operating expense. In effect, Cities Service argues that Gas Company ratepayers should make Cities Service stockholders whole for the tax losses of nonregulated enterprises even though this means an allowance for taxes over and beyond that which the consolidated system as a whole actually paid. We reject this view as neither just nor reasonable. Tax allowances in a cost of service are for the purpose of permitting the regulated entity to secure a rate which, after taxes, will provide a reasonable return on jurisdictional investment, not to insure that other components of a complex corporate system are enabled to "cash-in" on their tax losses.

However, we agree with Cities Service that the fundamental rate making principle governing our disposition of this issue requires a separation between regulated and unregulated costs and revenues. This principle controls our allocation of other costs which are jointly incurred by regulated and unregulated companies, or departments within the same company, and is controlling here.[4] If we were to allocate the consolidated system tax return among all profit companies including those in whole or part engaged in unregulated activities, there would be no sound reason for refusing to fix jurisdictional rates at a level sufficient to make up any real losses these companies might suffer.

Staff's approach possesses a quality of artificiality and instability which renders it unsatisfactory for ratemaking purposes. In effect, staff's effective tax rate is derived by taking the ratio Gas Company's income bears to the total income of the profit making companies, and applying this percentage to the system tax paid. It would be easy for Cities Service to escape from this onerous assessment by rearranging affiliates, mergers or intrasystem pricing arrangements in order to eliminate all or most of the other profit entities and thus increase the effective tax rate of the Gas Company. Significantly, the record shows that Cities Service could accomplish this result.

There are three preliminary matters to resolve before computing Gas Company's tax allowance according to the principles stated above. First, we must decide the period of time to be used in the computation. The Parent Company paid no federal income tax for 1958, the test year. If this test period were

[4] As shown above, this principle is inconsistent with Cities Service's position that Gas Company's tax allowance should be computed as if it were a separate company.

representative, we would include no tax allowance in Gas Company's cost of service. However, the tax liability of a complex such as Cities Service for a single year is not apt to be representative. As stated above, the record shows extensive tax data for each of the companies of the Cities Service system for the years 1957 through 1959. While data for a longer period of time might be useful for normalization purposes, in our opinion the detailed data for this three year period of time is sufficient to determine the tax rate applicable to Gas Company.[5]

A second preliminary matter requires us to compute taxable income by normalizing deductions for accelerated amortization and liberalized depreciation, consistent with our treatment in *Alabama-Tennessee Natural Gas Company*, 27 FPC 1180. This is done in Appendix A. However, here as in other rate cases following *Alabama-Tennessee*, the order herein will be made dependent upon our determination in that proceeding regarding the propriety of normalization for rate making purposes. In the event the so called flow through approach is adopted, the rates herein approved on a tentative basis will be appropriately modified.

The third problem is that there are certain companies in the Cities Service system a portion of whose business is subject to regulation. The taxable income of these companies should first be allocated into regulated and nonregulated categories. Cities Service, however, has failed to present any evidence upon which to make such an allocation. We can, however, make an appropriate allocation of the taxable income of Cities Service Oil Company, (which represents nearly 99% of the total taxable income of the mixed companies, i.e., those companies having both regulated and nonregulated income), by taking official notice of certain evidence presented in the Oil Company's rate case in Docket No. G-9510, *et al.* This evidence (taken directly from the Oil Company's own books), shows that 6.28% of Oil Company's gross investment in net plant is devoted to regulated activities (production of natural gas).[6] The data relative to the production of casinghead gas is not included in this figure. Inasmuch as casinghead gas represents 13.51 percent of Oil Company's gas revenues,[7] we will adjust the 6.28 percent figure to take this additional investment into account. Applying the resulting 7.13 percent[8] to Oil Company's total taxable income of $51,252,182 produces regulated income for Oil Company of $3,654,281.[9] A similar allocation with respect to Cities Service Production Company results in 24.16 percent or $6,404,235 of that Company's tax losses attributable to regulated activities.[10]

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[5] We recognize that the record contains limited information for earlier years, i.e., 1954 through 1956. However, the information for the earlier years in this case is not sufficiently detailed to be used in computing the tax allowance for Gas Company in the manner determined appropriate herein; and to the extent that it indicated a different profit and loss picture may have obtained earlier, the subsequent history of Cities Service indicates that such earlier periods could not be considered as representative for rate making purposes.

[6] Dockets No. G-9510, et al., Exhibit 38, Schedule 3.

[7] *Ibid.*, Exhibit 85, Schedule 3, Sheet 3.

[8] This figure was obtained by multiplying $29,775,181 (investment in gas plant excluding casinghead) by 1.1351. The resulting figure of $33,797,808 is divided by total plant investment of $473,788,545 which produces 7.13%.

[9] We wish to make it clear that a simple manner of allocating the taxable income of mixed companies should be used in any future cases involving this issue. Obviously, it is administratively infeasible to compute a detailed cost of service for large integrated corporations to determine one element of a regulated company's cost of service.

[10] $12,070,693 or 17.46 percent of Production Company's average net investment of $14,-276,476 relates to gas production, exclusive of casinghead gas. Casinghead gas represents 38.34 percent of the Company's gas revenues, and the 17.46 percent figure adjusted to take this further investment into account produces 24.16 percent. (Docket No. G-9510, Exhibit 32, Schedule 2, Sheet 1, and Exhibit 85, Schedule 2, Sheet 2.)

Having made these adjustments, we can now allocate the tax cost of the Cities Service system between regulated and nonregulated companies. For the three year period under consideration, the nonregulated affiliates, including nonregulated income of Oil Company, had no taxable income. In fact, the record shows they had a substantial tax loss. It is therefore inappropriate to assign any tax liability to this group of companies. Accordingly, we conclude that the actual tax paid by the Cities Service system, as normalized, is reasonably allocable among the regulated companies.

In sum, the proper method to be applied in computing the Federal income taxes to be included in the cost of service of a regulated company where that company has joined in a consolidated tax return with affiliates is (1) separate the companies into regulated and unregulated groups, (2) determine the net aggregate taxable income of each group, and (3) apportion the net total consolidated tax liability over a representative period of time between the two groups, and among the companies in the regulated group, on the basis of their respective taxable incomes; provided that the allowance so computed for the regulated company shall not exceed what its tax liability would be for rate making purposes, if computed on a separate return basis.

The computation of Gas Company's tax allowance is computed in Appendix B. As this Appendix shows, we based this computation on the ratio Gas Company's taxable income bears to the total taxable income of the regulated group. This, of course, is similar to staff's approach which we consider reasonable when the nonregulated affiliates have been excluded.

The Commission further finds:

(1) Gas Company's proper tax allowance is $5,866,847.

(2) The rates filed by Gas Company filed pursuant to the Settlement Agreement and our order of March 27, 1961, subject to the reservation of the tax issue are excessive and should be disallowed.

(3) Gas Company should file tariff sheets and make refunds in accordance with this opinion.

The Commission orders:

(A) The rates filed by Gas Company pursuant to the Settlement Agreement and our order of March 27, 1961, are hereby disallowed.

(B) Gas Company shall, within 45 days of the date of this order, file appropriate substitute tariff sheets to its FPC Gas Tariffs except for Rate Schedules I-1 and I-2 containing rates satisfactory to the Commission based on a tax allowance of $5,866,847 for the test year, found to be appropriate in this opinion and order. Gas Company shall accompany its rate filing with supporting cost of service and allocation data presented in the same form and manner as that contained in the exhibits attached to the stipulation approved in our order of March 27, 1961, revised only to reflect the change in the allowance for federal income taxes. Gas Company shall further furnish with its filing a statement setting forth the method of computation of such rates and showing the derivation thereof. Gas Company shall also accompany its tariff sheets and supporting data with a certificate showing service of copies thereof on all purchasers under the rate schedules involved, interveners in this proceeding, and interested state commissions. Comments by such parties shall be submitted to the Commission within ten days after service by Gas Company as required herein.

(C) Upon acceptance by the Commission of the tariff sheets filed by Gas Company pursuant to paragraph (B) above, the rates, charges and classifica-

tions set forth therein shall become effective for the period November 23, 1959, through December 22, 1961.

(D) Gas Company shall, within 70 days of the date of this order, file with the Commission a statement showing the distribution to its jurisdictional customers of appropriate amounts to be refunded with interest at 6 percent. With respect to Rate Schedules F-1, F-2, C-1, C-2, E, P and X-5 the refund shall represent the differences between (1) the amounts collected under rates charged in accordance with the stipulation of October 21, 1960, and our order of March 27, 1961, and (2) the amounts that would have been collected under the rates filed pursuant to this opinion and order, from November 23, 1959, to December 22, 1961, with interest at 6 percent. With respect to Rate Schedules I-1 and I-2 the refund shall, in accordance with the stipulation, represent an amount equal to 50 percent of the difference between (1) the sum that would have been payable under I-1 and I-2 Rate Schedules made effective February 23, 1961, for natural gas purchased from Gas Company during the period from June 23, 1959, through July 22, 1961, and (2) the charges which would have been payable for such service during the same period if I-1 and I-2 rates reflecting the Commission's determination of the reserved tax issue had been in effect.

(E) Gas Company shall accompany its statement of refunds with a computation of the refunds and interest, and the derivation thereof, and with a certificate showing service of copies thereof on all purchasers under the rate schedules involved, interveners in this proceeding, and interested state commissions. Comments by such parties shall be submitted to the Commission within ten days after service by Gas Company as required herein.

(F) Within 10 days of the approval of the statements of refunds by the Commission, Gas Company shall make the required refunds so computed and within 15 days thereafter shall report to the Commission in writing and under oath the amount of refund made to each of its customers, showing separately the amount of principal and interest so paid and shall serve a copy of such report upon each of the customers receiving a refund. Concurrently therewith, Gas Company shall file with respect to such refunds, releases from its jurisdictional customers showing receipt of the principal and interest in conformity with this opinion and order.

(G) As provided in the Settlement Agreement approved by our order of March 27, 1961, Gas Company shall file further rate reductions and make further refunds as a result of refunds to it by its suppliers or a reduction in its cost of purchased gas.

(H) The rates required to be filed herein are specifically subject to such further adjustment as may be required as a result of the application of a final decision by the Commission in *Alabama-Tennessee Natural Gas Co.*, Docket No. G-5471, *et al.*,* on the treatment of deferred federal income taxes to the computation of the tax allowance made herein but only from and after the date of such decision or a later date if specified by the Commission therein.

(I) Exceptions not granted herein are hereby denied.

Commissioner Morgan *concurring*, filed a separate statement appended hereto.

Commissioner Woodward *dissenting*, joined by Commissioner O'Connor, filed a separate statement appended hereto.

[*Issued February 8, 1964, 31 FPC —.]

APPENDIX A

CITIES SERVICE GAS COMPANY DOCKET NO. G-18799

NORMALIZATION OF CITIES SERVICE CONSOLIDATED TAX

(1) Particulars	Calendar year			
	(2) 1957	(3) 1958	(4) 1959	(5) Total
CALCULATION OF TAX ON CONSOLIDATED BASIS USING STRAIGHT LINE DEPRECIATION				
Consolidated taxable income (Form 1120)	$23,637,088	($7,146,571)	$7,003,440	$23,494,957
Add: Excess of liberalized depreciation and accelerated amortization over straight line	9,147,913	10,245,432	9,153,089	28,546,434
Subtotal	32,785,001	3,099,861	16,156,529	52,041,391
Deduct: Long-term gain	(808,323)	(2,248,731)	(2,486,203)	(5,543,257)
Income subject to 54 percent	(18,073,798)			(18,073,798)
Balance taxable at 52 percent	13,902,850	851,130	13,670,326	28,424,336
52 percent of utility income normalized	7,229,498	442,588	7,108,570	14,780,656
54 percent of non utility income normalized	9,759,851			9,759,851
25 percent of capital gains	202,081	562,183	621,551	1,385,815
Total	17,191,430	1,004,771	7,730,121	25,926,322
Less surtax exemption	5,500	5,500	5,500	16,500
Tax assuming straight line depreciation	17,185,930	999,271	7,724,621	25,909,823

APPENDIX B

CITIES SERVICE GAS COMPANY DOCKET NO. G-18799

COMPUTATION OF GAS COMPANY F.I.T.

Income (normalized)	1957	1958	1959	Total
Cities Service Gas Company	$11,280,832	$12,256,412	$18,340,470	$41,877,714
Cities Service Gas Producing	2,168,402	2,065,416	2,183,609	6,427,427
Cities Service Pipe Line Co	2,622,047	2,686,669	3,093,433	8,402,149
Lafitte Oil Traders, Inc	22,562	125,455	275,155	423,172
Kansas Gas Supply Company	215,128	339,359	313,433	867,919
Cities Service Oil Co., Del. (regulated portion)	1,499,006	1,259,798	895,477	3,654,281
				61,652,662
Percent of Cities Service Gas Co. to total regulated companies [1]				67.93
Consolidated tax allowance for years 1957-1959 (Appendix A)				25,909,822
Average consolidated tax allowance ($25,909,822÷3 years)				8,636,607
Tax allowance for Cities Service Gas Co. (67.93 percent × $8,636,607)				5,866,847

[1] No portion of the consolidated tax is allowable to Cities Service Production Company because that company had no taxable income.

MORGAN, Commissioner, *concurring:*

On the basis of the record before us it appears that, by virtue of filing a consolidated Federal income tax return for the years 1957 through 1959, the Cities Service System companies collectively enjoyed a Federal income tax saving in the order of some $48 million.

It also appears from the record before us that with few exceptions, one of which is discussed below, the parent company allocated this enormous saving

among the members of its corporate family on the proportionate basis of the taxable income each of them produced. This appears eminently fair, and this, moreover, is the method the tax regulations suggest for distributing these savings among the corporate family.

It is the "few exceptions" that concern us—most particularly, the Cities Service Gas Company. We are concerned with this "exception," first because that company sells a commodity vested with a public interest, at rates having the force of law, to consumers whose ratepaying welfare we are charged by Congress with protecting; second, because on the basis of allocating this saving which parent has chosen for its *unregulated* companies (that is, in proportion to taxable income), this particular public utility *should have* enjoyed savings of about $17.7 million during the period mentioned; third, because utility regulation traditionally and without detectable exception has always required savings in utility tax costs to flow through in the form of reduced rates to the consumers who alone and by law must bear the utility's entire tax burden; and fourth, because the parent in this case has refused to apportion, distribute, allocate or grant a single penny of the entire tax saving to the public utility that has been placed under what should be the watchful eye of the Federal Power Commission.

The vociferous legalisms and cries of outrage that the company has raised as a result of staff's suggestion that this utility, like its sister affiliates, should share fairly, equitably, and proportionately in the tax saving in question—a tax saving made possible in large part by the utility's taxable income—have created a large and to some degree confusing record here.

But the company's cries of outrage are no more heartfelt than the cries and suggestions of "outrage," "fraud," "fictitious," "dishonest," "indefensible," "sinful" and other expletives that were uttered in the United States Senate and House of Representatives when, despite the same defenses offered there as here, the details of the selfsame practices by the selfsame company were made known to the Congress during its consideration of the bill that became the Public Utility Holding Company Act of 1935.[1]

The practice was not then and there outlawed because—and it is safe to say *only* because—that very practice had been forbidden for any and all corpora-

[1] Specifically, see pages 477–482 of Volume 72A, "Utility Corporations," setting forth the results of certain financial practices uncovered in the course of the Federal Trade Commission's massive investigation in this utility area from 1928 to 1935; see the hearings on the bill before the House Commerce Committee at pages 153–155; Senate hearings at pages 234–255 and 514; the debate on the bill in the Senate at 79 Cong. Rec. 8302 and 8525–26; and in the House at 10328.

The comment of Senator Norris was typical:

> Practically all the systems I have shown on the various charts, together with others not shown, made what the law formerly permitted—that is, returns for taxation purposes on a consolidated basis—resulting in a great saving of taxes to the holding-company groups, although, as a matter of fact, operating groups as a rule were subject to a tax. However, the holding companies, taking advantage of the law permitting consolidated returns, collected the taxes from their operating companies, and then, by setting off losses sustained by some of the operating companies, it was possible in this way to retain these taxes by balancing losses of some operating companies against profits of other operating companies. Thus it has often happened that operating companies have paid taxes which ordinarily would have been due the Federal Government, and the holding companies by balancing off losses from other operating companies paid no tax to the Federal Government, but retained the money the operating company had paid as taxes. So some operating companies actually paid their taxes, expecting the money to go to the Federal Government through the holding companies, but by the process I have just described the holding companies kept the taxes and paid nothing to the Federal Government. If anybody can square that with honesty, I should like to have him do it.

tions, except railroads owning 95% of their operating subsidiaries, by the Revenue Act of 1934. But, with the imposition of the wartime excess profits tax, Congress by the Revenue Act of 1942 allowed the practice to be resumed. The matter is now before us, a Federal public utility commission, for disposition in the light of the basic tenents of the public utility law we are charged with administering.

If this were a matter of tax law, as company and the dissenting opinion would have us treat it, we, like the Internal Revenue Service, would only be interested in checking the accuracy of company's arithmetic. But this is a rate proceeding, not a tax audit. The problem here is only the problem of determining how the utility's share of the system's actual tax liability should be determined; or the extent to which a regulated utility's tax and ratepaying consumers should realize or be deprived of a saving in tax charges which in utility law are imposed upon and chargeable exclusively to utility ratepayers.[8]

The difficulty is not in determining whether this utility's share of the tax saving should benefit the consumers who pay its taxes: the difficulty is in estimating this utility's proper share of the saving. Many methods for allocating that saving or estimating the utility's share thereof have been explored, but each has been found wanting by my colleagues. Speaking for myself, I must say that the method used by Cities Service for allocating its total tax liability and tax saving among *some* of its subsidiaries, and by the staff for allocating that total liability and saving among *all* of Cities Service's subsidiaries, is the most logical method and the one which best meets the standards and requirements of utility regulation. Further, it alone of all methods considered here is the one which reflects those vigorous expressions of Congressional intent in this particular matter which should guide the exercise of our discretion.

Briefly, the facts in this case relating to the three-year period under review are these: The system of which Gas company is a part consists of 37 separate corporations, about 6 of which are regulated; and the tax losses of some of the system's companies reduce the taxable profits of its regulated and unregulated companies and thereby reduce the system's over-all actual tax liability. The amount of the system's actual liability—or its tax saving (i.e., the difference between the total tax that would have been paid if each company in the system had been taxed separately, and the tax actually paid on the profits of those companies as reduced by the losses of the other companies)—properly should be distributed or apportioned over the system's profit companies on the basis of the separate taxable income each profit company had; and the record before us is totally barren of any sensible reason for differentiating between regulated and unregulated companies. At least it is barren of any reason which will stand scrutiny in the light of the public interest.

Here the total profits of the system's profit companies for the three-year period were $123.4 million; other system companies had tax losses totalling $100 mil-

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[8] Consolidating the income of several wholly-owned corporations for the purpose of determining system income is especially appropriate in the case of public utility systems, because management often chooses to organize those systems into a series of separate corporations to facilitate doing business in each of the states in which the utility system operates. This is the reason used to justify the use of the consolidated return by utilities before Congress; and this also is the reason Congress removed the 2% penalty tax for public utilities that file consolidated returns (see House Ways and Means and Senate Finance Committee hearings on H.R. 8400 in the 84th Congress, the bill that became Internal Revenue Code of 1954). And in removing that penalty tax, as well as in making the privilege of filing consolidated returns available to public utilities as well as to other taxpayers, Congress was aware that from the time of the Supreme Court's opinion in the *Galveston* case, 258 U.S. 388 (1922), if not earlier, where the law of public utility regulation operates it requires utility consumers to pay the full amount, but not more than the full amount, of the utility's actual tax liability, or its allocated share of the system's actual tax liability.

lion; taxable system income thus was $23.4 million; and consolidated system tax liability for the three-year period was $11.4 million. The tax saving thus realized was the difference between the $63.2 million that the profit-making companies would have paid if they had been taxed separately, and the $11.4 million that the system actually paid, or (excluding a $4 million refund in 1958 of 1955 taxes) roughly $48 million.

Taxable profits of Gas company alone were $42 million; and it would have paid a tax of about $22 million *if* it had been taxed separately.

If the system's over-all tax liability or tax saving had been distributed among the profit companies proportionately on the basis of their separate taxable incomes, since Gas company's $42 million of taxable income was about 35% of total system taxable income ($123.4 million), Gas Company should bear about 35% (or $4 million) of the system's actual $11.4 million tax liability; and should benefit by about 35% (or $17 million) of the system's $48 million tax saving.

But Gas company did not charge its customers $4 million for taxes. It charged them the $22 million Gas company would have had to pay *if* it had been taxed separately. Gas company turned over the $17 million saving to the parent company, which, the record shows, used these funds to subsidize its non-regulated activities.[3]

Gas company says this is all right. It says it really did have a "tax" bill of $22 million, because the parent company on its books did not allocate any of the system's $48 million tax saving to Gas company. The parent company purposefully assumed that its tax losses wiped out the taxable income of its unregulated companies (only), and that the whole 37-company system's tax liability was chargeable to the regulated companies alone. The result of this "allocation theory"—to use a very dignified term—is that Gas company's consumers were charged an amount for "taxes" that was larger than the actual tax liability of the entire 37-company system.[4] Moreover, Gas company did not reduce its "tax" charge to its consumers even in years when the amount of system tax loss was so large that, after wiping out all unregulated company profits, it *should have* reduced Gas company's separately computed "tax" charge. The parent company did not give Gas company's consumers the benefit of Gas company's share of the tax savings as computed, *even under its own arbitrary allocation method.* The position of Cities Service company is that none of the system's tax savings should be used to reduce Gas company's hypothetical "tax" charges to its consumers, because those consumers did not finance the tax losses that gave rise to those savings. But, as we shall see, that is exactly what the consumers did, although involuntarily.

This entire practice is in complete conflict with the established principle that because a utility's consumers alone must pay its entire tax bill under rates having the force of law, a utility cannot charge its consumers more for taxes than the actual amount, estimated where necessary, that the utility actually paid or contributed to the U.S. Treasury, or more than the utility's *proper and equitable share* of the system tax actually paid. In the utility field, stockholders are entitled to a fair, constitutional rate of return, and the tax thereon is paid by utility consumers so that the fair return will not be reduced by taxes. Once the utility or its stockholders have received that return, they may not obtain

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[3] We are only concerned with Gas company's $17 million share of the system's $48 million tax saving, because that $17 million was actually paid in cash by Gas company's consumers who pay its "taxes." We are not concerned with the other $31 million. To the extent it is attributable to the system's unregulated companies, it belongs to the stockholders and management who must see that the taxes of those companies are paid.

[4] During the three-year period in question, although total system actual tax liability was (only) $11.4 million, Gas company's consumers were charged $22 million for "taxes."

more by claiming higher, fictitious, or hypothetical costs they might have incurred *if* they had been organized or operated in some other, *unreal* manner. To allow additional return—over and above a fair return as defined by the courts—is to countenance unjust enrichment of the utility or its owners at the expense of the ratepayer.

My colleagues, perhaps unwilling to chart clear regulatory policy amid the consolidated tax legalisms raised herein, prefer (a) to separate the system's business into its regulated and unregulated portions; (b) to apply all of the system's tax losses (which normally stem from some of its unregulated activities) to reduce the profits or tax liability of its unregulated profit companies first, and then (c) to use whatever loss deductions may remain to reduce the liability that the utility or utilities would have had if they were separately taxed. This, it will be noted, gives the priority of use of the system's tax loss benefits primarily or even entirely to is unregulated profit companies.[8]

In passing, it may be noted that if this policy is equitable and if "turn about is fair play," the priority could and perhaps should be reversed for regulatory purposes. That is, if preference is to be given either group of subsidiaries, regulatory authority might properly apply the tax loss benefits first to wipe out the tax liability of the *regulated* subsidiaries (which almost invariably operate at a taxable profit), and then to use whatever loss deductions may remain to reduce the tax liability that the *unregulated* subsidiaries would have had if their taxes had been separately computed. This would not alter the system's over-all tax liability. But it would produce significantly larger tax reductions for the regulated companies, which would eventually be translated by regulatory authority into reduced rates and gross revenues. It would likewise greatly reduce the expendable funds, generated in the guise of "taxes" paid by utility ratepayers, which the parent company now disburses across the face of the earth to operate the speculative ventures of its various non-regulated corporations.[9] It is these specific corporate operations, *in large part financed and underwritten by "taxes" extracted from ratepayers*, which give rise to the tax loss benefits which the parent company claims it has the *exclusive* right to enjoy on the ground that the ratepayers had nothing to do with them!

It naturally follows that reversal of the priorities herein approved would produce another barrage of legalisms and redoubled screams of rage and pain from the parent company. The reader, whether he is a judge, a corporate lawyer or a utility ratepayer, can reach his own conclusions as to the validity of such protests. For if he has followed the discussion this far he can see clearly what has been happening and he knows exactly to whom it has been happening.

In any event, it is clear that the policy adopted here gives priority and favored treatment to the non-regulated companies rather than to those whose rates are subject to regulatory control by this and other commissions. I should have preferred that no priority or favored treatment be given to either group; and, speaking only for myself, I therefore believe that the actual tax and actual

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[8] On the basis of Gas company's average "tax" charged during the three-year test period used herein, Gas company here claimed an average annual "tax" allowance of $7,055,981; on the basis of an allocation of the system's average actual tax during that period, staff claimed, properly, in my opinion, that Gas company should receive a tax allowance of $789,082; the majority opinion herein (after normalising tax deductions for liberalized depreciation and accelerated amortization and making other refinements) grants Gas company $5,866,847. This is not regulation at its best. My reasons for accepting this result are set forth hereinafter.

[9] That the great bulk of these far-flung speculative enterprises are of no benefit or advantage to consumers who are served by Gas company—and who pay its "taxes"—is made abundantly clear by the majority opinion in the second paragraph thereof.

tax allocation method here urged by the staff is the preferred solution to this problem.

Most reluctantly, however, and solely for the purpose of enabling a decision to be reached in this case, I concur in the policy adopted by my colleagues of the majority. Though far from perfect, it is a discernible improvement over the situation that has existed here and in numerous other corporate families for many years. The approach of the majority, which is more in the nature of an assignment than an allocation, will serve at least to limit the tax liability of Gas Company's ratepayers to the actual liability of the entire system as a whole. It at least will prevent them from having to pay a tax charge that is *larger* than the actual liability of the entire system of which Gas company is a minor part.[7] This is no small matter, for Gas company's lawyers have been unable to obscure the fact that in 1958, when the tax liability of the total system was zero, the parent company nevertheless imposed a "tax" charge upon the ratepayers of the regulated utility in the amount of $6,367,534, not one penny of which was paid to the Federal Treasury.

In sum, this method of apportioning the tax saving and tax burden has the limited virtue of accommodating, to a very small and unsatisfactory degree, the two irreconcilable concepts at war with one another here. That is, it permits company and stockholder to enjoy an overly generous portion of the benefits which they erroneously claim are entirely theirs by virtue of the tax law alone; and it goes some small way toward producing a more equitable charge to ratepayers for the estimated amount of tax liability actually incurred by or attributable to the regulated utility that serves them.

I should have preferred that we face, our responsibilities squarely and discharge them fully. Regrettably, that is not possible; and without my concurrence the little that has been accomplished herein will be lost. It is only on that account that I concur in the result reached by my colleagues of the majority.

WOODWARD, Commissioner, joined by O'CONNOR, Commissioner, *dissenting:*

This is a major rate case in which the Commission must decide a fundamental and critical question. While the Commission, in the past, has properly insisted that certain tax advantages to be obtained from filing a consolidated return for groups composed entirely, or predominantly, of regulated companies, be passed on to consumers, it has not held that business losses of unregulated and unrelated corporations participating in a consolidated return should be utilized for the benefit of the consumers of a regulated natural gas company. The latter issue is before us for the first time.

The majority concludes that the proper method to be applied in computing the Federal income taxes to be included in the cost of service of a regulated company where that company has joined in a consolidated tax return with affiliates is (1) separate the companies into regulated and unregulated groups, (2) determine the net aggregate taxable income of each group, and (3) apportion the net total consolidated tax liability over a representative period of time between the two groups, and among the companies in the regulated group on the basis of their respective taxable incomes. If each of the resulting groups shows a net taxable income, this formula would fairly allocate the total tax in accordance with the respective amounts of taxable income. But where, as here, the unregulated group has a net loss for the test period, the formula appropriates that loss which was the result of expenses and losses financed by the stockholders and deducts it from the tax allowance to be charged the ratepayers, thereby granting to them the entire benefit emanating from the tax loss. As applied here, the $2.4 million net taxable loss of the unregulated group is handed over to the ratepayers by deduct-

[7] Gas company's jurisdictional revenues represent about 5% of the system's gross revenues.

ing it from the taxable income of Gas Company, thereby reducing its tax allowance by $1.2 million.

The Opinion and Order adopted by the majority is based on the false premise that, as to industries regulated by it, the Commission has the authority to limit the effect of a mandate of Congress as expressed in Section 1501 of the Internal Revenue Code. Depriving Gas Company of a tax allowance which would be routinely granted to it by the Commission if it were not for its having a common owner with an unregulated and unrelated petroleum business, should not be done without some very persuasive reasons based upon sound rate-making policies which impose no confiscatory rates, which balance equitable consumer and investor interests and which take fully into consideration the impact of such action upon national economic policies. At the root of regulation is economic policy. The problem of economic growth in the United States is crucially important and inseparably related to economic growth is investment. Under the majority view, the consolidated return would not result in stimulating investment and growth because it has the effect of converting non-jurisdictional losses within the parent company's system into a rate reduction for gas consumers. The majority opinion is not supported by persuasive reasons based on sound policy.

Since this Commission possesses only the legislative powers which the Congress has granted to us, clearly we have no power to amend Section 1501 of the Code. Apart from the fact that there are no tax savings attributable to the inclusion of Gas Company in the consolidated return, the majority view is unlawful because it has the effect of regulating non-utility enterprises beyond the Commission's jurisdiction; it would strip the parent company of congressionally-conferred rights to tax deductions of its non-jurisdictional subsidiaries. The Majority is in error and I dissent.

The Cities Service system is operated principally as an integrated petroleum operation. The jurisdictional revenues of Cities Service Gas Company, a wholly owned subsidiary of Cities Service Company, comprised approximately 4.88%, 5.14% and 6.10% of the total system revenues in 1957, 1958, and 1959 respectively. Only 3% of the gross revenues of two other companies in the system are subject to Commission jurisdiction.[1]

In this proceeding, the Commission is to determine the proper Federal income tax allowance to be included in the cost of service of Gas Company, one of 37 subsidiaries joining the parent company in the filing of a consolidated return.[2]

Chapter 6 of the Internal Revenue Code, "Consolidated Returns," Section 1501, "Privilege to File Consolidated Returns" gives to "an affiliated group of corporations the privilege of making a consolidated return with respect to the income tax imposed" on corporations of which the parent company owns 80% or more of the outstanding stock. When corporations join in such returns, the Code, Section 1503, levies an additional 2% tax upon all includable taxable income except that of utilities such as Gas Company whose tax rate remains at the statutory rate of 52%.

The precise intent of Congress in granting the privilege of the consolidated return to an affiliated group of corporations was to encourage companies to expand their overall businesses for the betterment of the national and interna-

[1] Cities Service Production Company and Cities Service Oil Company (Delaware).

[2] Consolidated returns are based on the principle of levying a tax on the true income of a single enterprise even though the business is operated through more than one corporation. The primary advantages of filing a consolidated return may be summarized as follows:

(1) The offsetting of operating losses of one company against the profits of another.
(2) The consummation of inter-company transactions without the recognition of income.
(3) The designation of the parent company as agent of the group for all tax purposes. . .

tional economy and to eliminate any tax disadvantages of doing such through subsidiaries.

The parent company here owns, directly or indirectly, 100% of the stock of every corporation which participates in the filing of its consolidated return. As such stockholder it owns 100% of the assets of each corporation, and it is entitled to 100% of all net income of each, subject to income tax levies. Also, as the sole stockholder, it bears 100% of every risk, expense and loss sustained by its subsidiaries. These expenses and losses should not be appropriated for the consumers of a regulated natural gas company who bore no part of them, assumed no risks in relation to them, and have no right to use them to reduce their gas costs.

The parent's conducting of its petroleum business through many subsidiaries is a matter of lawful choice and the permission given by the Internal Revenue Code for the filing of one consolidated return by qualified affiliated subsidiaries recognizes such lawfulness. Gas Company performs no activity or function in relation to the parent company's primary business of conducting its petroleum operations. Gas Company is a regulated natural gas company transporting and selling natural gas for resale in interstate commerce and it is operated as such entirely separately from the petroleum operations of the parent company. *Whether one of the included corporations has a taxable gain or loss is determined from its individual tax return calculated separately. It is in the separate return where all lawful expenses of operation are deducted to determine whether there is income of the individual corporation subject to tax.* [Emphasis supplied.]

The examiner clearly determined, on the basis of record, that no part of the cost of producing the revenues of the petroleum business contributes in any way to produce Gas Company's revenues. No part of Gas Company's costs, including its income tax allowance, contributes in any way to producing revenues of the petroleum entity. No part of any loss of any subsidiary corporation in the petroleum business, operated as an entity, is reflected in Gas Company's agreed cost of service. The net taxable income of Gas Company gave rise to no tax savings by the parent; the parent, in effect, see p. 174 *infra*, paid the full 52% statutory rate on the taxable income of the Gas Company.

I see no justification for crediting the Gas Company with part of the losses, thereby reducing its allowance for income taxes. To do so would result in a windfall to the Gas Company's customers and would deprive the parent of tax deductions to which it is lawfully entitled. Stated simply, the tax savings were the result of non-jurisdictional operations and were not financed by Gas Company nor in any way made possible by the inclusion of the Gas Company in the consolidated tax return group. Most assuredly, Gas Company is not entitled to tax savings arising out of foreign and domestic exploration, production, refineries, gas station operations, petrochemical, tanker and other non-jurisdictional operations. The majority view would inflict harmful consequences on the unregulated subsidiaries which the Commission is without power to cure. Unlike the case when it regulates Gas Company alone, the Commission lacks authority either to increase or decrease the prices which the non-utility subsidiaries charge for their petroleum products. Briefly, the majority proposal is a regulatory one way street.

As Examiner Kelly has correctly declared, "The Code does not contain the criteria for rate making in this case. Under the Code, one only considers whether the corporations involved are qualified to participate in the consolidated return, whether such qualified corporations have lawfully computed their respective tax liabilities, what the consolidated tax should be, and whether all other tax laws or regulations have been met * * * The Commission determines

the proper return to be allowed upon the rate base and the proper income tax allowance to make the return net to the investor, and no tax law or regulations should interfere with the performance of this function by the Commission. * * * The Commission has the full right to examine all figures in such consolidated tax return, and to ascertain from what situations or circumstances they may have resulted. There considerations are demanded by the public interest. The public interest demands that a petroleum business receive, at the hands of the Commission at least as much encouragement and incentive in the conduct of its exploration and development activities as the national policy particularly as expressed in the income tax laws, dictates."

The uncontraverted evidence of record conclusively establishes that for each of the test years selected, the inclusion of Gas Company added a cost to the consolidated return in an amount equal to 52% of Gas Company's taxable income. In 1957, the parent company paid a consolidated tax of $12,251,680 on the income of its subsidiaries of which $5,860,308 was attributable to and equal to 52% of Gas Company's taxable income. In 1958 the parent company received a tax refund of $0,367,534, but it would have received a total refund of $10,224,060 if Gas Company had not participated in the consolidated return. Thus, the parent company, in effect, paid a tax of $0,367,534, representing 52% of Gas Company's 1958 taxable income, by forgoing the additional refund in that amount. In 1959, the parent company paid a tax of $2,065,014, but it would have received a refund in the amount of $6,566,531, if Gas Company had not been included in the consolidated return. Thus, the parent, in effect, paid $0,531,545 in payment of the tax at the rate of 52% on Gas Company's taxable income. The record shows that Gas Company's taxable income was not necessary to produce tax savings in the test years.

There is no question that Gas Company would pay a 52% tax had it been considered on a separate basis. The parent, by including Gas Company in the consolidated return, added a cost thereto equal to 52% and allocated a 52% cost to the Gas Company. I fail to see where the inequity of such an allocation lies. The parent company obtains no tax or other advantage from including Gas Company in its consolidated return. Owning 100% of the stock of Gas Company, the law requires that it include this subsidiary in its consolidated return. Gas Company, being a regulated monopoly with a practically assured net income each year, is not among the subsidiaries with losses to offset against the total net taxable income of all subsidiaries having such losses. Therefore, no tax saving whatever results to the parent company from the inclusion of Gas Company in the consolidated return.

The examiner noted further, "Any immediate but perhaps temporary tax saving accomplished by the filing of a consolidated return is not in any sense comparable to a real and permanent tax saving effected by taking a lawful deduction and passing on the benefit thereof to consumers. The tax saving effected by proper deductions is a definitely known and fixed saving for the tax year, which is certainly not true of any temporary saving effected through the offsetting of business losses against business gains. It is not the mere filing of the consolidated return but the fact of business losses having been sustained in the particular tax year which permit the temporary tax saving. The distinction must be acknowledged between the fixed and certain tax saving, and the temporary, uncertain and unascertained tax saving acomplished by utilizing business losses in a consolidated return. The latter should not be used to lower a tax allowance in a cost of service."

Completely ignoring the fact that Congress has provided that taxpayers may lawfully use their tax losses to offset their taxable income in the manner pro-

vided by statute, the majority imparts its own preemptory economic and regulatory philosophy to strike down an act of Congress.

The majority cites no authority of the Commission or the Courts to sustain this onerous theory. This proceeding cannot be resolved on the basis of an imagined rationale which is in fact contradicted by the record or by the reciting of an appealing slogan. This is a clear deprivation of property without due process of law since the majority proposes to take away from the non-utility subsidiaries and the parent company valuable property rights which belong to those companies. The tax deductions given by Congress as incentives to non-utility investment should not be taken away in such manner. No company owes anyone a duty either moral or legal to incur, or to continue to incur, losses in non-jurisdictional business so that jurisdictional rates can be reduced. Following the theory of the majority, how can an integrated oil company, which also has a natural gas pipeline company within its corporate structure, compete on equal terms with an oil company not having similar pipeline operations, if the latter can use all of its tax savings in its oil business but the former cannot? Clearly, it cannot so compete.

I would reflect on a point that deserves serious consideration. All but three of the 37 corporations involved in this proceeding are, in some way, connected with the petroleum business operated by the parent company. Conceivably, the parent's business could be conducted by a departmentalized single corporate entity. If this be true, there would be no losses to offset against taxable income since the single corporation would show an overall profit although some of its departments would lose money. Under such circumstances no consolidated return would be filed and the Commission would routinely grant to the Gas Company a tax allowance based on the statutory rate of 52%. In the instant proceeding, the majority places a penalty on the parent company because it has lawfully chosen to operate its world wide business through subsidiaries. Such a regulatory policy is unsound and inequitable.

The fact remains that Congress has given the parent company, not this Commission, the right to decide whether or not it will take advantage of the consolidated return and the benefits and obligations accruing thereunder. The Commission cannot interfere with this lawful decision of management so to conduct its business. The tax laws recognize this and they have given companies the opportunity to so operate without sustaining a tax loss because of their business activities. Congress did not commit management judgments to an administrative agency; this is the line past which a regulatory commission such as ours may not go.

If the economic advantage arising out of the filing of a consolidated tax return is to be passed on to Gas Company's ratepayers, which is the effect of the majority decision, the intent of Congress will be defeated. Here, the language of the statute is plain and unambiguous and it must be given effect according to its obvious meaning. By allowing the taxpayer the full advantage provided by the consolidated return, no attendant harm results to the ratepayers. This method does not result in higher rates to the consumer, it simply does not operate to reduce them. This view is in harmony with Section 1501 of the Internal Revenue Code, is fair to the ratepayer yet it does not constitute an expropriation of the constitutional powers of Congress.

The majority decision results in glaring defects and inequities; they have not offered any valid and compelling reasons for their decision. Contrary to the views expressed by the majority, I believe every effort should be made to afford all legitimate and necessary incentives to private enterprise while, at the same time, protecting the consumer ratepayer.

The examiner who heard the testimony in this proceeding correctly concluded, upon the basis of the record evidence and the pertinent law and regulatory policy, that the Federal income tax allowance included in the cost of service supporting the settlement agreement approved by the Commission in its order of May 27, 1961, computed at the statutory rate of 52%, is not excessive or in any way improper, and should be approved. In my judgment, the examiner's decision should be affirmed.

INITIAL DECISION

UPON THE SINGLE QUESTION OF INCOME TAX ALLOWANCE

(Issued April 23, 1962)

KELLY, *Presiding Examiner:* Cities Service Gas Company (Gas Company), a corporation engaged in the transportation and sale for resale of natural gas in interstate commerce subject to the jurisdiction of the Commission, proposed, pursuant to Section 4 of the Natural Gas Act (Act), an annual increase in its jurisdictional rates and charges, by tendering for filing revised tariff sheets on May 21, 1959. The proposed increased rates were suspended by Commission order of June 19, 1959, and they became effective subject to refund pursuant to Commission order of November 23, 1959. By order of March 27, 1961, the Commission approved and made effective the "Stipulation of Settlement filed October 21, 1960, as amended" which had been agreed upon by the parties, and which reserved for future determination only the single issue of what amount of Federal income taxes was properly to be included in the cost of service underlying the approved settlement. Tariff sheets, revised to be in keeping with the agreed settlement, were ordered to be, and have been, filed by Gas Company.[1] Gas Company was required by said order to make refunds to each of its jurisdictional customers in accordance with the settlement agreement; and such refunds have been made. The Commission found that good cause existed for the termination of this proceeding except as to the one reserved issue.

On June 28, 1961, the Commission ordered a public hearing to be held on July 10, 1961, concerning the lawfulness of the rates and charges contained in the revised tariff sheets here involved, to the extent that they are, or may be, "affected by a determination of the issue of the proper amount of federal income tax allowance to be included in the cost of service underlying the settlement agreement" approved and made effective by the Commission order of March 27, 1961.

Sessions of the hearing were held on July 10, September 21 and 22, and on November 20, 21 and 22, 1961. On October 6, 1961, the Commission permitted intervention by Cities Service Company (parent company), the owner through a subsidiary, of all of the outstanding stock of Gas Company. No evidence was presented at the hearing except by Gas Company and the parent company jointly, and by the Staff of the Commission. Gas Company and the parent company have jointly filed an initial brief and a final reply brief to the brief of the Staff which was the only other party to file a brief. The final reply brief was filed March 9, 1962. While there were interveners in this proceeding who represented customer and consumer interests, no briefs were filed by any of them.

On February 28, 1961, Gas Company filed a written motion seeking the approval by the Commission of the proposed settlement which was contained in the "Stipulation of Settlement Pursuant to Section 1.18 of the Commission's Rules of Practice and Procedure", filed October 21, 1960, as modified in certain particulars. The motion recited the pertinent facts concerning the filing of the

[1] A footnote at 25 FPC 582 of the Commission order of March 27, 1961, gives the designation of the tariff sheets here involved.

CITIES SERVICE GAS COMPANY and Cities Service Company, Petitioners,
v.
FEDERAL POWER COMMISSION, Respondent.
No. 7538.

United States Court of Appeals Tenth Circuit.
Oct. 9, 1964.

Harry S. Littman, Washington, D. C. (Conrad C. Mount, Oklahoma City, Okl., Jack Werner, Washington, D. C., Geo. H. Hill, Jr., Gen. Counsel, Melvin Richter and Richard Littell, Washington, D. C., with him on brief), for petitioners.

Richard A. Solomon, Washington, D. C. (Howard E. Wahrenbrock, Abraham R. Spalter and Cyril S. Wofsy, Washington, D. C., with him on brief), for respondent.

Before MURRAH, Chief Judge, HILL, Circuit Judge, and ARRAJ, District Judge.

MURRAH, Chief Judge.

In an order of the Federal Power Commission approving a settlement of the rates charged by Cities Service Gas Company for jurisdictional gas sales, the Commission reserved for future determination the Federal income tax allowance to be included in the cost of service underlying the approved settlement. This appeal is from a final order of the Commission determining that sole issue.

The stipulated settlement included as a part of the cost of service a tax allowance based upon the statutory corporate income tax rate of 52 percent applied to the agreed taxable income of the Gas Company for the test year 1958. And, that amount would be routinely granted as a cost of service but for the Gas Company's participation in consolidated returns filed by its parent, Cities Service Company.

Having elected to file consolidated returns under Section 1501, 26 U.S.C., Cities Service was required by Section 1504, 26 U.S.C., to include all affiliates in which it owns 80 percent or more of the stock. Under the consolidated returns the total tax liability was less than it would have been if each subsidiary had filed separate returns. The reduction in the total tax liability resulted from offsetting the losses incurred by certain nonregulated affiliates against the taxable income of all other affiliates; and the Commission determined a tax allowance which reflected the so-called "tax savings" effected by the consolidated returns. The decisive question is whether the Commission, in the exercise of its undoubted power to determine just and reasonable rates for jurisdictional gas sales, may, in these circumstances, take into account the losses of nonregulated and unrelated affiliates to calculate the tax allowance includible in the cost of service of a regulated company.

The Commission recognized the fundamental rate-making principle which requires a separation of regulated and nonregulated profits and losses in the determination of the tax allowance. And see

Cite as 337 F.2d 97 (1964)

Colorado Interstate Gas Co. v. F.P.C., 324 U.S. 581, 65 S.Ct. 829, 89 L.Ed. 1206; Panhandle Eastern Pipe Line Co. v. F.P.C., 324 U.S. 635, 65 S.Ct. 821, 89 L.Ed. 1241. In obedience to this principle, the majority of the Commission rejected its Staff's theory which determined the tax allowance by taking the ratio of the Gas Company's income to the total income of the profit-making companies and applying this percentage to the total tax liability. The Commission characterized this theory as possessing "a quality of artificiality and instability which renders it unsatisfactory for rate-making purposes."

The majority of the Commission also rejected the determinations and recommendations of its Examiner who discarded the Staff's theory in favor of the settlement allowance based upon the statutory 52 percent rate. The Examiner could find no authority to support the theory that "consumers of natural gas sold in interstate commerce should have the benefit of 'tax savings' derived from business losses of unregulated corporations whose business activities are entirely unconnected with and dissimilar to those of the regulated natural gas company transporting and selling such gas."

Proceeding on the established premise that only actual costs—hence actual taxes—are properly includible in a rate base, a majority of the Commission held that the consolidated income tax liability is the "only real cost which was incurred by Gas Company in conjunction with the other Cities Service affiliates", and that to accept the Gas Company's approach based upon the statutory 52 percent rate would have the effect of determining jurisdictional rates "on the basis of converting a hypothetical tax payment into a prudent operating expense."

To comply with the rate-making principle of separating regulated and nonregulated profits and losses, and in conformity with the equally controlling actual cost concept, the majority of the Commission devised a "method to be applied in computing the Federal income taxes to be included in the cost of service of a regulated company where the company has joined in a consolidated tax return with affiliates * * * (1) separate the companies into regulated and unregulated groups, (2) determine the net aggregate taxable income of each group, and (3) apportion the net total consolidated tax liability over a representative period of time between the two groups, and among the companies in the regulated group, on the basis of their respective taxable incomes; provided that the allowance so computed for the regulated company shall not exceed what its tax liability would be for rate-making purposes, if computed on a separate return basis." [1]

As the basis for the application of this formula, the majority first selected the consolidated returns filed for the years 1957, 1958 and 1959. After separating the affiliates into regulated and nonregulated groups, the Commission determined that during the pertinent period the nonregulated companies had no net taxable income and that no tax liability should therefore be assigned to that group. The total taxable income of the regulated affiliates, which included companies regulated by other Federal and State agencies [2] was determined to

1. One Commissioner would have adopted the Staff's theory but reluctantly joined two Commissioners in applying the above described method in order to form a working majority. The other two Commissioners dissented, contending that the Examiner's recommendations should be adopted. The dissenters were of the opinion that "Apart from the fact that there are no tax savings attributable to the inclusion of Gas Company in the consolidated return, the majority view is unlawful because it has the effect of regulating nonutility enterprises beyond the Commission's jurisdiction."

2. Included by the Commission in the so-called "regulated" group, in addition to the Gas Company, are Cities Service Pipe Line Co., and Lafitte Oil Traders, Inc., both subject to regulation by the Interstate Commerce Commission, and Kansas Gas Supply Company, subject to regulation by the Kansas Commission. Also included in this group is that por-

be $61,652,662, of which the Gas Company's share was 67.93 percent. This percentage was then applied to the normalized consolidated tax liability of all affiliates, an average of $8,636,607 a year, to arrive at the tax allowance of $5,866,847. The stipulated settlement had provided for a tax allowance of $7,055,981 based upon the statutory rate of 52 percent of the net separate taxable income of the Gas Company in 1958. The difference between these two sums is the bone of contention.

We think it is legally fallacious to calculate the Gas Company's tax allowance on the basis of the consolidated tax liability of the parent Company. This approach cannot be justified by the actualities of the case. The uncontroverted facts show that the Gas Company not only incurred a tax liability during the representative years at the statutory 52 percent rate, but its tax liability at that rate was reported to the parent Company, and the consolidated returns actually reflect that tax liability.

Thus the consolidated return for 1957 shows a consolidated tax liability of $12,251,639 paid by Cities Service. If the Gas Company had filed a separate return, the consolidated tax liability would have amounted to $6,391,241, and the Gas Company's tax would have been $5,860,398 based upon the statutory 52 percent rate. The sum of these amounts precisely equals that which was actually paid by Cities Service. From this it is demonstrably clear that the inclusion of the Gas Company in the consolidated return increased the consolidated tax liability by 52 percent of the Gas Company's taxable income. No "tax savings" resulted from the inclusion of the Gas Company in the consolidated return.

Similarly, in both 1958 and 1959 the inclusion of the Gas Company in the consolidated returns directly affected the consolidated tax liability in the amount of 52 percent of the Gas Company's taxable income, notwithstanding the fact that in those years the other Cities Service affiliates had aggregate tax losses. Application of the loss carry-back provisions of the Internal Revenue Code permit the offsetting of these losses against the taxable income of these affiliates in 1955 and 1956,[3] thereby resulting in tax refunds. No reduction in the actual total tax liability was thus effected since the net effect of the inclusion of the Gas Company in the 1958 and 1959 consolidated returns was to reduce the refund by 52 percent of the Gas Company's taxable income. See table below.[4] The simple fact is that the tax liability of the Gas Company as reflected in the consolidated returns was not hypothetical, but an actual cost to the Gas Company.

[1, 2] We know, of course, that the Commission is free to choose most any method which it deems appropriate in

tion of the income of Cities Service Gas Producing Co. and Cities Service Oil Co.—Delaware—subject to regulation by the Federal Power Commission. These companies, however, are primarily engaged in the wholly unregulated oil business.

3. The regulations promulgated pursuant to § 1502, 26 U.S.C. provide in accordance with § 172, 26 U.S.C. that a net loss in any year can be carried back to the three preceding years or carried forward to the succeeding five years. 26 C.F.R. Part 1, § 1.1502–31(a) (4).

4.

Year	(1) Consolidated Tax (including Gas Company)	(2) Consolidated Tax (excluding Gas Company)	(3) Gas Company's Separate Tax	(4) Sum of (2) plus (3)
1957	$12,251,639	$ 6,391,241	$5,860,398	$12,251,639
1958	(8,857,132)	(10,224,666)	6,867,534	(8,857,132)
1959	2,065,014	(6,566,531)	9,531,545	2,065,014

the determination of just and reasonable rates for jurisdictional gas sales—usually a legitimate end justifies the means. See: Colorado Interstate Gas Co. v. F.P.C., supra; Panhandle Eastern Pipe Line Co. v. F.P.C., supra; Wisconsin v. F.P.C., 373 U.S. 294, 83 S. Ct. 1266, 10 L.Ed.2d 357. But, we know equally well that the method utilized must surely be within acknowledged jurisdictional limits which require an effective separation of regulated and nonregulated activities for the determination of the ingredients of the rate base. As applied to our case, it means a separation of profits and losses between regulated and nonregulated businesses in determining the tax allowance includible in the cost of service of the regulated company. "Otherwise the profits or losses, as the case may be, of the unregulated business would be assigned to the regulated business and the Commission would transgress the jurisdictional lines which Congress wrote into the Act." Panhandle Eastern Pipe Line Co. v. F.P.C., supra, 324 U.S. p. 641, 65 S.Ct. p. 825.

And, as we have seen, the total tax liability is not affected when the Gas Company's tax liability at the 52 percent rate is included in the consolidated returns. Rather, the reduction in the total tax liability effected by the consolidated returns is due to the losses of the nonregulated companies. But, even so, under the Commission's method, the tax allowance of the Gas Company is made to depend upon the profits or losses, as the case may be, of the nonregulated companies.

It is thus plain that the apportionment of the total tax liability among the regulated companies fails to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the Act, and which the Commission prescribed for itself. The Commission's method is therefore unauthorized and its order based thereon must be set aside.

GENERAL SERVICES ADMINISTRATION,
Washington, D.C., August 30, 1965.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Your letter of August 25, 1965, requested the views of the General Services Administration on amendment 418, intended to be proposed by Senator Dirksen to H.R. 7502, 89th Congress, a bill relating to the income of certain casualty losses attributable to major disasters.

The proposed amendment would apply specifically to the earnings and profits of corporations who file consolidated tax returns. The crux of the proposed statutory change is that transfers and receipts of Federal income tax liability shall be treated as payments or refunds of Federal income tax by all Federal agencies or instrumentalities for the purpose of establishing the cost of service, for determining the overall rate of return or for determining the net income from the regulated activities on services of a member of such affiliated group.

The effect of this amendment could be to provide a windfall, for example to a parent company, who has consistently filed consolidated tax returns for itself and its subsidiaries. Under the provisions of this amendment Federal income tax would be reduced as a cost of service for those member corporations whose earnings are high and conversely be increased for those subsidiaries whose earnings have been low. In effect, this is an "equalization" of Federal income tax payments utilizing intracompany transaction as a medium.

The result would be to increase the revenue requirements of the less profitable subsidiary companies and reduce the revenue requirements of the more profitable subsidiaries.

The result of adoption of this amendment would be to make Federal and State regulation more difficult, create fictitious or hypothetical taxes by redistribution of expense of operation. Increased difficulty or regulation would, in turn, weaken the position of the Government as a customer of utility services and enhance recurring costs.

GSA is therefore strongly opposed to the proposed amendment of H.R. 7502.

The enactment of the proposed amendment to this measure would be an increase in the budgetary requirements of all Federal agencies to an extent that cannot be estimated at this time.

The Bureau of the Budget has advised there is no objection to the submission of this report to your committee, and that the adoption of the above-discussed provisions of this proposed amendment would not be consistent with the administration's objectives.

Sincerely yours,

LAWSON B. KNOTT, Jr.,
Administrator.

DEPARTMENT OF JUSTICE,
OFFICE OF THE DEPUTY ATTORNEY GENERAL,
Washington, D.C., September 1, 1965.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR: This will refer to amendment No. 418 intended to be proposed by Senator Dirksen to H.R. 7502, an act relating to the income tax treatment of certain casualty losses attributable to major disasters.

Section 1552 of the Internal Revenue Code (26 U.S.C. 1552) presently provides that earnings and profits of each member of an affiliated group of corporations filing a consolidated income tax return as provided for elsewhere in the code, may be determined by allocating the tax liability of the group through one of several specified methods pursuant to regulations prescribed by the Secretary of the Treasury.

The proposed amendment would authorize the transfer of earnings among the affiliated member companies and would require Federal regulatory agencies to treat such transfers as payments or refunds of Federal income tax for the purposes of establishing the cost of service, of determining the overall rate of return, and of determining the net income from the regulated activities or the services of such a member of such affiliated group.

The Department of Justice is in accord with the views expressed in the report submitted to this committee by the Federal Power Commission, dated August

25, 1965, as to the effect the proposed legislation would have in the field over which the Commission has primary jurisdiction. The legislation would distort the regulatory scheme since rate proposals submitted to regulatory agencies would not reflect true costs or returns. The agencies involved would not be able properly to carry out their functions to make rate and other determinations in terms of actual costs, returns, and other considerations pertinent to the operations of the specific public utility involved, since the agencies would be required to accept the allocations made by the utility and its affiliates. Transfer of earnings and shifting of tax burdens among regulated companies could result in rate increases and additional burdens to consumers of one utility with reduced rates to users of another utility for such private reasons as may motivate the members of the affiliated groups.

This Department is concerned that such a device would lead to further distortion of the regulatory scheme where earnings are transferred to nonregulated affiliates, such as service or equipment companies, with consequent higher rate structures and costs to consumers in the regulatory area. Obversely, an affiliated company competing in an unregulated market against other independent nonregulated companies would be able to relieve itself of tax costs by shifting them to the regulated segment of the enterprise where such tax costs would be recompensed, in whole or in part, by rate adjustments. Thus, the consumers in the regulated area would pay more for the regulated service than they should and production and sales of the unregulated product would not fairly reflect costs, leading to misallocation of resources and a distorting effect upon the competitive prices.

In view of the above, the Department opposes the adoption of amendment No. 418.

The Bureau of the Budget advises that enactment of the provisions discussed above would not be consistent with the administration's objectives.

Sincerely,

RAMSEY CLARK,
Deputy Attorney General,
By BAREFOOT SANDERS,
Assistant Deputy, Attorney General.

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., August 31, 1965.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Thank you for your letter of August 25, 1965, with which you transmitted a definitive copy of amendment No. 418 to H.R. 7502 which Senator Dirksen introduced on August 24, 1965, and which varies in some respects from the earlier draft of a proposed amendment which was supplied to us by the Bureau of the Budget with the request that we give your committee our comments on it. We appreciate the opportunity to review our previous comments in the light of the differences between the draft and the amendment as later introduced.

We have carefully reviewed the amendment and compared it with the draft to which our original comments were directed. Upon the basis of such review, it appears that the only changes which may be substantive, as distinct from matters of draftmanship, are made in subsection (c)(3) and new subsection (c)(4), both providing a limitation on reductions of earnings and profits of parent corporations by reason of the operation of the preceding paragraphs. This aspect of the amendment is essentially a matter of tax policy, with respect to which the Commission takes no position.

In our comments dated August 23 on the prior draft, we expressed concern as to the last sentence of subsection (c)(1), which would appear to nullify the Commission's longstanding rule 45(b)(6) under the Public Utility Holding Company Act of 1935. The amendment does not appear to change this aspect of the prior draft, and we accordingly reiterate our prior recommendation that a clause be inserted which would specifically negative such an interpretation.

We would be pleased to have this letter and our prior letter and memorandum of comment entered on the record incident to your current committee hearings on this amendment.

Sincerely yours,

MANUEL F. COHEN,
Chairman.

MEMORANDUM PREPARED BY DIVISION OF CORPORATE REGULATION AND OFFICE OF CHIEF ACCOUNTANT, OF THE SECURITIES EXCHANGE COMMISSION, WITH RESPECT TO PROPOSED AMENDMENT TO H.R. 7502

The proposed amendment would add a subsection (c) to section 1552 of the Internal Revenue Code of 1954 (relating to earnings and profits). It would permit one or more profitmaking members of an affiliated group joining in a consolidated return agreement to transfer funds to another member of the group whose net deductions or other credits reduce the consolidated tax liability. The amount of funds so transferred would be measured by the excess of the hypothetical separate-return tax liabilities of such profitmaking subsidiaries over their pro rata shares of the consolidated tax liability as computed under section 1552(a) of the Internal Revenue Code. The subsidiary which receives such funds would, in turn, be in a position to make a distribution, by way of dividends or otherwise, to the common parent corporation, or it could retain the funds and thereby enhance the equity owned by the common parent corporation.

If adopted, the proposed amendment would negate rule 45(b)(6) promulgated by the Commission under the Public Utility Holding Company Act of 1935. That rule specifies the method in which the corporate members of a public utility holding company system registered under the Holding Company Act shall allocate the consolidated Federal income tax liability among themselves. Specifically, it authorizes the members of a registered holding company system to enter into a consolidated return agreement without the necessity of obtaining a prior order of the Commission permitting such agreement to become effective, provided that the system's consolidated tax liability is allocated among such members pursuant to either of the methods of allocation prescribed by subparagraphs (a)(1) and (a)(2) of section 1552 of the Internal Revenue Code of 1954.[1] Additional provisions of the rule limit the amount of tax which may be allocated to any one subsidiary company in the group to an amount not to exceed what such subsidiary company would otherwise be required to pay if a separate return had always been filed for such company. Most, or all, of the registered holding company systems subject to the Holding Company Act follow the so-called source-of-income method prescribed in section 1552(a)(1) of the code. Under this method, the holding company—i.e., the common parent corporation—ordinarily pays little if any of the consolidated tax since the holding company ordinarily contributes little if any to the consolidated taxable income; all or substantially all of its income is generally derived from dividends and interest from the subsidiary companies, which dividends and interest are eliminated in a consolidated tax return.

Under rule 45(b)(6), the net deductions or credits of a so-called loss subsidiary which joins in a consolidated tax return are available to, and spread on a pro rata basis among, the profitmaking subsidiaries in the system, in direct proportion to the taxable income generated by each profitmaking subsidiary. This procedure is followed under the rule on the basis that the loss subsidiary is an integral part of a single, unified economic system and the operations of the loss subsidiary are deemed to be reasonably related to the operations of the system as a whole. For example, in two of the natural gas holding company systems registered under the Holding Company Act, there are subsidiary companies which report losses from their activities relating to the exploration and production of natural gas. These operations are deemed to be reasonable related to the pipeline and retail distribution operations of the remainder of the system. Hence, under rule 45(b)(6), the deductions or credits of the loss subsidiary are required to be allocated among the profitmaking subsidiaries.

Absent rule 45(b)(6), the profitmaking subsidiaries could be made to pay over to the loss subsidiary an amount equal to the reduction in the consolidated tax attributable to the loss subsidiary. Also, where the holding company provides the affiliated group with net deductions or credits, it appears that the profitmaking subsidiaries may be made to transfer funds to the holding company for the tax reduction resulting from such net deductions or credits. The holding company would be the sole beneficiary of such payments, while the expenses of the profitmaking subsidiaries would be increased to the exten t that the amount of Federal income taxes payable by such companies is increased. This, in turn, might well result in an increase in rates paid by the consumers of such companies or might preclude voluntary rate reductions.

The Holding Company Act is concerned with the interests of consumers as well as investors. The legislative history of the Holding Company Act indicates

[1] In appropriate situations, the Commission has by order granted exceptions to rule 45(b)(6) with respect to the allocation of certain deductions or credits.

that one of the practices found to exist in public utility holding company systems was this very practice of allocating to operating subsidiaries amounts for Federal income taxes greater than their respective pro rata shares of the consolidated tax liability. See particularly "Utility Corporations" summary report of the Federal Trade Commission to the Senate of the United States (Document 92, pt. 72-A, 70th Cong., 1st sess., pp. 477-479). Thus, at page 479, the Federal Trade Commission stated:

"The subsidiary companies in a holding company group are entitled to the benefit of any savings to the group due to filing a consolidated income tax return. Only the amount of Federal income tax paid by a holding company on the basis of a consolidated return should be borne, in proportion to the taxable income, by those companies having taxable income, for which companies a consolidated return was filed. Stated differently, each company in a holding company group should pay only its pro rata share of the tax paid for the group. Then no gain room this source would be derived by holding companies."

Specifically, the sentence following subsection (c)(1)(B), which in essence requires all Federal agencies to give effect to the provisions of the proposed amendment for regulatory purposes, is the thing that troubles us. We have no reason to believe that this amendment was intended to nullify the Commission's longstanding rule 45(b)(6) which we believe is in the interest of consumers. Accordingly, we would recommend that the amendment be opposed unless a clause were inserted which would specifically negate such an interpretation.

The CHAIRMAN. The chairman recognizes first Senator Dirksen.

Senator DIRKSEN. Mr. Chairman, I feel a little like one man against the gods. This morning the Judiciary Committee is considering the administration's immigration bill. I had two calls from the White House yesterday stressing their hope and their anxiety that I could be there. Judiciary meets at 10:30, and I would like to make a preliminary statement, and then go on to Judiciary, and then come back. So, if that is agreeable, I will make this statement now.

Mr. Chairman, it was some weeks ago that I first offered this amendment, and thereafter all manner of things began to happen. Almost the following morning there was an article on the front page of the Washington Post by one Laurence Stern, who is a Post staffwriter. The title of this article is "Dirksen-Backed Tax Amendment Hit as Bonanza for Big Utility Companies."

To make sure that the whole story is told, Mr. Chairman, I consent that this article be placed in the record as a part of my remarks.

(The document referred to follows:)

DIRKSEN-BACKED TAX AMENDMENT HIT AS BONANZA FOR BIG UTILITY COMPANIES

(By Laurence Stern, Washington Post staff writer)

Senator Everett M. Dirksen, Republican, of Illinois, is quietly promoting a tax amendment that administration officials say would create a bonanza in tax and rate benefits for large utility companies.

The Dirksen amendment, which was described at a closed session Tuesday of the Senate Finance Committee, is being sought by one of the Nation's biggest pipeline companies—Tennessee Gas Transmission Co.

Senator Paul H. Douglas, Democrat, of Illinois, who called for public hearings on the Dirksen measure during the closed session Tuesday, but was voted down 7 to 5, said yesterday the amendment would "greatly weaken" Federal utility regulation.

KEY PROVISIONS

Dirksen is trying to tack the special tax bill for Tennessee Gas on a routine House disaster relief measure sponsored by Representative Al Ullman, Democrat, of Oregon. When Ullman learned of Dirksen's move yesterday he called it a "legislative travesty" and said he hoped it would be defeated.

Like almost all of the special tax measures that originate in the Finance Committee, the Dirksen proposal is baffling in its complexity.

But a key provision would prevent Federal regulatory agencies from passing on to consumers the tax savings utilities realize by filing consolidated returns. It also would allow a utility to shift its tax burden in a way that, for example, would permit Tennessee Gas to unload the tax liability of a highly competitive west coast subsidiary onto consumers in New York, Pittsburgh, and the Midwest.

Dirksen's amendment, which is being cosponsored by Senator Russell B. Long, Democrat of Louisiana, would have a direct impact on several important cases now pending before the Federal Power Commission.

One is the rivalry between Tennessee Gas Transmission and the El Paso Natural Gas Co. for the booming California natural gas market. This competition figured in the celebrated Mayflower Hotel "bugging" incident that resulted in the conviction here of three private detectives last year.

Dirksen's amendment would permit a west coast subsidiary of Tennessee Gas, the Gulf Pacific Pipeline Co., to cut its rates to customers by shifting its tax liability to the parent company.

The effect would be to transfer Gulf Pacific's tax costs in California to the rate base of Tennessee Gas customers in the Midwest and Northeastern United States, areas where the competition is not as keen as with El Paso.

Also, the amendment would require the Internal Revenue Service to credit the payment by Tennessee Gas of its subsidiary's tax bill as a reduction in earnings and profits. Ultimately this would increase the amount of tax-free dividends the company could pay to its stockholders.

RULING ON CONSUMERS

Last year nearly a third of the $43 million in dividends paid by Tennessee Gas to its stockholders were nontaxable since they were paid, technically, out of the company's capital rather than profits and earnings.

Another case centers on a Louisiana company, United Gas Corp., which is contesting an FPC ruling that it pass on $2.8 million in tax savings to consumers. The saving was achieved through the filing of consolidated returns.

Dirksen, it was learned, sat in at a 2-hour meeting last week in the office of Stanley S. Surrey, Assistant Secretary of the Treasury for Tax Policy. The subject was the Dirksen amendment. A Washington attorney for Tennessee Gas was present at the meeting.

THREE BACK DOUGLAS

The Illinois Republican was not available for comment yesterday. A Senate Finance Committee aid said the staff never discusses pending amendments taken up in executive session. A Tennessee Gas spokesman here said he knew nothing about the case.

Among those alined with Douglas in the futile effort to force the issue to public hearings were Senators Albert Gore, Democrat, of Tennessee, John J. Williams, Republican, of Delaware, and Herman E. Talmadge, Democrat, of Georgia.

The Finance Committee is expected to take up the amendment at its next closed meeting Tuesday.

The amendment would apply not only to the FPC but to other regulatory agencies such as the Federal Communications Commission and Interstate Commerce Commission.

Earlier this month Dirksen sought to tack his amendment to dilute the Supreme Court's "one-man, one-vote" on another routine House bill. That measure would have proclaimed American Legion Baseball Week.

Senator DIRKSEN. Shortly thereafter there appeared an article in Mr. Drew Pearson's column of August 24, which is entitled "Pipeline Bonanza Bill Is Pushed," and it refers to this as a sneaky attack by the minority leader.

(The document referred to follows:)

[From the Washington (D.C.) Post, Aug. 24, 1966]

PIPELINE BONANZA BILL IS PUSHED

(By Drew Pearson)

The time for the American public to really watch Congress is during the dog days of August. It is in these hectic days, when Congressmen are enjoying long

weekends and rushing bills through committee in a hurry to get home, that "Sneaky Pete" bills suddenly pop up. Most are written by big corporation lawyers who want as much secrecy as possible. For if there is too much publicity, the bills will never pass.

Today the Senate Finance Committee is considering a "Sneaky Dirk" amendment, slyly tacked onto an Oregon disaster relief bill of Representative Al Ullman, Democrat, of Oregon, by the oleo-voiced Republican Senator from Illinois, Everett McKinley Dirksen.

The amendment would be a bonanza for the big pipeline companies, especially Tennessee Gas Transmission, which operates an important subsidiary, Midwest Gas Transmission, in Dirksen's bailiwick. It would also be a bonanza for United Gas Pipe Line, the chief gasline in Louisiana, which was why Senator Russell B. Long, Democrat, of Louisiana, the Democratic whip, lined up with Dirksen, a man he usually opposes.

The "Sneaky Dirk" amendment is complicated and the attorneys for Tennessee Gas worked on it a long time before they handed it to Dirksen. It would permit Tennessee Gas, among other things, to shift its tax burden from unregulated subsidiaries to regulated subsidiaries, thus permitting regulated companies in the East to charge higher rates to consumers than unregulated companies, such as Gulf Pacific Gas, in the Far West.

PROTECTING THE CORPORATION

While complicated, the tax amendment would mean millions to the gas and utility companies affected. Yet, in the last few weeks of Congress, the Republican Senate leader, giving no explanation why he had not acted in the previous 9 months of Congress, tacked this amendment onto an obscure House bill.

Furthermore, he demanded a Senate vote without even a public hearing. When the matter came up in the Senate Finance Committee, it was debated in closed session with the public unaware of what was happening.

Senator Paul H. Douglas, senior Senator from Illinois and the Democratic opponent of Dirksen, moved to call the Chairman of the Federal Power Commission, Joseph C. Swidler, and hear him publicly. The matter was too important to be decided in closed session, Douglas argued.

No military secrets were involved, only tax favoritism. Yet seven Senators voted against letting the public know about the tax bonanza. Five voted for public hearings: Clinton P. Anderson, of New Mexico; Albert Gore, of Tennessee; Herman E. Talmadge, of Georgia; and Douglas, all Democrats, with John J. Williams, Republican, of Delaware.

Seven Senators voted against letting the public hear the issue regarding the bonanza. When I asked Tom Vail, attorney for the Senate Finance Committee, for the recorded vote, he declined to give it.

I then began the laborious process of telephoning every other member of the Finance Committee and am able to report that Dirksen and Long voted against letting the public in on the debate regarding this tax bonanza. J. W. Fulbright, Democrat, of Arkansas, Frank Carlson, of Kansas, and Wallace F. Bennett, of Utah, Republicans, were not able to attend the meeting. Carl T. Curtis, of Nebraska, had gone home because of a death in his family.

Regarding the votes of Committee Chairman Harry F. Byrd, Virginia, of George A. Smathers, Florida, of Vance Hartke, of Indiana, Abraham A. Ribicoff, of Connecticut, all Democrats, inquiries at their offices met with a blank wall of silence.

However, after the queries were made, I learned that there was huddling among Senators with a view to making the hearings today public.

Senator DIRKSEN. Now, there is another editorial, Mr. Chairman, that appeared in the Washington Post on August 25. The title of this editorial is "A Shoddy Maneuver." I ask that it be made a part of my remarks.

(The article referred to follows:)

[From the Washington Post, Aug. 25, 1965]

A SHODDY MANEUVER

If Everett McKinley Dirksen could combine his antediluvian charm with a greater respect for orderly legislative procedure, he would gain a stature befitting his position as the minority leader of the Senate. But the good Senator has a penchant for tricky maneuvers. Surely his efforts to provide a tax windfall for the Nation's largest gas pipeline company and undermine the authority of the Federal Power Commission can only be characterized as "shoddy." And the same strictures apply to Senator Russell B. Long, the majority whip, who is cosponsoring the measure.

By attaching a rider to a routine disaster relief bill that has been passed by the House, Mr. Dirksen would permit the Tennessee Gas Transmission Co. to shift the tax liability from a west coast subsidiary, operating in a highly competitive market, onto the shoulders of consumers in the East and Midwest. In addition to the tax windfall the parent Tennessee company would also gain an unfair competitive advantage by dint of the ability of its subsidiary, Gulf Pacific, to cut its rate in the competition with El Paso Natural Gas. Similar tax benefits would be heaped upon the United Gas Corp., a Louisiana company, if this measure were to become law.

No measure affecting tax rates or the scope of Federal power regulation should reach the floor of the Senate without a series of public hearings in which interested parties have an opportunity to testify. This effort to circumvent orderly procedure should be exposed and quickly rebuffed.

Senator DIRKSEN. I submit also for the record a memorandum from the Securities and Exchange Commission, which surprised me a little, because the amendment at that time was not even in print, but if the Commission does not put it in their statement, I ask leave that it be made a part of my statement.

(The memorandum referred to was previously placed in the record by the chairman with a subsequent letter dated August 31, 1965.)

Senator DIRKSEN. Now, Mr. Chairman, I would like to take a moment to examine all these matters, and in connection with these memorandums, I understand that an opinion was sought by one of the agencies from the Budget Bureau,

I thought it was a rather interesting statement. I have not seen it. I have seen it quoted in the press, and it said this is inconsistent with administration policy.

Well, my only comment, Mr. Chairman, is that if every amendment is submitted to the Budget Bureau to ascertain whether or not an amendment is consistent with administration policy, very logically you would want to submit every amendment offered on the Senate floor to the Budget Bureau before it can be considered by the Senate. I thought that was a strange business.

Now, I do not know how this thing got into public hands so quickly, nor do I care, because I have only one interest in this amendment, and that is this is no Johnny-come-lately business with me.

I will submit for the record also amendment No. 337, dated December 3, 1963, which I offered to the then pending tax bill, because we had a whole procession of witnesses, and among other things this question of the intent of Congress, and whether or not it was followed by the regulatory agencies, and whether or not it was having the proper respect. I thought they were thwarting the will of Congress, and for that reason I offered that amendment, and that is more than 18 months ago, to rather indicate that this is not a new thing.

(The amendment referred to follows:)

88TH CONGRESS
1ST SESSION

H.R. 8363

IN THE SENATE OF THE UNITED STATES

DECEMBER 3 (legislative day, NOVEMBER 29), 1963

Referred to the Committee on Finance and ordered to be printed

AMENDMENT

Intended to the proposed by Mr. DIRKSEN to the bill (H.R. 8363) to amend the Internal Revenue Code of 1954 to reduce individual and corporate income taxes to make certain structural changes with respect to the income tax, and for other purposes, viz: In section 222 of the bill, relating to the repeal of additional 2 percent tax for corporations filing consolidated returns, add the following new subsection:

( ) TREATMENT OF TAXES OF AFFILIATED CORPORATIONS BY FEDERAL REGULATORY AGENCIES.—It was the intent of Congress in granting the privilege to file consolidated returns under chapter 6 of the Internal Revenue Code of 1954 to taxpayers subject to the jurisdiction of an agency or instrumentality of the United States, and it was the intent of Congress in repealing the additional 2 percent tax for corporations filing consolidated returns, that such taxpayers have the benefits provided by chapter 6 in the same manner and to the same extent as other taxpayers. Accordingly, Congress does not intend that any agency or instrumentality of the United States having jurisdiction with respect to a taxpayer (including a member of an affiliated group as defined in section 1504(a) of the Internal Revenue Code of 1954) shall, without the consent of the taxpayer, use the income, deductions and credits which arise from and are directly related to the nonregulated activities of such taxpayer (or of another member of the affiliated group) to reduce such taxpayer's Federal income taxes for the purpose of establishing the cost of service of the taxpayer, to reduce the overall return allowed such taxpayer, to increase the net income derived from regulated activities or services, or to accomplish a similar result by any other method.

Senator DIRKSEN. Now, further, Mr. Chairman, I had the advantage of staff counsel of this committee, and I am very grateful to Larry Woodworth and others for the amount of work that they did.

I also scheduled a meeting with the Treasury, with Mr. Surrey and his staff. Senator Long and I were both to attend that meeting at 5 o'clock on a given day. Senator Long had a conflicting engagement and could not go, but I did.

Senator LONG. I believe I did arrive for a few minutes, but I could not stay.

Senator DIRKSEN. That is right.

We spent 2 hours with the Treasury and, may I say parenthetically, Mr. Chairman, I think Stanley Surrey is one of the most knowledgeable, one of the most cooperative, one of the toughest, and one of the best tax men in the country, and I have always found him highly cooperative.

When we concluded that meeting that night, I thought we had arrived at language that was acceptable to the Treasury. A few days later modifications were suggested. A few days thereafter still other modifications were suggested, and still further modifications were suggested and, as a result, before the Senate adjourned last night, I offered the amendment in a somewhat different form, evidently acceptable to the Treasury, and that amendment is numbered 426. This thing has undergone an amazing transformation, but I did not mind, and I am glad they did cooperate.

Now, I want to respond, Mr. Chairman, to the fact and to the allegations that I have taken a bill to provide income tax relief for people in

disaster areas, and have tried to hook on something in a rather sneaky fashion.

Well, I want to submit for the record a list of 11 amendments that this committee has already approved to H.R. 7502, this very bill. They deal with expropriation loss recoveries, modification of pension plans for unions, assessments by soil and water conservation districts, investment credit amendment, a joint committee amendment, nonqualified annuities amendment, a casualty loss amendment, an estate tax fraud penalty, a modification of subchapter S corporations, another amendment dealing with modifications of subchapter S corporations on capital gains distributions, and another one dealing with the repeal of subchapter R.

Now, I may say that with respect to investment credit—first, I ask to put that list in the record.

(The document referred to follows:)

SENATE COMMITTEE ON FINANCE

The Senate Committee on Finance today approved the following amendments to H.R. 7502:

Expropriation loss recoveries.—This amendment, substantially similar to S. 1291, provides rules for taxing recoveries by corporations and insurance companies of property which had been expropriated by a foreign government. Under these rules, recoveries will not be taxed if the expropriation loss did not give rise to a tax benefit. To the extent the loss did create a tax benefit, the recovery would be taxed at the rates applicable in the year of recovery. If recoveries are realized in an amount in excess of the loss deduction, the excess is treated as gain on an involuntary conversion, and will be taxed immediately unless it is invested in property of a like kind to that expropriated. The amendment also permits the tax on recoveries of property (as contrasted to cash) to be paid over a 10-year period, with interest at 4 percent, with provision for accelerating the tax if the property recovered should be sold. This amendment would apply to recoveries after 1963.

Local 738, IBT pension fund.—This amendment (context of S. 1233) assures that contributions made to the local 738, IBT-National Tea Co. employees retirement fund from May 12, 1958, to May 25, 1959, are to be deductible, and not taxed to the fund, if it is shown that the fund has not been operated in a manner which would jeopardize the interests of its beneficiaries.

Assessments by soil and water conservation districts.—This amendment broadens the deduction for soil and water conservation expenditures to include assessments by a soil or water conservation district to acquire "machines, buildings, land, or to relocate roads, or powerlines, or other obstructions" in connection with soil or water conservation. It is to apply with respect to assessment payments made in 1964 and subsequent years and also to payments before 1964 which could have been paid in 1964 or later.

Investment credit.—This amendment enlarges the limitation on the amount of the 7-percent investment credit which can be taken against tax. Instead of $25,000 plus 25 percent of tax liability in excess of that amount, the new limit would be $25,000 plus 50 percent. In addition, the amendment extends the period over which the unused credit may be carried forward by regulated transportation corporations from 5 years to 7 years.

Joint committee.—This amendment eliminates the $10,000 ceiling on authorizations for appropriations for the Joint Committee on the Reduction of Nonessential Federal Expenditures

Nonqualified annuities.—This amendment broadens section 403(b) of the Internal Revenue Code to enable universities to provide unfunded retirement programs for their employees, provided the employee is granted the option of participating under a funded program. The amendment would also extend the $5,000 death benefit exclusion under the income tax and the estate and gift tax exemption to this type of unfunded annuity.

Casualty loss.—The committee agreed to an amendment which would repeal the $100 floor on deduction of casualty losses which occur as a result of fire, storm, flood, etc., which is designated by the President to be a major disaster.

Estate tax fraud penalty, 1939 code.—This amendment changes the fraud penalty under the 1939 code estate tax provisions from "50 percent of the tax" to "50 percent of the deficiency," to conform to the penalty under the 1954 code.

Subchapter S corporations.—This amendment provides that distributions by a small business corporation made within 3 months of the close of the corporation's taxable year shall be treated as if they had been distrubuted on the last day of the taxable year if the stockholders so elect. This will eliminate "bunched" income.

Subchapter S corporations—Capital gains distributions.—This amendment eliminates a tax-avoidance device. It will prevent the benefits of subchapter S treatment from applying in the case of a capital distribution where the capital gain exceeds the ordinary income of the corporation, unless the corporation has been a subchapter S corporation for at least 3 years. An exception would make this rule inapplicable if the capital gain does not exceed $25,000.

Repeal of subchapter R.—This amendment repeals subchapter R of the Internal Revenue Code, effective January 1, 1969. (This subchapter permits a partnership to elect to be taxed as if it were a corporation.) In the interval a partnership, or proprietorship, which has elected to be taxed as a corporation may become a true corporation without payment of capital gains tax on the appreciation in value of the property which goes on to the corporation and without payment of tax on accumulated earnings.

Senator DIRKSEN. Then I wish to add an article from the Wall Street Journal which analyzed this very thing, and carries the caption "Annual Tax Saving of $50 Million for Firms Using Investment Credit Urged in Senate," and it was approved with little discussion, and there was no request for a public hearing, so I am wondering about all this furor that took place when the committee has already loaded H.R. 7502 with amendments, and there are still other amendments pending.

(The article referred to follows:)

ANNUAL TAX SAVING OF $50 MILLION FOR FIRMS USING INVESTMENT CREDIT URGED IN SENATE

(By a Wall Street Journal Staff Reporter)

WASHINGTON.—A $50 million relaxation of the rules for companies using the 7 percent investment tax credit is taking shape in Congress.

The change would especially benefit airlines, railroads, and other companies that buy large amounts of new equipment in years when their taxable profits are relatively low.

The proposed liberalization of the 1962 investment credit rules was approved by the Senate Finance Committee yesterday. It becomes an amendment to a minor House-passed tax bill dealing with property losses in disaster areas; because it is the only income tax measure moving through Congress, this bill has become a popular vehicle for Senate amendments. The Finance Committee already has approved so many new provisions that the minor House bill resembles an omnibus revenue measure.

The proposed liberalization of the 7 percent investment credit, moreover, has a good chance of final enactment. It is supported by the Treasury and had previously been introduced in Congress by Chairman Mills, Democrat, of Arkansas, of the House Ways and Means Committee. Mr. Mills has a big voice in deciding what Senate amendments survive after being attached to House-passed tax bills.

ENACTMENT AS AN INCENTIVE

The investment credit was enacted by Congress in 1962 as an incentive for businesses to purchase cost-reducing new equipment. In general, it allows a company to subtract from its final tax an amount equal to 7 percent of the cost of newly purchased equipment.

However, the 1962 law limits the amount of credit that can be claimed in any one year. The credit can be used to cancel the first $25,000 of a company's tax liability, plus 25 percent of the tax above that level; thus, a company with a tax liability of $75,000 could claim no more than $37,500 in credit for equipment purchases in any given year. If this ceiling prevented the company from claiming the full 7 percent of its eligible investment outlays, the portion of unused credit would be claimed in up to 5 succeeding years.

The amendment offered in the Finance Committee by Senator Dirksen, Republican, of Illinois, would increase to 50 percent from 25 percent the amount of above $25,000 tax liability that could be canceled by the investment credit; thus, the company with a tax bill of $75,000 could use the credit to offset payment of the first $25,000, plus 50 percent of the amount of tax above that, for a total of $50,000 in available credit.

Except for the existing dollar ceiling on credit claims, the 7 percent investment credit would produce an estimated $300 million more in business tax savings than is realized at present. The change in the formula for computing the ceiling would allow an additional $50 million a year of these taxes to be saved, according to preliminary estimates. The new computation formula would apply for equipment bought after last January 1.

The Finance Committee approved another change in the investment credit rules that would help some railroads and other regulated transportation companies. The existing law provides a 5-year carryover of unused investment credit from a previous year. The committee voted to stretch the carryover period into line with the 7-year carryover allowed these companies for business loss deductions. The additional 2 years of carryover would be available upon enactment of the bill for all equipment bought by these companies since the beginning of the 1962 investment credit. The carryover for all other companies would continue to be limited to 5 years.

Another amendment approved by the committee would suspend for calendar 1965, and after, one of last year's hard-fought tax "reforms," in the case of taxpayers living in major disaster areas designated by the President. Congress last year said that casualty loss deductions can be claimed only for losses exceeding $100. The new amendment would allow deduction of the full loss by taxpayers in disaster areas.

Some other Finance Committee provisions dealt with extremely technical parts of the income tax law. One of these parts, known as subchapter S, allows up to 10 stockholders to incorporate a business but pay tax on their shares of earnings at personal income tax rates instead of at the 48 percent corporate rate. One committee amendment is designed to prevent a closely held ordinary corporation from temporarily converting itself into a "subchapter S" company for purposes of avoiding taxes on a large capital gain. Another change would avert accidentally heavy tax payments by subchapter S company holders whose taxable years end on a date different from their companies'.

The Finance Committee hasn't yet finished acting on the series of amendments proposed for the minor House-passed bill.

Senator DIRKSEN. A Senator only this last week asked me to propose that we modify the Tariff Act to suspend the duty on nickel because of a shortage of nickel, and for all I know there will still be other amendments.

I just submit to the committee whether or not, under all the circumstances, what Senator Long and I were trying to do was a "shoddy maneuver," as the Washington Post puts it, or not. This has been out in the open, this has gone on for 18 months, and utilities and others have been working with the Treasury in the hope that they could get clarification and a better understanding by the Treasury Department where investment tax credit is involved.

Now, I add one other thing for the record, and that is an article from the Washington Post dated August 25, 1965. In the first edition this article appeared and contained two paragraphs which read as follows:

Stanley S. Surrey, Assistant Secretary of the Treasury for Tax Policy, said last night the Department had "no objection" to the measure, assuming that certain modifications it suggested were incorporated to guard against an increase in tax-free dividends and a consequent loss of revenue to the Treasury.

During yesterday's hearing the Washington Post and Columnist Drew Pearson were understood to have come under fire for reporting the proceedings of last week's closed deliberations.

Now, if we are going to make the record, let us make the record in its entirety, and if there are leaks in this committee, let us just have it out first, as well.

(The article referred to follows:)

[From the Washington Post, Aug. 25, 1965]

TAX MEASURE HEARINGS TO BE OPEN

(By Frank C. Porter, Washington Post staff writer)

Reversing an earlier vote in the Senate Finance Committee, Chairman Harry F. Byrd, Democrat, of Virginia, ruled yesterday that open hearings be held on a public utilities tax measure that opponents claim could cost Americans consumer millions of dollars yearly.

The ruling came in the midst of an acrimonious closed meeting of the committee and was a victory for Senator Paul H. Douglas, Democrat, of Illinois, who had been voted down, 7 to 5, on the issue at another closed meeting last week.

It was a defeat for Senate Minority Leader Everett M. Dirksen, of Illinois, and Senate Majority Whip Russell B. Long, of Louisiana. They had been quietly promoting the amendment to a routine House-passed bill with the support of such giant corporations as Tennessee Gas Transmission Co. and Socony Mobil Oil Co., Inc.

LIMITS AGENCY ROLE

Douglas has said the measure would "greatly weaken" the regulatory power of such agencies as the Federal Communications Commission, the Federal Power Commission, the Interstate Commerce Commission and the Civil Aeronautics Board.

In essence, it would compel these agencies to accept whatever allocation of consolidated taxpayments is made by affiliated companies for ratemaking and other regulatory purposes. Currently the agencies may determine this allocation subject to court review, to insure that tax savings are passed on to the customers of regulated industries.

Affiliated companies are permitted to file consolidated tax returns so that the deductions or losses of one are allowed to offset the earnings of others to reduce tax liability.

The Dirksen-Long amendment would permit regulated affiliates to pay unregulated affiliates for the tax "savings" due to deductions or losses contributed by the unregulated affiliates to the consolidated return.

Following is a hypothetical example:

Company A is a regulated public utility permitted to earn a 6-percent return, or $60,000, on its $1 million investment. Suppose that it does earn $60,000 in a given year after taxes computed on a separate return basis. But under the proposed amendment, it figures that the losses or deductions of an unregulated affiliate, company B, saved $30,000 on its part of the consolidated tax return and it pays this amount to company B.

This reduces its earnings to $30,000 or 3 percent of its rate base. It then goes to the regulatory agency, asking permission to raise rates to bring it a 6-percent return.

RATE-CUTTING SUBSIDY

The $30,000 payment, meanwhile, would give company B economic muscle, permitting it, say, to undercut prices charged by an unaffiliated competitor, company C, which enjoyed no such payment transfer advantage.

Opponents of the measure claim it would permit Tennessee Gas Transmission in effect to subsidize rate cutting by its affiliate, Gulf Pacific Pipeline Co., in competition with El Paso Natural Gas Co. It would do this, critics allege, by shifting tax liability to the rate base of Tennessee Gas customers in the Midwest and Northeast, where competition is not as keen.

Tennessee Gas has denied this and insisted that "each taxpayer included in a consolidated group would be required to pay its own tax with no shift of tax burden allowed."

Stanley S. Surrey, Assistant Secretary of the Treasury for Tax Policy, said last night the Department had "no objection" to the measure, assuming that certain modifications it suggested were incorporated to guard against an increase in tax-free dividends and a consequent loss of revenue to the Treasury.

During yesterday's hearing the Washington Post and Columnist Drew Pearson were understood to have come under fire for reporting the proceedings of last week's closed deliberations.

Senator LONG. Mr. Chairman, I just want to make one point.

Senator DIRKSEN. I would prefer if you would not intrude at the moment.

If the Federal Power Commission does not put in the whole case—and Mr. Swidler is the first witness—I would like to stay and hear him if I can, but I will submit and make sure that there is in the record a letter from Commissioner O'Connor which takes issue with the Commission. That letter is dated August 25, 1965, and I read only a sentence from Mr. O'Connor's letter:

> It is my opinion that the proposed amendment should be enacted for it expresses legitimate concern on the part of Congress that the national economy should be accelerated by permitting financially sound corporations to diversify and expand their operations.

That was the whole burden of the tax bill, and I heard most of the testimony, and from Henry Ford III on down, the emphasis was almost entirely upon the creation of jobs.

Yet it occurred to me that the Federal Power Commission was not carrying out the intent of Congress in that respect, and I felt this matter urgently needed attention, and I pursued it since December of 1963.

(The documents referred to were placed in the record previously by the chairman.)

Senator DIRKSEN. Now, in the light of all this, there was a court case in the Tenth Circuit Court of Appeals which came down on October 9, 1964. I read only one sentence from the opinion of the judge who wrote it, Judge Murrah, and he says:

> We think it is legally fallacious to calculate the gas company's tax allowance on the basis of the consolidated tax liability of the parent company. This approach cannot be justified by the actualities of the case.

The Commission was reversed in that case, and that happened to be Cities Service Gas Co. and Cities Service Co. as petitioners versus the Federal Power Commission. So I am going to put Judge Murrah's opinion, decision, in the record as a part of my remarks.

(The document referred to follows:)

UNITED STATES COURT OF APPEALS—TENTH CIRCUIT

(Filed, United States Court of Appeals, Tenth Circuit, October 9, 1964)

JULY TERM—1964

(No. 7538)

Cities Service Gas Company and Cities Service Company, Petitioners, v. Federal Power Commission, Respondent

ON PETITION TO REVIEW AN ORDER OF THE FEDERAL POWER COMMISSION

Harry S. Littman (Conrad C. Mount, Jack Werner, George H. Hill, Jr., Melvin Richter and Richard Littell with him on brief) for Petitioners.

Richard A. Solomon (Howard E. Wahrenbrock, Abraham R. Spalter and Cyril S. Wofsey with him on brief) for Respondent.

Before MURRAH, Chief Judge, and HILL, Circuit Judge, and ARRAJ, District Judge.

MURRAH, Chief Judge.

In an order of the Federal Power Commission approving a settlement of the rates charged by Cities Service Gas Company for jurisdictional gas sales, the Commission reserved for future determination the Federal income tax allowance to be included in the cost of service underlying the approved settlement. This appeal is from a final order of the Commission determining that sole issue.

The stipulated settlement included as a part of the cost of service a tax allowance based upon the statutory corporate income tax rate of 52 percent applied to the agreed taxable income of the Gas Company for the test year 1958. And, that amount would be routinely granted as a cost of service but for the Gas Company's participation in consolidated returns filed by its parent, Cities Service Company.

Having elected to file consolidated returns under Section 1501, 26 U.S.C., Cities Service was required by Section 1504, 26 U.S.C., to include all affiliates in which it owns 80 percent or more of the stock. Under the consolidated returns the total tax liability was less than it would have been if each subsidiary had filed separate returns. The reduction in the total tax liability resulted from offsetting the losses incurred by certain nonregulated affiliates against the taxable income of all other affiliates; and the Commission determined a tax allowance which reflected the so-called tax savings effected by the consolidated returns. The decisive question is whether the Commission, in the exercise of its undoubted power to determine just and resonable rates for jurisdictional gas sales, may, in these circumstances, take into account the losses of nonregulated and unrelated affiliates to calculate the tax allowance includible in the cost of service of a regulated company.

The Commission recognized the fundamental ratemaking principle which requires a separation of regulated and nonregulated profits and losses in the determination of the tax allowance. And see *Colorado Interstate Gas Co.* v. *F.P.C.*, 324 U.S. 581; *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 324 U.S. 635. In obedience to this principle, the majority of the Commission rejected its Staff's theory which determined the tax allowance by taking the ratio of the Gas Company's income to the total income of the profitmaking companies and applying this percentage to the total tax liability. The Commission characterized this theory as possessing "a quality of artificiality and instability which renders it unsatisfactory for ratemaking purposes."

The majority of the Commission also rejected the determinations and recommendations of its Examiner who discarded the Staff's theory in favor of the settlement allowance based upon the statutory 52-percent rate. The Examiner could find no authority to support the theory that "consumers of natural gas sold in interstate commerce should have the benefit of 'tax savings' derived from business losses of unregulated corporations whose business activities are entirely unconnected with and dissimilar to those of the regulated natural gas company transporting and selling such gas."

Proceeding on the established premise that only actual costs—hence actual taxes—are properly includible in a rate base, a majority of the Commission held that the consolidated income tax liability is the "only real cost which was incurred by Gas Company in conjunction with the other Cities Service affiliates," and that to accept the Gas Company's approach based upon the statutory 52-percent rate would have the effect of determining jurisdictional rates "on the basis of converting a hypothetical tax payment into a prudent operating expense."

To comply with the ratemaking principle of separating regulated and nonregulated profits and losses, and in conformity with the equally controlling actual cost concept, the majority of the Commission devised a "method to be applied in computing the Federal income taxes to be included in the cost of service of a regulated company where the company has joined in a consolidated tax return with affiliates * * * (1) separate the companies into regulated and unregulated groups, (2) determine the net aggregate taxable income of each group, and (3) apportion the net total consolidated tax liability over a representative period of time between the two groups, and among the companies in the regulated group, on the basis of their respective taxable incomes; provided that the allowance so computed for the regulated company shall not exceed what its tax liability would be for ratemaking purposes, if computed on a separate return basis." [1]

As the basis for the application of this formula, the majority first selected the consolidated returns filed for the years 1957, 1958, and 1959. After separating

[1] One Commissioner would have adopted the Staff's theory but reluctantly joined two Commissioners in applying the above described method in order to form a working majority. The other two Commissioners dissented, contending that the Examiner's recommendations should be adopted. The dissenters were of the opinion that "Apart from the fact that there are no tax savings attributable to the inclusion of Gas Company in the consolidated return, the majority view is unlawful because it has the effect of regulating nonutility enterprises beyond the Commission's jurisdiction."

the affiliates into regulated and nonregulated groups, the Commission determined that during the pertinent period the nonregulated companies had no net taxable income and that no tax liability should therefore be assigned to that group. The total taxable income of the regulated affiliates, which included companies regulated by other Federal and State agencies,[2] was determined to be $61,652,662, of which the Gas Company's share was 67.93 percent. This percentage was then applied to the normalized consolidated tax liability of all affiliates, an average of $8,636,607 a year, to arrive at the tax allowance of $5,866,847. The stipulated settlement had provided for a tax allowance of $7,055,981 based upon the statutory rate of 52 percent of the net separate taxable income of the Gas Company in 1958. The difference between these two sums is the bone of contention.

We think it is legally fallacious to calculate the Gas Company's tax allowance on the basis of the consolidated tax liability of the parent Company. This approach cannot be justified by the actualities of the case. The uncontroverted facts show that the Gas Company not only incurred a tax liability during the representative years at the statutory 52-percent rate, but its tax liability at that rate was reported to the parent Company, and the consolidated returns actually reflect that tax liability.

Thus the consolidated return for 1957 shows a consolidated tax liability of $12,251,639 paid by Cities Service. If the Gas Company had filed a separate return, the consolidated tax liability would have amounted to $6,391,241, and the Gas Company's tax would have been $5,860,398 based upon the statutory 52-percent rate. The sum of these amounts precisely equals that which was actually paid by Cities Service. From this it is demonstrably clear that the inclusion of the Gas Company in the consolidated return increased the consolidated tax liability by 52 percent of the Gas Company's taxable income. No "tax savings" resulted from the inclusion of the Gas Company in the consolidated return.

Similarly, in both 1958 and 1959 the inclusion of the Gas Company in the consolidated returns directly affected the consolidated tax liability in the amount of 52 percent of the Gas Company's taxable income, notwithstanding the fact that in those years the other Cities Service affiliates had aggregate tax losses. Application of the loss carryback provisions of the Internal Revenue Code permit the offsetting of these losses against the taxable income of these affiliates in 1955 and 1956,[3] thereby resulting in tax refunds. No reduction in the actual total tax liability was thus effected since the net effect of the inclusion of the Gas Company in the 1958 and 1959 consolidated returns was to reduce the refund by 52 percent of the Gas Company's taxable income. See table below.[4] The simple fact is that the tax liability of the Gas Company as reflected in the consolidated returns was not hypothetical, but an actual cost to the Gas Company.

We know, of course, that the Commission is free to choose most any method which it deems appropriate in the determination of just and reasonable rates for jurisdictional gas sales—usually a legitimate end justifies the means. See *Colorado Interstate Gas Co.* v. *F.P.C., supra; Panhandle Eastern Pipe Co.* v. *F.P.C., supra; Wisconsin* v. *F.P.C.*, 373 U.S. 294. But, we know equally well that the method utilized must surely be within acknowledged jurisdictional limits which require an effective separation of regulated and nonregulated activities for the determination of the ingredients of the rate base. As applied to our case, it means a separa-

[2] Included by the Commission in the so-called regulated group, in addition to the Gas Company, are Cities Service Pipe Line Co., and Lafitte Oil Traders, Inc., both subject to regulation by the Interstate Commerce Commission, and Kansas Gas Supply Company, subject to regulation by the Kansas Commission. Also included in this group is that portion of the income of Cities Service Gas Producing Co. and Cities Service Oil Co., Delaware, subject to regulation by the Federal Power Commission. These companies, however, are primarily engaged in the wholly unregulated oil business.

[3] The regulations promulgated pursuant to § 1502, 26 U.S.C. provide in accordance with § 172, 26 U.S.C. that a net loss in any year can be carried back to the three preceeding years or carried forward to the succeeding five years. 26 C.F.R., Part 1, § 1.1502-31(a)(4).

[4] See the following:

Year	Consolidated Tax (including Gas Company) (1)	Consolidated Tax (excluding Gas Company) (2)	Gas Company's Separate Tax (3)	Sum of (2) plus (3) (4)
1957	$12,251,639	$6,391,241	$5,860,398	$12,251,639
1958	(3,857,132)	(10,224,666)	6,367,534	(3,857,132)
1959	2,965,014	(6,566,531)	9,531,545	2,965,014

tion of profits and losses between regulated and nonregulated businesses in determining the tax allowance includible in the cost of service of the regulated company. "Otherwise the profits or losses, as the case may be, of the unregulated business would be assigned to the regulated business and the Commission would transgress the jurisdictional lines which Congress wrote into the Act." *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, *supra*, p. 641.

And, as we have seen, the total tax liability is not affected when the Gas Company's tax liability at the 52-percent rate is included in the consolidated returns. Rather, the reduction in the total tax liability effected by the consolidated returns is due to the losses of the nonregulated companies. But, even so, under the Commission's method, the tax allowance of the Gas Company is made to depend upon the profits or losses, as the case may be, of the nonregulated companies.

It is thus plain that the apportionment of the total tax liability among the regulated companies fails to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the Act, and which the Commission prescribed for itself. The Commission's method is therefore unauthorized and its order based thereon must be set aside.

Senator DIRKSEN. When I introduced this proposal in December of 1963, my colleague from Illinois took an interest. He sent not only a letter but a telegram to the Federal Power Commission with respect generally to this same subject matter, and the Power Commission wrote him on December 30, 1963. I ask, Mr. Chairman, that the Power Commission letter to my colleague be inserted in the record. It is adverse to my case, but I believe in making the whole record and putting everything in.

(The document referred to follows:)

FEDERAL POWER COMMISSION,
Washington, D.C., December 30, 1963.

Hon. PAUL H. DOUGLAS,
U.S. Senate, Washington, D.C.

DEAR SENATOR DOUGLAS: This is in response to your telegram of December 19, 1963, and your letter of December 24, 1963, requesting my comments on two recently proposed amendments to H.R. 8363, the pending revenue bill. The proposals are amendment No. 350 (Senator Bennett, Dec. 9, 1963) and amendment No. 337 (Senator Dirksen, Dec. 3, 1963). No public hearing has been held on either amendment.

On November 15, 1963, I testified before the Senate Finance Committee and on behalf of a majority of the Federal Power Commission, opposed the proposal contained in section 202(e) of the bill. This provision would forbid this Commission and other Federal agencies from recognizing for ratemaking purposes any part of the tax savings to utility companies resulting from the investment credit provisions of the tax laws. Among other things I noted that this prescription by the Congress would be a break with the practice of the past to entrust regulatory agencies with the responsiblity for determining just and reasonable rates, and I expressed the apprehension that it would result in further demands upon the Congress to decide other specific issues involved in ratemaking, thereby eroding the regulatory authority which Congress delegated to the Commission, placing rates at a higher level than might be required by the "just and reasonable" standard under which the utilities have prospered in the past, and defeating the basic purpose for creating regulatory agencies which is to make use of them to arrive at such decisions in the light of their more detailed knowledge of the economics, prospects, and changing circumstances of the utility industries.

I mention this testimony because amendments 350 and 337 are patterned after section 202(e). They would cost consumers large amounts of money and would constitute a further erosion of the regulatory process.

Amendment 350, relating to liberalized depreciation, would impose at least three requirements. First, the Commission would be required in fixing rates for natural gas companies or electric power companies to allow them to charge rates based on the assumption that they were paying the higher taxes which would be due if they were using straight line depreciation even though in fact they were using liberalized depreciation under section 167 of the Internal Revenue Act and thereby reducing their taxpayments. Second, in establishing the overall rate of return of the regulated company, the Commission would be directed to

ignore the fact that by paying rates based on constructive rather than actual tax-payments ratepayers would be supplying cost-free capital to the company. The third requirement would compel us to ignore the tax savings from using the new Treasury guidelines on depreciation.

The question of the proper ratemaking treatment for the tax effect of liberalized depreciation is one that the courts have repeatedly found to be a matter for the discretion of the regulatory agencies. *Cities of Lexington, Kentucky* v. *F.P.C.*, 295 F. 2d 109 (CA4, 1961); *El Paso Natural Gas Co.* v. *F.P.C.*, 281 F. 2d 567 (CA5, 1960), cert. denied 366 U.S. 912; *Panhandle Eastern Pipeline Co.* v. *F.P.C.*, 316 F. 2d 659, 661–663 (CADC, 1963); cert. denied — U.S. —.

A large number of the State regulatory commissions have adopted the view that the use of liberalized depreciation produces a tax saving in the circumstances of the electric and gas companies subject to their jurisdiction and therefore rates need not include, in addition to taxes paid, further amounts to establish reserves for deferred taxes. These States have required the regulated companies to flow through the savings from liberalized depreciation to their consumers by rate reductions. The Federal Power Commission is now reexamining its treatment of liberalized depreciation in the pending *Alabama-Tennessee Natural Gas Co.* case. The Commission in the past has permitted normalization of the taxes for rate purposes but has permitted only a 1½-percent return on the funds generated by the normalization. The two described requirements of amendment 350 would preclude the Commission from ever adopting a flow through of the tax savings in the rates paid by consumers, and would reverse a Commission decision, which has been upheld in the courts, by requiring a full return to the utility on excess funds supplied by ratepayers rather than a 1½-percent return as at present.

The scale of the impact on consumers of the first two requirements of amendment 350 can be illustrated by the overall figures applicable to class A and B natural gas pipelines (44 of the largest companies). Between 1954 and 1962 these companies reported an accumulation of $278 million in "deferred tax" accounts attributable to liberalized depreciation. Because of the tax effects of the 52-percent corporate tax rate, the ratepayers have contributed 208 percent of this amount, or approximately $565 million, to provide the accumulation. Natural gas ratepayers in the past 2 years have been paying upward of $100 million a year in their rates to provide the reserves required by normalization and of course, the figures would be much greater if we were to include all regulated companies.

A third requirement of amendment 350 appears to relate principally to the recently adopted Treasury guidelines on depreciation under which it is possible to calculate shorter useful lives for depreciable property and achieve a much higher depreciation allowance for tax purposes than the existing book depreciation in use for ratemaking. For example, the guideline permits a 22-year life for pipeline transmission facilities, almost a 5-percent depreciation rate, as compared to book depreciation which has been averaging about 3.3 percent based on an average 30-year life. Under amendment 350, the Commission would not be permitted to consider the additional tax saving achieved under the higher tax depreciation rate for the purpose of computing the taxes allowed in the cost of service for fixing rates. The depreciation guidelines are too new for us to estimate the dollar effect of this third requirement but, as in the case of the two requirements affecting liberalized depreciation, it would provide the regulated companies with enormous sums which would be outside regulatory scrutiny.

Amendment No. 337 would apply in cases where regulated companies use consolidated tax returns with unregulated affiliates and thereby reduce or eliminate the taxes which otherwise would be payable. The amendment would prevent the Commission in fixing rates of the regulated company from reducing the cost of service to reflect any part of the tax saving which the consolidated companies achieved by virtue of filing a consolidated return. Thus, a company with large earnings which had no taxes because of offsetting losses of an affiliate could nevertheless include a full hypothetical tax charge in its costs of service. This amendment would reverse the Commission's decision in Opinion No. 396, *Cities Service Gas Company*, issued on July 15, 1963 (Commissioners O'Connor and Woodward dissenting), which required proration of the tax benefits. The result would be an unfair penalty on the ratepayer. For example, in the *Cities Service* case, under the proposed amendment the Cities Service regulated gas affiliate would have been entitled to a cost of service tax allowance of about $7 million annually (though such amount would not actually be paid) as compared to the Commission's adjusted allowance of approximately $5.9 million based on the consolidated tax return. Industrywide figures are not available but the example and result can be multiplied by reference to the other natural gas pipeline companies effecting tax savings by the use of consolidated returns.

If section 202(e) of the House bill and Senate amendments 350 and 337 should become law they will be faithfully administered by this Commission, but we believe that they are not in the interest of gas and electric consumers or required for the protection of any legitimate interests of gas and electric companies. Moreover, they erode the regulatory process by freezing into the law grants to the utilities to earn large amounts in excess of the amounts allowable under present ratemaking standards.

I am authorized to say that a majority of the Federal Power Commission opposes the enactment of amendments 350 and 337. However, Commissioner Woodward favors the enactment of these amendments. Commissioner O'Connor favors the enactment of amendment 337, but is of the opinion that it is inappropriate to discuss amendment 350 at this time inasmuch as the regulatory treatment of liberalized depreciation is now pending before the Commission in the *Alabama-Tennessee* case.

As you requested in your letter, I am sending a copy of this letter to Chairman Byrd. Senator Magnuson, chairman of the Senate Commerce Committee, has also requested my views on these two amendments inasmuch as they would affect the Commission's regulatory authority and I have sent him a similar reply.

Sincerely,

JOSEPH C. SWIDLER, *Chairman.*

Senator DIRKSEN. When that was introduced in December, the opinion of the Treasury Department was sought, and on December 11, 1963, the Treasury Department, Mr. Chairman, wrote you over the signature of Stanley S. Surrey, the Assistant Secretary. The Treasury at that time took a dim view of my amendment and my case, and they were opposed to it, but I like to see all of the opposition represented in the record.

(The document referred to follows:)

TREASURY DEPARTMENT,
Washington, December 11, 1963.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request for the views of the Treasury Department on amendment No. 337 to H.R. 8363, the proposed Revenue Act of 1963. Amendment No. 337 would set forth the intent of the Congress as to the treatment of items of income, deductions, and credits by Federal regulatory agencies in setting consumer rates in cases where a regulated company carries on some nonregulated activities or files a consolidated income tax return with an affiliated company which carries on nonregulated activities. In substance, the substance, the amendment would provide in these cases that the income, deductions, and credits arising from the nonregulated activities, which may result in a reduction in Federal income tax liabilities, are not to be taken into account by the Federal regulatory agency in reducing rates for the regulated activityor in preventing an increase in rates which might otherwise occur.

This amendment relates primarily to ratemaking or regulatory issues rather than to questions of tax policy. It would provide broad new directives to Federal regulatory agencies in carrying out their regulatory functions as respects their treatment of Federal income tax items. Since the amendment covers all items of income, deduction, or credit, it would apply to a broad range of situations including the following:

(1) If a regulated company having income filed a consolidated return with a nonregulated company having a loss, and because of the loss the consolidated group had no tax liability, the regulated company would nevertheless be considered for ratemaking purposes as having the same tax liability it would have had if it had not filed the consolidated return.

(2) If a regulated company having income carried on a nonregulated activity which was operated at a loss, and because of the loss the company had no tax liability, the regulated portion of the company would be considered for ratemaking purposes as having the same tax liability it would have had if it had not carried on the nonregulated activity.

(3) If the tax liabilities of the regulated company were smaller because of the fact that special deductions, such as those for percentage depletion or intangible drilling and development costs, were allowed with respect to the

nonregulated activity (or a nonregulated affiliate filing a consolidated return), the regulated company would nevertheless be considered for ratemaking purposes as having the same tax liability it would have had if its actual tax liability had not been reduced by these special deductions.

The Treasury Department does not have primary responsibilities on questions of regulatory policy, and hence we are not in a position to comment on the merits of amendment No. 337. It appears, however, that the amendment raises controversial issues which should be carefully considered by the appropriate regulatory agencies and the committees of Congress. Such consideration would delay the progress of the pending tax bill in the Finance Committee as well as in the Senate and the conference committee.

It should be pointed out that the subject matter of amendment No. 337 is not directly related to any of the provisions presently contained in H.R. 8363, and the adoption of this amendment is not necessary to accomplish the major goals of the tax bill. We do not think that the prompt consideration and enactment of H.R. 8363 should be delayed by the consideration of matters which are outside the scope of the present bill, and which would inject complex and controversial new issues which would require substantial analysis and debate. As Secretary Dillon has stated in his appearance before your committee, delays in the consideration of the tax bill would involve serious economic risks. For these reasons, the Department is opposed to considering amendment No. 337 as an amendment to H.R. 8363.

The Bureau of the Budget has advised the Treasury Department that there is no objection from the standpoint of the administration's program to the presentation of this report.

Sincerely yours,

STANLEY S. SURREY, *Assistant Secretary.*

Senator DIRKSEN. So all I can say, Mr. Chairman, is that this is a funny piece of business, and why it should merit such attention and so many scold letters is more than I know.

One thing that surprises me is that in the 10th circuit the Federal Power Commission has not undertaken to take that case on appeal to the Supreme Court of the United States. Maybe they prefer to comb some other case out of the woodwork in the hope of getting a decision in another circuit, and then going to the Court.

But if I were running the Power Commission, I certainly would not wait 10 months or more before petitioning the Supreme Court on appeal to see exactly what the law is and what it is not, what the intent of Congress is, and whether at long last we are setting up a third legislative branch in Government. We have one here, the Congress; it seems we have got one over across the way, the Supreme Court, and I refer to the *Reynolds* v. *Simms* case and how the Court moved into a legislative thicket.

Now, I refer to the regulatory agencies, and if they are going to thwart and they are going to disdain the intent of Congress then, perhaps, we have a third legislative branch of Government, and if we do, it is high time that the Congress finds out what this is all about.

I do not believe, Mr. Chairman, I have anything more to say, but I wanted to be sure that this whole record, good and bad, will be in print, and I assume the hearings will be printed. I want them printed, and I am going to get copies to send out to some of these people who have undertaken to take me over the coals for what I thought was an appropriate proceeding, and for a few kind words for the business fraternity of the country.

Once upon a time, Mr. Chairman, a newspaper publisher could point to the map and get his best reporter and send him out there and say, "Go out and see what kind of scandal you can dig up." Those were the days when muckraking was in its prime and in its halcyon days.

Now, if that is the way it is going to be, all right. I have been around here too long to be frightened by oblique newspapers and columnists when I pursue the people's business. That, Mr. Chairman, brings me to the end of the story. I end on a note of levity, because we have had four, five, or six versions of this now, and the latest version I introduced last night before the Senate adjourned. As I think of all these changes of mine, I think of the drunk who got caught in a revolving door, and he would go into one cubical, and a lady in a red dress would go out on the sidewalk. When he made another swing, a lady in a green dress would be out on the sidewalk. When he made another swing, a lady in a blue dress got out on the sidewalk. Finally, the drunk lost his bearings, and while he was there topsy-turvy on the sidewalk, he looked, and he said, "By golly, it beats me how she changes her clothes so fast." [Laughter.]

I am done, Mr. Chairman.

The CHAIRMAN. Without objection, these documents will be inserted in the record.

Senator LONG. Mr. Chairman, may I make one brief statement? I think we have had the good fortune of having good statesmanship and good journalism. I personally regret very much to see what I believe is very unfair treatment of Senator Dirksen of Illinois in regard to the fact that he offered his amendment.

I have had the honor, thanks to the chairman and members of this committee, to manage some of the major committee bills that this committee has reported this year, and on occasion I have had the responsibility for defending these committee bills against some amendments which would cost as much as $3 billion, without any explanation or any pretense of explanation. The Senator just brought up his amendment and asked to vote on it, and some of those amendments have had surprisingly strong support, even though we defeated some of them amounting to a quarter of a billion dollars, which have been added to our committee bills, and no one was more surprised than this Senator in committee sessions on this very bill.

A Senator is perfectly within his right in offering an amendment cutting the depletion allowances. That would be a tax decrease of $2 billion, and no one complained about the amendment being offered. That is his privilege, and if he has the votes, that would become the committee amendment.

If a Senator has an amendment he has a right to offer it. Senator Dirksen's amendment has been around for 18 months. In the closing days of the session, any Senator who has an amendment that he thinks is a good amendment has the privilege of doing so. As I understand it, the tax consequences of this amendment would be very slight, although I also understand it is generally considered a controversial amendment. As far as I am concerned, as a member of the Finance Committee, we would have to vote that amendment up or down, ready or not, and if the Senator wants to offer his amendment, that is his privilege.

I do feel, Mr. Chairman, that the press of this city are really more responsible ordinarily, and I think even the reporter who wrote some of these stories is more responsible than to suggest that a Senator who has had an amendment printed, available for everybody to comment on for a year and a half, is doing anything improper when

he offers an amendment, particularly in a committee which is supposed to study it and look at it and is supposed to pass judgment on it.

The CHAIRMAN. The first witness will be the Chairman of the Federal Power Commission, Mr. Swidler. You may proceed, Mr. Swidler.

Senator BENNETT. Mr. Chairman, before Mr. Swidler starts, I wonder whether it would not be well to have someone explain to the committee and get into the record the difference between the amendment introduced last night and, I assume, the amendment Mr. Swidler had when he prepared his testimony.

Senator ANDERSON. I would like to know the difference.

Senator LONG. Mr. Chairman, I suggest that Laurence Woodworth, chief of staff of the Joint Committee on Internal Revenue Taxation, take the witness chair and simply explain the difference between the two.

Mr. WOODWORTH. There is no difference between these two amendments insofar as the regulatory commissions are concerned.

Senator ANDERSON. I am sorry.

Mr. WOODWORTH. There is no difference between the two amendments so far as the regulatory commissions are concerned—no difference at all. In other words, the change that has been made in Senator Dirksen's amendment, at the request of the Treasury Department, relates to an income-tax matter, and only an income-tax matter. I thought I should make that general statement before explaining how the amendment works. It does not in any way affect the features of this amendment which relate to the regulatory aspects of it.

Senator DOUGLAS. Mr. Woodworth, then do I understand that the amendment of August 30, retains the language from lines 11 to 23 on page 2 of amendment 418?

Mr. WOODWORTH. Yes, that is correct; that is correct. There is no change at all in that part of the amendment, Senator Douglas.

Senator ANDERSON. Senator Bennett said he would like to have an explanation of it to see if Mr. Swidler's testimony, written previously, might have been altered by it. Your statement now is it would not make any difference in Mr. Swidler's testimony?

Mr. WOODWORTH. That is correct.

Senator ANDERSON. So what he has written, he has prepared in advance——

Mr. WOODWORTH. That is right. As I see it, the amendment would make no difference from his standpoint, at all.

What it does, is provide in the case of the limitation on earnings and profits for income tax purposes a further restriction in the earlier Dirksen amendment. What it does can best be illustrated, I believe, by an example.

Let us take as an example a parent company with a single subsidiary. Assume that earnings and profits in the subsidiary amounted to $100, and that a payment from the parent corporation under the consolidated return agreement was supposed to be made by the parent to the subsidiary.

Let us suppose also that the subsidiary did pay dividends to the parent of $100. Under the earlier version of the amendment, when the $25 payment was made from the parent to the subsidiary in that type of case, the payment would have been allowed as a reduction in

the earnings and profits of the parent corporation and as an increase in the earnings and profits of the subsidiary.

Now, under the revised amendment it would not. The earnings and profits of the subsidiary are reduced from $100 to 0 by the dividend distribution. The $25 would under the first version of the amendment increase these earnings and profits by $25. The later version of this amendment would not permit this shift in earnings and profits to the subsidiary where after the payment there would be positive earnings and profits in the subsidiary.

As a result this is a further restriction in the amendment initially offered which was desired by the Treasury Department to be sure that it was not possible for the parent corporation to pay out any taxable distributions so long as there were any net earnings and profits in the hands of the subsidiaries. That is the entire modification made in this latest version of the amendment. The change appears in paragraph (4) of the amendment.

Senator LONG. Let me ask you now, Mr. Woodworth, isn't that more or less standard operating procedure, the way we do business? The Treasury says, "Here is something we object to in this," and you say, "Well, can you prepare language that would meet your objection?" And they prepare it, and we say, "Fine, that takes care of that."

Mr. WOODWORTH. That is frequently done; that is correct.

Senator LONG. Almost standard, if I might use a term borrowed from somewhere, it is sort of standard operating procedure. Someone says, "Here is a bug we found in your amendment. Can you prepare language to straighten it out?" "Yes, here it is," isn't that correct?

Mr. WOODWORTH. Yes.

Senator ANDERSON. Is that the genealogy of this language? Did the Treasury prepare this?

Mr. WOODWORTH. The Treasury requested a further modification, yes, and I was requested by Senator Dirksen to work with the Treasury Department yesterday, to modify the amendment to accomplish the Treasury Department objective.

Senator ANDERSON. Does that satisfy the Senator from Utah?

Senator BENNETT. It is still a little bit hazy, but I am satisfied with the original statement that it does not affect the regulatory aspects of the bill, and when we have the Treasury before us we may be able to get a more detailed explanation of how it affects the tax aspects.

Senator DOUGLAS. Mr. Chairman, I appreciate very much the courteous statement of my colleague, giving some of the background of the legislation. I welcome the opportunity to state some of the background behind this hearing, with your permission.

The CHAIRMAN. Very well.

Senator DOUGLAS. Mr. Chairman, I am not acquainted with the substance of what became amendment 418 when it was first proposed, but when the amendment was proposed in executive session a few days ago, I felt that this matter was sufficiently important to deserve a hearing. The practice, which has unfortunately developed over a period of years, of having very important tax legislation which also affected regulation considered in camera by the Finance Committee and the House Ways and Means Committee, can frequently lead us into mistakes. I know this practice has developed over a long time

and I am not putting any blame on anyone. Nevertheless, if you go back over the history of tax loopholes, you will find that a very large proportion of them have been adopted in executive meetings of the Finance Committee, without public testimony being taken either in the House Ways and Means Committee or in the Finance Committee, and that we have frequently been compelled to act on the basis of ex parte statements and very incomplete evidence.

While I was not fully aware of what was involved in this amendment and, perhaps, still am not fully aware of what is involved in it, it did seem to me of sufficient importance to justify a public hearing. So when this matter was first considered I moved that we have a public hearing.

The members of the committee in perfectly good faith felt that this was not necessary. I have never made any reflections upon them. My motion was voted down.

At a subsequent meeting of the committee I renewed my request for a public hearing, but it was not necessary to put it to a vote because of the very gracious and fair action of the chairman who, of his own free will and by his own decision, decided to order a public hearing.

My colleague has made his statement in perfectly good spirit and I felt that I should indicate some more of the background. I hope that the public hearing will bring out the various interests and points involved, and that the committee and the Congress and the general public can come to a more informed decision. That has been the sole reason for any action I have taken.

I want to thank the chairman for his courtesy throughout this matter and for his sense of fairness.

The CHAIRMAN. You may proceed, Mr. Swidler.

STATEMENT OF HON. JOSEPH C. SWIDLER, CHAIRMAN, FEDERAL POWER COMMISSION

Mr. SWIDLER. Chairman Byrd and members of the committee, I am accompanied here by Mr. Richard Solomon and Mr. David Bardin, General Counsel and Assistant General Counsel of the Federal Power Commission.

I am here in response to your invitation to discuss the treatment of consolidated income taxes by the Federal regulatory agencies, as proposed by amendment 418 to H.R. 7502.

Relying on the testimony we have just heard from committee staff, I shall assume that what I have to say is pertinent to the revised amendment which is now the business of the committee.

Senator ANDERSON. Could you use the term "applicable" as well as "pertinent"?

Mr. SWIDLER. Applicable, if you please, sir.

I appreciate the opportunity to present the views of the Federal Power Commission on the provisions of amendment 418 which could vitally affect consumers of natural gas and electric energy, which are important to the investors in the utility companies, and which seem to us to raise serious questions as to the proper administration of the Natural Gas Act and Federal Power Act. The Commission believes that the provisions of amendment 418 respecting the Federal agencies would tend to raise utility rates and to encourage utilities to alter

their corporate arrangements in a manner inimical to the public interest. These provisions would erode the Commission's responsibility to strike a fair balance between the interests of consumers and investors.

As Senator Dirksen pointed out, Commissioner O'Connor takes a different view, and his separate statement has already been made a part of the record.

The provisions of amendment 418 which concern the Federal Power Commission appear in a single sentence at lines 11–23 of page 2, as follows:

> Transfers and receipts to which the preceding sentence applies (and transfers and receipts made prior to the date of the enactment of this subsection, whether or not made under an agreement of the type described in paragraph (2), to the extent made pursuant to a consistent practice having a similar purpose and effect as such an agreement) shall be treated as payments, or refunds, of Federal income tax, as the case may be, by all Federal agencies or instrumentalities for the purposes of establishing the cost of service, of determining the overall rate of return, and of determining the net income from the regulated activities or services of a member of such affiliated group.

As we read this sentence, in its context, it would allow regulated companies which participate in a consolidated tax return and thereby reduce their taxes to allocate the tax savings in such manner as they may wish, which presumably woud be in the way which would achieve maximum returns for their stockholders.

It would require regulatory agencies to treat interaffiliate transfers of funds based on such allocations as if they were actual tax payments to the U.S. Treasury. It would thereby eliminate the present allocation standard of fairness to consumers and stockholders alike and could substantially increase rates.

The amendment could open the door to business arrangements which unfairly transfer from the consumer to the stockholder tax savings now available to reduce rates of the regulated companies. For one example, tax savings due to interest expense paid by the class A and B natural-gas pipeline companies amounted to about $138 million last year. Pursuant to established regulatory principles, these tax savings were made available to the customers in the form of lower rates. To put it differently, these savings were noncosts which could not be considered in any cost-oriented price or rate determinations. Amendment No. 418, as I shall explain in detail, raises the prospect of a shift of those savings from the consumers to the stockholders through a multimillion dollar increase in gas rates.

The sentence beginning at line 11 on page 2 of amendment 418 provides, for the future (ignoring for the time being the retroactive provision), that—

> Transfers and receipts to which the preceding sentence applies * * * shall be treated as payments * * * of Federal income tax * * * by all Federal agencies or instrumentalities for the purposes of establishing the cost of service, or determining the overall rate of return, and of determining the net income from the regulated activities or services of a member of such affiliated group.

The "transfers" referred to are transfers of funds from one affiliated company to another. They must be treated for purposes of rate regulation as if the transfer were to the U.S. Treasury whenever the "preceding sentence applies."

The "preceding sentence," commencing at line 8 of page 1 of the amendment would, standing alone, apply only to the work of the

International Revenue Service. I do not present myself as an expert on the tax code and express my understanding of the tax aspects only insofar as they bear on the regulatory provision of the amendment.

I might say I am testifying with considerable hesitation because the tax and regulatory aspects are intertwined, and they bring me to unfamiliar tax territory. I stand corrected on my interpretation of the tax aspects of this legislation if the Treasury should differ. I have tried to understand it as best I could although, as I say, I do not by any means offer myself as a tax expert.

The "preceding sentence" applies by its terms to the computation of "earnings and profits" or E. & P. as it is called, for tax purposes. The significance of "earnings and profits" under the present Internal Revenue Code is limited to the taxable status of dividends paid by a corporation to its stockholders. Specifically, to the extent that dividends are paid out of earnings and profits, the stockholder must report them as ordinary income, but to the extent that the dividends exceed E. & P. they are classified as a return of capital and are tax free to the stockholder.

To compute "earnings and profits" one must extract Federal income tax from the gross profits of the corporation paying the dividends. The concept of "earnings and profits" applies only to individual corporations. Where two or more corporations file a consolidated return, there is no such thing as a "consolidated E. & P." (since the consolidated entity does not pay out the dividends). It thus becomes necessary to allocate the actual taxes among the corporations for the limited purpose of determining the "earnings and profits" of each corporation. The present Internal Revenue Code provides three methods of allocating the consolidated income tax and permits the Secretary of the Treasury to authorize other alternatives in particular cases. This is in section 1552(a) of the code, which would immediately precede this amendment.

Amendment 418 provides that the "earnings and profits" of a corporation which are reduced by the amount of the allocated tax liability under existing law, may be further reduced by the amount of a transfer of funds from the corporation paying the dividends to any member of the consolidated tax family in accordance with "a consolidated return agreement" described in paragraph 2.

Paragraph 2 provides a complicated definition of a "consolidated return agreement" as an agreement for the transfer of funds between affiliates—it is a private agreement among the parties to the consolidated return—in such a way as to transfer the tax savings arising from consolidation to those affiliates whose "deductions or credits reduce the consolidated tax liability * * * of the group" to the extent agreed upon by the companies themselves. Thus, the amendment seems to permit a reduction in "earnings and profits" to the extent of certain transfers of funds between affiliated companies.

It is not the province of the Commission to discuss the merits of this change from the point of view of tax law. The Federal Power Commission's concern arises because the same transfer which the amendment would treat as a payment of Federal income tax for the purposes of computing "earnings and profits" would also have to be treated as a payment of Federal income tax for the purpose of computing the rates to be borne by gas and electric consumers. The danger, as we see it, is that funds transferred to a private company

and not in fact paid to the U.S. Treasury will become the basis for charges to the ratepayer as a result of the statutory fiction that the transfer is a payment of Federal income tax.

A discussion of the need for amendment 418 must be in the context of the underlying basis for Federal Power Commission regulation of the natural gas pipelines and electric power companies. Congress has provided for Federal regulation of these two industries because they are natural monopolies with respect to the customers they serve and regulation is considered a necessary substitute for competition. In the case of competitive companies presumably, as our economic system functions, income tax reductions, like other cost reductions, would ultimately be passed along to the consumer by the forces of competition. This does not happen in the case of the monopolies under regulation. There the savings presumably would not be passed along except through the regulatory process.

Senator LONG. If I might interrupt you, you recognize that is not always the case even among regulated utilities. You sometimes do have competition.

Mr. SWIDLER. It is not always the case on either side of the line, sir. Sometimes the savings are not passed along by competitive industry, and sometimes they are passed along by the noncompetitive. I say this is in general the way our economic system functions.

Neither the Federal Power Act nor the Natural Gas Act contains a detailed formula to direct the Commission in its task of regulating the wholesale prices of natural gas and electricity. As in the case of almost all regulatory legislation, State and Federal, the standard in both statutes administered by the Federal Power Commission is a general one—"just and reasonable rates." Congress delegated to the Commission the task of perfecting the detailed standards to implement this broad and general statutory guide, subject to constitutional controls and the great body of precedents which has grown up in this field. The reason for such a policy is obvious. The Federal Power Commission can be expected to acquire expert knowledge of the problems and needs of the industries it regulates and to apply its informed judgment in developing realistic rules that will keep the industries healthy while affording customers protection against excessive prices.

This indeed is the purpose of creating regulatory agencies.

In determining just and reasonable rates for the gas pipelines and electric power companies the Federal Power Commission over the years has developed a workable set of standards. In essence, the Commission allows utilities to charge rates which compensate them for their expenses of doing business plus a reasonable rate of return on their investment in utility operations. Federal income taxes have long been regarded as an operating expense to be covered by the utilities' rates. As early as 1922 the Supreme Court in the case of *Galveston Electric Co.* v. *Galveston* (258 U.S. 388 (1922)), stated that "In calculating whether the 5-cent fare"—this is an old case—

> will yield a proper return, it is necessary to deduct from gross revenue the expenses and charges; and all taxes which would be payable if a fair return were earned are appropriate deductions (p. 399).

At the same time the courts have made clear that a regulated company's actual savings in taxes "must be passed on to the consuming public" and that—

whatever Federal income taxes were actually paid for the test year should be treated as part of the cost of service * * * no theoretical amount not actually paid can be so included. (*El Paso Natural Gas Co.* v. *F.P.C.*, 281 F. 2d 567, 573 (CA5) certiorari denied, 366 U.S. 912).

Incidentally, this decision was written by Judge Tuttle, who was General Counsel of the Department of the Treasury at the beginning of the Eisenhower administration.

The amendment opens the door to dealings between regulated companies and their affiliated companies for the purpose of requiring regulatory agencies to sanction rates based not on costs but on intercompany bookkeeping entries. We believe this would not be fair to the consumers whom Congress intended the regulatory agencies to protect. For example, many natural gas and electric companies are subsidiaries of holding companies which issue all or a major portion of the long-term debt utilized in financing the construction activities of the subsidiaries.

The outstanding example is in the Bell System where a great share of the securities are issued by the holding company, A.T. & T.

Other companies could rearrange their form of business to achieve the same pattern. Interest paid to the holders of such bonds is deductible in the consolidated tax return of the group of companies and reduces the tax under the consolidated return, just as it would normally reduce the tax if a single corporation conducted the pipeline operations and issued the bonds. Under amendment 418, however, the subsidiary operating pipeline would be allowed to transfer funds to the parent company pursuant to a consolidated return agreement to reimburse the parent for the tax savings that resulted from the interest deduction contributed by the parent to the consolidated return and the regulatory agencies would be instructed to treat the payment to the parent as if it were a Federal income tax payment to the U.S. Treasury. The ratepayers would then have to bear the added amount of the transfer.

I have never heard a responsible spokesman for the regulated industries contend for such a result under existing law or under sound regulatory principles. I do not believe that such a result is supportable under our traditional notions of fairness to investors and consumers alike. Nonetheless, such a transfer resulting in increased rates is sanctioned by amendment 418.

I should explain that in virtually all regulatory proceedings involving financing by a holding company for the benefit of a subsidiary, a share, an allocable share, of the debt is assumed to have been issued by the subsidiary, and a compensating income tax adjustment is made for that purpose. This would be prohibited by the proposed amendment if the companies entered into an agreement to treat the income tax saving as a saving by the parent company.

Let me give an example. Company A is a holding company which owns and finances operating companies B and C. A issues bonds, B and C sell utility services. A pays interest on the bonds of, let us say, $20 million a year. This is a holding company. The rates of B and C must be high enough to cover the interest payments by A. The rates of B and C are also high enough to cover actual Federal income tax paid by A and B and C, after taking account of all deductions and credits, including the interest deduction, which results in a tax saving of $9.6 million, that is to say, 48 percent of the $20 million of interest.

Amendment 418 would change this. It allows B and C to pay to A, the holding company, the $9.6 million toward the savings and then to turn around and charge their customers an extra $9.6 million a year in their rates.

Amendment 418——

Senator LONG. What page are you on in your statement?

Mr. SWIDLER. I am departing from my statement.

Senator LONG. That is why I could not find it. Go ahead.

Mr. SWIDLER. The illustration in my statement seemed to me to be a little obscure, and I tried to simplify it.

Amendment 418 permits this change by splitting the tax deduction away from the people who would incur the cost and the risk. Amendment 418 allows affiliates to transfer the deductions, without the revenue to pay the deductible expense. Thus in the example B and C receive revenue to cover the $20 million expense, but the tax deduction of $20 million is siphoned off to A.

The amendment permits similar transfers of tax deductions for other business expenses, possibly even payroll costs. It permits the transfer to a nonoperating company or to any member of the affiliated group

Senator ANDERSON. May I ask a question there? You said a while ago you were not an expert on taxation. Doesn't that come under that field rather than the regulatory field?

Mr. SWIDLER. Well, the impact, Senator Anderson, comes from the fact that the amendment authorizes these companies to treat as tax payments the intercompany bookkeeping transfers that are made pursuant to their agreement among themselves, and requires the regulatory agencies to honor those intercompany agreements as though they involved payments to the Treasury.

Senator ANDERSON. But you would concede, would you not, we would need some testimony from the Treasury Department?

Mr. SWIDLER. Yes, sir. All I am talking about is the rate impact. We would be required to honor tne agreement to the extent of treating as a payment to the Treasury these transfers among the companies themselves.

Senator DOUGLAS. May I follow that up?

Mr. SWIDLER. Yes, sir.

Senator DOUGLAS. Would you be required to accept as a payment of taxes a nonpayment of taxes?

Mr. SWIDLER. Oh, yes, sir. This is the essence of the amendment, Senator Douglas, that these noncosts, these tax reductions, would have to be treated as though they were actual tax payments and reflected in the rates accordingly. It is just as though the Congress should reduce the tax rate from 48 percent to 24 percent, and then say for the remaining 24 percent that the Federal Power Commission and other regulatory agencies should treat that as though it were paid and should let the companies allocate among themselves how much of that tax savings should be utilized by one company or another.

Senator DOUGLAS. Let me see if I understand you. Are you saying that amendment 418 would permit a company to shift tax burdens from its unregulated subsidiaries to its regulated enterprises?

Mr. SWIDLER. Yes, sir; for rate purposes.

Senator DOUGLAS. For rate purposes.

Mr. SWIDLER. Yes, sir.

Senator DOUGLAS. And that the full benefit of any savings made by consolidated tax returns should accrue to the companies, and no portion to the public?

Mr. SWIDLER. That is right, sir. The only limitation on these agreements is that the operating company, the regulated company, should not pay more taxes than it would pay if it filed a separate return, but none of the savings, none of the noncosts, none of the tax reduction would redound to the regulated company if the management group wanted to arrange it otherwise.

Senator DOUGLAS. In other words, a noncost must be treated for regulatory purposes as a cost.

Mr. SWIDLER. Exactly.

Under amendment 418, the regulated companies could shift savings due to the tax deduction for interest paid by entering into a "consolidated return agreement" with the parent. The agreement would provide, in accordance with paragraph 2 of amendment 418, for transfers of funds by the regulated subsidiary equal to the amount by which its tax liability, had it been computed on a separate return basis, would have exceeded its fair share of the actual tax liability on the consolidated tax return. In the case of single subsidiary with a parent which has only interest expenses and whose revenue comes exclusively from the subsidiary, the consolidated income tax would be allocated 100 percent to the subsidiary. In addition, the subsidiary, pursuant to the agreement, would pay the parent the difference between separate return taxes and consolidated taxes. This difference would be made up of the tax savings due to the interest deduction. The transfer of funds to the parent on account of the tax savings would then have to "be treated as payments * * * of Federal income tax" by the Federal regulatory agencies for purposes of determining the subsidiary's cost of service which it would be allowed to recover through regulated rates. Thus, the consumer would pay and the stockholder would reap a windfall.

The amendment could have a drastic impact if the regulated companies generally accepted it as an invitation to restructure their form of doing business. As I have stated, transfer of the benefits of the interest deduction alone from consumers to shareholders of natural gas pipeline companies would permit rate increases in excess of an eighth of a billion dollars a year.

The vice of the amendment from a regulatory standpoint is by no means limited to its actual or potential effect as a result of intercorporate interest payments. In many existing situations where some of the members of a consolidated tax group contribute more deductions than revenues to the consolidated return, the amendment may require the ratepayers of the profitable members of the group to pay more for taxes than the Treasury actually receives from all of the companies filing the consolidated return.

Consider two affiliated companies X and Y which participate in a consolidated return under which they pay the U.S. Treasury $3 million. X, let us assume, has a net operating loss for tax purposes whereas Y has taxable income which, on a separate return basis, would lead to a tax of $20 million. Consolidation resulted in a savings of $17 million. Under amendment 418 the ratepayers of Y could be compelled by the company to bear the hypothetical cost of $20 million in the rates based on Y's cost of service. It should be noted

that an agreement between X and Y would be allowed to create those results even if Y, as an established concern, had provided managerial skills and funds at the expense of Y's ratepayers to bring X into existence; and even if the substantial risks of creating company X had rested in the early years on the ratepayers of Y as a practical economic reality.

These are conditions that are not uncommon in the natural gas-field where many of the pipelines have gone into various fields on the basis of their stability and revenue status as regulated companies. They have used their earning power and their credit from the regulated business to enter upon many other ventures. Yet these agreements would permit all of the benefits of the consolidation to go to these other ventures.

Nonetheless, amendment 418 would prescribe that tax benefits generated by combining the net operating losses of X in the early years with the income of Y could not in any way be shared by the ratepayers of Y unless management so agreed.

The "consolidated return agreements" raise a curious administrative problem under amendment 418. The long and complicated definition of "consolidated return agreement" in paragraph 2 of the amendment (p. 2, line 24 through p. 4, line 9) was created essentially for tax purposes and not for regulatory purposes. Presumably it would be the Treasury Department rather than the various regulatory commissions which would have the authority to prescribe regulations governing these agreements and, perhaps, to determine whether or not particular agreements are consistent with the act and such regulations. Yet the Internal Revenue Service of the Treasury Department would have no real interest in deciding whether particular agreements qualify except in the few cases where a regulated company believed itself entitled to pay out tax-free dividends, whereas the various regulatory commissions would have the problem before them in virtually every rate case. Thus the anomalous situation may very well be created in which the Treasury Department will be taking action under this amendment which will be of little significance to the Treasury but which would be vital to the responsibilities of the Federal regulatory agencies.

Amendment 418 also provides for regulatory recognition of interaffiliate transfers on a retroactive basis "whether or not made under" a consolidated tax agreement. The effect of such retroactive legislation, if enacted, could prejudice two pending court cases in the U.S. Court of Appeals for the Fifth Circuit involving petitions to review orders of the Federal Power Commission which allocate consolidated income taxes. In each case the utility in question disagrees with the allocation found fair and equitable by the Commission and seeks on judicial review, as is its right, to upset the Commission's order. One of these cases involves United Gas Pipe Line Co. and the tax savings achieved by consolidation with its affiliates, principally United Gas Corp. and Union Producing Co. (both of which are regulated companies). The case has a large impact on consumers, amounting to $773,000 in the test year cost of service and affecting rates which have been collected at the higher level subject to refund since January 1, 1963. (I should like to note that the $2.8 million amount shown in our letter of August 25, 1965, is an estimate of the amount which will be determined by the case as of the end of the litigation; as of now the

amount involved is approximately $2 million.) I cannot tell whether enactment of amendment 418 would necessarily upset the Commission's orders in those cases. The other one is the *Florida Gas Transmission* case, since they were tried in the context of present regulatory principles and the utilities had no reason to prove that they had made a "transfer" of the kind to which amendment 418 applies. There is a possibility, however, that enactment of the retrocative feature of the amendment would prejudice the outcome of those court cases and alter the rights of consumers and investors.

Let me say a word here about the recent *Cities Service* case referred to here by Senator Dirksen at the outset of this hearing in which the Court of Appeals for the 10th Circuit reversed a Commission decision allocating consolidated tax savings between a regulated natural gas pipeline and a large number of affiliated companies.

I might explain for the benefit of the committee the reason we did not ask the Supreme Court for certiorari in that case. There were several reasons. For one thing, after the FPC decision the company discontinued the filing of consolidated returns insofar as the regulated company was concerned, so we are talking about only a locked-in period and the case had little forward importance.

Senator ANDERSON. Are you talking about the 10th Circuit case?

Mr. SWIDLER. Yes.

Senator ANDERSON. The one Senator Dirksen referred to?

Mr. SWIDLER. Yes. It seemed to us this was the wrong case to raise the general issue because it might have gone off on minor ad hoc grounds, and that it was better to take up a case that involved the straightforward question of the authority of the Commission to allocate the benefits of savings from consolidated taxes.

Senator ANDERSON. Which were those?

Mr. SWIDLER. What is that, sir?

Senator ANDERSON. Which were those cases?

Mr. SWIDLER. The *Florida Gas Transmission*, and *United*—the two cases presented to the Commission that immediately succeeded the *Cities Service* case. Both of those have been taken to the courts, Florida Gas Transmission and United Gas.

Senator LONG. You lightly brush aside that case. But wasn't that the case on the very issue you are testifying on here, and did not the court say to you that you were wrong?

Mr. SWIDLER. Yes, sir; the court did say——

Senator LONG. Insofar as the courts decided upon it, they say what you are saying here is wrong.

Mr. SWIDLER. Yes.

Senator DOUGLAS. But the decision of the circuit court is not final law on this point, is it?

Mr. SWIDLER. That decision is final.

Senator DOUGLAS. What is that?

Mr. SWIDLER. The decision in the *Cities Service* case is final, but the question is not disposed of because we are taking up the issue in two other cases.

Senator LONG. You say you do not know of any responsible regulatory man who contends contrary to you. But, on the other hand, you say you went to the court and the court said you were wrong.

Mr. SWIDLER. No, sir. What I said was——

Senator LONG. You just got through admitting it.

Mr. SWIDLER. No, sir. What I said was——

Senator LONG. You admitted the court said you were wrong about what you are saying here.

Mr. SWIDLER. No, sir. I am sorry, sir, the court said that we were wrong about the major point of my testimony. What I said no one had contradicted the Commission on was the narrower point that the savings due to interest expense paid by a parent company should be allocated. This is only a part of the loophole that would, for regulatory purposes, be created by this amendment. But it was on that one narrow point that I said I knew of no disagreement.

Senator LONG. You say that Commissioner O'Connor does not agree with you. Does he agree with you on this?

Mr. SWIDLER. So far as I know he does.

Senator LONG. He does?

Mr. SWIDLER. On the question of treatment of interest expense, I do not think he disagrees on that.

Senator LONG. You think he agrees with you on that?

Mr. SWIDLER. I believe he does. As I understand it, he is testifying tomorrow, and if I misstate his position he will correct the record. I have never heard any expression of disagreement from him on that point.

Senator DOUGLAS. Since my friend and colleague has brought up the question of decisions inside the Federal Power Commission on this matter, may I ask if this present testimony of yours has been approved by a majority of the Federal Power Commission?

Mr. SWIDLER. The report, Senator Douglas, was approved by the entire Commission except for——

Senator DOUGLAS. The report of August 25?

Mr. SWIDLER. Of August 25. Mr. Ross was away.

Senator DOUGLAS. And your present testimony, has that been approved?

Mr. SWIDLER. No, sir. I did not have an opportunity to submit this testimony——

Senator DOUGLAS. But your present statement——

Mr. SWIDLER (continuing). To my colleagues.

Senator DOUGLAS (continuing). Is substantially the same as the report of the Commission on August 25.

Mr. SWIDLER. Yes. My statement is an elaboration of the report of the Commission.

Senator DOUGLAS. That was approved by a vote of 3 to 1.

Mr. SWIDLER. Yes, sir.

Senator LONG. How many judges on that court agreed with you? You say you were 3 to 1 on your Commission. How many judges on that court agreed with you, in the court of appeals?

Mr. SWIDLER. In the 10th circuit, sir, the entire court disagreed with the Commission.

Senator LONG. So when you went to court on the major issue—you would be 3 to 1 in your Commission, but in the court you lost by a complete zero, I take it?

Mr. SWIDLER. There is no question that we lost the *Cities Service* case in the 10th circuit, Senator Long.

Senator ANDERSON. The reason I asked the question a while ago is that all the mail we have been getting would indicate there are only two companies involved in this, Tennessee Gas and El Paso, and I

have been waiting for them to get the story. Can you explain the interest of these two companies in this when you get through?

Mr. SWIDLER. Well, I will do what I can, sir. Do you want me to try to answer that now?

Senator ANDERSON. No.

Mr. SWIDLER. As I have said, we think the 10th circuit was in error in that case and we are continuing to litigate the issue in the two cases to which I have just referred. Even assuming, however, that the court was correct in *Cities Service*, this would not mean that what I have said here today would be of only academic interest. The court made clear in reversing the Commission that it was only passing on the question "whether the Commission, in the exercise of its undoubted power to determine just and reasonable rates for jurisdictional gas sales, may in the circumstances take into account the losses of nonregulated and unrelated affiliates to calculate the tax allowance includable in the cost of service of a regulated company." The opinion of the dissenting Commissioners was similarly limited (30 FPC at p. 171). Amendment 418, however, is applicable even if all of the companies involved in the consolidated return are subject to Commission regulation.

Senator BENNETT. Mr. Chairman, before we leave the question of the court decision, and for the record, were these two cases you are taking up also decided in the 10th circuit?

Mr. SWIDLER. They are both in the fifth circuit.

Senator BENNETT. They were decided against you?

Mr. SWIDLER. They have not been decided.

Senator BENNETT. They are now in the court of appeals?

Mr. SWIDLER. They are now in the Court of Appeals for the Fifth Circuit.

Senator BENNETT. Thank you.

Mr. SWIDLER. Allocation of the benefits of consolidated tax returns involves a delicate balance between consumer and investor interests which the regulatory agencies are traditionally required to perform. It does not seem to the Commission to make sense to entrust the balance to company management when the stakes for the consumers of the Nation are so high.

The Federal Power Commission believes that the present system of administrative allocations, subject to the safeguards of judicial review, is best adapted to the proper disposition of these complicated matters. Amendment 418 goes counter to the purpose of creating regulatory agencies which are entrusted with the duty of arriving at rate decisions in light of a specialized and detailed knowledge of the economies, prospects, and changing circumstances of the utility industry.

Whatever may be the purpose of amendment 418 it is drawn with such breadth and generality that it could have wide and unforeseen consequences which would do injury to the regulatory process and to the users of utility services.

For one thing it would create strong incentives for the acquisition or creation of net loss affiliates thus introducing additional elements of speculative diversification into the utility management structure. There would be strong economic inducement for existing holding company systems or for additional systems which might be created to enter new lines of activity involving substantial risk of loss because

the risks could be transferred to the regulated customers and through them to the consumers of utility services.

Another possible consequence which could prove to raise serious regulatory problems whould be the allocation of the consolidated tax savings within the group affiliated companies in such manner as to aid one or another for competitive purposes or in order to effectuate a discrimination. If all of the savings within a group of affiliates are massed by management for the benefit of one of them the favored company can be given enormous advantages in competitive situations as compared with companies which must survive on the strength of their individual tax situation.

Needless to say, if the amendment should become law it will be faithfully administered by this Commission, but clearly, it seems to us, it is not in the interests of gas and electric consumers. We think it equally clear that it is not required for the protection of the legitimate interests of regulated gas and electric companies. Finally, we believe that it erodes the regulatory process by freezing into the law grants to some of the utilities to earn large amounts in excess of allowances under present ratemaking standards which we think are fair and reasonable. That is the conclusion of my prepared statement.

The CHAIRMAN. Senator Long.

Senator LONG. Mr. Swidler, I would be curious to know if you disagree with everything in this amendment or you disagree with that part of it that you feel affects the Federal Power Commission.

Do I understand that you said you are no tax expert, and you disqualified yourself in that regard? Do I understand it that you take no position with regard to the tax aspect of this amendment?

Mr. SWIDLER. Yes, sir. If the committee will strike lines 11 through 23 on page 2, we would have no interest whatever in this amendment.

Senator LONG. While Treasury has not authorized me to say anything with regard to Treasury's position, Treasury does not care to debate the regulatory aspects. My guess is that if we twisted Treasury's arm and made them testify about what they thought about regulation, they might be a favorable witness, but Treasury does not feel they ought to testify about your business, but rather about taxes which is their own business, and you feel you ought to testify about your business.

Mr. SWIDLER. Yes.

Senator LONG. So they do not want to argue with you about regulations, as I understand it, and they would not do it unless somebody beat them about the head and twisted their arm; they would not do it because they feel they are tax collectors and not regulators.

So I understand your position corresponds with that. You do not propose to testify on what the taxes ought to be or how they are to be handled. You want to testify on how the regulation ought to be handled.

Mr. SWIDLER. Exactly so, Senator.

Senator LONG. It is my understanding, and I wonder if you are against everything in this amendment or just against some things in it. For example, if we had two companies filing a consolidated return—let us apply it to pipelines, because you testified mainly about pipelines—let us say one pipeline is building—one is a new company

that is building—a pipeline; and the other is an old company that has a pipeline, but they are both under a consolidated return.

Now, when they make that consolidated return, the new company has no income against which to take their tax credit. If that is a big pipeline they might have many millions of dollars of tax credit which ordinarily they could carry forward into future years under tax law, and under our law, section 202(e)(2), as I recall it. This money is theirs, and you are not permitted to take it from them or even to make them give it to their consumers. This is theirs to do with whatever they want to do with it.

Now, if this new company has, let us say, a tax credit of $20 million, the old company could use it against taxes they would owe. If that situation exists, where the old company would have owed the Treasury $20 million, but they use the new company's tax credit, and by doing that the new company loses its tax credit, which later on would have been worth $20 million to them, do you feel that you have any right to object or at least would you feel that the consumers of the old company are involved in this when this old company simply passes to the new company something that is worth $20 million to them which otherwise would have been paid to the U.S. Government?

Mr. SWIDLER. I think that——

Senator LONG. In other words, in that situation would it not be irrelevant as far as the consumers are concerned whether Uncle Sam got the $20 million or the company simply paid it to the other fellow who had the $20 million tax credit?

Mr. SWIDLER. If there is no tax payable it makes a great deal of difference to consumers that they must reimburse the company for $20 million which was never paid as taxes.

Now, in the situation you mention, which is very close to the classic situation of the occasion for consolidated taxes, you have one company with a tax loss or a tax credit, and another with earnings and a tax liability, and your suggestion is that in this situation the entire benefit should go to the company with the loss. In order to realize any benefits from consolidated taxes there must be a company with a loss and a company with earnings. It seems to me from a regulatory standpoint to be most unfair that the entire benefit should go to the loss company, and that the people who pay to make the other company profitable should get none of the benefit.

Senator LONG. Well, let us just try to cover the case I am talking about now. Let us assume you have an old company with a pipeline, and they have $100 million profit. Out of that they owe $50 million in taxes. Let us assume they have $50 million left over which you think would be in this case, in this case might be, a fair return on their investment or, perhaps on that $50 million you want to make them distribute $10 million of it to their consumers, feeling that maybe $40 million would be all they are entitled to make after taxes.

But on this $50 million that they owe Uncle Sam in taxes, they have a credit, not their credit, but somebody else's credit, that they are going to use. So they use the other fellow's $20 million. That is worth $20 million to him. So that reduces their tax liability from $50 million down to $30 million.

What has that got to do with their consumers? It is just a matter of whether they are going to pay it to Uncle Sam or whether they

are going to use the other man's $20 million tax credit, and if they use it, the other man loses his $20 million credit.

Mr. SWIDLER. I may have been perverted by being on a regulatory agency, but I must say if the company only pays $30 million, I do not see why the consumer should pay $50 million.

Senator LONG. You say if they only pay $30 million in taxes. You do not see why the consumers——

Mr. SWIDLER. Yes. I do not see why consumers should reimburse the company for $50 million if only $30 million were paid.

Senator LONG. Why should the consumers reimburse them for a thing?

Mr. SWIDLER. Taxes are part of the cost of service, Senator Long. They must be reimbursed for taxes paid—this is a constitutional requirement since Galveston in 1922.

Senator LONG. Yes, I understand that. You have a problem that arises from the consolidated return. You are using the other man's tax credit; it is not yours, it is his.

Mr. SWIDLER. You are using the consumer's money. It is a two-key problem, as Justice——

Senator LONG. Why don't you write down the same thing I have down here. Write yours down, $50 on one line and $50 beneath that.

Mr. SWIDLER. Two $50.

Senator LONG. $50 million on both lines. It adds up to $100 million.

Mr. SWIDLER. Yes.

Senator LONG. All right. Put a square around the top $50 as I did.

Mr. SWIDLER. A square.

Senator LONG. That you owe in taxes to Uncle Sam.

Mr. SWIDLER. Yes, you owe $50 million in taxes.

Senator LONG. Right, to Uncle Sam.

Now, this other $50 million is what you earn. That is what you have left after taxes.

Mr. SWIDLER. Yes.

Senator LONG. That is what you have to quarrel with the Federal Power Commission and the consumer about, whether you are entitled to keep that $50 million. But this other $50 million, you owe that to Uncle Sam. But meanwhile you are using somebody else's tax credit for $20 million, and it is worth $20 million to you. It is either Uncle Sam gets the $50 million or else Uncle Sam gets $30 million, and the fellow whose tax credit you used gets the $20 million. What has that got to do with the consumer? It seems to me it is the same as if I go up to a cash register and I have a $10 bill, and I ask the man to give me 10 ones for the $10. He pushes a button and opens the cash register, and he gives me 10 ones, and the button says "no sale." What has that got to do with the consumer?

Mr. SWIDLER. The consumer would just be paying for taxes that were not charged, a fictitious amount.

Suppose, Senator Long, to take another illustration——

Senator LONG. Let us take this one because it is complicated enough the way it is. A tax credit means that if you owe taxes, you have a credit against that, and you reduce your taxes by the amount of that credit.

Now, if I use your tax credit and I pay you for it, what has that got to do with some creditor of mine?

Mr. SWIDLER. Then I misunderstood your illustration. How will you pay me for it?

Senator LONG. In cash. If I use your tax credit and I pay you for it, if you have one company and I have another, you have a tax credit and I have a tax liability, I use your tax credit and pay you for it, what has that got to do with my creditors?

Mr. SWIDLER. And the fellow who contributes the money is entitled to something for paying the taxes. Suppose there are two people, A and B, and B has a tax loss, and A is paying taxes, and the fellow with the tax loss comes and says, "Let me make a deal with you so that we can reduce our taxes together, and you can reduce the amount of taxes you pay," would he ever in his right mind suggest that the fellow with the tax loss get all of the benefit? Doesn't the fellow who paid the taxes get any of it?

Senator LONG. Let us just cover this case. You and I are in business together. We make $100 million out of which we have $50 million profit after taxes. Now, that is our profit that we are going to divide between ourselves.

You owe $50 million taxes, and you use somebody else's tax credit. What interest do I have in that? I have an interest in the $50 million we have left after taxes. If I am a consumer in this case, what interest do I have in your tax liability, whether you pay it with cash or you pay it using the other man's tax credit?

Mr. SWIDLER. Well, you have a very strong interest in not paying in rates any more than the company pays in taxes and in not reimbursing the company for a tax it did not pay.

Senator LONG. But, you see, we are not talking about the taxes I am going to pay. All we are talking about are the taxes you are going to pay, and I have no interest in that.

Mr. SWIDLER. But the consumer has an interest in his rates, Senator Long.

Senator WILLIAMS. You were in business together a moment ago. [Laughter.]

Senator LONG. Frankly, if we cannot agree on this problem, then I have to agree with the court of appeals that you are just wrong. It seems to me that if you are using somebody else's tax credit, if he has a $20 million credit, and you are in a consolidated return, you use his credit and he loses it, so he is out a $20 million credit. It is worth $20 million to you. You pay it to him. You pay him his $20 million. It seems to me anybody you are doing business with has no interest in that transaction, and I cannot, for the life of me, see how you feel that the consumer has a right to claim a rate reduction for the fact that someone used the other man's tax credit, because otherwise he would have paid it to Uncle Sam in taxes. He would not have given it back in reduced rates.

As I understand it, you would have allowed it to the man as a reduction of his profits because he paid it out in taxes.

Mr. SWIDLER. What I say is that if there is a saving from consolidated taxes that reduce the costs, or if no taxpayment is made, why should the consumer reimburse the company for a nonpayment any more than it would reimburse him for overtime that was not paid or a higher tax rate that was not charged? This is a noncost. The company just never paid out the money in taxes.

It seems to me that there may be room for looking at special circumstances; there is always a problem in allocating the benefit of the

savings. But I see no fairness in allocating none of it to the the ratepayer who provides all the money.

Senator LONG. Let us take this point again Senator Douglas asked you: Is this a noncost? You said, yes, you agree it is a noncost. All right.

Let us take the same figures again. Here is a company that owes $50 million in taxes. In paying their taxes they use either a brother and sister corporation or a subsidiary's tax credit, so they use his tax credit which to them is worth $20 million, and he loses $20 million when they use it. Under a consolidated return you do not carry that tax credit forward, you use it that year when the other man uses it.

When you lose your $20 million tax credit in the new company, and the old company uses your $20 million tax credit, and then he proceeds to pay you $20 million for it which he owes you, do you mean to tell me that is not a cost of doing business, to pay him for something that was worth $20 million to you which in the future would have been worth $20 million to him if he was not in a consolidated return?

Mr. SWIDLER. Of course, it is not a cost as long as it is not paid; it is obviously not a cost.

Senator LONG. When you do pay him you give him the money in cash, $20 million, which you owe him.

Mr. SWIDLER. You would never give it to him if you were not part of a holding company system. You would never do it in arm's-length bargaining.

Senator LONG. You would not pay it to him if you did not owe it to him. You have a new company and you built a new pipeline out here, and you are a minority stockholder in that company, and you do not own any stock in the parent company, and he owns stock in the parent company, and no particular interest in that subsidiary company.

If this parent proceeds to use up your $20 million tax credit and does not pay you for it, you can sue him. I do not know whether the Federal Power Commission would help, but any honest court would make me pay him for what I used. If I were even a minority stockholder, I would make him pay you for it. Isn't that right? It is a cost.

Mr. SWIDLER. But when you use it that does not make it a cost. It is a reduction in your tax.

Senator LONG. Well, you have got to call it something, and if I pay you $20 million I owe you——

Mr. SWIDLER. Well, you would not owe it unless you had an intercompany memorandum dictated by people at the top.

Senator LONG. All right. What would you call it then? You used the other man's $20 million and it saved you $20 million in taxes. What would you call it?

Mr. SWIDLER. I would call it a tax saving.

Senator LONG. A tax saving.

Mr. SWIDLER. Yes, sir.

Senator LONG. All right. So you made a tax saving of $20 million. What would you call it when you paid it for him? What is it to him?

Mr. SWIDLER. Well, to him, assuming that this is something that company management dictated, you get in cash $20 million, but it is a bonanza.

Senator LONG. You say it is a bonanza to pay a man $20 million for something that is worth $20 million to you, and he loses something worth $20 million when you do not pay it?

Mr. SWIDLER. It seems to me when you pay the other fellow in cash for a contingent tax claim, he is a very lucky man. You would normally not want to do that unless you got something out of it.

Senator LONG. Well, when you file a consolidated return you lose the right to carry forward your deductions, your losses and your tax credit. You understand that when you come under a consolidated return you lose that right?

Mr. SWIDLER. I do not——

Senator LONG. You lose your carry forward.

Mr. SWIDLER. I do not pretend to be a tax expert here; no, sir. I understand what you have said, but I do not claim a detailed understanding of the tax aspects.

Senator LONG. Well, if you do not understand it I can understand some of your testimony. [Laughter.]

Mr. SWIDLER. I did not claim to be a tax expert.

Senator LONG. But the point is when you file the consolidated return, and this man is a new company with you in the same consolidated return, you have profits, he has a big investment credit, so he loses his investment credit, and that is used to pay the taxes that are owed on the other man's business—on the other man's operation. I am talking about this point because this is the point I understand and my mind is unquestionably right about this amendment. When you use his tax credit and he loses it, you owe him something for it, and when you pay him for it you are paying him out of money you would otherwise have owed Uncle Sam. You just got through calling it a tax saving. All right. So you are paying him for the tax saving you made at his expense.

Mr. SWIDLER. Well, Senator Long, I think perhaps the reason that this seems fair to you is that you are thinking in terms of a constant rate. You say here is a consumer paying at a constant level and why shouldn't he keep on paying at that level simply because the regulated company in 1 year took some of the money that would otherwise be paid to the Treasury, and paid it to an affiliate.

But suppose that the amount of the payment made the difference between continuing at the same rate or getting a rate reduction or worse, continuing at the same rate or facing a rate increase. These rates fluctuate from year to year, and I do not know any fairness in saying that the regulated company must continue to pay as though it were filing a separate return when, in fact, the return is a consolidated return, and there are substantial tax savings.

Senator BENNETT. Will the Senator yield to me?

Senator LONG. If you don't mind, I would just like to finish my few questions and then I would be glad to let other Senators ask their questions.

Now, you and I know that under the law, and I assume that you respect an act of Congress, that you are not permitted to make a company pass on to its consumers investment credit. You wanted to do that. I did not agree with you on that. I thought it ought to be an incentive to build new pipelines.

Mr. SWIDLER. Yes.

Senator LONG. Any my position prevailed in the Congress, in both the House and the Senate. Now, as between two sets of customers, suppose when you go to build a pipeline, the people on the other end have enough competition between carriers, and they put the pressure on these fellows and say, "We are not going to sign a contract with you unless you make a contract better than the other follow." That is where you have competition among carriers, all of them trying to get the business.

Suppose these people would sign a contract and say, "All right, I will give you my tax credit; I will just pass it on through to you and you can have it, and I will do that in order to get the business," just like when you sell automobiles, you make a better deal in selling a fleet of them than you would to sell just one. Well now, as between the two sets of customers, if they are under a consolidated return, which set of customers would have the better claim on that tax credit? Wouldn't it be the customers who are being served by that pipeline or the customers who are not being served by that pipeline?

Mr. SWIDLER. Senator Long, I think maybe we are drifting into a hypothetical case which may come so close to actual transactions that I would be commenting on something that the Commission might one day have to decide. I think, perhaps, I had better not try to answer that question beyond my restating my feeling that the fellow who pays the tax ought to get some of the benefit.

Senator LONG. Well, I think the difference between us is fairly clear on that.

In other words, it is my feeling that the underlying principle involved in the amendment is that the tax savings or benefits should be allocated to the corporations which gave rise to the savings or benefits. In other words, if one company spends money in making an investment, it is to receive the benefit of the investment credit which flows from this. This is true whether this is a regulated company or an unregulated company. Why shouldn't the tax benefits be allocated to the company which gives rise to them? If the company making the investment is a regulated company isn't there a chance that this will increase the benefits going to the consumers associated with that company?

Mr. SWIDLER. Well, there are two things about that, Senator Long. In the first place, as I understand the amendment, it would not necessarily work that way because by agreement the tax benefits could either go to the fellows who had the losses or it could be shifted some other way. This is a matter for the company management to decide and not the regulated agency or, for that matter, probably the Treasury either.

My second comment on it is to reiterate that the fellow who pays the rates which provide the money with which to make these payments ought to get at least a share of the benefits. He ought not to pay the full tab without any recognition of the fact that it is his money.

Senator LONG. Well, you see, you and I arrive at a different conclusion. My thought about this matter is that you are talking about a tax liability that one man owes. He reduces his tax liability by using either the credits or deductions belonging to the other man, and he pays him for that. It seems to me that insofar as he pays him for this out of money that he would otherwise have owed in taxes, it is completely irrelevant and makes no difference whatever to his cus-

tomers, whether Uncle Sam gets it or whether he uses somebody else's tax credit, thereby reducing his liability to Uncle Sam.

I take it you feel his consumers have a claim on the taxes that he would otherwise have paid to the U.S. Government.

Mr. SWIDLER. If the money must go either to the Treasury or to an affiliated company, then it makes no difference to him. But if he can get a share of the benefit of the tax savings it makes a lot of difference to him, and this is something that we think he is entitled to.

Senator LONG. Let me get to just one other point here now. You had this very point that you are now arguing about before the 10th Circuit Court of Appeals. You lost the case. You did not take certiorari. You did not apply, you did not appeal, you did not want to.

Mr. SWIDLER. That is right.

Senator LONG. You struck out, you didn't get a single point in your favor before that court.

If I had had that case, and I had pleaded the case and lost it, I would have felt that the court has decided, and I would either appeal to the Supreme Court or I would admit that is the law of the land.

What right do you have when you lose a case before the court of appeals to say that is not the law, and to continue on the basis that the court is wrong and that is not the law?

Mr. SWIDLER. Well, sir, when there is an adverse decision the question that is always presented to counsel is whether this is the proper case to try to take to the Supreme Court in order to get a decision on the basic issue. This seemed to be a case which might well have run off into the rabbit trails, to be decided on collateral ground, and for that reason we did not think it was the right case to take up. We are proceeding to get the question decided. We are not——

Senator LONG. Do you respect a decision of a court of appeals from which you elect not to appeal? Do you respect that as being the law of the decision of the court of appeals from which you elect not to appeal?

Mr. SWIDLER. It is the law of that case, but I do not think that any one court of appeals sets the law for the country. There are 11 of them. We, I think, have the responsibility for taking these questions up in an orderly way to get the decision of the Supreme Court, and this we are trying to do.

Senator LONG. I must say, Mr. Swidler, that is something which is difficult for me as a lawyer to understand. If you sue me in Louisiana and I lose that lawsuit in that district court, I have only one court of appeals I can go to, and that would be the fifth circuit, and I am not happy about that court. I have a minimum high regard for that court. But that is the only court I can go to, and I cannot go to any other one. As far as I am concerned that is the law. I can either appeal or take it on the chin right then and there, and that is the law.

As I understand it you can decide that you are going to go into court, and after the court decides against you, you don't have to ask that the case be appealed. Instead you can seek a different court decision in another circuit. Let us face it, you Federal boys can do some things that we citizens cannot do.

Mr. SWIDLER. No. I think it works probably the other way around. After all, you must remember that the people who appeal our decisions have quite a bit of freedom in where they will seek review, and that the choice of forum is theirs and not ours.

Now, I think what is left for us is the question whether any given decision is one (*a*) that merits taking the time of the Supreme Court.

Senator LONG. Hold on just a bit, let us not kid ourselves about why you did not appeal that case. You lost by a unanimous decision of that court. If you appeal that case you are just standing ready to have them tell you "cert. denied" and it is all over with then. So what do you want to do? You want to get into some other court, and to try it all over again, and you want to pick up one judge, maybe Tuttle. So when you are asking for certiorari, you are not fighting a unanimous decision of the court of appeals. That is what you are doing.

Mr. SWIDLER. Sir, what you say is speculative.

Senator LONG. You took that into consideration when you made that decision, did you not?

Mr. SWIDLER. I am not going to pass on your qualifications as a mindreader. They may be very good, but I am trying to respond very seriously to you and say that the decision not to apply for cert. was based on the fact that this was too narrow a case, and did not seem to be the case that raised the broad questions and that we risked taking up a case that could go off on a minor ground.

Senator LONG. And nothing else?

Mr. SWIDLER. As far as I am aware, nothing else.

Now, we are not dropping the question, we are pursuing it. It is involved in two current cases, and we hope in the near future to get this question resolved in the Supreme Court.

Senator LONG. Well now, let us just understand this. When these Washington newspapers, and the morning paper which I respect as being a good paper, and I respect the reporter as being a good reporter, but when this reporter undertook to suggest that Senator Dirksen was doing something mischievous or something that was not right, Senator Dirksen was undertaking to support the decision of the court which, as far as I am concerned, makes it the law inasmuch as you do not want to appeal it. You people are the ones who are trying to avoid respecting that decision where you yourself went into court and the court ruled that you were wrong about it, so you want to try the case somewhere else rather than appeal it.

As a practical matter, the main point we have here at issue is a case where you are declining to respect the decision of the court of appeals, that you declined to appeal, as being the law.

Mr. SWIDLER. I tried to explain, sir, why it did not seem the appropriate case to apply for cert (certiorari). Even if cert had been applied for and denied, this would not necessarily set the law. The law is set by the Supreme Court and not by one of the circuits, nor is the law determined by the denial of cert. The Supreme Court has repeated again and again that denial of cert is not to be taken as any expression on the merits. This was not an appropriate case, we were open about our position, we announced that we intended to adhere to it, and that we would try to take it up in an appropriate case, which we are now doing.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. Mr. Swidler, your statement, the questions of the Senator from Louisiana, and your replies thereto have all been very clear, illuminating, and informative. I am confident that every member of the committee and all other interested parties thoroughly understand it, but I am going to admit that as a layman I am confused.

I am wondering if you won't drop all hypothetical cases, drop the generalities, and get down to the issue. Tell us just exactly how the approval of this amendment would affect the fortunes of the Tennessee Gas Transmission and El Paso.

Senator DOUGLAS. What is the question of the Senator from Delaware? How would it affect Tennessee Gas?

Senator WILLIAMS. Just tell us how this particular amendment would affect both of them, because that is before us, and I would like to know in clear layman's language.

Senator LONG. Senator Williams, I would quarrel with that statement. This is a piece of general legislation. It would undoubtedly affect those two companies. It would affect any company filing a consolidated return subject to regulation. There are many other companies that the Senator referred to, and I do not object to his discussing anything that has got to do with Tennessee or El Paso Gas, and I might say I feel it is unfair—I might say to John, and you are not an unfair man—to suggest that this is all that is involved in this amendment.

Senator WILLIAMS. No, it is not all that is involved, I am not saying that at all. But I could understand if we got down to the issue, and if you have some other cases to put in I think I could understand them better than the hypothetical cases.

Senator ANDERSON. That is the reason why I raised a while ago the question, because all the correspondence I have got comes from El Paso or Tennessee What is the fight about?

Senator WILLIAMS. That is what I want to know.

Mr. SWIDLER. Well, I do not want to be evasive, Senator Williams, but my problem is that this is a hard fought competitive hearing before the Federal Power Commission. Both companies have applied for certificates for service to southern California. Southern California is the Nation's largest and fastest growing market for natural gas. At the present time the major supplier to that market is El Paso.

Tennessee Gas Transmission Co., through its affiliate, Gulf Pacific, has applied for a certificate to share in that market.

Now, this is a proceeding which is now before an examiner of the Commission for decision. The parties have filed their briefs, including the staff of the Commission, and the examiner has yet to render his decision. When the examiner has handed down a preliminary decision, the case will undoubtedly come on exceptions to the Commission for final decision.

I might say there are other parties to that proceeding as well, Transwestern Pipeline Co., for one, which has also filed to expand its facilities for service to southern California.

Now, there is a part of the case which involves questions of gas supply, the reserves and that sort of thing. A part is also involved in the comparative cost of service. Now, this seems to be the nub of it. I want to go as far as I can without saying anything improper,

Senator Williams. This seems to be the nubbin of the impact of this bill on that proceeding.

I have here a statement which was handed me this morning by the Southern California Edison Co. in which the company quotes from the agreement between the Southern California Edison and the city of Los Angeles, on the one hand, the purchasers of the gas, and Gulf Pacific, on the other, which will be the carrier of the gas. I have not had a chance to analyze it thoroughly, but the substance of it seems to be that the purchasers will get the benefit of a tax savings by Gulf Pacific. (The full text of statement submitted by Southern California Edison Co. appears on p. 223.)

This is also reflected in a release by the Tennessee Gas Transmission Co. which came to my desk and in which the president of the company is quoted as follows:

> In regard to the proposed new Gulf Pacific natural gas pipeline to supply California, under the provisions of the Long-Dirksen proposed amendment, the purchasers of the gas—the Department of Water and Power of the City of Los Angeles and Southern California Edison Co.—will receive the full benefits of the use of the costs, depreciation, and other expenses, and investment tax credit generated and used by Gulf Pacific to reduce its own tax liability. The customer companies have contracted to pay, as a part of the cost of service, only the actual tax paid by Gulf Pacific, Burrow said.

This seems to indicate that there may be some question of cost saving involved here, which might be passed along by Tennessee Gas, and which would have its impact in the competitive proceeding.

But I do not think I would want to go beyond that, Senator Williams. I think that this is a matter that the Commission would want to decide on the record, and I would not want to try to determine even what issues were involved from the newspaper releases and from statements filed with this committee. I think we ought to consider all that in light of the record made in our hearing.

Senator WILLIAMS. I have been listening to that, and I hear you make reference to a suggested passalong of a tax saving to the consumers, and then we hear, on the other hand, much said about higher costs to the consumer.

Are they transferred costs, or is this a cost to be passed on, or where does the higher cost to the consumer develop?

Mr. SWIDLER. I do not want to talk about this particular case because I do not know that it was involved here, but this language would permit the assignment of cost savings within a system to one or more of the subsidiaries so that the costs could be structured in that way, and could be concentrated in one point or another. This is a general possibility as I read the amendment, and it is one to which I referred in the last page of my statement. I do not want to say that this is involved in any particular proceeding, but that is a possibility when the companies are permitted by agreement to focus the benefits of the tax reduction generated by consolidated returns in any way that they want, as they may agree within their own holding company system.

Senator WILLIAMS. In this particular instance would it result in higher or lower costs to the consumer, that is what I am trying to get at?

Mr. SWIDLER. Well, it could be either way. If they are permitted to—it could mean—I cannot talk about this particular case, but if

you wanted to discuss the thing more generally, it could mean giving some consumers the benefit of tax payments made by all. It could mean lower costs for some and higher costs for others or it could mean that consumers would get none of the benefits. Any of these things could be done by the decision of company management.

Senator WILLIAMS. You have lost me again by going back to hypothetical cases, and I pass. Maybe I will get an understanding later.

The CHAIRMAN. What is the pleasure of the committee? I think the hour of noon has arrived.

Senator BENNETT. Mr. Chairman, I agree we should recess, but on this very subject, I think there is one little bit that should be in the record before we break up, and that is a reference to the bill itself. I am reading on page 3, if you will turn to it, Mr. Swidler, I think you are leaving the committee with a completely erroneous idea that management has the right to switch these benefits back and forth in any amount and under any pattern that it chooses. But this is what the bill says: "For purposes of this subsection"—I am beginning on the bottom of 2.

Mr. SWIDLER. Page 2?

Senator BENNETT. Yes. [Reading:]

> a consolidated return agreement is an agreement among members of an affiliated group with respect to the use of deductions or credits in a consolidated return which provides for transfers of funds (A) from those members whose inclusion in such group with respect to any taxable year increases the consolidated tax liability (or reduces the net operating loss) of the group to those members whose deductions or credits reduce the consolidated tax liability (or increases the net operating loss) of the group, paragraph (B) in amounts consistently determined by a formula under which the funds transferred by any member approximate 100 percent of the amount by which such member's tax liability for the taxable year, computed on a separate return basis (determined without regard to carrybacks to such year and without regard to dividends received from other members of such group) exceeds such member's allocable portion of the tax liability of the group.

In other words, the law fixes the amounts which can be transferred between these various members of the groups. It must be the difference between what their tax would be if it were not consolidated, if their returns were not consolidated, and the amount that is available because they are consolidated, and those who have that benefit must pay that to those who fail to have that benefit, and assuming that from one year to another the amount of savings or the amount by which the tax would be increased would change or the amount that each member of the group must contribute to the benefit of those whose taxes would be otherwise adversely affected must be changed. I think you have left the committee with the impression that management sits there and decides that for a particular and sinister reason it is going to concentrate its tax benefits in the hands of a particular member of the group when, as a matter of fact, it is bound by the language of the law; am I not right?

Mr. SWIDLER. Well, that is not the way I read it, but perhaps you are right. This is a very complex thing. I was reading on page 1 and page 2. The provision is:

> If each member of an affiliated group is bound for a taxable year by a consolidated return agreement described in paragraph (2)—

and that is the part you read—

> the earnings and profits of each member of such group for such year shall be determined by—

and then it goes on—

(A) allocating the tax liability of such group for such year in the manner provided by subsection (a)—

and subsection (a) lists three optional ways of doing it. As I recall you prorate the savings according to net income or according to the taxes that would be payable on separate returns or according to savings—three ways of doing it.

Senator BENNETT. That is the present law.

Mr. SWIDLER. Yes, or such other way as the Treasury may allow. All that is incorporated by (A).

But then you go on to (B) which says "reducing the earnings and profits"—remember, you started by saying—

the earnings and profits of each member for such group for such year shall be determined by (A) and (B)—

and then it says—

reducing the earnings and profits of a member who transfers funds to another member or members in accordance with such agreement in the amount of such transfer, and increasing the earnings and profits of a member who receives funds from another member or members in accordance with such agreement in the amount of such receipt.

That did not seem to me to impose the limitation.

Senator BENNETT. Yes. But the limitations on the agreement are written into section (2), and they are very clear, and this is not an open hunting license or an open permission for management to juggle its tax benefits around from year to year as it pleases.

It seems to me the amendment is very clear and says that those members of the consolidation whose tax would be higher than it would be if they filed separate returns will be benefited by a contribution to the combination for those members whose tax would be lowered, and the amount transferred must be 100 percent of the amount by which their taxes are lower or higher than if they had filed separate returns. It seems to me it is a perfectly clear proposition that does not permit of any management finagling of the type that has been discussed here at great length.

Mr. SWIDLER. If (B) is qualified by the provisions that you have just read this would restrict the freedom of management to focus the benefits in particular subsidiaries. But it would not, of course, go to the principal question of whether consumers should pick up the tab for payments to subsidiaries or to affiliates, and call those tax payments when, in fact, they were paid to the affiliated companies.

Senator BENNETT. Well, Mr. Swidler, if you will read line 8 on page 1, you will see that it refers to a consolidated return—line 8, page 1—for the taxable year by a consolidated return agreement described in paragraph (2), and I have just described the agreement to you. So I think it is very clear and very limiting and I think this means that the opportunity of management to juggle these things is restricted almost to the point where management has no choice, and you would be faced with the situation in which one subsidiary one year would reduce its liability by the agreement, and the same subsidiary next year would find its liability increased by the agreement, even though it did not want to have that happen.

Mr. SWIDLER. I see the point that you make, Senator Bennett. You may be right.

Senator BENNETT. OK. That is all I wanted to bring out, Mr. Chairman.

Senator DOUGLAS. Mr. Chairman, could we meet this afternoon. This turns out to be a very highly complicated subject. The witnesses who are to testify tomorrow morning are the companies and the general public. Mr. Hyde and Mr. Stone are not such witnesses. Could we not ask permission to meet this afternoon?

Senator WILLIAMS. I understand the President wants his program expedited the next 2 months, and if we want to expedite it, we should be on the floor. We cannot be in two places at the same time.

The CHAIRMAN. What is the pleasure of the committee?

Senator LONG. I personally would like to see us get on with the business of the committee. We have other matters that we are going to have to take up in executive session and, perhaps, hold hearings on some of those. Personally I would like to see us go on with this hearing, and I would even be willing to come back tonight if need be because, as far as this Senator is concerned, this is just one more amendment, and we will vote it up or down and go on with the next business. I have lost on some mighty good amendments on occasion when I thought if I had more time I could have won on them. But we thought we had to get on with the business. I would hope we would just meet some time this afternoon and go ahead and hear the witnesses.

As the chairman so well knows, on some occasions I volunteered to sit here until midnight because some Senator wanted to ask some questions for a week running, and I would hope we could go ahead and hear these witnesses. I can see that Mr. Swidler has made a statement with which some Senators agree very much, and with which I find myself in disagreement. But as much as I disagree, I am glad to hear him. He represents a very powerful Commission, and I hope we can hear Mr. Swidler on through, and then if a Senator has questions to ask, he may do so, and then we can go on to the next witness, and hear all these people.

Senator BENNETT. The Republicans have a policy luncheon today, and we are going to start a half hour late because of an agreement to vote, so I would say we would not be through under normal procedures before 2:30, and that would be a tight fit.

Senator LONG. How about meeting at 3 or 3:30?

Senator BENNETT. I could be back at 3.

Senator LONG. Let us make it 3:30.

Senator ANDERSON. Quite obviously if you are going to finish with this it is going to take 4 or 5 weeks on the floor, too.

Senator LONG. It seems to me we ought to hold this hearing. We agreed to hold a hearing.

Senator BENNETT. I would rather have it at 3 o'clock.

Mr. SWIDLER. Mr. Chairman, am I excused or shall I be here?

The CHAIRMAN. Please be on hand for questioning, Mr. Swidler, at 3 o'clock.

Senator LONG. Mr. Swidler, you are going to have some very friendly questions asked you by at least one or two members here. You will have to respond to them.

The CHAIRMAN. The committee will stand in recess until 3 o'clock, and the chairman will determine how long we would sit this afternoon.

(Whereupon, at 12:15 p.m. the committee recessed, to reconvene at 3 p.m. on the same day.)

AFTERNOON SESSION

The CHAIRMAN. The committee will come to order. Mr. Swidler, will you take the stand. I believe Senator Anderson is the next member to question you.

STATEMENT OF HON. JOSEPH C. SWIDLER—Resumed

Mr. SWIDLER. Thank you, Mr. Chairman.

Senator ANDERSON. Mr. Swidler, I am not able to follow through all these definitions and descriptions, and you have a series of statements on page 12 about "X" company and "Y" company and how they work out their consolidated return. What happens if they buy up a tax loss from somebody else?

Let me give you an example that I have some interest in and familiarity with. A company had a net operating loss of some $10 or $11 million.

Mr. SWIDLER. How much?

Senator ANDERSON. $10 or $11 million, and sold that to another company. They had enough of it and they did not want to take any more of it, so they sold it for $1 million to a company which wanted to stay in the business and that company was able to write off the $11 million of indebtedness at a cost of $1 million.

Is it your theory if they have written off the $11 million as a real bargain they should not use that $11 million as part of their costs or part of their returns? Which should they use, the $1 million figure or the $11 million figure, or is that not involved in this case?

Mr. SWIDLER. Senator Anderson, I do not know there is necessarily one right way to allocate tax savings from consolidation.

One way of doing it may be right in one situation, and another way may be appropriate in some other context. My point is that there ought not to be frozen into the law a command, in effect, that the regulated company would never share in the benefits at all, and that all of the benefits would go to the nonregulated companies; that is to say, that the ratepayers would not benefit from the tax savings.

Now, this is what Justice Jackson, in the *Western Railroad* case, referred to as the two keys problem.

You have here a treasure consisting of a potential tax savings, and it is locked in a box that takes two keys. One key is held by the company that has the tax loss, and the other is held by the company that has a tax gain, and in order to realize on this treasure, this privilege not to make a payment to the Treasury, both keys must be used.

Now, there is a great deal to be said, as the Justice did, in favor of dividing the benefits between the two. This is what would happen in an arm's length transaction.

Now, in the case that you mention, apparently at arm's length, an $11 million credit was sold for $1 million, if I understand your illustration.

In another case perhaps the $11 million credit might be sold for $10 million. Justice Jackson advocated that if there were to be a single rule it should be done on the basis of splitting the saving.

But I am not here, Senator Anderson, to try to contend for a particular allocation formula. I do say that the consumer should

be entitled to a share of these benefits, and that the share is one that should be determined in the course of the established regulatory procedures rather than within a holding company context where there is not any arm's length bargaining.

Senator ANDERSON. Well, you say:

For one thing it would create strong incentives for the acquisition or creation of net loss affiliates.

Mr. SWIDLER. Yes, sir.

Senator ANDERSON. Do you mean by that that a business sets out purposely to have losses?

Mr. SWIDLER. No, sir. It does not set up to have losses, but frequently it sets up to have tax losses or at least not to show taxable income, and this happens particularly with respect to companies which are entitled to a statutory depletion allowance or to rates of depreciation in excess of realized depreciation, so that it is quite a common thing in the petroleum industry, in real estate and so forth, for companies to operate on a basis that for tax purposes shows a loss even though some of these companies are quite prosperous.

Now, this also covers the situation where a company is new and will have initial losses, but has good prospects of future earnings, so that the initial starting period can be covered by the tax benefits generated by the earnings of the regulated company. There are many situations where it is good business to take over a tax loss company either because of future prospects or because the tax loss does not reflect its true economic position.

Senator ANDERSON. Have you read this morning a release by Tennessee Gas?

Mr. SWIDLER. Yes, sir.

Senator ANDERSON. And earlier in that release which I was reading it says:

"The story says the proposed amendment would permit a west coast subsidiary of Tennessee Gas Transmission Co.—Gulf Pacific Pipeline Co. to cut its rates to customers by shifting its tax liability to the parent company," Burow said. "This is completely opposite from the truth."

What do you——

Mr. SWIDLER. Are you reading from my statement?

Senator ANDERSON. That is the second paragraph in the first sentence—the first sentence of the third paragraph.

Mr. SWIDLER. The Tennessee press release, I see. Let me see if I can find it.

Senator ANDERSON. Tennessee Gas release of August 20. I can lend you my copy if you wish.

Mr. SWIDLER. I have it right here.

Senator ANDERSON. What I am trying to say here is a company which says the story was completely opposite from the truth.

Mr. SWIDLER. Yes, sir.

Senator ANDERSON. I do not know whether the story is exactly what somebody said or did not say. What do you conceive the situation to be as far as Tennessee Gas is concerned; anything different from what you outlined earlier today?

Mr. SWIDLER. Well, this seems to be a matter of considerable controversy. During the lunch hour I received a copy of the letter that was sent to Chairman Byrd by the El Paso Natural Gas Co.

which contends that the purpose of these tax arrangements is to influence the competition in a pending proceeding before the Federal Power Commission with respect to service to southern California. Now, I cannot say that this is so of my own information, but it could be so, and El Paso contends that it is so.

(The full text of the letter submitted by El Paso Natural Gas Co. appears on p. 222.)

Senator ANDERSON. To cut its rates to customers by shifting its tax liability to one parent company. Do you think that is possible under the amendment?

Mr. SWIDLER. It is possible under the amendment, in my opinion, for the profitable regulated companies in the Tennessee system to make payments to the unprofitable ones which could be a new starting company like Gulf Pacific, which would, perhaps, in the initial period show a tax loss particularly after the investment tax credit.

Senator ANDERSON. Mr. Chairman, I find it a little difficult to follow through what this is all about from an accounting standpoint, and I think I ought to stop in my questions. I want to say that I only know of one way of doing business, and that is to make a profit. I did not know there was another way.

Mr. SWIDLER. Well, sir, if you employ tax counsel, I believe you would find that there are other ways.

Senator ANDERSON. I missed that part of my education. I have no further questions.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

Before we broke up today I raised the question of the interpretation of the amendment which would indicate that the shifting of the tax liabilities and the shifting of the benefits between the various members of the consolidation is not within the judgment of the management or the managements of the various companies in the group, but is set out very clearly, the formula is set out very clearly, in the law or in the proposed amendment.

I assume you took a look at that during the noon hour. Do you agree with it?

Mr. SWIDLER. Well, I think that your position is a reasonable interpretation and, as I said, you may be right. But I would like to call your attention to some of the—even assuming that you are, I wonder if under paragraph (2) beginning on line 24 on page 2, which is the part you stressed in your question to me, I wonder whether that is so definite as to preclude the possibilities for manipulation.

For example, the agreement described in (A) and (B) does not say that there can be no amendments from year to year. Now, this permits companies to come in and out of the agreement and it permits the basis of allocation to be changed.

Suppose, for example that a company showing a tax loss, a nonregulated company showing a tax loss, should become profitable. The agreement for the following year could then be revised, a new consolidation agreement could be filed which would exclude that company in order to avoid the necessity for that company to pass along any of its earnings to the loss companies in order to insure that all the payments would be made by the regulated company.

Senator BENNETT. But if they go out they cannot get back in. They cannot get out in the years in which it is to their advantage and

then move back in again freely in the years in which it is not to their advantage.

Mr. SWIDLER. I do not see where the language says that, Senator Bennett.

Senator ANDERSON. Where does it say that?

Senator BENNETT. I think that is basic law, is it not, with respect to consolidated returns, that you cannot set them up a different way every year, just keep removing the membership of the group for the benefit of the tax advantage. Larry, can you answer that question?.

Mr. WOODWORTH. You can get out of a consolidated return with the permission of the Commissioner or if there is a substantive change in the tax laws. Generally speaking, however, once you file a consolidated return it is my understanding that you are required to continue unless, of course, the common holding in the subsidiary falls below 80 percent.

Senator BENNETT. OK.

Mr. WOODWORTH. With those exceptions.

Senator BENNETT. In order to get out you must get permission of the Commissioner.

Mr. WOODWORTH. Or else there must be a substantive change in the tax law which permits a new election with respect to consolidated returns or the ownership falls below 80 percent.

Mr. SWIDLER. This is not my information. I do not purport to be an expert on it. But my information on it is there has been a lot of movement in and out as the profit status of some of the companies changes, and while this requires a degree of consistency, under any one agreement in any one year, it does not prevent changes in the agreement or changes in the composition of the consolidated group from one year to another.

Senator BENNETT. It is my understanding, as I read this, that it does prevent changes in the agreement because the limitations that control the agreement are set forth in the law.

Mr. SWIDLER. Yes. But the agreement can be changed by filing a new agreement for another year.

Senator BENNETT. But the conditions in the agreement are very clearly set forth.

Mr. SWIDLER. Yes. But they are not very stringent conditions. If you will look at (B), for example, you will find that all that says is that the profit companies can retain no part of the benefit. That is not a very stringent condition.

Senator BENNETT. Well, it says that, it sets forth the formula under which funds may be transferred.

Mr. SWIDLER. Yes. But what it says is that——

Senator BENNETT. It says 100 percent of the amount by which such member's tax liability for the taxable year computed on a separate return basis exceeds such member's allocable portion of the tax liability of the group. That is a very simple, straightforward statement.

Mr. SWIDLER. It is a simple and straightforward statement, but it is not very comprehensive. What it says is that the company that has the earnings can retain no part of it which, from my point of view, is just the opposite of what I would like to see. I would like to see some assurance that for rate purposes—now, as I say, I have no interest for tax purposes, but for rate purposes, what I would like to see is some assurance that the companies, the regulated companies, that provide the earnings would get some share of the tax savings.

Senator BENNETT. When we have the Treasury witness before us I will want to ask him about this particular thing so that I can clearly understand one way or the other whether it is the right of a group of companies that operate on a consolidated basis every year to change the basis of their distribution of income for purposes other than their responsibility as taxpayers.

Mr. SWIDLER. I might well testify in a different way if I were testifying after the tax witness. But the order of presentation required me to make my own interpretation for purposes of my testimony.

Senator BENNETT. Mr. Swidler, I have a question that I want to ask you for the sake of the record. I think I know what your answer will be, but I would like to give you a copy of it so that you can follow it as I read the question, which is a little bit involved.

Mr. Swidler, I know you would not want anything you say to be construed as a reflection on the merits or the possible outcome of any competitive certification proceeding pending before the Federal Power Commission, and I would not want this to happen either.

I also realize that the outcome of any contested proceeding of the kind that comes before your Commission necessitates the weighing of many factors, favorable and unfavorable, and it cannot be said that just because an applicant—or applicant A has one particular factor in his favor, he will necessarily be the winner.

At the same time, I do think it is essential for this Committee to know the possible consequences of the action we are being asked to take.

We all know about the contested Federal Power Commission proceedings involving the competing applications of Gulf Pacific Pipeline, a subsidiary of Tennessee Gas Transmission Co., and El Paso Natural Gas Co. I understand that the testimony has all been taken in this case, is that so?

Mr. SWIDLER. Yes, sir.

Senator BENNETT. That all briefs have been filed?

Mr. SWIDLER. All the briefs before the examiner have been filed.

Senator BENNETT. Yes, before the examiner. And that the case is now awaiting the hearing examiner's initial decision?

Mr. SWIDLER. Yes, sir.

Senator BENNETT. Mr. Swidler, I want to make sure that I understand how this proposed amendment works. Let us assume that Tennessee were to pay Gulf Pacific $29 million under an allocation agreement of the type described in the proposed amendment. I understand that the published testimony and exhibits filed in this proceeding indicate that Tennessee proposes to shift to Gulf Pacific at least that much—I do not ask you to confirm this, but merely assume that Tennessee pays over to Gulf Pacific that amount.

Is it not true, Mr. Swidler, that under the proposed amendment, Tennessee's cost of service for ratemaking purposes would have to take into account an additional $29 million item of cost if Tennessee pays over that amount to Gulf Pacific, and that Gulf Pacific's cost of service, on the other hand, would have to be determined by treating that $29 million as a reduction in its cost of service?

Mr. SWIDLER. Well, the answer is—and I will treat this as a hypothetical question——

Senator BENNETT. That is right.

Mr. SWIDLER. The answer is "Yes," with one qualification, that the word "additional" where you say for ratemaking purposes, Tennessee's cost of service would have to take into account an "additional" $29 million item of cost, that $29 million is in its cost of service now. For ratemaking purposes—the cost of Tennessee would continue to reflect that $29 million even though it was not paid to the Treasury but paid to Gulf Pacific.

Senator BENNETT. So in striking the word "additional" from the question——

Mr. SWIDLER. Yes.

Senator BENNETT (continuing). The answer is an unqualified "Yes."

Mr. SWIDLER. As I understand this hypothetical question.

Senator BENNETT. Yes. Thank you very much. I have no further question, Mr. Chairman.

The CHAIRMAN. Senator Douglas?

Senator DOUGLAS. Mr. Chairman, may I start by commenting that I think the issues which have been raised thus far prove that it was desirable to have public hearings on this bill and I, therefore, wish to congratulate the chairman for the ruling which he made that we should have public hearings.

Now, Mr. Swidler, you and my friend Senator Long were discussing the question as to whether or not the payments made by a regulated company to an affiliated or parent company in the same holding company ensemble, if I may use that word, whether those were costs. It seems to me that the answer hinges largely on whether you take the viewpoint of the individual company or whether you take the considered holding company system as a whole. Granted that it is a bookkeeping cost to the regulated company, it is an earning or an asset to another company in the same holding company system; isn't that true?

Mr. SWIDLER. Yes, sir.

Senator DOUGLAS. And, therefore, for the system as a whole does not represent a cost; isn't that true?

Mr. SWIDLER. Yes, sir.

Senator DOUGLAS. But it is counted as a cost in the regulated portion of that system for ratemaking purposes.

Mr. SWIDLER. Under this amendment it would be; yes, sir.

Senator DOUGLAS. That is right. And, therefore, one of the things which this amendment would do would be to give an allowance for costs which, in fact, are not incurred.

Mr. SWIDLER. Yes, sir.

Senator DOUGLAS. Is that correct?

Mr. SWIDLER. Yes, sir.

Senator DOUGLAS. And, therefore, it would serve to keep the rates higher than they would otherwise be?

Mr. SWIDLER. Yes, sir.

Senator DOUGLAS. Well, it seems to me this is a fundamental question.

In other words, taxes not paid to the Government are then treated as a cost, and rates are supposed to be adjusted to meet them; is that correct?

Mr. SWIDLER. Yes, sir.

Senator DOUGLAS. Is this purely a finicky point to be disputed by tax lawyers and regulatory lawyers, or are there large sums of money

involved in this matter? That is, is this purely a series of intellectual niceties or does it amount to large sums? I believe you mentioned this morning that an eighth of a billion dollars might be involved.

Mr. SWIDLER. An eighth of a billion dollars is involved with respect to one item, the interest expense of the natural gas pipeline.

Senator DOUGLAS. And this would not include electric companies?

Mr. SWIDLER. No, sir.

Senator DOUGLAS. Nor companies under the jurisdiction of the Federal Communications Commission.

Mr. SWIDLER. No, sir.

Senator DOUGLAS. When you say an eighth of a billion dollars; is this in annual sums or in capital sums?

Mr. SWIDLER. This is in annual sums.

Senator LONG. How much is an eighth of a billion?

Senator DOUGLAS. $125 million.

Senator LONG. That is all I want to know. Why don't you say $125 million?

Senator DOUGLAS. Well, I think we are able to divide.

Senator LONG. When you talk in those terms of billions, if I might just interrupt the Senator, it reminds me of his discussion of the natural gas bill itself. He talked in terms of trillions of cubic feet, hundreds of trillions. Well, gas sells for about, well, it is anywhere from 7 to 23 cents a thousand, so it is easy to talk in trillions, and it sounds like big numbers. It is sort of like the Amos and Andy Fresh Air Taxicab Co., where Andy would keep talking in big figures, $1 million, $2 million, making his plans for the future. Actually a trillion cubic feet of gas is not nearly as much as it sounds like when you talk about what it really sells for.

Senator DOUGLAS. May I say this to my good friend, although we are not now discussing this question of natural gas rates or pipeline charges or the price of gas at the wellhead or as it enters the pipeline system, I think that there has been involved in those transactions approximately $600 million a year, and if my friend wants to have these quoted in hundreds of millions of dollars rather than in fractions of a billion, I will say $600 million in that case. Mr. Swidler says in this case $125 million a year on gas companies alone, plus x number of millions on electrical companies, plus y number of millions in communications companies, plus z number of millions in others.

Senator LONG. How many trillions?

Senator DOUGLAS. Don't quote in trillions.

Senator LONG. Is $600 million?

Senator DOUGLAS. It has nothing to do with the case. Trillions confuse me.

It has nothing to do with thousands of cubic feet. We just talk in terms of dollars. In order that my friend—and he is my friend, my very dear friend—may understand it, would you say $125 million a year is involved in this point in gas companies?

Mr. SWIDLER. Yes, sir; on the interest expense.

Senator DOUGLAS. And you have no estimate made of the amounts that might be involved by the electrical companies?

Mr. SWIDLER. No, sir.

Senator DOUGLAS. Senator Anderson wants to know just where this $125 million would be involved.

Senator ANDERSON. Would the company lose it or the Government lose it, or who would lose it and who would gain it?

Mr. SWIDLER. Well, the Treasury would lose it.

What would happen, you see, Senator, is that—what I am now talking about is a possibility of the future. If this should pass then there would be every reason for pipeline companies which now issue their own bonds and get an income tax credit for the interest, to finance themselves through another company which would issue the bonds, either in return for stock or if it owned all of the stock of the pipeline company already, by way of capital contributions. Then the credit could be assigned either to the parent company or to nonregulated subsidiaries. Now, this is what would become possible if this amendment should pass. There would be an invitation to escape this tax obligation or to pass along this tax saving.

Now, this tax saving, I think I misspoke when I said the Treasury gets it now—it is now——

Senator ANDERSON. That is what I did not understand.

Mr. SWIDLER. It now goes to the consumers because this is the result—the interest payment results in a tax reduction, and the actual taxes are allowed, but if the financing were done through a holding company, then the tax advantage would all go either to the parent company or to loss companies in the holding company system.

Senator DOUGLAS. May I ask another question?

Senator ANDERSON. I want to say if the Treasury were going to be penalized that much money, I could not understand how the Treasury would be for the bill.

Mr. SWIDLER. I think this is a question of the stake of consumers; I misspoke.

Senator LONG. Wait a minute, you gave two answers. You said, one, Treasury loses two, the consumer loses. Which one? Do they both lose it or one of them?

Mr. SWIDLER. No, sir, it is the consumer who would lose it.

Senator DOUGLAS. Do I understand what you are saying is this: that if there are gains to be made by restructuring a holding company financial setup, there are enough tax brains and regulatory brains who will tell the companies how to do it; is that right?

Mr. SWIDLER. Yes, sir.

Senator DOUGLAS. I once heard Assistant Secretary Surrey describe the tax lawyers as "having the best brains in the country, the finest brains in the Nation," and that they could be depended upon, therefore, to serve their employers with great acumen. So you are saying that if these "best brains of the Nation," if these opportunities exist, the "best brains in the Nation" will take advantage of it.

Mr. SWIDLER. Yes, sir.

Senator DOUGLAS. I want that phrase "the best brains" put in quotation marks. [Laughter.]

Mr. SWIDLER. If they can live their lives happily dealing with such complex statutory provisions as these, they must be the best brains in the country, without quotation marks.

Senator DOUGLAS. Well, I want to have those words put in quotation marks. They are not mine.

Now, you made some reference to the fact that this amendment would stimulate public utilities going into diverse enterprises. The regulated companies would be more willing to take on unregulated enterprises.

Mr. SWIDLER. Yes, sir.

Senator DOUGLAS. I wonder if you would explain just how this amendment would be a stimulus?

Mr. SWIDLER. Yes, sir.

The pipeline companies now are engaged in fairly extensive diversification programs. Many of them have gone into gas and oil production. I do not think this is necessarily bad. This is a related endeavor, and it could have a beneficial effect on their pipeline operations.

Some of these companies, however, have gone into production in totally unrelated spheres, drilling in Saudi Arabia, Yemen, and Lord knows where else. This is one example of the kind of thing that a good many pipeline companies are doing.

Some have gone into totally unrelated activities, real estate, insurance, electronics. Now, it is one thing to look at an acquisition on the basis that each company must carry its own load, and that you take a chance of substantial losses in the period of infancy.

It is quite another thing to be able to bankroll these enterprises with the tax savings from a consolidated return, and to be able to offset losses by appropriating the taxpayments which would otherwise be made by the regulated companies.

This would, from the point of view of the stockholders, tend to make it a corporate, what shall I say, sin of overconservatism, to stick to your knitting. The pipeline or electric power business, because the inducements to speculate on the strength of the tax savings from consolidation, which could be, as I say, diverted to meet the losses of the acquired companies, would be almost irresistible. This was the point I was trying to make.

Senator DOUGLAS. May I ask you this: Do I understand you to say that in the case of a regulated utility going into a completely alien business, this amendment would mean that if the new and unregulated business succeeded the company dealing with that unregulated business would have the profits, but that if it failed, the losses could be shouldered off on the regulated companies and, in effect, a subsidy would be paid by the consumers of the regulated company?

Mr. SWIDLER. At least to the extent of 48 percent of the losses.

Senator DOUGLAS. Yes.

Mr. SWIDLER. The tax component of losses; yes, sir.

Senator DOUGLAS. So it is "heads I win, tails the consumers bear 48 percent of my loss."

Mr. SWIDLER. Yes, sir. And when and if the company becomes profitable, then it is withdrawn from this consolidated tax complex. Now, this is not as difficult as it sounds, I mean from the consolidated return group, because the magic number for consolidation is 80 percent. So that if you begin to make some money and you own 82 percent of the stock, you can sell 3 percent to friendly interests, and that company will no longer be eligible for consolidation. Then if it begins hitting losses again, why you can reacquire that 3 percent, and you are back to being supported, 48 percent, at least, by the regulated companies. This is as I undertand it.

Senator DOUGLAS. One final question: If a tax penalty should be levied upon regulated companies, you would feel obligated, would you not, assuming the other facts remained the same, to increase the rates, so that the consumers would pay for the tax penalty?

Mr. SWIDLER. If this amendment were to pass——

Senator DOUGLAS. No. I mean—well, all right, if this amendment were to pass.

Mr. SWIDLER. If this amendment were to pass, why, of course, we would be unable to take account of any tax savings in fixing rates. We would have to allow——

Senator DOUGLAS. What I was saying was, under present law if a tax penalty is levied upon the regulated company you have to increase the rates because of the amount of the penalty.

Mr. SWIDLER. Yes, sir.

Senator DOUGLAS. But if a tax refund is granted, can the refund be shifted to the parent or affiliated corporation so that you would not be able to reduce rates because of the tax-free bonus?

Mr. SWIDLER. As things stand now we think we could make a fair allocation for the consumers.

Senator DOUGLAS. But with this amendment?

Mr. SWIDLER. With the amendment we could not.

Senator DOUGLAS. Mr. Chairman, despite the bill announcing the vote I hope we won't call the game at the end of the fifth inning, and that we will return.

The CHAIRMAN. We will try to come back.

Senator LONG. Shall we try to come back after we go over and vote? We will stand in recess at the call of the chairman until we can get back from voting.

Mr. SWIDLER. Yes, sir.

The CHAIRMAN. Yes.

(At this point a short recess was taken.)

The CHAIRMAN. Senator Dirksen is recognized.

Senator DIRKSEN. Mr. Swidler, I assume that your primary interest is in the second part of this bill?

Mr. SWIDLER. Yes, sir.

Senator DIRKSEN. Insofar as it concerns the regulatory agencies.

Mr. SWIDLER. My sole interest.

Senator DIRKSEN. Your sole interest.

Mr. SWIDLER. Yes, sir.

Senator DIRKSEN. So you do not pass judgment on the first part——

Mr. SWIDLER. No, sir.

Senator DIRKSEN (continuing). Which is purely a tax matter.

Mr. SWIDLER. No, sir.

Senator DIRKSEN. Let me assume a situation like this: a parent company with affiliates, none of which are under regulation. In the second group a parent company with some affiliates that are under regulation.

Is it or is it not true that under your interpretation of the investment credit provision that you are actually exercising jurisdiction over a nonregulated company, because it comes within the purview of a consolidated tax return?

Mr. SWIDLER. I do not think I understand your question, Senator.

Senator DIRKSEN. You say you do not?

Mr. SWIDLER. No, sir.

Senator DIRKSEN. Well, assume a parent company had affiliates, some regulated and some not regulated, and you have these intercompany transfers. Do you assume jurisdiction there in order to do what you think you should do for the consumers in the regulated company?

Mr. SWIDLER. Congress has given us direction with respect to the treatment of the investment tax credit in particular and, of course, those we would observe.

Senator DIRKSEN. I am trying to get at your interpretation of the construction of the whole investment credit feature and the intent of Congress when they put it into law. You go on the theory that there ought to be a flow through to the consumer. My estimate of the intent of Congress was that inasmuch as we were dealing with a rather difficult unemployment problem in the country, that this was intended for expansion and diversification and ventures into new lines of enterprise for the purpose of creating jobs, and that the Congress did not have in mind that whatever benefits accrued to a company should flow through to the consumer, because what we were trying to do was to find a solution to the job problem.

Mr. SWIDLER. In the hearings, the Commission took a position on flow through of investment tax credit. This did not appeal to this committee or to the Congress, and Congress has prescribed how we shall treat investment tax credit for regulatory purposes. I do not think that is a controversial matter. I have no intention here, Senator Dirksen, of suggesting reopening that particular feature of the tax laws

Senator DIRKSEN. Well, my problem is a very simple one. I listened to nearly all the testimony on the tax bill back in 1963 and 1964. I had a clear impression as to what the Congress fully intended, and when I introduced that amendment in December, that was the purpose of the amendment, to reexpress the intent of Congress with respect to the use of these benefits which the Congress had provided for corporate enterprises, including the purpose of doing those things that would create jobs, and it was not in the mind of Congress to have that money flow through for consumer benefit, for if that were the case, then we entirely missed the point in the tax bill.

Mr. SWIDLER. I think, without trying to pass upon particular situations, my recollection is in accord with yours, that this matter was disposed of by Congress, and that the Commission's argument for a flow-through did not appeal either to the committee or to the Congress.

Senator DIRKSEN. I am just trying to get a very clear expression of how you interpret that provision that we put in the law and, frankly, it goes back to what Walter George once said to me when he was the chairman of this committee long ago. He said, "One of the greatest difficulties is in getting the commissions and the agencies of government to carry out the intent of Congress."

I went on the theory that your interpretation did not carry out that intent. That was the reason for that amendment nearly 18 months ago, and that is the reason that this thing has been incubating in my mind and in the minds of a good many others ever since that time.

Mr. SWIDLER. I am not trying to dodge your question, Senator Dirksen. I do not have in mind at the moment the precise language of the investment tax credit provisions which directed the Commission in effect, as I recall, to ignore the amount of credit for rate and other regulatory purposes. But if it is as sweeping as I recall it, then I do not see any basis for the Commission to consider the investment tax credit in its ratemaking or other regulatory work.

Senator DIRKSEN. Could you commit to a half page of paper the intent of the Commission and the rule that the Commission presently follows with respect to its construction of the investment credit benefits?

Mr. SWIDLER. I would be very glad to do that.

Senator DIRKSEN. If you put it in simple language in a half page——

Mr. SWIDLER. I will be very glad to do that.

Senator DIRKSEN. So we can put it in the record——

Mr. SWIDLER. I will do that.

Senator DIRKSEN. I think it will serve a very useful purpose.

Mr. SWIDLER. Very good.

(The information referred to follows:)

FEDERAL POWER COMMISSION,
Washington, September, 1, 1965.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This responds to Senator Dirksen's inquiry, voiced during the course of my testimony on amendment 418, regarding steps taken by the Federal Power Commission to carry out the congressional mandate in section 203(e) of the Internal Revenue Act of 1964 (Public Law 88-272) as to regulatory treatment of investment tax credit.

The Commission has faithfully complied with the mandate since enactment of that law. In the *United Gas Pipe Line Company* rate case, which was pending at the time of enactment, the Commission rejected arguments that "the investment tax credit was a tax reduction" which "must be reflected by an equivalent reduction in United's cost of service" to the benefit of the customers (31 FPC 1180, 1193). The Commission expressly held that the action of Congress required that the credit not be used for the purpose of establishing the company's cost of service without the consent of the company. This is the same *United* case, incidentally, in which the Commission separately decided the consolidated tax issue (not related to investment tax credits) now pending in the fifth circuit. Our accounting regulations, like our rate cases, honor the option between flow through and retention which Congress gave the pipeline companies in the case of the investment tax credit.

Sincerely,

JOSEPH C. SWIDLER, *Chairman.*

Senator DIRKSEN. I think the questions this morning have probably covered the situation pretty well. I have no further questions.

Mr. SWIDLER. Thank you, Senator.

The CHAIRMAN. Are there any further questions?

Senator LONG. I just want to ask one more question to get this thing straight, because, as I understand it, this, I think, is the fundamental difference between your point of view and mine.

If you take two steps, one, take a company that made $1 million in profits, and let us assume that, say, they have a 48-percent tax rate, so that leaves them with $520,000 after taxes.

Now, out of that $480,000 that would be taxes, if that company were not a part of any consolidated return at all, you would concede that the consumer has no claim whatever on that $480,000 in taxes?

Mr. SWIDLER. No, sir. That is a payment to the Treasury, and we would have to recognize it for rate purposes.

Senator LONG. But if that company were a part of a consolidated group, and some of that company's taxes were paid over into another company to pay for that company using that tax benefit, you would nevertheless contend that the consumers of that company would then have a claim on that $480,000.

Mr. SWIDLER. Yes, sir.

Senator LONG. But you would concede if that company was not in a consolidated group that the consumers of that company would have no claim whatsoever on that $480,000.

Mr. SWIDLER. Yes, sir.

Senator LONG. Now, if what that company paid the other company—let us say if it paid the other company $200,000, to use a $200,000 tax credit of the other company, and that company thereby lost that $200,000 credit, used it up for the benefit of that company, you would contend then that the consumers of that company would be entitled to a share of the $200,000 that they paid for the use of the other man's tax credit?

Mr. SWIDLER. Yes.

Senator LONG. Now, would you give me some idea as to what share of that tax credit you think those consumers would be entitled to? Mind you, the tax credit is being generated entirely by the other company.

Mr. SWIDLER. The tax credit is generated by the loss company, but the money is generated by the regulated company.

Senator LONG. I understand.

Mr. SWIDLER. In the *Cities Service* case and in the *United* case, the Commission has adopted the rule of allocating the savings on the basis of the relative contribution to the net earnings. Now, of course, before this can be done it is necessary to make a preliminary allocation between the regulated and the unregulated companies. This is done by netting out the results for the unregulated companies so that the unregulated companies get the full benefit of all the tax losses before any of those tax losses are made available for sharing among the regulated companies.

But after the unregulated companies get the full benefit of the tax losses as far as they will go around, then the balance is allocated according to relative net earnings. This is the formula that the Commission has approved in these cases.

Senator LONG. Well, I think I understand your position, Mr. Swidler. I have no further questions.

The CHAIRMAN. The next witness is Mr. Lawrence M. Stone.

Mr. SWIDLER. Thank you very much, Mr. Chairman and members of the committee.

The CHAIRMAN. Take a seat, Mr. Stone, and proceed if you will, please.

STATEMENT OF LAWRENCE M. STONE, TAX LEGISLATIVE COUNSEL, TREASURY DEPARTMENT

Mr. STONE. My name is Lawrence Stone, and I am the tax legislative counsel of the Treasury Department.

Mr. Chairman, I appreciate this opportunity to appear before your committee to explain the views of the Treasury Department on amendment No. 418 to H.R. 7502. This amendment concerns affiliated corporations which are eligible to and do report their income upon a consolidated tax return. It deals with the effect to be given payments made by some members of such a group to other members of the group in exchange for the tax benefits which the latter contribute to the group.

The general effect of the amendment can be summarized quite briefly. When affiliated corporations elect to file a single, consolidated return for Federal income tax purposes, they generally combine the income, deductions, and credits of the component members as though they together constituted a single corporate entity. Some members may contribute tax benefits to the group which they themselves could not use currently. One affiliate may, for example, have more deductions than income for the year in question—a net operating loss. Another may be entitled to an investment credit in excess of that which it would have been permitted to apply against its own tax liability if it had filed a separate return. In the absence of the consolidation privilege such benefits might be wasted at least temporarily. Where other corporations in the group have taxable incomes which make possible the use of these tax advantages, a reduction in the overall tax liability of the group results as compared to the sum of the tax liabilities of each of the individual affiliate companies. In such a situation, the affiliated group may decide that the corporations whose taxes have been reduced should pay the tax savings to those members of the group who have made that reduction possible by contributing tax benefits.

With certain limitations, amendment 418 prescribes two types of consequences for payments of this kind. First, the amendment specifies that, for Federal income tax purposes, the payment will decrease the "earnings and profits" of the corporation which makes it and increase the "earnings and profits" of the corporation which receives it.

Now, "earnings and profits," as I am using it here, is a technical term from the code, and I will explain what effect that has in a moment.

The second effect of the bill is as follows: if the payor or the recipient is subject to the jurisdiction of a Federal regulatory agency, the amendment provides that the agency shall treat the payment as a tax expense of the payor and a tax refund to the recipient for all purposes of determining the parties' costs and rates of return.

The operation of the amendment can be illustrated by a simple example. Assume that the parent corporation has $100 of taxable income for the year. Assume also that parent would have had to pay $50 of Federal income tax if it filed a separate return. Its subsidiary has a $100 net operating loss for the same year. Parent and subsidiary file a consolidated return; since the subsidiary's loss entirely offsets its parent's income, together they pay no Federal tax that year. The parent has, hence, been able to save $50 by joining in the consolidated return. If, pursuant to an agreement with its subsidiary, the parent pays that $50 tax savings to the subsidiary, the proposed amendment would treat the payment as a reduction on the parent's earnings and profits and as an increase in the subsidiary's earnings and profits for income tax purposes. Secondly, if the parent or the subsidiary engage in activities which are regulated by a Federal agency, the amendment would classify the payment as a tax expenditure by the parent and a tax refund to the subsidiary for rate-fixing purposes.

Of the two quite distinct effects which the proposed legislation would have—one upon income tax rules and the other upon regulatory practices—only the first is within the jurisdiction of the Treasury

Department. We understand—and I heard Chairman Swidler's testimony—that the second has immediate impact upon the rules of several Federal regulatory agencies. Representatives of the agencies concerned and other witnesses are discussing for the committee that portion of the amendment and the problems which it presents to them. With respect to that aspect of the proposal, the Treasury Department defers to those Federal agencies, within whose area of jurisdiction it lies, to state their position as to the appropriate method for computing tax expenses for regulatory matters.

The effect of the amendment upon the computation of "earnings and profits" for tax purposes is, however, of direct concern to the Treasury Department. The status of a corporation's earnings and profits can determine, for example, whether a corporate distribution to shareholders will be taxable or tax free to shareholders. To the extent of earnings and profits (either current or accumulated), a distribution to shareholders is normally treated as a dividend, and thus taxable to the shareholders as ordinary income. To the extent that a distribution exceeds earnings, however, it is treated as a return of capital and can be tax free. Because of the very significant tax difference which the level of corporate earnings can create for the shareholders of the corporation, it is very important from the Treasury's viewpoint that the earnings and profits account constitute an accurate reflection of the real earnings of the corporation and be free of possible manipulation.

The present rules governing the computation of earnings and profits under the code contain substantial defects. Some of the problems with this concept of earnings and profits related especially to situations of affiliated groups of corporations, some operating to create hardships for taxpayers and some operating to their advantage. Amendment 418 is intended to alleviate one of the hardships that can be created under the existing rules. Existing principles may result in an unrealistic allocation of earnings and profits among the component corporations of a consolidated group in situations in which some members of the group contribute tax deductions or credits beyond those which they could have used on separate returns. The bill would provide a reasonable and effective method of dealing with this problem. It would permit affiliated corporations a means of reassigning earnings among the members of a consolidated system to prevent undue attribution of earnings to those members whose profits have made possible the utilization of excess benefits provided by other members. The objective of the amendment is, hence, proper.

On the other hand, when the Treasury Department first examined the original proposal directed to this objective, we were concerned that it might aggravate a related—and equally serious—problem in the consolidated return area that operates to the advantage of taxpayers. Under present law, corporations which join in a consolidated return compute their earnings and profits separately, corporation by corporation. The earnings and profits account of the parent corporation alone determines the tax consequences of distributions from the consolidated system to its shareholders. That is, you look only to the earnings and profits of the parent company and ignore earnings elsewhere in the system. Because of this rule which looks only to the parent's earnings, it is frequently possible for substantial portions of the earnings of the whole group to be maintained in one or more

subsidiary members until after distributions to shareholders have been made by the parent; and the owners of the consolidated system obtain return-of-capital treatment despite the fact that substantial net earnings remain in the system. In that way, they obtain more favorable tax treatment than would be available to them if their enterprises were operated within a single corporate entity.

To prevent the possible use of the intercorporate "in lieu of tax" payments contemplated by amendment No. 418 as a further means of segregating consolidated earnings in subsidiary corporations—and thus securing artificial tax advantages for the owners of consolidated corporate systems—the Treasury Department developed limitations upon the operation of the amendment which are now incorporated in it. The general effect of the restrictions is to permit the shift of parent corporation earnings to subsidiaries only in situations in which a net earnings deficit exists among the subsidiary system as a whole. A further technical amendment (attached to my statement), which is now incorporated, I understand, in amendment No. 426 introduced by Senator Dirksen, provides that such payments can be made from the parent to the subsidiaries only to the extent of such net deficit in the subsidiary system. With this change, the limitation has, in our opinion, been framed to allow proper operation of the rule of amendment No. 418 but—at the same time—to preclude possible abuse of that rule.

Since, then, the problem to which amendment No. 418 is addressed is a real one, since the solution adopted by the amendment is reasonable, and since the amendment contains an appropriate limitation to prevent possible abuse, the Treasury Department has no objections to the enactment of those portions of the amendment which are within its jurisdiction.

Thank you.

(The attachment referred to follows:)

PROPOSED REVISION OF AMENDMENT NO. 418, H.R. 7502

(References are to the draft dated August 24, 1965, referred to the Committee on Finance)

On pages 5 and 6, delete paragraph (4) (lines 9 through 25, p. 5, and lines 1 and 2, p. 6), and insert in lieu thereof the following:

"(4) NET EARNINGS AND PROFITS.—For purposes of paragraph (3), the net earnings and profits of all of the other members of the group shall be the greater of—

"(A) the net earnings and profits of such members for their taxable years ending with the common parent corporation's taxable year (hereinafter referred to as the current taxable year), or

"(B) the net earnings and profits of such members accumulated in taxable years beginning after December 31, 1964, reduced by any dividend distributions made in such years (other than the current taxable year) by such other members out of earnings and profits accumulated prior to such years.

For purposes of subparagraphs (A) and (B), the net earnings and profits of such members for the current taxable year shall be determined as of the close of such year after application of paragraph (1) but without regard to paragraph (3), and determined without regard to distributions paid by such members, or received by such members from other members, during such year."

The CHAIRMAN. Any questions?

Senator LONG. I would like to ask this, Mr. Stone. The Treasury Department is planning to make a study as to whether the method of allocating tax items among members of a consolidated return

group as set forth in amendment No. 418, should be made mandatory for all taxpayers filing consolidated returns?

Mr. STONE. Yes, Senator. We do intend to look into that question, and also to look into other problems that we now have with the earnings and profits concept.

Senator LONG. So from the point of view of the Treasury, not only is Treasury prepared to go along with the proposal Senator Dirksen makes, to permit a company to do business this way, but Treausry thinks that possibly companies ought to all be required to do business this way under a consolidated return, and Treasury is studying that possibility, as I understand it?

Mr. STONE. Yes, we are studying that possibility. I do not know how the whole proposal will come out when we get through, because we might be requiring other rules.

Senator LONG. Right.

Mr. STONE. But we are looking at it. That was one of the problems we had with the original bill; namely, that it was not mandatory.

Senator LONG. Right.

Is Treasury also planning to make a study determining whether limitations contained in paragraph (3) of the proposed new subsection are really necessary after a trial period? In other words, that is a limitation you insisted on, and I am asking you, are you planning to study to see whether that limitation is really necessary?

Mr. STONE. Yes; we would like to study it and see if we can eliminate some of the problems that led us to require that we have these limitations. In other words, if we could correct some of the problems that led to the limitation, the limitation could be lifted.

Senator LONG. The point being that you want to be cautious about this matter, and you think that perhaps this might not be an essential requirement, but out of an abundance of caution to protect the Treasury, you insisted on this.

Mr. STONE. Yes, sir.

Senator LONG. Now, would you agree that the first sentence in paragraph (1) represents an appropriate way of dividing tax liability as among members of a consolidated group for purposes of earnings and profits?

Senator BENNETT. Will you identify that a little better.

Senator LONG. I am talking about subsection (1).

Mr. STONE. You mean the first sentence of the amendment?

Senator LONG. Yes.

Mr. STONE. With our limitations at the present time, yes.

Senator LONG. I want to say this, Mr. Stone, and I think you can comment on it if you care to. This matter came to my attention about a year ago, and I believe I at that time proposed an amendment somewhat parallel to what Senator Dirksen has provided.

I asked for a conference with the Treasury on this subject, and Mr. Surrey was there, and I am not sure whether you were there. Perhaps you were not, but you knew something about it. Mr. Surrey said it was a very complicated problem. He realized there was a problem here, and he wanted time to study it, and from the point of view of the Treasury, so far as I know, Treasury has studied this matter for more than a year as to what they thought of recommendations as to how they thought this problem should be handled. Is that correct?

Mr. STONE. That is correct.

Senator LONG. This is no overnight thing so far as Treasury is concerned. You have been studying this problem over a long period of time, relatively speaking.

Mr. STONE. Right, although, as you pointed out, this is a temporary solution, to our way of thinking.

Senator LONG. Yes. Thank you very much.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. Not at this time.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. I would like to ask Mr. Stone if he has any comments to make on the question of the interpretation of section (2), consolidated return agreement. You heard the discussion between myself and Mr. Swidler.

Does this come in your opinion, this section, represent a requirement upon management for the distribution or the division of its taxable liability or taxable credits among its subsidiaries or is Mr. Swidler right that management has the right every year to sit down and decide how these tax credits are going to be divided up so as to have the best of all possible worlds?

Mr. STONE. Well, once an agreement is entered into, and so long as a consolidated election remains in effect, I believe that there would not be too much flexibility on the part of management.

However, I do have to agree with some of Mr. Swidler's comments to the effect that it is possible to, for example, break one of the companies out of the consolidated group by selling some of its stock, and that would effectively remove it from the agreement.

Senator BENNETT. This leads me to my second question. Have you had enough experience with this proposal to know whether this device is used fequently? Are companies able to break themselves out one year and move back the next?

Mr. STONE. Well, it is probably not easy to move in and out too quickly. If you own 80 percent of the company and sell 5 percent to somebody else you may not be able to buy it back. But you could, if you so planned, consolidate a company for a period of years and then sell enough of, a few points of, your ownership so that it would no longer be 80 percent owned, and would not be included in the consolidated tax group.

Senator BENNETT. I realize this is theoretically possible, but is it practical on a year-to-year basis, in your opinion, where a regulated company decides that it can get a rate advantage by getting out of the consolidation in 1965, and it discovers it gets a rate advantage by getting in in 1966, do you think this kind of a ping-pong situation is possible——

Mr. STONE. Well——

Senator BENNETT (continuing). And out again in 1967?

Mr. STONE (continuing). I am afraid occasionally it is engaged in.

Senator BENNETT. Does the Treasury have any plans for narrowing these possibilities?

Mr. STONE. Well, some of them, yes.

There are two types of situations. One is where you break the entire consolidated election. In other words——

Senator BENNETT. You break up the consolidated group.

Mr. STONE. No, where you have the right to terminate your election. The consolidated group remains in existence, but you have a right to file separate returns thereafter.

Now, that kind of right under existing law arises when there are substantial changes made in the law, and during the last few years there have been frequent elections made available——

Senator BENNETT. That is right.

Mr. STONE (continuing). To corporate groups to revoke their consolidated status. That, in effect, gave them an election on several occasions.

Senator BENNETT. That is really not within the control of the members of the group. That is created by changes in the law.

Mr. STONE. That is correct.

Now, also under existing law it is possible upon the acquisition of a new member for the whole group to terminate the election if the new member does not consent.

Senator BENNETT. It is not possible to change the election—well, no, I withdraw the question. You are either in or you are out. You cannot change the pattern of distribution inside the group when you take in a new member.

Mr. STONE. Well, under the existing consolidated return regulations if a new member joins the group then for that year the whole group, in effect, has a choice as to whether they will remain consolidated or not, depending on whether the new member consents. If the new member does not consent, the election is broken for that year.

Now, in the next year, they can elect again and file consolidated returns. The consolidated return regulations, however, are under study at the moment, and that privilege may not remain.

There is a separate situation where the group continues to file consolidated returns, but one of the members is left out of it because the parent's ownership drops below 80 percent.

Senator BENNETT. That has been changed.

Mr. STONE. And that is the other half of the situation.

Senator BENNETT. I will be glad to yield to Senator Williams.

Senator WILLIAMS. In making that change as a result of a new member being taken in, is there any requirement that that be related to the size of the new member as it comes in? Would a relatively large operation be able to go out and buy 80 percent of a very small operation just for the purpose of kicking or triggering this change?

Mr. STONE. I do not believe there is any size requirement under existing regulations. But, as I say, the whole regulations are under study right now, and we hope shortly to change some of the rules.

Senator WILLIAMS. I do not say it has been done, but theoretically it could be done by going out and buying 80 percent of an incorporated filling station, couldn't it?

Mr. STONE. That is correct. It has been relatively easy in the last few years to break the consolidated election and then, of course, there is no bar in coming back next year under exisiting law.

Senator WILLIAMS. Or they could form a new subsidiary of their own.

Mr. STONE. Formation of a new subsidiary does not give them the privilege.

Senator WILLIAMS. It does not?

Senator BENNETT. If they break the election they have to operate 1 year without getting the opportunity of getting the consolidated return benefits.

Mr. STONE. That is correct. They would have to do that, and under this amendment they could then either choose to have the kind of agreement that the bill allows or not have it.

Senator BENNETT. No further questions, Mr. Chairman.

Senator LONG (presiding). Senator Dirksen.

Senator DIRKSEN. Mr. Stone, thinking of affiliated enterprises generally, and quite aside from whether they move in and move out, what is your estimate of the general practice among American business for the purpose of a consolidated return, that they move in and generally stay in, is that correct?

Mr. STONE. It is hard to generalize. I would think they probably do, except that there is a good deal of moving in and out.

Senator DIRKSEN. Is that your experience?

Mr. STONE. Yes.

Senator DIRKSEN. In your statement you say that the present rules governing the computation of earnings and profits contain substantial defects. By that do you mean the Treasury rules and regulations?

Mr. STONE. Well, I mean the statute also, because the Treasury rules are limited by the existing statute, section 1552.

Senator DIRKSEN. That is true.

Mr. STONE. Yes.

Senator DIRKSEN. But for purposes of giving the practical effect in administering them, you do issue rules and regulations.

Mr. STONE. That is correct.

Senator DIRKSEN. Now then, how long have you been aware of those substantial defects that you mentioned in your statement?

Mr. STONE. Well, I might say we became more aware of them in the last year as we grappled with this problem. But people have been aware of them for a number of years.

Senator DIRKSEN. Actually you have been grappling with this for 18 months or more; is that correct, generally speaking?

Mr. STONE. At least going back to December of 1963, I believe.

Senator DIRKSEN. I believe so.

One other question. Do what we seek to achieve in the first part of the pending amendment—could that have been achieved by regulation rather than by amendment to the law?

Mr. STONE. Not to the same degree; no, sir.

Senator DIRKSEN. Now, there would have to be additional regulations then to cover what is in the amendment so far as the tax feature is concerned.

Mr. STONE. There would have to be new regulations; yes.

Senator DIRKSEN. It is a fact, I take it, that American enterprise has been working with the Treasury for quite some time to find some relief in this field?

Mr. STONE. Yes.

Senator DIRKSEN. Now, this is version number what that we have before us? I introduced this one last night. The third one, I think, I introduced on August 24. I introduced an amended version of the first one, although it was not—there was a second version, and it is on the second version that we had the meeting at the Treasury at 5

o'clock, and then there was one prior version on which we had no prior agreement, so actually what is before use today, amendment No. 426, is really version No. 4 containing the suggestions that the Treasury has made from time to time to me and to Mr. Woodworth of the staff and others; and this version, which is actually the Treasury version, is acceptable?

Mr. STONE. That is correct.

Senator DIRKSEN. That is all.

Senator LONG. Anything further? Senator Douglas.

Senator DOUGLAS. Mr. Stone, having been on the floor for the last 45 minutes and, therefore, having not had the privilege of hearing the questions and your responses, if I rethresh old straw, I do not mean to do it.

Let me also say that in the past I have considered primarily the regulatory features of the amendment and not the tax effects.

I would like to ask if amendment 418, introduced on August 24, would possibly have permitted a reduction in the total tax revenues of the Treasury.

Mr. STONE. Amendment No. 418?

Senator DOUGLAS. That is right, which was the amendment we had up until last evening.

Mr. STONE. Yes, it might have; yes.

Senator DOUGLAS. It might have permitted a reduction in total tax revenues?

Mr. STONE. Right. Well, amendment 426 may, too, may also.

Senator DOUGLAS. Wait a minute; I am speaking now of 418.

Mr. STONE. Right; yes.

Senator DOUGLAS. I would like to know in what ways would this have permitted a decrease in total tax revenues, because I had understood that the Treasury said 418 was neutral so far as tax receipts by the Government were concerned. If you say that it is not neutral, and it might have resulted in a decrease in total revenues by the Government, this is startling news to me, and I would like to have you discuss it. Then we will go to 426.

Mr. STONE. Let me give you a simple example where it might have some effect, and this is the only effect which it has.

If a parent has some profits and its subsidiaries have losses, if you look at the group as a whole, assuming that the losses and the profits are equal, there are no earnings in the system. Therefore, if there are any distributions made to shareholders, the question arises as to whether they are made out of earnings or whether they are made out of capital and, therefore, tax free.

Now, the amendment would allow, in the case that I have given, the parent to make payments down to the subsidiary to the extent of that deficit and, thereby, in effect, bring the consolidated system to a neutral position as far as earnings are concerned. It would not look to the earnings of the parent and say, "Well, the parent had profits and it is immaterial that the subsidiary had losses, the distributions are coming out of the parent and, therefore, this should be treated as coming out of earnings and profits and, therefore, taxable as ordinary income to the shareholders."

The amendment would say, no. In that circumstance the parent may make payments down to the subsidiary, filling up the deficit, so to speak, bringing the whole system to even, and then the distributions would be made out of capital, which is the consolidated situation.

Senator DOUGLAS. And result in a lesser total tax payment.

Mr. STONE. By the shareholders.

Senator DOUGLAS. By the shareholders.

Mr. STONE. Yes, sir.

Senator DOUGLAS. And a lesser total tax receipt by the Government.

Mr. STONE. That is correct.

Senator DOUGLAS. Then 418 was not neutral so far as its overall effect upon revenues received by the Federal Government.

Mr. STONE. That is the only situation in which it would operate, and we conceive of that as being, you might consider that as being, neutral in a sense, because in that situation if we treat the distributions coming out of the parent as though they were coming out of earnings and profits, we are being too harsh on the taxpayers in some sense, since if you look at the total that they own, the parent and the subsidiary, there are no earnings. So, to that extent you can say that it is neutral in that it is correcting an unjustified hardship.

Senator WILLIAMS. How do you do it under existing law?

Mr. STONE. Under existing law——

Senator DOUGLAS. As compared to existing law.

Mr. STONE. Under existing law, the payments going down would not affect the earnings and profits of the parent company. They would be treated as contributions to the capital of the subsidiary, and the parent would remain with its earnings and if it made a distribution it would be treated as a dividend.

Senator DOUGLAS. Was my understanding incorrect, then that the Treasury had approved 418 on the ground that it would not result in any reduction of total revenues to the Government, and that the sole issue was one of regulation with which the Treasury did not concern itself?

Mr. STONE. Well, if you are trying to distinguish between 418 and 426, Senator——

Senator DOUGLAS. I am talking about 418 which was the amendment before us up until this new amendment was printed overnight.

Mr. STONE. I am sorry. I find it hard to distinguish because we thought in amendment 426 we were making a correction although there is disagreement.

Senator DOUGLAS. I have been very careful to distinguish between amendment 418 of August 24, and amendment 426 as of August 30.

Mr. STONE. Well then, I have to retrace my steps.

Senator DOUGLAS. I am speaking solely of 418 as of August 24. I will come to amendment 426 later.

Mr. STONE. I will have to retrace my steps, Senator, because I think I may have misled you. It is possible to read amendment No. 418 as doing more than what I said. It is possible to read amendment No. 418 as saying that if in the subsidiary system as a whole, there are no earnings and profits, in other words, there is a break even, then the payments can be made down to subsidiaries in unlimited amounts. That is why I preferred to discuss the two of them together. I think I can make clear the distinction.

Senator DOUGLAS. Please do not say anything about 426 for the moment.

Mr. STONE. Okay. The subsidiaries have a break-even system. If you compare all of the subsidiaries down below, their profits and losses exactly cancel out, and they have no earnings and profits, but they have no deficit——

Senator DOUGLAS. Then there will be no taxes.

Mr. STONE. Assume that the parent corporation does have taxable income, and that the subsidiaries contribute a tax credit in that situation, an investment credit. The subsidiaries could have exactly a break-even position, but they might have an unused investment credit. That would be an example.

Senator DOUGLAS. Well now, Mr. Stone, I do not want to be captious.

Mr. STONE. Yes.

Senator DOUGLAS. But certainly it is not the normal situation for a utility system to just break even without profits and losses. I mean the normal situation is to make profits. Indeed the whole aim of regulation is to give to the regulated utilities a fair and reasonable profit, but not in excess of a fair and reasonable profit.

So let us assume that they make profits. Would 418 have permitted such a readjustment of credits or debits as to diminish the total taxes received by the Federal Government as compared with existing law?

Mr. STONE. If the subsidiaries made profits they would have earnings and profits, and 418 would allow no payments to go down.

Senator DOUGLAS. Would allow no payments——

Mr. STONE. No payments—would allow no payments from the parent to the subsidiaries for tax purposes.

Senator DOUGLAS. And, therefore?

Mr. STONE. And, therefore, there would be no tax effect.

Senator DOUGLAS. What?

Mr. STONE. No tax effect. There would be no reduction of the earnings and profits of the parent.

Senator DOUGLAS. May I ask if what are you saying is that 418, therefore, was neutral so far as its total effect on Federal revenues was concerned?

Mr. STONE. No. It was not neutral because there was one circumstance where it would have allowed payments to go down which we thought was unjustified, and that is the situation which I described to you before, where there is a break-even situation among the subsidiaries. It is possible that this could occur because the subsidiaries may be engaged in regulated and unregulated businesses, and they may just offset each other. Yet the subsidiaries may have an unused investment credit of $10 million. At that point there would be no earnings and profits among the subsidiaries, and 418 would have allowed a $10 million payment from the parent to the subs, which would have reduced the parent's earnings by $10 million. We thought that was an unjustified situation, and that is what amendment 426 corrects.

Senator DOUGLAS. All right.

Now I will move to 426.

Mr. STONE. All right.

Senator DOUGLAS. Does 426 eliminate this possibility?

Mr. STONE. Yes. 426 says that payments can be made, these "in lieu of tax" payments can be made, from the parent to the subsidiary only if there is a deficit in the subsidiaries, and then only to the extent of the deficit. If there is a $1 deficit on a net basis in the subs, you can make a payment of $1 down there. But you must look to all the subsidiaries and consolidate them. You cannot have earnings in one and a deficit in another, and make a payment to the deficit one. You must look at all of them consolidated, and then if they come up with

a net deficit you can make payments only to the extent of the net deficit.

Senator DOUGLAS. Let me ask you this question: Then are you saying that 426 eliminates the possibility of a reduction in total tax revenues?

Mr. STONE. No, it does not eliminate it because it still allows it in a situation where there is a net deficit in the subsidiaries. In that situation we would allow the transfer, in effect, of earnings and profits from the parent to the subsidiaries to make up their deficit, and allow that payment to have a tax effect, and we would not view that as an unjustified transfer because of the fact that if you look at the system as a whole that deficit should be taken into account.

Senator DOUGLAS. In other words, it does, in your judgment, offer the possibility of a tax reduction, but a justifiable tax reduction.

Mr. STONE. That is correct.

Senator DOUGLAS. Is this amendment in its present form acceptable to the Treasury?

Mr. STONE. Well, I am only commenting on the tax portions of it. Yes; the tax portions are acceptable.

Senator DOUGLAS. I understand that.

Senator ANDERSON. He did not answer your question. Is 426 acceptable to the Treasury as a whole?

Mr. STONE. Well, as a whole, it encompasses regulatory aspects which are not within our jurisdiction, and you heard Chairman Swidler on that.

Senator ANDERSON. I know I have, and that is why I asked that question. You would have to testify, wouldn't you, that the Treasury does not approve the amendment as a whole?

Mr. STONE. Well, I do not think we could testify on the regulatory part. If we had to testify on the regulatory part, yes; then you are correct, we will have to oppose it, I think, because it is the position of the administration.

Senator ANDERSON. The position of the administration is in opposition then——

Mr. STONE. To the regulatory portion.

Senator ANDERSON. Yes.

Mr. STONE. I believe the reports of the FCC and the FPC so indicate.

Senator DOUGLAS. But on tax features, like Pontius Pilate you wash your hands and say——

Senator ANDERSON. No; it is a question of a house divided against itself cannot stand. Cannot there be only one way for the Administration to testify? It is either yes or no. We do not vote line by line on the bill. We vote on the whole bill, and on the whole bill you would have to testify that the Government, the administration, was against it, wouldn't you?

Mr. STONE. Well, the bill is separable. Last year——

Senator ANDERSON. How is it separable?

Mr. STONE. Senator Long introduced an amendment that related solely to section 1552 of the code. That amendment, in a limited form, is in this bill. At the same time last year, Senator Dirksen introduced an amendment which related solely to regulatory matters. That is also in this bill. So there are obviously two separable things in here.

Senator DOUGLAS. Let me ask you this question: Suppose we were to eliminate lines 11 to 23 on page 2. Would it then be acceptable to the administration?

Mr. STONE. I believe that Chairman Swidler testified that he would then have no interest in the bill; I am not certain. I think he did.

Senator DOUGLAS. You are not Chairman Swidler, you are Lawrence Stone.

Mr. STONE. Yes. It would be acceptable; it would then only encompass tax matters, and it would be acceptable.

Senator DOUGLAS. So far as tax matters are concerned, the Treasury has no objection?

Mr. STONE. That is correct.

Senator DOUGLAS. When you say you have no objection on tax matters, do you speak for the administration or for the Treasury?

Mr. STONE. I am speaking for the Treasury on this. Although we have not been——

Senator DOUGLAS. When I was a boy growing up in the country there were people who had the shell game. It was always a question under which shell was the pea, and you would guess under one shell, and you always find it was under another. It was very illusive.

Mr. STONE. Let me try to clarify this.

Senator DOUGLAS. Here you say first you are speaking for the Treasury; then you are speaking for the administration, but as little as possible, apparently.

Mr. STONE. Senator Douglas, perhaps I can clarify it this way. The Treasury Department informed the Bureau of the Budget that it intended to testify only on the tax aspects of the bill, and the manner in which we intended to testify, and that was said to be all right. That was said to be all right so long as we deferred to the other agencies on the regulatory portion of the bill.

Senator ANDERSON. I think you said correctly a man testifying for the administration can only testify to that thing to which he is allowed to testify properly.

Mr. STONE. That is right.

Senator ANDERSON. And you are only allowed to testify on the financial part of the bill.

Mr. STONE. That is right.

Senator ANDERSON. Mr. Swidler testified on the rest of it. If that is eliminated, then he has no objection, and nobody has any objection, is that right?

Mr. STONE. Right.

Senator DOUGLAS. All right. Thank you, Mr. Stone.

Senator LONG. Thank you very much for your testimony, Mr. Stone. I think you have done the very best you could to testify on your views, the Treasury view, and when pressed you have tried to predict what you would say if you were somebody else. So I think you have done about the best that could be expected under the circumstances. Thank you very much.

Now, we have Chairman Rosel Hyde, Acting Chairman of the Federal Communications Commission.

Chairman Hyde, we extend to you our apology that we could not put you on sooner. We appreciate your being here and understand Mr. Stone has to go to New York.

STATEMENT OF HON. ROSEL H. HYDE, COMMISSIONER, FEDERAL COMMUNICATIONS COMMISSION

Mr. HYDE. Mr. Chairman and members of the committee, we appreciate the opportunity of presenting the views of the Federal Communciations Commission. This has become my duty in the absence of Chairman Henry, who is out of the city.

I have accompanying me Mr. Asher Ende, Associate Chief, Common Carrier Bureau; and Mr. Roy Baker, Chief, Revenue Requirements, Common Carrier Bureau.

The amendment appears to the Commission to be primarily a tax bill. Accordingly, the Commission does not believe it is competent to or should comment on the overall tax implications or revenue effects of the bill. However, the Commission is concerned with the potential effects the amendment could have upon the rates and charges which users of interstate and international communication services are required to pay, if the last sentence of paragraph c(1) thereof (which appears on lines 11 through 23 on p. 2 of the August 24 draft) were enacted into law.

As you may be aware, all operating expenses, including Federal income taxes, properly incurred by a public utility or common carrier in providing service, may be recovered by the carrier from its charges to the public. It is also axiomatic in the public utility field that all expenses, including taxes reported or claimed by the carrier, are subject to regulatory review to ascertain whether such claimed expenses are reasonably related to the services furnished. Through this process, the utility is assured that it will be reasonably compensated for its undertaking and risk, and the public is assured that it will not be required to pay for either real or assumed expenses which have no reasonable relationship to the service rendered.

Our concern with the proposed amendment results from the fact that it would deprive the using public of the protection afforded by the review heretofore made by regulatory agencies of the effects of the allocations agreed upon or transfers made by members of a corporate system filing a consolidated return.

As we understand the amendment, the allocations would not be subject to review by the regulatory agency.

Senator DOUGLAS. It is specifically stated, is it not, in lines 11 through 23 on page 2?

Mr. HYDE. I think that is clear.

Specifically, the provisions of the proposed amendment would appear to allow members of an affiliated group which files a consolidated return to allocate the group's total tax liability among the participating members. The members of the group would be able to agree among themselves to a plan under which the share allocated to the regulated members would be maximized, I should say here, within the ceilings which were referred to in discussions earlier today. We recognize that there are very significant restrictions. Furthermore, the last sentence of paragraph c(1), lines 11 through 23 on page 2 of the proposed amendment, provides that for regulatory purposes such transfers must be considered as taxes actually paid. Under these circumstances, revenue requirements of the regulated member would be increased, with the result that the using public could be required to pay increased rates or to forgo rate reductions that would be otherwise justified.

It appears to the Commission only reasonable to expect that if the pending amendment were to be enacted into law, the entities to which it would apply would review their respective situations to determine how they could use its provisions for their benefit. By the very nature of things, there would be definite incentives on the part of regulated carriers to use the amendment. This incentive results from the fact that many carriers are parts of corporate systems consisting of regulated and unregulated entities. For the most part, the regulated entities are monopolies or quasi-monopolies, while the nonregulated entities must sell in a competitive market. Thus, in any consolidated tax allocation, there would be a natural tendency to minimize costs for those entities which must compete at the expense of those entities which do not have to face direct competition. The proposed amendment provides a vehicle whereby this could be accomplished without any review or possibility for adjustment to remove inequities.

Senator DOUGLAS. Mr. Hyde, the tax attorneys and the regulatory attorneys in this country are a very able set of men, are they not?

Mr. HYDE. I am sure they are.

I think I should qualify the statement I have just made by saying that there would be no review so far as the regulatory agency is concerned.

Senator DOUGLAS. I see. In the words of Assistant Secretary Surrey, "the best brains in the country would be available to take advantage of these possibilities offered by the amendment."

Mr. HYDE. I am sure you are talking about a very knowledgeable professional group.

Senator DOUGLAS. These are not unsophisticated lawyers.

Mr. HYDE. No. In this field I think you have to have a high measure of sophistication to succeed.

Senator DOUGLAS. To survive and prosper.

Mr. HYDE. Yes, survive and prosper.

We have been unable in the time permitted to analyze in depth the specific manner in which enactment of the amendment might increase the rates which users of the various communications services are required to pay. We can, however, indicate various areas in which we are concerned that application of the proposal could have an effect on the rates and charges of users.

The first of these relates to what could happen if it were determined to restructure corporate relationships to maximize one of the potential benefits made available by the proposed amendment. Before proceeding to describe this hypothetical example, I should like to stress that the Commission has no evidence that such a course is being contemplated or will actually be followed. Instead, I desire to point out that it would appear to be lawful and, if implemented, could have significant adverse effects on charges to the users of interstate and international communication services.

Senator DOUGLAS. In other words, if the "best brains in the country" would discern these possibilities, would offer advice to the systems, financial systems.

Mr. HYDE. Yes, sir. I am, of course, referring to possibilities which could be worked out, and not to any matters which have been proposed by any of the carriers. While I may refer to companies by name in explaining our position, I am not undertaking to impute to them any of these actions.

The hypothetical situation to which I am referring relates to what could be done in the case of the telephone industry. Under the amendment as we understand it, A.T. & T. could restructure the Bell System in such fashion that A.T. & T. would be a senior holding company having no telephone operations of its own. A.T. & T. would be responsible for the raising of all debt capital while each of the operating affiliates would have 100 percent equity capital. Under such circumstances, and using actual figures for current periods, the holding company would be responsible for some $330 million of annual interest payments and would receive, as A.T. & T. now does, some $1,200 million in dividends and other income from wholly owned affiliated companies. On a separate return basis, the newly created holding company might be required to include in its tax computation 15 percent of its dividend income, if that much, as taxable income. Or to put it another way, it would, for tax purposes, be considered to have $180 million taxable income before deductions. However, its interest payments, which are deductible for tax purposes, would amount to the aforementioned $330 million. Thus, the holding company would have a loss for tax purposes of about $150 million.

Under applicable tax law, if a consolidated return were to be filed by such a restructured corporation, the total tax liability would be the same as it is now. However, as we understand it, if the proposed amendment were to become law the regulated operating affiliates could each transfer to the holding company a proportionate part of the $75 million tax saving resulting from the inclusion of the holding company in the consolidated return.

If such transfers were made, the proposed amendment specifies that the appropriate regulatory agency, in this case the Federal Communications Commission, must treat such transfers as Federal income taxes for the purposes of determining the cost of service of each of the operating members of the affiliated group. Since Bell's interstate and foreign communications account for about 25 percent of the total system operations, the restructuring described above could increase the annual revenue requirements which users of interstate and foreign service would be required to pay by an estimated $20 million annually.

Senator DOUGLAS. Mr. Hyde, you heard Chairman Swidler say that in his judgment the regulatory system in gas and oil would be increased by approximately $125 million a year. Are you saying in the telephone service it will be increased by $20 million a year insofar as A.T. & T. and its subsidiaries are concerned?

Mr. HYDE. Yes.

Senator DOUGLAS. In addition to this you have General Telephone.

Mr. HYDE. Well, that is true, and I have not undertaken here to make a firm estimate. I have given one illustration, using the kind of volumes and figures that are involved in communications.

Senator DOUGLAS. What about the broadcasting industry?

Mr. HYDE. They are not subject to regulation. I have used a phrase here with which there could be dispute. I am sure members of the industry think they are being subject to considerable degree of regulation. They are, however, specifically exempted from regulation as carriers. This is provided in section 3 of the Communications Act.

Senator BENNETT. There is no rate regulation.

Mr. HYDE. There is no rate regulation in broadcasting.

Senator DOUGLAS. On the ground that service to the ultimate recipient is free and revenues are collected from advertising, is that right?

Mr. HYDE. They operate in a competitive field, and there is no regulation as to rates.

Senator DOUGLAS. What about telegraph companies?

Mr. HYDE. Telegraph companies are subject to rate regulation. In our case we regulate interstate and international aspects of communication.

Senator DOUGLAS. Might there be further sums added to this?

Mr. HYDE. Yes. This would involve additional amounts of money, you are right, sir.

Senator DOUGLAS. Have you any estimate as to what this would be?

Mr. HYDE. I am not prepared to give an estimate.

Senator DOUGLAS. On General Telephone?

Mr. HYDE. Well, General is essentially a domestic company operating in the so-called independent group. It is a large company, perhaps the largest independent, but they do have manufacturing affiliates and, as a matter of fact, it is typical among the larger communication companies to have associated with them manufacturing affiliates or subsidiaries.

Senator DOUGLAS. Western Electric is A.T. & T.; and Automatic Electric is the manufacturing subsidiary for General——

Mr. HYDE. In the case of A.T. & T., it is Western Electric that you have mentioned and, of course, among the communication carriers, there is RCA communications affiliated with RCA which is a manufacturer.

Senator DOUGLAS. What about ITT?

Mr. HYDE. It likewise is a name for a group which does include manufacturing and regulated services, and so the principles that I am discussing here do apply as to all of these groups. There are other smaller ones. These are the larger ones.

I have mentioned these in my statement. I deal next with questions I think I have gone over but, perhaps, I should review some of this in order to put it in context with the rest of my statement, if I may.

We feel it pertinent to note that Federal income tax consititutes a substantial part of any carrier's revenue requirements for rate purposes. In this connection, the Bell System reported for 1964 a consolidated Federal income tax liability of $1.44 billion.

Senator LONG. Mr. Hyde, since you have been asked a number of questions about this, and I would not interrupt until you were through, but have you got a copy of the amendment before you?

Mr. HYDE. Yes.

Senator LONG. Will you look at page 3.

Mr. HYDE. Right.

Senator LONG. Lines 16 through 19.

Mr. HYDE. Right.

Senator DOUGLAS. Is this the August 30 amendment?

Senator LONG. That is what we are discussing. That is amendment No. 426. That is what I have before us.

Mr. HYDE. The document I have is August 24.

Senator LONG. The one you have does not differ in that respect. Look at page 3, line 16.

Mr. HYDE. Right.

Senator LONG. Do you find these words "determined without regard to carrybacks to such year and without regard to dividends received from other members of such group"?

Mr. HYDE. I find that language.

Senator LONG. My staff advises me that that would prevent what you fear from happening here, and I would like to ask you if you can tell me that that language does not preclude this.

Mr. HYDE. We felt that the act did permit the transfer of tax liabilities from manufacturing to the operating companies under conditions where we would be precluded from reviewing it.

Senator LONG. The point is that if one company wants to take advantage of this $1,200 million in dividends that you are talking about, the other company has got to make it back to them so the transaction would wash itself out, and this language here was intended to prevent exactly the thing you are talking about, and it has been in the bill all the time.

Mr. HYDE. We said at the beginning of our statement we do not purport to be experts in the internal revenue field. If we are in error in our illustration that we have used, why, we will be most eager to correct that. Our general councern with this amendment has been that it seemed from our analysis of it to remove from Federal or from review of the regulating agency, the transfers of tax liability from one entity to another. We are concerned, of course, when any part of the cost of rendering a utility service is excluded from review of the agency which must find that the charges paid by the users are just and reasonable, and reasonably related to the cost of rendering the service.

Senator LONG. In the past I have had occasion to criticize your regulatory efforts in some instances. You have made some good efforts since that time and I applaud you for it.

Mr. HYDE. Senator, I wish you would find occasion to take a look at the review of our regulatory experience which we made before the Senate Committee on Interstate Commerce. We were asked this very question, what have we been doing. We did review our regulatory practices, and I believe that we made a pretty good showing. I have no doubt that you would be pleased by the reduction of $100 million in charges to consumers on an annual basis which we made in the early part of this year.

Senator DOUGLAS. In the early part of this year, after the addresses of the Senator from Louisiana.

Mr. HYDE. We, of course, have the highest respect for the Senator's views.

The Bell System reported for 1964 a consolidated Federal income tax liability of $1.44 billion. Because of the very magnitude of this income tax liability, it is clear that shifts in the tax liability from the nonregulated to the regulated entities could result in significant increases in the public's communications bill. For example, for each 1 percent of tax liability that could be transferred from other affiliates to operating telephone companies, there would be an increase of almost $15 million in such telephone affiliates' revenue requirements. This could result, in turn, in an increase of $15 million per annum in the sums that users would be required to pay for communications services.

Furthermore, I should like to point out that in addition to the Bell System, most of the other communications common carriers subject to this Commission's jurisdiction are affiliated with or are members

of larger corporate entities. Thus, the General Telephone System is part of the General Telephone & Electronics Co.; RCA Communications, Inc., is a wholly owned subsidiary of Radio Communications of America; ITT World Communications, Inc., is owned by the International Telephone & Telegraph Co.; and Tropical Radio Telegraph is owned by the United Fruit Co. Similar possibilities involving smaller amounts could be available to each of these entities.

Finally, as I mentioned in my letter of August 23, Mr. Chairman, there is one other possible effect of the rider which the Commission feels merits consideration. In many instances manufacturing affiliates of a group furnish major portions of the physical equipment and supplies to their regulated affiliates, which are used to furnish common carrier service. The prices charged for such equipment and supplies include an element for the payment of Federal income taxes. At present, we understand that in certain cases adjustments are made periodically to eliminate from costs of service the tax effect of intrasystem sales of capital equipment. The Commission has not had the opportunity to analyze the effect of the rider upon such intrasystem sales, or the income tax treatment thereof which could be applied if the amendment were to become law.

However, we must point out that in one case at least, intrasystem sales run into the many hundreds of millions of dollars per year and the potential effect, on a cumulative basis, could involve many millions of dollars of revenue requirements. Thus, from the standpoint of the amounts involved and possible effects upon ratepayers, the regulatory commission should not be estopped from reviewing these intrasystem transactions for reasonableness and fairness.

In closing, I should like to point out that the Commission does not feel that all agreements between affiliates for the allocation of consolidated taxes would necessarily be deemed improper by the Commission. We are, however, definitely of the view that determinations with respect to the propriety of those allocations should be made in the light of all of the circumstances in each case after a careful and impartial review of all of the pertinent data by the regulatory agency which was created by Congress for that specific function. The Commission believes that only in this way can it be determined whether a specific proposal is reasonable, and fair to the investor whose risk capital makes the service possible and to the user whose payments provide the return to the investor.

In view of all of the foregoing, the Commission respectfully suggests that the last sentence of paragraph c(1) which appears on lines 11 through 23 on page 2 of the August 24 draft of the proposed amendment be deleted.

The Commission appreciates the opportunity afforded it to appear today to present its views to you. We shall be happy to attempt to answer any questions which you may have.

Senator LONG. Sir, if you would make yourself available to us tomorrow morning for questioning——

Mr. HYDE. I will be available.

Senator LONG. Some of the Senators, including myself, want to ask a question or two, and we have to go to vote, so rather than keep you here I would appreciate it if you could come back at 10 tomorrow.

Mr. HYDE. Thank you very much.

(Whereupon, at 5:20 p.m., the committee recessed, to reconvene at 10 a.m., on Wednesday, Sept. 1, 1965.)

TREATMENT OF TAX BENEFITS UNDER CONSOLIDATED RETURNS

WEDNESDAY, SEPTEMBER 1, 1965

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2221, New Senate Office Building, Senator Russell B. Long presiding.

Present: Senators Byrd (chairman), Long, Anderson, Douglas, Hartke, Williams, Bennett, and Dirksen.

Also present: Elizabeth B. Springer, chief clerk, Thomas Vail, professional staff member, and Laurence N. Woodworth, chief of staff, Joint Committee on Internal Revenue Taxation.

Senator LONG. The committee will come to order.

Chairman Hyde, will you please resume the stand. Although you submitted your statement yesterday, you were asked to come back today for questioning.

STATEMENT OF HON. ROSEL H. HYDE, COMMISSIONER, FEDERAL COMMUNICATIONS COMMISSION—Resumed

Mr. HYDE. Yes, sir.

Senator LONG. I wanted to ask you a few questions about that.

Chairman Hyde, have you had occasion to reveiw this *Cities Service* case in the 10th circuit?

Mr. HYDE. No, no; we have not.

Senator LONG. So you do not comment on that whether you think it is right or wrong?

Mr. HYDE. No, sir; I have no comment on that.

Senator LONG. I myself was critical of the Federal Communications Commission, and I was very critical during the course of the satellite debate because, for one thing, it seemed to me that the FCC should have been taking a close look at what Western Electric, which was a subsidiary, was charging A.T. & T. for telephones and equipment, and I think that you are taking a look at that; are you not?

Mr. HYDE. We are. We maintain what we call—a continuing surveillance attitude here—we do ask for information, and we do ask for adjustments from time to time, and I feel that we have been successful in this program.

Senator LONG. Well, that gets back to the old regulation problem that existed when a railroad owned a coal mine. If the railroad—it was possible for the railroad, which also owned the coal mine, the railroad being regulated and the coal mine not being regulated, to pay that coal mine twice as much as that coal was worth, and thereby

shift the railroad profits over into the coal mine. The only thing you could do, the only way you could properly regulate that railroad, if you had the job of doing it—my old daddy once had that kind of a job—was to take a look and see what the fair price for coal would be, and you would then say, "Well, now, coal is worth just, to pick a figure, let us say, $10 a ton, and that is all we are going to let you charge for that coal." That is one of your regulatory problems that makes you look at a subsidiary where people are doing business together.

Mr. HYDE. Right. But, of course, Senator, you know there is a special situation in the case of A.T. & T. and Western Electric. Western Electric supplies most of the equipment used by the carrier, and its associated companies. Although Western Electric is not a carrier subject to our jurisdiction in the sense that a public utility would be, still we must pass upon the justness and reasonableness of the investment in plant, and we could, if the charges were improper, disallow payments made to the manufacturing company.

Also, as you know, there was an antitrust case involving, or looking toward, possible division or divestment, and in the consideration of the consent decree, attention was given to the fact that the FCC does have a certain degree of jurisdiction here and could, in fact, as we do, look into prices charged by Western Electric to the carrier.

Senator LONG. Yes.

Mr. HYDE. It has been our practice to require an accounting, and from time to time adjustments have been made pursuant to our suggestions.

Senator Long. Right. I agree with that.

What would your reaction be if I owned two companies, if I owned one, a telephone company subject to regulation, and the other, a chicken farm, which is not subject to regulation, and kept two sets of books for the two. Do you think that you have, would have, any right to require me to pay out the profits of the chicken farm over to the users of my telephone service?

Mr. HYDE. It would seem incorrect, highly unfair.

Senator LONG. You would have every right to look at every deduction, every tax, every tax credit of my regulated utility——

Mr. HYDE. Right.

Senator LONG (continuing). Which you regulate.

Mr. HYDE. Right; that is what we are concerned with here.

Senator LONG. But the chicken farm is none of your business.

Mr. HYDE. None of our business.

Senator LONG. Unless you could catch me selling chickens to my telephone company at a higher price than selling them to the public.

Mr. HYDE. That seems quite remote.

Senator LONG. But assuming nothing of that sort is happening, it would not be proper to require me to pay out my chicken farm profits over to my regulated utility.

Mr. HYDE. No, indeed.

Senator LONG. Now, if I had these two under joint ownership, and one of them made $1 million, and the other lost $1 million, in the absence of a consolidated return, one of them would have a tax to pay of $480,000, and the other one would have a loss to carry forward, which would be worth $480,000 against future taxes that he might owe, at such time—in other words, if in the next year he made $1

million, then he would have a $480,000 credit against $480,000 in taxes, would he not? Do you understand that?

Mr. HYDE. I do.

Senator, I would like to say that we are not here to oppose the principle of a consolidated return at all. As a matter of fact, it would appear to us from the testimony given in the hearings yesterday, and particularly by Mr. Stone, that there would be distinct advantages to the economy, and we would not want to be understood as opposing this in principle.

Our concern goes simply to the possibility that tax obligations of the noncarrier part of a complex could be transferred to the carrier and not be subject to regulatory review. We think that the regulating agency should have the opportunity to take into consideration all of the charges—all the costs which the user eventually must pay to make sure they are reasonably related to the service, and so forth.

Senator LONG. Chairman Hyde, it seems to me at this point you and I agree completely. I do not disagree with a thing you have said. I do not find you disagreeing with a thing I have said up to this point. I want to see where we disagree, if we disagree at all.

Now, I would like to go one step further. I described these two situations. Here is a telephone company and a chicken farm. One made $1 million, and the other lost $1 million. Instead of this chicken farm carrying its loss forward, it joins me in a consolidated return with that telephone company. One made $1 million, the other lost $1 million. How much in taxes do they owe?

Mr. HYDE. Well, I should think they would cancel out.

Senator LONG. They owe zero at that point.

But now where do your books stand? At that point you owe zero in taxes, but you have got $480,000 on the telephone company's books, which is a tax savings.

Mr. HYDE. Right.

Senator LONG. You saved that because of this consolidated return.

Mr. HYDE. Right.

Senator LONG. And over here on the chicken farm, you have a $480,000 tax credit that he could carry forward, which he loses because of the consolidated return, so your telephone company is $480,000 too rich, and your chicken farm is $480,000 too poor. That is the problem.

Mr. HYDE. Right.

Senator LONG. That is the problem that Senator Dirksen has tried to do something about.

Now, the question is how do you get your $480,000 tax savings of the telephone company that owes the money to the Government, and in the chicken farm that has $480,000 coming to it next year. Now, that is what we are talking about.

Mr. HYDE. This is the problem of how to make, how to get this benefit, without imposing upon the users of the regulated service.

Senator LONG. Now, look, as far as your regulated service is concerned, that man is entitled to make a fair return after taxes.

Mr. HYDE. Right.

Senator LONG. Let us assume he is entitled to make $400,000 against that rate base after taxes. All right. He has got $520,000, so he owes those users $120,000 if he is not in a consolidated return; wouldn't that be correct?

Mr. HYDE. I think so.

Senator LONG. And he owes Uncle Sam $480,000 in taxes. All right.

Now, you put him in a consolidated return. How much does he owe Uncle Sam? Does he owe him the same $120,000 or does he owe him the $480,000 of taxes?

Mr. HYDE. I would have to say that we have not had occasion to make a decision on that kind of a situation where it might prove entirely reasonable. We do not want to be precluded from——

Senator LONG. You see the problem is not very complicated though, is it? It is not a very complicated problem for a man in your business who thinks about rate regulation.

Mr. HYDE. No. It does not seem too complicated. It is a new factor in rate regulation that is not in the pattern that has been developed.

Senator LONG. Let us just take that same illustration a point forward. Let us just say that I am a minority stockholder in that chicken farm.

Mr. HYDE. Right.

Senator LONG. And I have no interest whatever in that telephone company. All right. So in 1965 you strip me of my deductions. Now, we lose $1 million, but we have got a carry forward that is good for the next 10 years, which is worth $480,000 in the year we can take it.

So you strip me of that and give it to the telephone company.

Let us move a year forward. In this year we make $1 million, and we are entitled to get by with no taxes, but we owe $480,000 because you took my deductions and you took my tax credits away from me and gave them to the telephone company.

As a minority stockholder I would have a right to sue you if you did not give me back my money and say, "Give me back my deductions, give me back my credits. They are worth $480,000, and you have no right to give my money to those telephone users."

Doesn't that make sense?

Mr. HYDE. It does.

Senator LONG. Now, all I am contending for, Chairman Hyde, is that the same principle should work both ways. You do not take the moneys from the telephone company and give that money to the chicken farm. But, by the same token, do not take the money that belongs to the chicken farm and give that money to the telephone company.

As I construe Chairman Swidler's testimony sitting right where you are sitting now, his testimony is that he wants to take the chicken farm money and put that over into the pipeline, and he is regulating pipelines, you are regulating the telephone companies.

Now, he had the case before the court of appeals and lost the case. As far as I am concerned, I am perfectly content to amend this language anyway necessary in case the illustration that you gave yesterday is not protected, I am willing to admit, however necessary, to assure that it is protected, but I do not think I feel this way about it when somebody goes to court and he says, "You are making me give away the profits of my unregulated company to my regulated company, so that can then be distributed to the users," and the court says that the man is right in his contention, and they so rule. If

that commission does not want to appeal it, does not want to let the Supreme Court take a look at it, then they ought to be willing to concede that is the law. If they do not think that is good law they can come to us and we can change it.

Here is somebody else who says, "Look, this is the law," and they have a right to appeal it, they have a right to ask the Supreme Court to look at it, which they declined to do because they are going to lose up there, and then I think that fellow has a right to come to the Congress and say, "This is what the Court decided and these people are refusing to obey the law," and they have a right to put their case before Congress. Doesn't that seem fair to you? In other words, if you think the case is wrong you have a right to ask us to change the law, and if the guy thinks that case is right, he has got a right to insist that you abide by it.

Mr. HYDE. Well, Senator Long, we become concerned with this matter only because of its possible impact upon communications services, and we would be very happy to work with you or our staff to work with you to consider amendments which would prevent any untoward interference with our regulatory duty.

Senator LONG. Yes.

Mr. HYDE. I am not prepared to discuss the impact in other areas.

Senator LONG. You see, what I am contending here, and I think that you and I agree on this, is that what you have a right to regulate is the profit that a company makes after taxes; and my contention, and what I am trying to do here and what Senator Dirksen is trying to do here, is the same thing, we say as far as that figure of profits after taxes is concerned, that is a constant figure and should be constant regardless of how this is handled.

But where you have got one company that owes a tax, and the other company with a tax saving, just to give you a simple case where it works out to zero tax, the company that has the tax savings is entitled to be paid for their tax savings, and the company that owes the tax has no right to claim any advantage when it pays that company that full value of the tax savings it wishes to use.

Mr. HYDE. We can easily visualize cases where there may be advantages for the common carrier service, for the associated companies, to be able to file a consolidated return. We think it would be a more logical and more accurate result in terms of the actual cost of providing service. All we are concerned about is——

Senator LONG. Well, you see it does pretty good for taxpayer purposes, too, because, let us look at it this way: so far as Uncle Sam is concerned, he wants his money. But he has a situation where, in the absence of a consolidated return, you carry forward tax losses over a period of years while somebody else writes it off. That is a lot more difficult way to do business, where I owe you money, Uncle Sam owes this taxpayer money, and when the taxpayer gets enough profits, Uncle Sam is going to pay him back, that is a much more complicated way and less reasonable way of doing business than to say to these people who are all owned 80 percent by the same company anyway, "Let us put it all in one pot. You owe us something here, we owe you something here, let us add up the column of figures and subtract, and here is your net liability."

It is something which keeps everything current. If we owe you money we settle up right here and now.

But the problem is, and that is what we are trying to correct here, that where one company uses the other company's tax credits and deductions, the company whose deductions are being consumed has a right to be paid back for them.

Mr. HYDE. Right.

Senator LONG. So far as I am concerned——

Mr. HYDE. I would not question the validity of that argument at all.

Senator LONG. You see, as far as taxes are concerned, Chairman Hyde, as the witness testified here, a year or two ago I put in an amendment that related to the taxes on that problem. There has not been an objection made yet, not a soul has shown us why I am not right about the taxes.

Senator Dirksen said, and I think he is correct about this, too, where one company uses up the other company's tax credits and deductions, the company that uses them up ought to pay that company for them, and it ought to pay them what they are worth to it, and as far as I am concerned, I would be willing to settle for that being a mandatory rule. It might be difficult for some company to live by, and the Treasury is studying that.

But as far as the company wants to live by that rule, where we pay our subsidiary, or if you are a brother and sister relationship, we pay our sister over here for what we used that belonged to her, and we pay her what it was worth to us, and the same thing works vice versa, and if we are willing to live by that rule consistently and abide by it, it seems to us that is the logical, reasonable way to do business. Over in the Treasury that looks to them that likes that is how it ought to be.

Mr. HYDE. Yes.

Senator LONG. If they were sitting where you are sitting they would probably be willing to say that it ought to be mandatory that you do business just that way. But they are willing to say on an optional basis that they are willing to let them do business that way. This is the easiest way to do it.

As far as you are concerned, I would not want to deny you the right to look at any deduction, any tax credit or anything, any other relevant expense that has got to do with the cost of these people doing business.

But what I protest against is where one company uses the assets of another, I protest against any rule that denies them the right to pay it back. Do you object to that?

Mr. HYDE. No. I can appreciate your concern.

Senator LONG. Thank you so much. I appreciate this very much.

Senator DOUGLAS Mr. Chairman?

Senator LONG. Senator Douglas.

Senator DOUGLAS. First, let me say not so much in reply to the questioning of my very able colleague, but in expansion of it, those of us who are skeptical about certain features of this amendment are not particulary interested in the question of intercorporate transfers. What we are interested in, and very dubious about, is the way in which the nonpayment of taxes becomes treated as a payment of taxes for the purpose of increasing rates. The amendment would transform non-costs into costs. If we could eliminate lines 11 to 23, on page 2, with my present understanding of the bill, I personally would not object to it.

Mr. HYDE. We have suggested such an amendment. We would, of course——

Senator DOUGLAS. Eliminate lines 11 to 23, on page 2?

Mr. HYDE. This would completely satisfy the point that we have raised and, Senator, my staff would be available to consider any other language changes that might be found necessary to satisfy the problem as to the regulatory agencies.

Senator DOUGLAS. I am very glad to hear that.

Senator LONG. May I just say, Mr. Hyde, as far as you are concerned, you would be willing to consider language which would say, in effect, that you have the right to look at all these facts.

Mr. HYDE. Right, sir.

Senator LONG. As far as the question of to whom do these tax credits belong, you are not prepared at this point to say.

Mr. HYDE. We have been endeavoring to stay out of the tax business as far as possible, and only protect the area in which we have responsibilities.

Senator LONG. Right.

Pardon me.

Senator DOUGLAS. I may say you will be inevitably involved in these matters. You may want to remain out of them, but you inevitably will be affected by them if this amendment were to go through. You would not be able to avoid responsibility.

Mr. HYDE. As we understand it, Senator, we would be precluded from making any regulatory examination.

Senator DOUGLAS. Exactly. As a matter of fact, if these lines were eliminated, the ordinary and existing regulatory functions would go on subject to court review; isn't that true?

Mr. HYDE. That is correct.

Senator DOUGLAS. My good friend from Louisiana has somewhat reproved the Federal Power Commission for not appealing the case in the 10th circuit, saying that we should obey the law. Now, if this amendment becomes the law, the Power Commission will be bound by it and you will be bound by it, isn't that true?

Mr. HYDE. That is the way we understand it.

Senator DOUGLAS. What this bill does is to foreclose any reversal by the U.S. Supreme Court of that opinion; isn't that true?

Senator LONG. I do not know——

Senator DOUGLAS. Reversal of that opinion or——

Senator LONG. Has time for certiorari passed?

Mr. HYDE. I really am not familiar with the opinion, but have been addressing myself just to the proposed statute.

Senator DOUGLAS. I am not very good in arithmetic, Mr. Hyde, but I did a little checking of your figures and I have the feeling that you have grossly underestimated the possible amounts which users of interstate and foreign telephone service might be required to pay.

You come out with an estimate of $20 million annually. My figure is approximately $40 million.

Mr. HYDE. Since preparing this illustration, I have been advised that we have not taken into consideration certain changes in the tax requirements, and refiguring it, my illustration could show a $40 million figure.

Senator DOUGLAS. Thank you.

For the sake of the record let us make clear what is involved. Interest payments deductible for tax purposes would amount to $330 million; the holding company would have a loss for tax purposes of 48 percent of this or approximately $150 million. Those are your figures.

Mr. HYDE. Right, sir.

Senator DOUGLAS. Now, as a practical matter it would be $158 million.

Mr. HYDE. Right.

Senator DOUGLAS. $158.4 million.

Mr. HYDE. Yes.

Senator DOUGLAS. Now, interstate and foreign service is approximately 25 percent of companies' business.

Mr. HYDE. Right.

Senator DOUGLAS. Twenty-five percent of that would be just short of $40 million.

Mr. HYDE. You are correct.

Senator DOUGLAS. So that the potential loading of telephone rates would not be $20 but $40 million. For the sake of my good colleague, I will say that is one twenty-fifth of $1 billion.

Senator LONG. By the time you get through with that I have a memo to show you are both wrong. But go ahead.

Senator DOUGLAS. So $40 million, plus indeterminate amounts involved in the case of other telephone companies which have manufacturing subsidiaries, plus amounts that might be involved in the telegraph industry.

Mr. HYDE. This was only designed to be an illustration of what it might be possible to work out.

Senator DOUGLAS. In other words, you were very cautious, you took the amount that might be involved and divided it by two in order to be conservative; is that right?

Mr. HYDE. That is about it. We undertook to state the minimum case and made no effort to make an assessment of the total amount which could be involved.

Senator DOUGLAS. Well, you see, this is already amounting to very large sums. Chairman Swidler testified there is $138 million annually involved in the gas industry, plus indeterminate amounts in the electrical industry, plus $40 million on A.T. & T. alone, plus indeterminate amounts for General Electric, I.T. & T. and the others, plus amounts for Western Union. These are annual figures. These are not one-shot totals, these are annual figures. I think a conservative estimate would be at least $200 million a year, one-fifth of $1 billion.

Senator LONG. Just on that point, Mr. Chairman, you will recall that on yesterday you and also Chairman Swidler suggested there was a serious loophole in the proposed amendment because of the parent holding company which could borrow money, receive the interest deduction relating to it, and yet use the fund as a contribution to the capital of subsidiaries. It was suggested that this would create a loss at the holding company level, and you suggested, Chairman Hyde, that this would, in part, be offset by 15 percent of the dividends from the subsidiary which the parent would take into income.

I pointed out yesterday that because of a parenthetical statement in paragraph (2)(b), the dividend income would not be taken into account in the manner that you suggested.

I would now like to present for the record part of the proposed regulations of the Internal Revenue Service relating to section 482 of the Internal Revenue Code which would have the effect of allocating the interest deduction in the case of the debt where it is used without the payment of interest to the subsidiaries even though incurred by the parent holding company.

Where it is capital which is contributed to the subsidiary, it seems to me that it is to the advantage of the regulatory agency to allocate interest costs to the holding company since this would shift the costs to the holding company.

This might be a problem under the tax provisions since a loss at the holding company level can mean the tax-free distributions. However, if this is true it is a fault in present law and not the proposed amendment. It is undoubtedly one of those points that Mr. Stone will study in the next 2 years.

I will submit the Internal Revenue regulations.

(The regulations referred to follow:)

[From Federal Register, Apr. 1, 1965]

§ 1.482-2 Determination of taxable income in specific situations.

(a) *Loans or advances*—(1) *In general.* Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of another member of such group, and charges no interest, or charges interest at a rate which is not equal to an arm's length rate as defined in subparagraph (2) of this paragraph, the district director may reallocate income or deductions to reflect an arm's length interest rate for the use of such loan or advance.

(2) *Arm's length interest rate.* For the purposes of this paragraph, the arm's length interest rate shall be the rate of interest which was charged or would have been charged at the time the indebtedness arose, in independent transactions under similar circumstances considering the amount of the loan, the security involved, the credit standing of the borrower, the interest rate prevailing at the situs of the lender or creditor for comparable loans, and all other relevant facts. If the creditor was not regularly engaged in the business of lending or advancing money or other consideration to unrelated parties the arm's length rate for purposes of this paragraph shall be—

(i) The rate of interest actually charged if at least four, but not in excess of five, percent per annum simple interest, or

(ii) Five percent per annum simple interest if no interest was charged or if the rate of interest charged was less than four, or in excess of five, percent per annum simple interest.

unless the taxpayer can establish to the satisfaction of the district director that another rate would have been more appropriate under the circumstances. Notwithstanding the other provisions of this subparagraph, if the loan or advance represents the proceeds of a loan obtained by the lender at the situs of the borrower the arm's length rate shall be equal to the rate actually paid by the lender.

(3) *Loans or advances to which subparagraph (1) applies.* Subparagraph (1) of this paragraph applies to all forms of bona fide indebtedness and includes:

(i) Loans or advances of money or other consideration (whether or not evidenced by a written instrument), and

(ii) Indebtedness arising in the ordinary course of business out of sales, leases, or the rendition of services by or between members of the group, or any other extension of credit.

Subparagraph (1) of this paragraph does not apply to alleged indebtedness which was intended by the parties to be a contribution of capital or a distribution by a corporation with respect to its shares. The real intent of the parties must be determined by considering all the surounding facts and circumstances. Except as otherwise provided in this subparagraph (with respect to indebtedness described in subdivision (ii) of this subparagraph) the interest period shall commence at the date the indebtedness arises. Subparagraph (1) of this paragraph shall not apply to balances on indebtedness described in subdivision (ii) of this subpara-

graph outstanding for six months or less, unless the indebtedness was evidenced by a written instrument requiring payment of interest for such period. Furthermore, subparagraph (i) of this paragraph shall not apply to balances on indebtedness described in subdivision (ii) of this subparagraph outstanding for more than six months if the taxpayer demonstrates that either it, or others in its industry, as a regular trade practice, permits comparable balances in the case of similar transactions with unrelated parties to remain outstanding for a period longer than six months. For the purpose of determining the period of time for which a balance is outstanding, payments or credits shall be applied against the earliest balance outstanding, unless the taxpayer applies such payments or credits in some other order on its books in accordance with an agreement or understanding of the parties.

Senator LONG. Again let me say as far as I am concerned, the point that you raise in your testimony, that you fear could happen in your regulation of that enormous American Telephone & Telepragh Co., is one that I am just as anxious as you are to see would not occur in any event, and I think is is covered as far as the regulatory aspects of it are concerned. But if it is not, I am ready and willing to agree to language, and support language, that would cover that point.

What I do object to is something that does not at all involve any of your problems, but it does involve some other people's problems, and that is this point of forcing one company to declare out and distribute earnings of another which properly belong in that other company.

Senator DOUGLAS. My good friend, you object to this for tax purposes. What about regulatory purposes?

Senator LONG. Well, as I say, as far as the regulatory aspects, I do not think you have a regulatory problem here. I do not think the point that the Chairman makes is a problem. I think if you go deeper into the tax law you would find out that the tax law does not permit that to happen. But in the event that—in other words, as far as the regulation problem is concerned, I think he is protected. But in the event he is not, I would welcome an opportunity for those who agree with me to consult with his experts and make sure it is protected.

Senator DOUGLAS. Why not simply eliminate lines 11 to 23 on page 2?

Senator LONG. We have one problem that he and I mentioned, the point we discussed, and that is to whom does this belong. For example, if one company uses, as I indicated, one company uses $480,000 of deductions that belong to another company, the company whose deductions are used is entitled to be paid back for it because in future years that company would have been able to use all those deductions by carrying them forward. Under a consolidated return he loses them.

Now, that is an issue that I think we are capable of understanding, and we ought to decide it, and this Commission has never studied that. It may very well be when this Commission studies it they might agree with me on that subject or agree with the court on that subject.

Senator DOUGLAS. Insofar as intercorporate transfers are concerned, I do not object to them. But what I do object to is making the consumers pay for taxes which are not paid. I object to the requirement that noncosts must be treated as costs, and loaded onto the consumers.

If we can eliminate that possibility and provide a possibility for intercorporate transfers for tax purposes, that is something else again. My objection is to lines 11 to 23 on page 2.

Senator LONG. As far as I am concerned, I have read the Chairman's statement and I have had a chance to ask the Chairman a number of questions to understand his views, and so far as I am concerned, the burden of the Chairman's statement, as I understand it, he wants the right to take a look at every deduction——

Mr. HYDE. That is right.

Senator LONG. And every tax credit related to the company that he is regulating.

Mr. HYDE. That is right.

Senator LONG. And I have no objection to that.

Mr. HYDE. That is our point.

Senator LONG. That gets us to a different point, which is the point I tried to explain very simply, that if a man owns a telephone company and a chicken farm, you have no business stripping the chicken farm of its earnings or even its tax credits to pay them out to the fellow who is a user of the telephone service. You ought to keep two separate sets of books, and let one have what he earns, and if he earns more than a fair rate of return he has to give it to his consumers, and the other one, which is a nonregulated company, is entitled to keep whatever he can make as a nonregulated concern.

Senator DOUGLAS. In a similar fashion, I would contend that the users of telephone services should not be compelled to pay for losses in the chicken farm.

Senator LONG. I just agree 100 percent. Now we are together.

Senator Bennett?

Senator BENNETT. No questions.

Senator LONG. Senator Dirksen?

Senator DIRKSEN. Commissioner Hyde, I have only one question. You mentioned the possibility of amendments here. My colleague suggests striking out from lines 11 to 23. Of course, that might cure the malady but it would certainly kill the patient. That is hardly a cure.

Mr. HYDE. Senator Dirksen, we are only looking at this from the standpoint of our particular agency and its responsibility. You won't hold me responsible for the effect my suggestion might have on other areas because we have not purported to make a study of that.

Senator DIRKSEN. Do you have amendatory language ready?

Mr. HYDE. Well, in my statement I did make the same suggestion, but I made it in the light of our own interest, the interest peculiar to us.

Our suggestion, and it is incorporated in my statement, was to eliminate lines 11 to 23. But, as I say, this was designed only to protect the interests that we are concerned with, and does not purport to take into consideration other problems that may be of concern to you.

I would say this, that we would be very willing to lend our assistance, our expertise, so far as our area is concerned, to working out an amendment that would satisfy our points, and hopefully would not be too disruptive of your purposes.

Senator DIRKSEN. When could you submit amendatory language?

Mr. HYDE. Tomorrow morning.

Senator DIRKSEN. That is all.

(The amendatory language subsequently furnished by Commissioner Hyde follows:)

FEDERAL COMMUNICATIONS COMMISSION,
Washington, D.C., September 1, 1965.

Hon. HARRY FLOOD BYRD,
Chairman, Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reference to amendment 426, proposed by Senator Dirksen to H.R. 7502 which would amend section 1552 of the Internal Revenue Code of 1954.

At the hearings this morning, Senators Long and Dirksen requested that we furnish for your committee's consideration revisions in the wording of amendment 426 which would remove the objections which this Commission has to the amendment as set forth in my presentation at the hearings before the Senate Finance Committee yesterday. As indicated in my statement to the committee at the hearings, the Commission's recommendation is that the last sentence of paragraph c(1) which appears on lines 11 through 23 on page 2 of the proposed amendment be deleted. In our opinion, that recommendation is the preferable method for revising the amendment to remove the features which we believe to be objectionable. However, in accordance with the requests made at the hearing we are enclosing herewith a suggested revision of the sentence (last sentence of paragraph c(1) which we believe will remove the objectionable features of the amendment insofar as they relate to the regulation of the rates paid by the public for interstate and international communications services.

In drafting the suggested revision, we have attempted to be as responsive as possible.

Sincerely yours,

ROSEL H. HYDE,
Acting Chairman.

PROPOSED REVISION OF LAST SENTENCE OF PARAGRAPH c(1) IN AMENDMENT 426 SUBMITTED BY SENATOR DIRKSEN TO H.R. 7502

Transfers and receipts to which the preceding sentence applies (and transfers and receipts made prior to the date of the enactment of this subsection, whether or not made under an agreement of the type described in paragraph (2), to the extent made pursuant to a consistent practice having a similar purpose and effect as such an agreement) shall, *in the case where the transfers and receipts are between a member regulated by any Federal agency or instrumentality and another member, whether or not regulated by such agency or instrumentality, which does not supply any services or facilities to the regulated member or does not serve the same members of the public,* be treated as payments, or refunds, of Federal income tax, as the case may be, by all Federal agencies or instrumentalities for the purposes of establishing the cost of service, of determining the overall rate of return, and of determining the net income from the regulated activities or services of a member of such affiliated group; *provided, however, that nothing contained herein shall alter the existing authority of any Federal regulatory agency or instrumentality to adjust the amounts of any such transfers or receipts to the extent that such amounts are affected by the capital structure of such regulated member.*

NOTE.—Italicized portions contain suggested amendment.

Senator DOUGLAS. Well, I wonder if the Federal Power Commission could be invited at the same time to look over this proposed amendment?

Senator BENNETT. Who is writing the law, the Federal Power Commission or this committee?

Senator DOUGLAS. Well now, wait a minute. We are writing the law, but we are seeking advice of the FPC, and I see no reason why we cannot accept advice from the FPC.

Senator LONG. I will assure the Senator if he does not make it available I will make it available to the Federal Power Commission. One way or the other, if he fails to make it available to them I will make it available to them.

Senator DOUGLAS. I will make it available to them.

(A letter subsequently submitted by the Federal Power Commission referred to above appears on p. 230.)

Senator LONG. Any further questions? If not, thank you so much, Mr. Chairman.

Mr. HYDE. Thank you, Mr. Chairman.

Senator LONG. I would like to ask all persons in the room who are spectators to keep their seats if they want a copy of Commissioner O'Connor's statement because it will be passed out to everyone who wants a copy. Yesterday we had such a rush to get copies of the Chairman's statement that it created great confusion. So I will just ask everybody who wants a copy of the statement to hold his seat, and they will be offered a copy of Commissioner O'Connor's statement.

I will now call Commissioner O'Connor. Will you please proceed, sir.

STATEMENT OF HON. LAWRENCE J. O'CONNOR, JR., COMMISSIONER, FEDERAL POWER COMMISSION

Senator DIRKSEN. Commissioner, could I ask you how long have you been on the Commission?

Mr. O'CONNOR. Since August, 4 years, sir.

Senator DIRKSEN. Four years. Thank you.

Mr. O'CONNOR. I remember it well.

Chairman Long and members of the Committee on Finance, it is a privilege for me to appear in response to an invitation to discuss the proper regulatory treatment to be accorded benefits realized in consolidated Federal income tax returns; specifically, those proposed by amendment No. 418 to H.R. 7502.

My statement today is not intended as an exhaustive review of all the problems; the issues are most thoroughly discussed in the Commission's *Cities Service* opinion, and in the 10th circuit's unanimous reversal of the majority position.

Recent news reports on the proposed amendment have been directed to the erroneous assertion that certain consumers may be burdened by the proposed amendment. A recent news article presented an example to show that offsetting losses with the profits of an affiliate could permit the latter to raise his rates. This is not true. The tax liability of a company that is reduced by the losses of an affiliate is strictly a cost item, and the lower taxes that result from such offsetting goes only to reduce the costs of the profit-realizing company. Briefly stated, taxes are not profit to any company; they are a cost of doing business.

When viewed in the proper perspective, the issue before the committee is clear. Congress has decided to forgo tax revenues for the purpose of encouraging economic expansion. Can a regulatory agency of that Congress then utilize the tax reductions achieved by filing a consolidated return for the purpose of benefiting the consumer? Or, stated in another way, are regulated companies to be permitted to participate in the benefits of consolidated tax reporting?

I emphasize the word "benefit." Consumers are not in the least injured by the proposed amendment; rather they could receive windfall taxes that Congress intended to apply for the company's benefit. It is an exercise in futility to assume that consumers will be so benefited. If the tax incentives cannot be realized, the regulated company will cease to utilize a consolidated return. I assume such an option

will remain to a regulated company. It has been contended that the "actual tax" theory encompasses the lowest possible tax costs whereby a regulated company would be required to base its rates as if it filed a consolidated return although it actually filed a separate return.

It is my opinion that how Congress disposes of taxes forgone is a fiscal policy decision that belongs with the legislative body. For a regulatory agency to presume that it is better qualified and is charged with a greater responsibility for determining the disposition of these tax benefits is a presumption that should not be permitted. This, in essence, is what the 10th Circuit held in reversing the *Cities Service* decision. The Commission does not have jurisdiction or authority to inquire into fiscal policy. The opinion of the court, authored by Chief Judge Murrah, properly concluded:

> It is * * * plain that the apportionment of total tax liability among the regulated companies fails to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the act * * *. The Commission's method is therefore unauthorized and its order based thereon must be set aside.

There is no dispute as to the purpose of consolidated returns. In *Cities Service* it was agreed that the overriding purpose of Congress in permitting companies to file a consolidated return was to accelerate the national economy by permitting financially sound companies to diversify and expand their operations. Nevertheless, a majority of the Commission would treat the proper tax allocations of the regulated corporation as a fiction, and would require that only the actual taxes paid by the parent company, arbitrarily apportioned between all affiliated companies, be recognized in the cost of service. Clearly contrary to this theory, the Congress has stated that the tax liability of a group of consolidated affiliates may be reduced, not for the purpose of enriching the ratepayer, but for the purpose of permitting management to diversify and expand its operations.

The congressional purpose is clear. Even more compelling is the fact that Congress, when it determines that taxes should be reduced for the benefit of the general public, does so in clear terms by reducing the income or excise tax. That was not its purpose in permitting the filing of a consolidated tax return. It there determined to utilize expanded investments rather than direct windfalls as a benefit to the public. This is entirely proper since the denial of a direct windfall to some consumers is insignificant when it is considered that the benefits to the company of filing consolidated tax returns will redound to all the people in the form of increased business activity with its concomitant increase in employment. When so viewed the benefits denied to some ratepayers are minimal. For natural gas companies the total benefits denied to consumers, but significantly retained by the companies, are less than one-tenth of 1 percent of total revenues; for electric companies the benefits are less than two-hundredths of 1 percent. For each ratepayer this amounts to less than 10 cents a year. In my opinion the national economy is benefited whether tax revenues are forgone by Congress to the end that companies expand their operations or that consumers be given increased purchasing power. In any event the choice between the two should rest with Congress, not with the agents of Congress.

(The following computations, which are the basis for the figures in the previous paragraph, were later supplied:)

Natural gas companies, year 1964

Consolidated tax savings [1]	[2] $5,537,914
Total revenue [3]	6,960,247,000

[1] Table 1 of letter from Acting Chairman Black.
[2] Equals 0.07956 percent.
[3] Gas Facts, 1965, p. 114, table 103.

Electric companies, year 1963–64

Consolidated tax savings [1]	[2] $3,050,307
Total revenue [3]	14,179,967,748

[1] Table 2 of letter from Acting Chairman Black.
[2] Equals 0.0215 percent.
[3] Statistics of Electric Utilities, Privately Owned, 1963, p. XIV.

Savings per ratepayer

Gas savings	$5,537,914
Electric savings	3,050,307
Total	8,588,221
Gas ratepayers [1]	36,463,300
Electric ratepayers [2]	49,559,457
Total	86,022,757

[1] Gas Facts, 1965, p. 80, table 65.
[2] Statistics of Electric Utilities, Privately Owned, 1963, p. XV.

NOTE.—Savings per taxpayer $8,588,221 divided by 86,022,757 equals $0.099.

Mr. O'CONNOR. Certain regulators assert that, by virtue of their special expertise, they can better provide for expanded economic operations in their sector of the economy. This assertion of authority is patently improper. It avoids the key question, previously mentioned, of whether regulated companies are to be permitted to participate in the tax benefits accorded increased investments for the purpose of economic acceleration. They should be permitted so to act. Such tax incentives as accrue to the company shareholders are in effect used only to reduce the affiliates' loss that created the tax deduction. This treatment is appropriate because that affiliate is thereby deprived of a loss carryover which it could otherwise have used to reduce taxes in the future. It is my position that there is not and should not be protection against competition under Federal laws. Competition between energy sources exists at the national level to the end that there shall be a free choice between the available fuels. A jurisdictional company subject to such risks should be entitled to protect its financial integrity by diversifying its investments and by realizing the congressionally authorized benefits of consolidated tax returns.

For all these reasons I commend to this committee the purpose of the proposed amendment No. 418 to H.R. 7502, subject to two clarifications. The first would be similar to that added last year to the investment tax credit provisions, where it was specifically declared as the congressional intention that such tax credits were—

> to provide an incentive for modernization and growth of private industry (including that portion thereof which is regulated).

The language utilized in proposed amendment 337 to H.R. 8363 in the 88th Congress, 1st session, would accomplish this. There should also be added a proviso which would permit a regulatory agency to review the propriety of allocations between affiliates to prevent any possibility of inequitable apportionments between jurisdic-

tional or nonjurisdictional affiliates which would not be consistent with the congressional intention.

Proposed amendment No. 418, as clarified, would reflect a policy of encouraging economic expansion to the benefit of all persons; it would permit regulated companies to participate in the benefits of such tax incentives from Congress as fiscal policy should necessitate; it would not in the least infringe upon ratepayers' interests in just and reasonable rates; and it would not infringe upon the interests of the Federal Power Commission.

Senator LONG. Thank you very much, Mr. O'Connor.

It seems to me that you put your finger on what I have been trying to contend, and what I believe Senator Dirksen contends, when you say here right on page 4:

> Such tax incentives as accrue to the company shareholders are in effect used only to reduce the affiliates' loss that created the tax deduction. This treatment is appropriate because that affiliate is thereby deprived of a loss carryover which it could otherwise have used to reduce taxes in the future.

Now, if I might just give you an illustration I gave to Chairman Hyde, if I had—in your case—a pipeline that made $1 million profit, and I had a chicken farm that lost $1 million, if I let the pipeline take the tax deductions of the chicken farm, then in the subsequent year when the chicken farm made $1 million, the chicken farm would be out the $480,000 in taxes that it otherwise could have saved by carrying forward that loss. Would that be correct?

Mr. O'CONNOR. That is correct, subject to the limitation on loss carryovers.

Senator LONG. If neither one of them were regulated companies and just, say two of them were in a consolidated return, and you were a minority stockholder in a chicken farm, you would have every right to pursue that company and have them make it up to you, and if they would not just let you keep that $480,000 in tax credits generated by that loss in the previous year.

Mr. O'CONNOR. That is the way I think of it.

Senator LONG. Yes. Thank you very much. Senator Anderson?

Senator ANDERSON. No questions.

Senator BENNETT. No questions.

Senator LONG. Senator Dirksen?

Senator DIRKSEN. Well, Mr. O'Connor, you stated the case that I tried to state 18 months ago in offering an amendment in order to get this thing clarified at the time the tax bill was before us, and I believe you put the emphasis in the right place. Either I am wholly mistaken or if I do correctly remember the burden of most of the testimony when we were talking about investment credit, it was for the purpse of expansion and diversification, to create jobs because our unemployment percentage was rather high at the time, and nearly every witness who appeared indicated that the tax reduction would help in this field.

Now you have clarified this situation, and If I had undertaken to write your brief I certainly could not have done any better and, therefore, I have no further questions.

Mr. O'CONNOR. I might say that certainly the investment credit provision was one that was fought out here. But since it was settled by the Congress there has been no problem to us as a regulatory agency since then.

Senator LONG. If we had not settled that question for you there would have been a fight from now to eternity, I suppose. Thank you so much.

Senator DIRKSEN. One other question, Mr. O'Connor, other than the *Cities Service* case in the 10th circuit, have there been anterior cases dealing with the same problem?

Mr. O'CONNOR. The Commission presently has a decision with respect to United Gas Pipeline that involves a similar problem which is in the fifth circuit for decision at the present time. It has been briefed and is awaiting argument and decision.

Senator DIRKSEN. Let me ask you one leading question which you do not have to answer if you do not want to. Why have you waited so long, why has the Commission waited so long, to appeal that decision in the 10th circuit?

Mr. O'CONNOR. Senator Dirksen, I was not——

Senator ANDERSON. I cannot hear you very well.

Mr. O'CONNOR. I cannot speak for the majority of the Commission.

Senator DIRKSEN. Very well.

Mr. O'CONNOR. I would have let it drop long before that.

Senator ANDERSON. I did not hear the last part of what you said.

Mr. O'CONNOR. Senator Dirksen asked me why the Commission waited so long to appeal the decision, and I said I could not answer for the majority of the Commission because I felt that the case should never have been decided the way the Commission decided it in the first place.

There is no appeal from the *Cities Service* case because the time for certiorari has passed, so that the case is dead. The Commission did not choose to appeal the *Cities Service* case. A somewhat similar issue has been presented in the fifth circuit in the *United Gas* case.

Senator ANDERSON. You feel the Commission has the right to try to put it on the best basis it can?

Mr. O'CONNOR. I think the Commission has the responsibility to protect the public interest, and this includes all facets of the public interest.

Senator ANDERSON. Well, do you think the Commission has the right to pick out the battleground on which it fights?

Mr. O'CONNOR. Yes, sir. If I were on the side of the majority I think I would have done exactly the same thing. A regulatory agency has a right to fight the battle in the best place it can.

Senator ANDERSON. There has been reference made to the investment credit. Most of us know it is a pretty hard problem to get the investment credit provision through with the provision for regulating utilities; isn't that so? There was a bill with the provision for the regulation of utilities. That got in because they did not have quite enouth votes for the investment credit alone.

Senator LONG. When I saw it it came over from the House and it had the provision for the regulated utilities in there. That was section 202(e)(2) of their bill, 202(e)(3) of ours. I never saw——

Senator ANDERSON. Senator Douglas has some questions.

Senator DOUGLAS. Mr. O'Connor, there seems to be implicit in your statement the assertion that Congress has already decided this issue in favor of your contention and that of my colleagues here. Are you saying that?

Mr. O'CONNOR. I felt that the implication—not the implication but the philosophy of consolidated tax returns——

Senator DOUGLAS. Now, Congress decided the investment credit issue, wrongly I think. I think it was a great mistake, but Congress did decide it. But this is something else again. You can defend investment credit on the ground it is a stimulus to investment although, as a matter of fact, investment would be guaranteed a fair rate of return on capital invested. But this is a transfer from the consuming public to the holding company structure without any requirement in return. It is taking income away from the regulated portions and causing consumers to bear a heavier burden. There is no requirement in return that investments be increased whatsoever.

Now, you propose a little face-saving language that this should be used to stimulate investment. But this is not mandatory in any sense, that the amount so transferred should be used for investment. So that the precedent in the investment credit case, which I feel was a bad move, does not apply here. This is entirely a different kettle of fish.

Mr. O'CONNOR. I did not mean that the precedent should apply, Senator Douglas. I meant that the decision of this committee and the Senate put to rest a controversy which would still be raging in the courts. I think this committee and the Senate should decide this matter, too. I did not mean to imply that this was not before the Congress.

Senator DOUGLAS. In other words, this is still a controversial issue.

Mr. O'CONNOR. I agree with you on that, sir. But I would like to say that I can justify the amendment here more than any other because a tax loss can only be taken once by somebody. Once you take it away from one person you deprive the other person of it, and, as I say in my statement I could not justify either between two regulated companies or between regulated and nonregulated companies.

Senator DOUGLAS. You expressed approval of the decision in the 10th circuit. Why not allow this whole issue to remain in the courts? What you are proposing is that the courts be foreclosed and prevented from giving an opinion contrary to the opinion of the 10th circuit. Why not let the courts pass upon the issue from these fifth circuit cases?

Mr. O'CONNOR. With respect to the decisions of the Commission in which I participated, the courts are going to decide it unless the Congress wants to decide it in their stead.

Senator DOUGLAS. Why not let the courts decide it? If the Commission loses its cases in the fifth circuit, I suppose it will stop there on the particular question of investment credit. If they win, I suppose the case will be appealed. It will be appealed, probably, whichever side loses, so it will go up to the Supreme Court. Why not let it go up to the Supreme Court instead of stepping in with this provision?

Senator LONG. Well, may I just interrupt to see if I understand. If I understand what you are saying here, what you are saying, "when you passed the provision on the investment credit you told us what you wanted to do about that investment credit, who you wanted to have it, and if you had not told us that, we would have probably had a divided opinion on the Commission, it would have gone to court, and if we did not like it we would have done what we did in the *Cities*

Service case, not appeal from that, try to find a court to decide with us, and then let the other guy worry about appealing."

But then, on the other hand, now on the consolidated return, we did not tell you what to do about it, so you are in court, and your thought is that you ought to say it one way or the other, either they get it or they do not get it. In that way you save the Commission having to spend years having to argue about it and disagree, to save this thing ever going to the court, this court and that court and the other court; if they don't like the decision of this one, try it in a different court; if they don't like it there, try another circuit, and finally run out of circuits and appeal to the Supreme Court. You save all that foolishness, and you say either get it or not get it. That is what you are saying, the law ought to be definite and clear one way or the other. That is the way I interpret your statement.

Mr. O'CONNOR. That is correct.

Senator DOUGLAS. Certainly we would get it clear if we enact this language, lines 11 to 23 on page 2, providing that noncosts must be treated as costs, that taxes not paid must be treated as taxes paid, and that the consumer, as a consequence, must carry the burden.

The question is, as I repeat again, intercorporate transfers for tax purposes are, perhaps, justified, but they are not justified for regulatory purposes.

Senator LONG. Paul, if I may just interrupt you there, because I would just like to get this clear so we both understand the same thing, you are talking about treating noncosts as costs.

Senator DOUGLAS. That is our contention.

Senator LONG. Yes. It is my contention that if you are a minority stockholder in that chicken farm, and I am a minority stockholder in this telephone company, and I use up your tax deductions so you lose them, and I then pay you for it, that is a cost. I am paying you back something that I used that was yours, and that is a cost to me to pay you back something I took from you.

Senator DOUGLAS. Senator, again, I would say for the moment I am not interested in the transfers in this holding company structure. But what I am interested in is the question as to whether the users of the services of the regulated companies have to pay for amounts transferred to other companies for expenses which never occurred to the structure as a whole.

Senator LONG. But it is an expense.

Senator DOUGLAS. The expense may be to that individual company. It is not an expense to the holding company system, merely an intercorporate transfer. This is a ridiculous position that taxes not paid constitute an expense.

Mr. O'CONNOR. What would you do, Senator Douglas, in a future year when the company that had the loss carryover then was in a profit position and had no benefit of its loss carryover? Would you have a regulatory agency then approve a transfer from the regulated company to the nonregulated company at that time?

Senator DOUGLAS. Which one was making the profits?

Mr. O'CONNOR. I beg your pardon for asking you this question, but this is a key question to me. You have used an example which, could be two regulated companies. But even if we have a nonregulated and a regulated company, in a future year when the company that provided the loss to reduce the taxes of the regulated company

was then itself in a profit position, it would not have the benefit of the carryover, and, therefore, its taxes, assuming the tax rate was the same, will be that much higher in that year. How would that company be reimbursed?

Senator DOUGLAS. Well, there are subtleties. I would normally think that each company should be considered on its own merits. That would be my offhand judgment. But that is not the issue immediately before us.

May I ask you a question?

Mr. O'CONNOR. Yes, sir.

Senator DOUGLAS. I am not a particularly bright man, and I sometimes fail to understand language. You say:

> I emphasize the word "benefit." Consumers are not in the least injured by the proposed amendment. Rather they could receive windfall taxes that Congress intended to apply for the company's benefit.

Do you mean by this amendment that they would receive windfalls, that the consumers of the regulated company could receive windfall benefits?

Mr. O'CONNOR. The amendment will prevent the regulatory agency from giving them windfall benefits.

Senator DOUGLAS. Rather they could receive windfall taxes. In other words, the amendment provides that they could not receive these windfall——

Mr. O'CONNOR. The amendment provides that the tax savings, as I interpret the amendment——

Senator DOUGLAS. Then you go on to say:

> It is an exercise in futility to assume the consumers would be so benefited.

Whose futility would it be? The futility of the amendment or the futility of those of us who do not believe in the amendment?

Mr. O'CONNOR. With due deference, sir, I believe it is the futility of the people who adopted this philosophy because if this amendment does not go through these companies are not going to file consolidated tax returns. Therefore, there will be no possibility of this tax benefit going to the regulated people. I would say that they would not.

Senator DOUGLAS. Well, the tax benefit does not go to the regulated industry consumers. It is siphoned away from the regulated companies to the unregulated, thus diminishing the earnings of the regulated companies and strengthening the case either for an increase in rates or against a decrease in rates.

Mr. O'CONNOR. I cannot agree with you, sir.

Senator LONG. Senator, if I might just give you an illustration, let us go back to that chicken farm again.

Senator DOUGLAS. Ye gods, how old are the chickens? I think they will come home to roost.

Senator LONG. Right now they are an hour and ten minutes old.

Now, you have the chicken farm, and I have the regulated company, and we filed a consolidated return. You lost $1 million and I made $1 million. The Government owes you $480,000 at such time as you make money because you have a loss carry forward.

Now, I owe the Government $480,000. We filed a consolidated return, and the two of us owe the Government zero. We take our losses, and my profits, put them all together and we owe the Government zero.

Now, what this man is saying is that if I get the benefit of keeping that $480,000 of tax savings, his agency is going to give this tax savings to my users, and when I pass that money through to them you have lost your $480,000. You would be a fool to join in a consolidated return with me, and you would get fired as an officer of that company.

Senator DOUGLAS. Wait a minute, Russell. What you are saying is that the consumers of a regulated utility should pay in rates for the losses which a nonregulated company bears. That is exactly what you are saying, and I think such a requirement is unjustified and unwise.

Senator LONG. Not at all; not at all. What we have here is that in my company we made a profit of $525,000. Let us assume a fair return would have been $500,000, so we give $20,000 back to our consumers in a rate reduction, and we keep the other $500,000 for profits.

Now, what he is saying is that I should pay you for using your deductions, because next year you make a million dollars, and in that year you would have been entitled to a $480,000 tax credit for the losses in this year, and so since you lost all the advantages of your deductions and your carry-forwards, you ought to be paid for it, and he says if I were to take your deductions and get a windfall benefit in my business, and then give that to my consumers, that I would not have been benefited, and you would have been out $480,000, and you would have refused to join me in a consolidated return.

Senator DOUGLAS. Russell, these are nonregulated companies, with prices fixed by supposed competition. If that were all that is involved, I think this issue would not arise. But it does arise when you have one regulated company, where they are already guaranteed a fair rate of return on capital invested, already guaranteed that, so if they do not get it they can go to the courts and get it. The courts have always upheld them, and the rate of return is generally ample. The issue is whether the losses of a nonregulated business ought to be saddled in addition upon the consumers of the regulated service. That is the issue. Now, you hold one point of view and I hold another.

Senator LONG. If you can picture for a moment the Paul Douglas chicken farm——

Senator DOUGLAS. And the Russell Long Gas Co.

Senator LONG. The Russell Long Gas Co. and the Paul Douglas chicken farm. The Russell Long Gas Co. makes $1 million and the Paul Douglas chicken farm loses $1 million, with every possibility of making it back next year. Next year the Paul Douglas chicken farm makes $1 million, and pays out $480,000 in taxes that he would not have owed except for the fact that the Russell Long Gas Co. had taken the tax saving, so you pay $480,000 that you wouldn't have owed in a consolidated return.

Senator DOUGLAS. But either that year or the next year or the year after, the corporate structure would have been changed. So you get a reversal position, because the determination of the corporate structure and the distribution of earnings is solely within the discretion of the corporation, and the subsidiaries will go in or out as it suits them best.

Senator LONG. Exactly.

Senator DOUGLAS. It is heads, Long wins, and tails, Douglas loses.

Senator LONG. No, it is not. Let us just turn that around for a minute. When you pay me my $480,000 back, the people do get the rate return. That is just the point.

Senator BENNETT. Mr. Chairman, I would just like to raise with Commissioner O'Connor the question I raised with Mr. Swidler and Mr. Hyde yesterday. The inference in all this testimony is that the management of the various companies in these consolidations sits down and, at its own whim, based on its own interests, divides up these tax losses and tax credits each year without consideration of any other situation.

But section (2) of the bill, as I read it, sets down a very clear formula on which these tax losses and tax benefits must be divided among the various members of the consolidation, and when Senator Douglas says every year they are going to change it around for their benefit, the only way they can change it is to break up the consolidation.

Senator ANDERSON. Oh, no. Didn't we have testimony they can do it by amending the agreement?

Senator BENNETT. No, they cannot amend the agreement, except with the permission of the Internal Revenue Service. This is the basic law, not in the amendment. Once you enter into a consolidated return agreement you are bound by that agreement.

Senator DOUGLAS. For how long?

Senator BENNETT. Until the Commissioner gives you approval to change it or until you withdraw from it.

Senator DOUGLAS. But the Commissioner of Internal Revenue operates solely for tax purposes, as we have seen here. He does not consider regulatory purposes. He has especially disavowed any relationships with regulation.

Senator BENNETT. Whether the Commissioner operates for tax purposes or not, he controls the conditions of the agreement.

Senator DOUGLAS. Yes.

Senator BENNETT. And the only way a company can get out of it is to withdraw from the consolidation, and it must remain out of the consolidation for at least 1 year after it withdraws.

Senator DOUGLAS. That is what I said, if not next year, then the year after, it can be changed.

Senator BENNETT. Well, when a company finds itself in a position where it might benefit by a change in the agreement, it has to withdraw and take the full effects of its tax as a separate company.

Senator DOUGLAS. And then get the benefits the next year.

Senator LONG. Just so that the record will be clear——

Senator BENNETT. May I finish?

Senator LONG. Yes.

Senator BENNETT. It is assumed apparently when a unit decides to withdraw it can look into the future 2 years and say, "I can benefit by withdrawing now, but I can be sure I will make enough money or lose enough money 2 years from now to come in."

It seems to me that this assumption that these people can sit down after they have had their operating period, after it has ended, after they see how their profits are going to be divided up, and then decide to divide them up on the basis of their self-interest, and do that every year, is completely fallacious.

Senator DOUGLAS. The Senator from Utah is retreating very markedly from the position he took yesterday. Yesterday he initially

took the position that once a corporation went into a given structure it was bound indissolubly in that structure, and could not retire.

Senator BENNETT. The Senator never took that position. I am sorry my friend from Illinois misunderstood me.

Senator DOUGLAS. Oh.

Senator BENNETT. The Senator took the position that a corporation is bound until it can get permission of the Commissioner of Internal Revenue to withdraw. The law binds the group in this pattern. Every member of the consolidated group that has tax benefits greater than it would have if it operated as a single company must contribute that benefit to those whose benefits would be less if they had operated singly in approximately 100 percent of that amount. That is what this amendment says, and it seems to me that there are only two ways out: the Commissioner can say, "Well, we will give you an exception from this requirement," or the particular company must withdraw, and if it withdraws it has to stay out for at least 1 year and pay the tax obligation that is assessed against it, as a single company. To assume that it can go back in 2 years later on the theory that it can project what its tax situation will be, seems to me to be assuming a lot. Even Mr. Swidler said he had not realized that there was this much of a limitation on the distribution of earnings, and that if he had realized it, his testimony might have been different.

Have you read the part of the bill, Mr. O'Connor, to which I am adverting?

Mr. O'CONNOR. Yes, sir.

Senator BENNETT. Do you agree that there is a rigidity in this requirement?

Mr. O'CONNOR. I so interpret it, Senator Bennett.

It is my opinion that the amount of tax saved by filing a consolidated return should be put back into the company that provided the loss by the amount of tax saving that they had. I feel that even among completely owned or partially owned companies, it should be subject to suit if you did not.

I feel if there were any other basis—if the Internal Revenue Service might consider any underage or overage, it might turn this back as a capital contribution, which is what started it all in the first place.

Senator BENNETT. The chicken farm business.

Mr. O'CONNOR. Yes.

Senator BENNETT. I have nothing else.

Senator ANDERSON. Senator Williams says the paper this morning quoted me as saying that I was a little confused, and I concede that you have me confused now.

I used an example the other day of a transaction I knew something about, where company "A" had a tax loss of $11 million. It decided to go out of business. It could not continue, did not want to continue. The loss was big enough, and another company was going to continue in the same business, and pay them $1 million for that tax loss, company "B."

It is your contention, is it not, that company "B" should be able to include the whole $11 million as a cost?

Mr. O'CONNOR. Senator Anderson, that is not the type of a situation we face in the regulatory agency.

Senator ANDERSON. I did not ask you that. But that is what existed. Do you believe they should put the whole $11 million and put it in their rate structure as a cost?

Senator BENNETT. Can I raise a question?

Senator ANDERSON. Let him answer the question. He does not need coaching.

Senator BENNETT. I am not coaching him. I want a clarification from you on your question.

Senator ANDERSON. Very well.

Senator BENNETT. Isn't this a consolidated return problem? In your illustration, the company that bought the tax liability, had passed the point where it could include that tax liability in a consolidated return, because the liability originated in a year before there was any consolidation?

Senator ANDERSON. He has been talking about philosophy. I do not care whether it is a consolidated return. I am trying to find out if he thinks a company which bought a $11 million tax loss for $1 million should be allowed to use the whole $11 million in the structure for ratemaking purposes.

Mr. O'CONNOR. In the philosophy of ratemaking, I would not permit that to be put in.

Senator ANDERSON. You would not permit it?

Mr. O'CONNOR. I would not.

Senator ANDERSON. You just got through testifying you would have some use for tax losses and carryforwards. You would not permit it? How could you stop it?

Mr. O'CONNOR. I would not permit the $11 million they pay for this company to be included.

Senator DOUGLAS. They pay $1 million.

Senator ANDERSON. They pay $1 million. How can you stop it? Can you give me a provision in the law which could stop it?

Mr. O'CONNOR. In the first place, the Internal Revenue Service itself does not permit the purchase of tax losses.

Senator ANDERSON. It does not?

Mr. O'CONNOR. Not in my opinion.

Senator ANDERSON. Maybe these people did not know what they were buying, but they thought they were buying a tax loss.

Mr. O'CONNOR. I am sure you are more familiar with the tax law than I am. But the company has to have a continuity before it can use the carryover.

Senator ANDERSON. I did not say company A had continuity. Company B had continuity. It bought a tax loss from company A and got the advantage for company B. Do you dispute that that can be done?

Mr. O'CONNOR. I would not approve it foı ratemaking purposes.

Senator ANDERSON. How would you stop it?

Mr. O'CONNOR. Simply because if we looked at it in the philosophy of the clarification here we would say that this was not what the Congress intended to have happen.

Senator DOUGLAS. Well, you would have to authorize it under lines 11 to 23.

I would like to have light upon—Mr. Chairman, a statement of facts has been made here which I would like to have light upon. The statement has been made that you cannot purchase a tax loss. I would like to ask Mr. Woodworth be invited to testify as to whether this is true, as to whether a company can purchase a tax loss or not.

Mr. WOODWORTH. It is possible for tax purposes, to make use of the loss of another corporation where certain conditions are met. These conditions, in general terms, require that there be a continuity of interest to the extent of 20 percent. In other words, there has to be a transfer to the stockholders of the loss corporation of at least 20 percent of the stock of the other company. I have been speaking up until now of those tax-free acquisitions generally referred to as reorganizations. There are also several restrictions when a corporation is acquired by purchase of more than half of the stock. In such a case the loss cannot be used in any event if the business of the corporation is changed. In addition, a loss may be disallowed when the Commissioner can show that a corporation was acquired in order to evade or avoid Federal income tax.

Whether the same conditions are required for regulatory purposes or not is a matter I could not answer.

Senator DOUGLAS. Isn't this quite a common practice, Mr. Woodworth?

Mr. WOODWORTH. There are cases where a loss corporation is purchased, but there are other cases where this cannot be done. As to whether it is common practice or not to purchase loss corporations I would have difficulty in saying. There were modifications made which tightened this provision up to some degree, but it certainly is still possible to some extent to purchase loss corporations.

Senator DOUGLAS. How large an extent?

Mr. WOODWORTH. I do not have the statistics on that. I do know that the advertising for loss corporations is not as prevalent as it was at one time.

Senator ANDERSON. I want to be clear. I think it is all right. The law permits it, and tax practice says it is proper, not for regulatory purposes, but for tax losses, and I am trying to find out if you think it is a proper cost for ratemaking purposes.

Senator DOUGLAS. I do not think it is proper for tax purposes, but that is neither here nor there.

Senator ANDERSON. If you do not think it is proper you should put in an amendment to change the tax law. But I think it is the tax law at the present time.

Mr. O'CONNOR. My answer is for regulatory purposes I do not think it would be allowed in this type of situation where it was bought.

Senator ANDERSON. But it is very difficult to get into this question because many of us have no idea of what the importance is of filing these consolidated returns, at least I do not, and it may be there are instances where it is perfectly all right, there may be instances where it is not all right, and we are trying to find out what the score would be.

Senator LONG. If I may say, yesterday—I do not think you were in the room at the time—but Chairman Hyde, Acting Chairman of the Federal Communications Commission, spelled out a case in his prepared statement where money could be shifted upward into the holding company from the operating company, and we took a look at the tax law and concluded that could not happen, that the existing law, that the existing tax law precludes that from happening.

Senator ANDERSON. Was that the A.T. & T.?

Senator LONG. Yes. He used the A.T. & T., and I put a memorandum in the record here to show how that could not happen, and the language in this very amendment here would preclude that from happening, based on the illustration that he gave.

Now, I further say that if on his examination of this matter he can find where that conceivably could happen, reviewing what I have provided for, I would be glad to support any language that would preclude that from happening because that is not the intention.

Senator ANDERSON. It is very useful, I think, to get that information.

Senator LONG. Right.

Senator BENNETT. Mr. Chairman, may I ask one more question? Assuming that the case Senator Anderson quoted is not a consolidated return case, and I do not see how it could be if the loss was acquired before the two companies were in a position to file a consolidated return, do you have authority in the Commission to recognize that situation and reject the deduction?

Mr. O'CONNER. I feel that we would certainly have authority, and, as a Commissioner, I would not permit that to go through. Of course, anything could be appealed to the courts. But the particular situation of the interest deduction, I think, has been settled by the courts 25 years ago in holding that the Federal Power Commission has the right to look between affiliated groups to see that a proper allocation of interest deductions was made.

Senator BENNETT. This is not interest, this is a loss, this is an operating loss.

Mr. O'CONNER. Yes. By the same token I would want to look, and that is why I felt it desirable to make the clarifications I suggested to the amendment. All I think any regulatory agent needs is to know the intent of Congress, and we will follow it.

Senator BENNETT. That is all.

Senator DOUGLAS. Mr. Chairman, I wanted to amplify that point. The witness has testified that he now, under existing law, has the authority to disallow such a payment. I would like to ask him whether if this amendment were to be adopted into law he would have that authority.

Mr. O'CONNER. If the present amendment were adopted——

Senator DOUGLAS. Amendment 418 or 426.

Mr. O'CONNOR. I would feel that if this amendment were adopted I certainly would feel this expressed the intent of Congress that these tax benefits were to be handled in this manner. While the Commission might go ahead and vote another way, I think it would be an improper exercise of their jurisdiction since we are an agent of this Congress.

Senator DOUGLAS. How can you maintain that in view of the language on lines 11 to 23, page 2:

> Transfers and receipts to which the preceding sentence applies—

that is, reducing the profits by transfer, and then remitting the retroactive feature in the parentheses——

Senator LONG. Read that, it is very important.

Senator DOUGLAS. All right. [Reading.]

> (and transfers and receipts made prior to the date of the enactment of this subsection, whether or not made under an agreement of the type described in paragraph (2), to the extent made pursuant to a consistent practice having a similar purpose and effect as such an agreement) shall be treated as payments, or refunds, of Federal income tax, as the case may be, by all Federal agencies or instrumentalities for the purpose of establishing the cost of service, of determining the overall rate of return, and of determining the net income from the regulated activities or services of a member of such affiliated group.

In other words, once the allocation has been made it must be treated as an expense by the regulated company. I do not see how you can say you could exercise your discretion and refuse to approve it.

Senator BENNETT. I would like to raise the question again. The example the Senator from New Mexico gave us was not an example of a loss acquired through a consolidated return, because the loss was created before the group was consolidated.

Senator ANDERSON. I will try to find out if the loss credit was taken by a consolidated return. I do not know. I did not examine this firm or this business. I only said that I tried to find out one thing from him, the question of philosophy, did he think a company which bought a tax loss for $1 million should put the whole $11 million in for cost purposes. He says he does not think that, so that helps me quite a bit.

Senator LONG. May I just ask this question, because I think the witness could help me with this, because he is in the regulation field. Suppose you had this situation, and if I give you the chicken farm-pipeline illustration—suppose the pipeline lost $1 million and the chicken farm made up that—used the $480,000 deduction and credits belonging in that year to the pipeline.

Now, let us say in the next year the pipeline makes $1 million, and it has coming from it—it is entitled to be paid back from the non-regulated company. What would the situation be there as far as the consumers are concerned?

Mr. O'CONNOR. As a regulatory agency I would not permit the pipeline at that time to come and ask for an increase in its tax costs. It did not have the tax carryover to pay, which it had given to an affiliated company in a previous year.

Senator LONG. In other words, that company would at that point owe no taxes.

Mr. O'CONNOR. Which, the pipeline company?

Senator LONG. If the pipeline company owed no taxes on it, then——

Mr. O'CONNOR. If the loss carryover was taken by the chicken farm in the first year, and in the second year the pipeline company had a profit, then the pipeline company would owe taxes, where it would not have if it had kept its own loss carryover.

What I was trying to say is that in that case, the pipeline company would not have the money to pay the taxes, but I certainly would not permit it to go to its consumers and ask for an increase in its cost of service to have that money because it had already used up its tax benefit.

Senator LONG. That is all.

The CHAIRMAN (presiding). Any further questions?

Senator LONG. The point I was making is that it does not, that does not, work out to a "heads-I-win, tails-you-lose" proposition as far as the pipeline company is concerned.

Mr. O'CONNOR. Not in my opinion.

Senator LONG. Yes.

Senator DOUGLAS. May I say this: The utility business is not one subject to sharp ups and downs such as chicken farming may be subject to. On the whole, what you have is a relatively constant rate of demand, a relatively constant rate of earnings.

If over a period of time, the earnings fall below a reasonable rate, then I certainly would say that the consumers should pay a higher

price for the services afforded, and that they should not call on profitable ventures in other lines to subsidize the regulated service. Each set of services should stand on its own. The unregulated service should be subject to competition; the regulated service, which is monopolistic in character, should be subject to regulation.

Senator LONG. Well, they all show a loss in their first year, don't they? I mean, in other words——

Mr. O'CONNOR. That would certainly be presumed in the early years and, of course, the ones who utilize the investment tax credit and utilize accelerated depreciation, might show a loss in the early years. But it has to be paid back in the later years when they have a profit.

Senator LONG. So it would be entirely possible that the unregulated company would achieve advantages under a consolidated return in the early years of an operation of a pipeline or regulated company. The years they were building the pipeline, for example, they would have no customers, just no sales. It might take a year or two to build it, and then after they build it, it might take 2 or 3 years to get it operating at capacity.

Mr. O'CONNOR. I think in the history of the transmission companies they show losses for 3 or 4 years.

Senator LONG. During that period of time they are being paid by the nonregulated company, they are depending on it during that period. But later on when they start making a profit they are entitled to keep less of it because they have had refunds made to them by the nonregulated company during those early years. Would that be correct?

Mr. O'CONNOR. That is right, sir. I would say just to make it clear, it is not my intention that any ratepayers would ever pay any more in their cost of service under the amendment under consideration than they would pay if the regulated company filed its own individual return and paid its own taxes.

Senator LONG. In other words, they would pay——

Mr. O'CONNOR. Over a period of time.

Senator LONG. What you are saying here is that as far as the customer is concerned, his rate would be exactly the same whether the company was in a consolidated return and using this amendment or not in a consolidated return using this amendment.

Mr. O'CONNOR. Using this amendment.

Senator DOUGLAS. But you base that statement on the assumption of long-term averages identical between the two sets of enterprises or substantially constant over long periods of time, which they need not be. Is it not a fact we know, as a practical matter, that the industries affected are not only gas pipelines but wells, which the company owns for the purpose of developing gas or oil—and here the depletion allowance, 27½ percent, with gross up to one-half of net, plus writing off the first year of drilling and developmental costs, which would be from 70 to 90 percent of revenue, is such that in the early years companies can show a loss——

Senator LONG. Does this amendment affect those factors in any respect whatsoever?

Mr. O'CONNOR. Not in my opinion.

Senator DOUGLAS. I do not see why not. If a bookkeeping loss shows you can transfer them——

Senator LONG. But that is not affected by the amendment. This amendment does not have a thing in the world to do with that.

Senator DOUGLAS. Just a minute. The transfer of taxes resulting from a consolidated statement can take payments from the regulated utility over to the nonregulated well or company developing wells. Those transfers would be deducted from the earnings of the regulated company, and rates could be correspondingly increased to make up for the payments made.

Mr. O'CONNOR. I do not believe any regulatory agency would permit a rate increase based on those facts.

Senator DOUGLAS. Mr. O'Connor, that is precisely what lines 11 to 23 require. You ethically recoil from that. But legally that is precisely what is granted by lines 11 to 23.

Senator LONG. Let me ask you this question: Isn't this correct, that first starting out on what I thought Senator Douglas was saying, if the regulated company owns wells or is drilling gas wells, this amendment would not have a thing in the world to do with it one way or the other, if that is the regulated company.

Senator DOUGLAS. If it is an affiliated company, either a parent or a brother and sister or a cousin.

Senator LONG. I first thought you were talking about a regulated company with respect to the wells. If that were the case it would not affect it at all.

Senator DOUGLAS. I am talking about the system. They generally are regulated companies.

Senator LONG. If a regulated company owns an oil company in this instance, which is a company that has a depletion problem, all you are talking about is what you are doing on the tax credits insofar as one company or the other owes taxes; isn't that correct?

Mr. O'CONNOR. Yes, sir.

Senator DOUGLAS. It is a common procedure for a holding company to own both, and to maintain nominal corporate separation, but to amalgamate them for tax purposes.

Mr. O'CONNOR. Depletion alone would not permit a company not to pay taxes. It has to be a combination of depletion and intangible deduction.

Senator LONG. Well, I have no further questions.

The CHAIRMAN Any further questions? Thank you, Mr. O'Connor.

The next witness is Mr. William J. Grove. Take a seat, Mr. Grove.

STATEMENT OF WILLIAM J. GROVE, ATTORNEY

Mr. GROVE. Mr. Chairman and members of the Finance Committee, I am a practicing attorney and appearing here today at the invitation of Senator Dirksen for the purpose of making a statement with respect to the holding of the Court of Appeals for the Tenth Circuit in *Cities Service Gas Company and Cities Service* v. *the Federal Power Commission* in its opinion issued October 9, 1964.

I have prepared a statement which summarizes the issues before the court and sets forth the relevant positions of the Commission staff in the hearing before the Commission as to the income tax component of the cost of service of Cities Service Gas Co.; the holding of the presiding examiner, the holding of the Federal Power Commission in opinion No. 396 upon exceptions to the decision of the presiding

examiner, and the holding of the court of appeals as being consistent with established principles of law.

If the committee would agree, I would submit the statement to be placed in the transcript as though read. I repeat, Mr. Chairman, I would like to submit the statement without reading it.

Senator LONG. No, sir; you go right ahead and read the statement; I thought the chairman was still here. Will you please proceed?

Senator DOUGLAS. Mr. Grove, may I ask, were you an attorney in this case?

Mr. GROVE. No, sir.

Senator DOUGLAS. You did not appear for Cities Service?

Mr. GROVE. No, sir; I did not.

Senator DOUGLAS. You are simply as an attorney expressing your legal opinion upon the case?

Mr. GROVE. Yes, sir; and undertaking to submit what was involved in the case——

Senator DOUGLAS. As you see it.

Mr. GROVE. As it proceeded through the Commission and the courts.

The issue before the court was whether the Commission erred, as a matter of law, when it fixed as the income tax component of the cost of service of Cities Service Gas Co. an amount calculated at a tax rate determined by apportioning the total tax liabilty of the parent Cities Service Co. among regulated subsidiaries. The court, in a unanimous opinion written by Chief Judge Murrah, reversed the Commission and held that, as a matter of law, the Federal Power Commission had failed—

to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the act.

Cities Service Gas Co. is a natural gas company subject to the Natural Gas Act of 1938, as amended (15 U.S.C. sec. 17, et al.), and the rates which it charges for sales of natural gas in interstate commerce for resale are subject to regulation by the Federal Power Commission. The Commission, on March 27, 1961, approved a settlement of a rate increase filed May 21, 1959. Included in the stipulated overall cost of service for Cities Service Gas Co. was the Federal income tax component in amount of $7,055,981, representing the 52-percent statutory rate, then in effect, upon the stipulated allowable return. Although such tax rate, concededly, would have been proper if Cities Service Gas Co. had not been a 100-percent subsidiary of Cities Service Co., the Commission reserved for further hearing and determination the issue whether such allowance was propc. inasmuch as the gas company had been joined, along with 36 other corporations in the then Cities Service Co. system, in the consolidated tax return filed by the parent under sections 1501, and the following of the Internal Revenue Code. The Commission order provided that in the event it was determined after hearing that the stipulated income tax component of the cost of service was improper and that a lesser amount should have been included, the gas company would be required to make further refunds and reductions in rates.

Cities Service Co., at the time of hearing upon the reserved issue, owned directly, or through other wholly owned subsidiaries, 100 percent of 37 subsidiary corporations. The subsidiaries considered by the Commission as "regulated" are Cities Service Gas Co. (FPC),

Cities Service Gas Producing Co. (FPC) Cities Service Oil Co. (FPC), Cities Service Production Co. (FPC), all of which are to an extent either as a natural gas pipeline or independent producer regulated by the Federal Power Commission; Cities Service Pipe Line Co. and Lafitte Oil Traders, Inc., both of which are regulated as to rates by the Interstate Commerce Commission; Kansas Gas Supply Co. regulated by the Kansas Corp. Commission; all other subsidiaries are considered by the Commission to be entirely unregulated.

Exploration for and development and production of crude oil and natural gas are conducted through various subsidiaries both in the United States and foreign countries, including Canada, Italy, French Sahara, Egypt, Colombia, Arabia, Peru, and Venezuela. Through the activities of the other subsidiaries the petroleum operations include the refining of crude oil; the purchase and sale of crude oil and natural gas; operation of 19 wholly or jointly owned gasoline extraction plants; the transportation of crude oil and petroleum products by pipelines, tankcars, and oceangoing tankers; the marketing of all of its petroleum products; scientific research in relation to petroleum and products derived from it; owning and operating office buildings to house the officials and office employees of the parent company and various subsidiaries; the fiscal and financial activities needed for such an extensive petroleum business; and all other activity incident to the operation of the business of Cities Service Co.

Senator LONG. Mr. Chairman, when the witness appeared he offered to submit his statement and, I believe, to comment on it, and I stopped him from doing that.

I have glanced through the statement, and I believe it would be best if the witness would summarize the statement and then let us ask him whatever questions we want to about it.

Mr. GROVE. All right, sir.

Senator LONG. Because his statement, as I see it, goes into very considerable detail about that decision.

Mr. GROVE. It does as to the facts that were involved.

Senator LONG. Yes, sir.

Would you just summarize what the pertinent part of the decision was as it applies to this legislation because that, I think, is pertinent.

Mr. GROVE. I think that the pertinent part of the decision of the court of appeals is probably summarized in my prepared statement, and that is that the holding of the court of appeals that you could not set off losses or profits or costs and expenses from the regulated against unregulated and vice versa is consistent with the basic principle of law that rates must be based upon cost and expenses associated with the particular company and the activity involved, and not upon costs and expenses or profits or losses of some activity as to which the regulatory agency has not been given jurisdiction by the appropriate legislative body.

The CHAIRMAN. Thank you very much.

Senator DOUGLAS. May I ask a question? I have not had time to read your statement since I received it only as you began to testify. I notice you say:

> Commission staff contended that the dollar amount of the income tax component should be determined by applying a tax rate of 10.53 percent instead of the statutory rate of 52 percent.

How was it that it was decided that the tax owed was only 10½ percent instead of 52 percent?

Mr. GROVE. Senator Douglas, in my statement I set forth in detail the manner by which the staff arrived at this conclusion. Basically——

Senator DOUGLAS. I read this hastily, but I do not see the specific items for which the deduction was made. What were they?

Mr. GROVE. Basically what they did was to take the taxable income, the tax which would have been paid by each participating company, if they had filed a separate tax return. Then the total of the consolidated tax return filed by the company was deducted from the total that would have resulted from the addition of all taxes that would have been paid had each company, in fact, paid as a separate corporation; then it was determined what percentage of tax saving was of the total taxes payable upon the basis of separate returns of the participating corporations, and this was multiplied by that resulting percentage. That resulting percentage was then applied to the—the resulting percentage was then subtracted from the ordinary 52 percent, and that result then was arrived to reflect what the consolidated effective tax rate for the respective years 1957, 1958, and 1959 would have been.

In my statement, I show where they arrive at the 23.92 percent consolidated effective tax rate for 1957; zero for 1958 inasmuch as the tax saving of total income taxes equaled 100 percent by reason of the fact that losses of other corporations completely offset the taxes that had already been paid.

Senator DOUGLAS. Do I understand that what reduced the tax from 52 percent to 10½ percent was that there were losses on the part of the nonregulated companies?

Mr. GROVE. Yes, sir.

Senator DOUGLAS. And that these nonregulated companies included refining companies?

Mr. GROVE. Yes, sir.

Senator DOUGLAS. Gasoline extraction plants?

Mr. GROVE. It included——

Senator DOUGLAS. It included refineries, gasoline extraction. These are losses?

Mr. GROVE. Yes, sir. If there were in fact losses shown——

Senator DOUGLAS. Marketing losses.

Mr. GROVE. If there were, in fact, losses shown for those years, they were included; yes, sir.

Senator DOUGLAS. Scientific research?

Mr. GROVE. If, in fact, they showed a loss——

Senator DOUGLAS. Well now, you are an expert on this case. Did they so include it? Were they so included?

Mr. GROVE. I cannot state precisely what each of the 37 corporations—whether each one showed a profit or a loss.

Senator DOUGLAS. There must have been very large aggregate losses to reduce the tax from 52 percent to 10 percent; isn't that true?

Mr. GROVE. Yes, sir.

Senator DOUGLAS. Very large.

Do you know what these losses came to in the aggregate?

Mr. GROVE. I do not have it at my fingertips, Senator. I am trying to find it, but it was so stated in the examiner's decision.

Senator DOUGLAS. I thought you were an expert, and you should know this essential fact. But if you do not, would you please supply it for the record?

Mr. GROVE. Yes, sir; I will.

(The information referred to follows:)

LAW OFFICES, GROVE, PAGLIN,
JASKIEWICZ, GILLIAM & PUTBRESE,
Washington, D.C., September 2, 1965.

Re amendment 418 to H.R. 7502.

U.S. SENATE COMMITTEE ON FINANCE,
New Office Building, Washington, D.C.
(Attention: Mrs. Elizabeth B. Springer, chief clerk).

DEAR MRS. SPRINGER: During the Committee on Finance hearing on September 1, 1965, regarding amendment 418 to H.R. 7502, Senator Paul A. Douglas (Illinois) requested that I submit to the committee a statement of the losses in the aggregate of the affiliate companies in the Cities Service Co. system.

The following statement appears in the concurring opinion of Commissioner Morgan (30 FPC 168–169):

"Here the total profits of the system's profit companies for the 3-year period were $123.4 million; other system companies had tax losses totaling $100 million; * * *."

Respectfully submitted.

WILLIAM J. GROVE.

Senator DOUGLAS. This reduced the tax from 52 percent to 10 percent?

Mr. GROVE. In the manner in which it was calculated; yes, sir.

Senator DOUGLAS. Now, then, what were the regulated companies, gas pipelines?

Mr. GROVE. The regulated companies—well, the position of the staff—all right. The regulated companies were those which I have named, Cities Service Gas Co., Cities Service Gas Producing Co., Cities Service Wells——

Senator DOUGLAS. These are all pipeline companies?

Mr. GROVE. No, sir. The only natural gas pipeline company is the Cities Service Gas Co. Cities Service Gas Production, Cities Service Oil, and Cities Service Production.

Senator DOUGLAS. Are these producing companies which sell gas which enters the pipelines?

Mr. GROVE. Cities Service Gas Producing, Cities Service Oil Co., and Cities Service Production do have sales of natural gas as independent producers and, as such, they are regulated by the Federal Power Commission.

Senator DOUGLAS. I would say in the past somewhat irregularly regulated.

Now, was the sum of there earnings transferred then to the unregulated companies?

Mr. GROVE. Under the staff theory——

Senator DOUGLAS. I want to ask you by ruling of the Commission were they transferred from the regulated companies to the unregulated companies?

Mr. GROVE. The position and the holding of the Federal Power Commission itself rejected the staff approach, and what they held was that the starting point for the determination of the income tax component in the cost of service of Cities Service Gas Co. was the consolidated income tax return.

Senator DOUGLAS. Well, you see, you have prepared a statement which we have not had time to read, and you are asking us to comment about it. I am trying to cut through this.

What was the situation? Did the companies transfer money from the regulated companies to the unregulated companies because of the tax loss of the unregulated companies?

Mr. GROVE. This I do not know.

Senator DOUGLAS. What?

Mr. GROVE. This I do not know.

Senator DOUGLAS. You do not know?

Mr. GROVE. No, sir.

Senator DOUGLAS. Well, this is the issue that is supposedly at stake.

Mr. GROVE. No. I do not think that is the issue at all, Senator.

Senator DOUGLAS. If it is not the issue, then the decision in this case would not be binding with respect to the particular matter before us.

Mr. GROVE. I think that the issue which is involved and decided by the court was whether, in the determination of an income tax component in the cost of service, once having determined what the return should be to the company, it is required under the law that an additional amount be allowed as income taxes, so that after the payment of income taxes by the regulated company there will remain in the hands of the company——

Senator DOUGLAS. Which company?

Mr. GROVE. The regulated natural gas company, the dollar amount of return which the Commission has found they are entitled to receive under the law.

Senator DOUGLAS. Now, is that the decision of the Commission or the decision of the court?

Mr. GROVE. That is the decision of the court.

Senator DOUGLAS. Of the court.

Mr. GROVE. The effect of the decision of the Commission is to allow less than the then applicable 58 percent tax rate, so that if the dollar amount received by the company were, in fact, taxed at a 58-percent rate, Cities Service Gas Co. would have received or would have had remaining approximately somewhat over $1 million less.

Senator DOUGLAS. I do not wish to prolong this, but you say:

> The holding of the court of appeals is consistent with the basic principle of law that rates must be based upon costs and expenses associated with the activity involved, and not upon costs and expenses or profits or losses of some activity as to which the regulatory agency has not been given jurisdiction by the appropriate legislative body.

Well, now, to an untutored person it would seem that this is precisely what we have been contending for; namely, that the losses of unregulated companies should not be used to pull down the return of the regulated company. So in this paragraph I think you have given great aid and comfort to us, sir, Mr. Grove.

Mr. GROVE. Thank you, sir.

Senator DOUGLAS. This seems to strengthen our case very markedly and to imply that the decision of the 10th circuit, instead of being against us is very much for us, because if this is what they said, namely, that you could not charge off losses and make it a burden, losses of unregulated companies, you could not make it a burden

upon the profits of the regulated companies, this is precisely what we are contending for.

I may be reading your statement incorrectly, but I will read every word again because it would seem they bear our what you said. Your statement was that the holding of the court of appeals is consistent with the basic principle of law that rates must be based upon costs and expenses associated with the activity involved, and not upon costs and expenses or profits or losses of some activity as to which the regulatory agency has not been given jurisdiction by the appropriate legislative body.

Mr. GROVE. Yes, sir. I think that the quote on the following page from the *Panhandle Eastern Pipe Line* case, quite succinctly states what it is my understanding from practice that the law is with respect to rate regulation.

Senator DOUGLAS. Well, this seems to be eloquent proof for the principles which we have been contending.

Thank you very much.

Mr. GROVE. As you say, Senator, it is a matter of interpretation, I guess.

Senator DOUGLAS. Well, you agree with my interpretation.

Mr. GROVE. Well, I think what you are saying is true if you applied it both ways. Neither can you deny to the regulated company the income tax, in the income tax component, of the cost of service that which it would have received but for the fact that losses were incurred in some other affiliated company, which was joined with them in the filing of a consolidated return.

Senator DOUGLAS. I and my associates are contending that regulated companies should stand on their own feet and should neither receive profits from unregulated companies, nor be credited with, or pay out for, taxes not paid.

Mr. GROVE. If you are saying, sir, what I think you are, it is that in the determination of the cost of service of a regulated company, you look to that company without regard to any affiliates who might be involved in a consolidated tax return irrespective of whether those affiliates have produced a profit or a loss.

Senator DOUGLAS. I read again your statement:

> The holding of the court of appeals is consistent with the basic principle of law that rates must be based upon costs and expenses associated with the activity involved, and not upon costs and expenses of profits or losses of some activity as to which the regulatory agency has not been given jurisdiction by the appropriate legislative body.

Thank you again, again, again, and again.

Senator LONG. May I ask the witness one question here?

Mr. GROVE. Yes, sir.

Senator LONG. Do I understand this ruling, and the way you explain it, to be simply this: that if you are trying to say what rates can this company charge, and in this particular case the company was a pipeline company, and you say what rates can they charge, what the court said is you would regulate them and let them charge exactly the rate that they would charge if they were not in a consolidated return, that is exactly what you are saying. You would treat them as though they were not in a consolidated return.

Mr. GROVE. Yes, sir; and that can very well be stated as to agree with what the Senator agreed with.

Senator LONG. And the whole idea of a consolidated return is that for tax purposes you can treat companies as though they are one company even though we will understand they are not one company. You can treat 30 companies, for example, as though they were 1 company, even though they are not, in fact, 1 company but 30 companies for tax purposes. But that for regulatory purposes you treat the company as though it were one company which, in fact, is what it is.

Mr. GROVE. Yes, sir; and that is the company being regulated.

Senator DOUGLAS. No, no, nothing of the kind.

Senator LONG. That is what he said.

Mr. GROVE. That is what he said, too.

Senator LONG. That is what you read to him.

Senator DOUGLAS. I simply read his statement. It can be understood in complete support of the position we have taken.

Senator LONG. May I just suggest that that is somewhat like the situation that occurred when a man says, "What you think, Max Jones press your pants for nothing." He went in and got his pants pressed, and Max Jones said, "Pay me 50 cents." He said, "Look at the sign 'Max Jones,'" he said, "What you think, Max Jones press your pants for nothing?" [Laughter.]

Senator DOUGLAS. Well, I think in this case you are the Max Jones. [Laughter.] Thank you again and again and again and again. [Laughter.]

(The prepared statement of Mr. Grove follows:)

STATEMENT OF WILLIAM J. GROVE ON AMENDMENT NO. 418 TO H.R. 7502

Mr. Chairman, I am an attorney and am appearing before your committee at the invitation of Senator Dirksen. My statement is limited to the holding of the Court of Appeals for the 10th Circuit in *Cities Service Gas Company and Cities Service Company* v. *Federal Power Commission*, issued October 9, 1964, and reported in 337 F. (2d) 97. The issue before the court was whether the Commission erred, as a matter of law, when it fixed as the income tax component of the cost of service of Cities Service Gas Co. an amount calculated at a tax rate determined by apportioning the total tax liability of the parent Cities Service Co. among regulated subsidiaries. The court, in a unanimous opinion written by Chief Judge Murrah, reversed the Commission and held that, as a matter of law, the Federal Power Commission had failed "to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the act."

I do not attach a copy of that opinion inasmuch as it has already been made a part of this record.

Cities Service Gas Co. is a natural gas company subject to the Natural Gas Act of 1938, as amended (15 U.S.C. sec. 717, et al.), and the rates which it charges for sales of natural gas in interstate commerce for resale are subject to regulation by the Federal Power Commission. The Commission, on March 27, 1961, approved a settlement of a rate increase filed May 21, 1959. Included in the stipulated overall cost of service for Cities Service Gas Co. was the Federal income tax component in amount of $7,055,981, representing the 52 percent statutory rate, then in effect, upon the stipulated allowable return. Although such tax rate, concededly, would have been proper if Cities Service Gas Co. had not been a 100 percent subsidiary of Cities Service Co., the Commission reserved for further hearing and determination the issue whether such allowance was proper inasmuch as the gas company had been joined, along with 36 other corporations in the then Cities Service Co. system, in the consolidated tax return filed by the parent under sections 1501, et seq., of the Internal Revenue Code. The Commission order provided that in the event it was determined after hearing that the stipulated income tax component of the cost of service was improper and that a lesser amount should have been included, the gas company would be required to make further refunds and reductions in rates.

Cities Service Co., at the time of hearing upon the reserved issue, owned directly, or through other wholly owned subsidiaries, 100 percent of 37 subsidiary corporations. The subsidiaries considered by the Commission as "regulated" are Cities Service Gas Co. (FPC), Cities Service Gas Producing Co. (FPC), Cities Service Oil Co. (FPC), Cities Service Production Co. (FPC), Cities Service Pipe Line Co. (ICC), Lafitte Oil Traders, Inc. (ICC), and Kansas Gas Supply Co. (Kansas Corporation Commission); all other subsidiaries are considered by the Commission to be entirely unregulated.

Exploration for and development and production of crude oil and natural gas are conducted through various subsidiaries both in the United States and foreign countries, including Canada, Italy, French Sahara, Egypt, Colombia, Arabia, Peru, and Venezuela. Through the activities of the other subsidiaries the petroleum operations include the refining of crude oil; the purchase and sale of crude oil and natural gas; operation of 19 wholly or jointly owned gasoline extraction plants; the transportation of crude oil and petroleum products by pipelines, tank cars, and oceangoing tankers; the marketing of all of its petroleum products; scientific research in relation to petroleum and products derived from it; owning and operating office buildings to house the officials and office employees of the parent company and various subsidiaries; the fiscal and financial activities needed for such an extensive petroleum business; and all other activity incident to the operation of the business of Cities Service Co.

Whenever permitted so to do by the Internal Revenue Code, Cities Service Co. has filed a consolidated return. For the years 1957, 1958, and 1959 (considered as appropriate for determination of a representative test year), after offsetting losses of unprofitable companies against the taxable income of profit companies, Cities Service Co. paid a tax in amount of $12,251,638 in 1957, received a refund of $3,857,132 in 1958 by invoking the carryback provisions to 1955 income, and paid a tax of $2,965,014 in 1958. Cities Service Gas Co., each year, paid to its parent income taxes calculated at the 52 percent rate.

Commission staff contended that the dollar amount of the income tax component should be determined by applying a tax rate of 10.53 percent instead of the statutory rate of 52 percent.

The staff formula for deriving a consolidated effective tax rate was to first ascertain the income tax of each participating corporation having taxable income upon a separate return basis. The total of the consolidated income tax paid by the parent company, as shown by its consolidated return, was then subtracted from the total of income taxes shown on the separate returns, and the difference classified as the tax savings for the year. It was then determined what percentage the tax saving was of the total of the taxes payable upon the basis of separate returns of all the participating corporations having taxable income. The statutory tax rate of 52 percent was multiplied by such percentage, and the result subtracted from the 52 percent to obtain the consolidated effective tax rate for the particular year. Thus, in 1957 the tax saving was 54 percent of the total of the taxes payable upon a separate return basis by all corporations having taxable gains. Fifty-four percent of the 52 percent statutory rate was 28.08 percent, which was subtracted from the 52 percent to arrive at the consolidated effective tax rate for 1957 at 23.92 percent. By this same arithmetical procedure, the consolidated effective tax rate for 1959 was calculated to be 7.67 percent. For 1958, the test year, the tax saving was 100 percent of the total income taxes payable on a separate return basis by the corporations having gains, by reason of the fact that the losses of other corporations were in excess of the total taxable income of the gain corporations. Therefore, the consolidated effective tax rate for 1958 was zero percent. The consolidated effective tax rates for 1957, 1958, and 1959 were then simply added together and divided by three to arrive at 10.53 percent. This reduction of 52 percent to 10.53 percent would have reduced the income tax component in the cost of service by $6,270,416 and the rates of Cities Service Gas Co. would have been calculated accordingly.

The presiding examiner rejected the staff theory and held that the income tax component must be determined by use of the 52-percent rate. His decision is reported at 30 FPC 176–197.

Upon exceptions filed to the decision, the Commission, in opinion No. 396, by Commissioner Ross, Chairman Swidler joining and Commissioner Morgan concurring, reported at 30 FPC 158–166, reversed the examiner. The staff theory was rejected as possessing "a quality of artificiality and instability." The Commission held that the "starting point" is the amount of the consolidated tax payment and that the proper method to be applied in computing the Federal income taxes to be included in the cost of service of a regulated company, where that company

has joined in a consolidated tax return with affiliates, is (1) separate the companies into regulated and unregulated groups, (2) determine the net aggregate taxable income of each group, and (3) apportion the net total consolidated tax liability over a representative period of time between the two groups, and among the companies in the regulated group, on the basis of their respective taxable incomes; provided that the allowance so computed for the regulated company shall not exceed what its tax liability would be for ratemaking purposes, if computed on a separate return basis.

Applying the new formula, the income tax component was determined to be $5,866,847, or $1,189,134 less than the amount computed at 52 percent of the taxable income based on the stipulated return to be allowed Cities Service Gas Co.

Commissioner Morgan filed a separate concurring opinion in which he favored adoption of the staff position but joined Chairman Swidler and Commissioner Ross in order to permit Commission resolution of the issue. Commissioners Woodward and O'Connor dissented.

A timely application for rehearing was filed pursuant to section 19(a) of the Natural Gas Act, and upon denial thereof, appeal was taken to the Court of Appeals for the 10th Circuit.

The court of appeals viewed the issue of law presented as follows (337 F. 2d at 98):

"The decisive question is whether the Commission, in the exercise of its undoubted power to determine just and reasonable rates for jurisdictional gas sales, may, in these circumstances, take into account the losses of nonregulated and unrelated affiliates to calculate the tax allowance includible in the cost of service of a regulated company."

It held that jurisdictional limits of the Commission imposed by the Natural Gas Act require a separation of profits and losses between regulated and unregulated businesses in determining the income tax allowancei ncludible in the cost of service of the regulated company; that, under the Commission's method, the amount to be included in the income tax component "is made to depend upon the profits or losses, as the case may be, of the nonregulated companies," and that

"It is thus plain that the apportionment of the total tax liability among the regulated companies failed to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the act, and which the Commission prescribed for itself. The Commission's method is therefore unauthorized and its order based thereon must be set aside."

The Commission did not apply to the Supreme Court of the United States for a writ of certiorari to review the holding of the court of appeals. Upon remand of the record to the Commission, the proceeding was terminated on February 17, 1965.

The holding of the court of appeals is consistent with the basic principle of law that rates must be based upon costs and expenses associated with the activity involved, and not upon costs and expenses or profits or losses of some activity as to which the regulatory agency has not been given jurisdiction by the appropriate legislative body. This principle has been succinctly stated by the Supreme Court of the United States in *Panhandle Eastern Pipe Line Co.* v. *FPC*, 324 U.S. 635, 641–2 (1945):

"We agree that the Commission must make a separation of the regulated and unregulated business when it fixes the interstate wholesale rates of a company whose activities embrace both. Otherwise, the profits or losses, as the case may be, of the unregulated company would be assigned to the regulated business and the Commission would transgress the jurisdictional lines which Congress wrote into the act."

The CHAIRMAN. The next witness is Mr. N. Knowles Davis of the Tennessee Gas Transmission Co., accompanied by Robert Nathan and F. Cleveland Hedrick, Washington, D.C.

STATEMENT OF N. KNOWLES DAVIS, VICE PRESIDENT, TENNESSEE GAS TRANSMISSION CO., ACCOMPANIED BY ROBERT NATHAN AND F. CLEVELAND HEDRICK

Mr. DAVIS. Mr. Chairman I am N. Knowles Davis. If it please the committee, I would like permission of the committee to have Mr. F. Cleveland Hedrick, Jr., sit with me during my presentation,

and Mr. Robert Nathan. Mr. Hedrick is a member of the Washington law firm of Hedrick & Lane and is Washington tax counsel for the company. Mr. Nathan is an economic consultant in Washington, D.C.

I understand that copies of the prepared statements of each of us are being distributed, and I would request that they be made a part of the record of the hearing of this committee.

The CHAIRMAN. Without objection it will be done.

Mr. DAVIS. My prepared statement is fairly long, Mr. Chairman, so if it pleases the committee, I would like to just highlight it and let the committee have the benefit of the full statement at its leisure.

Senator DOUGLAS. Mr. Chairman, if this is done I suggest we recess until a convenient hour this afternoon so that we may have a chance to examine the statement over the noon hour. I think the discussion would be much more intelligent.

Senator LONG. Why not let the man highlight his statement while we are here and quit about 12:30; let him highlight his statement and then he can come back and answer questions this afternoon.

Mr. DAVIS. I am vice president of the Tennessee Gas Transmission Co. specializing in pipeline ratemaking and regulatory problems.

I would like to say that I appreciate the opportunity to appear before the committee and present a statement on this matter.

Prior to my present employment with Tennessee Gas, I was for 23 years associated with Georgia Public Service Commission in Atlanta, Ga., as the chief of its staff concerned with the regulation of all electric, gas, telephone, telegraph, and urban bus rates in the State of Georgia.

I served on numerous committees of the National Association of Railroad and Utilities Commissioners dealing with regulatory problems.

It is my opinion that the proposed amendment should be enacted. This amendment, as the committee knows, provides for an adjustment of earnings and profits which may be made to reflect payments pursuant to a consolidated return agreement by one member of an affiliated group to another member to the extent that losses or tax deductions of the recipients have served to reduce the consolidated income tax liability of the group.

In the regulation of public utilities, the principle of determining tax costs based upon a separate tax responsibility of an individual company under review has been recommended, recognized, or adopted on numerous occasions.

I would just like to cite a few instances, if I may. In the first instance there is the case of the Federal Power Commission itself adopting the principle in the *Olin Gas Transmission Company* rate case decided in 1957.

The staff of the Commission proposed that no income tax should be allowed in that case as the result of a fact that the company was included in a consolidated tax return with its parent which paid no taxes. The Commission rejected the staff's position, observing that the staff proposal would penalize Olin as an affiliated member of a corporation system, and the Commission went on to explain that the reason the consolidated tax return reflects no income taxes for Olin was, in part, due to losses generated by Olin Oil & Gas Corp. from unregulated business activities unrelated to Olin's natural gas operation. Those are the words of the Commission in its opinion.

In another instance, Examiner Joseph Zwerdling, who is now the Chief Examiner of the Federal Power Commission——

Senator LONG. Just one minute. Let me get that straight. Do I understand the Commission ruled in that case that the principles for which you are contending apply—

Mr. DAVIS. That is correct, in the *Olin Gas Transmission Company* case.

Senator LONG. In doing that did that benefit the consumer or that benefit the company—

Mr. DAVIS. Let me put it this way: I have a little trouble with your phraseology, if I may say so, Senator Long. In doing so it did not pass onto the gas customers tax credits which were generated by reason of filing a consolidated return.

Senator DOUGLAS. That was a different Commission; was it not?

Mr. DAVIS. It was the Federal Power Commission, Senator Douglas.

Senator DOUGLAS. A different administration.

Mr. DAVIS. Well, the members of the Commission change, that is quite right, from time to time.

Senator LONG. Here is what I want to know. Was that ruling to the advantage of the company or was it to the advantage of the company's users?

Mr. DAVIS. The ruling refused to reduce rates because of tax reductions brought about by the filing of a consolidated tax return.

Senator LONG. That was the company's advantage?

Mr. DAVIS. That was to the company's advantage; yes.

Senator LONG. And that was how the Commission ruled.

Mr. DAVIS. That is right.

Senator DOUGLAS. As of 1954?

Mr. DAVIS. 1957, if I may say so.

Senator DOUGLAS. Yes.

Mr. DAVIS. And in another instance, Examiner Joseph Zwerdling, now the Chief Examiner of the Federal Power Commission, in a decision issued on May 28, 1962, upheld the principle embodied in the proposed amendment to H.R. 7502.

Zwerdling rejected the staff's proposal stating the staff would thus do violence to the basic principle that every operation should stand on its own feet.

In another instance, the FPC staff again raised the issue in the *Cities Service* case, which has been discussed at great length before this committee. However, I would like to call the committee's attention to the testimony of Mr. Leon H. Keyserling in that case. He testified against the staff proposal. Mr. Keyserling is a recognized and outstanding economist having had broad experience in Government and private economic work. Mr. Keyserling testified at one point, and these are his words:

> I yield to no one in my concern about the consumer interest.

In concluding his testimony he stated further:

> I do not take easily the responsibility of opposing so vigorously a staff proposal within this Commission, which is advanced with the utmost sincerity. Yet I am profoundly convinced that the national economic interest, as well as the fair interest of investors, producers, and consumers, including those most proximately connected with Cities Service Co., and its subsidiaries, will be served well by abandoning the staff proposal. I, therefore, urge this course.

In another instance, the examiner in the *Cities Service* case rejected the staff proposal, and he stated:

At the very outset, wonderment arises as to the justice of permitting gas companies' customers to receive a windfall from losses occurring in businesses utterly unrelated to that of the regulated natural gas company whose rates are here involved.

In yet another instance, Professor Bonbright, an eminent authority on utility regulatory matters, characterized as "not square shooting" a similar proposal which was advanced by the FPC staff in the *Natural Gas Pipe Line Co.* rate case, Docket No. RP–61–8, and that statement of Mr. Bonbright can be found at transcript page 2084 of that record.

In a further instance, the Separations Manual adopted by the NARUC, and recommended for use by all State commissions, itself adopts the principle that taxes should be determined upon the actual results of operation of the individual service under review. This manual is used by State commissions and by the Federal Communications Commission in the determination of the reasonableness of telephone rates.

In addition to the above, there are numerous State commission decisions, and the views of Mr. Robert Nathan, an eminent economist, here presented, as well as the decision of the 10th circuit court in the *Cities Service* case——

Senator DOUGLAS. Well, sir, this may be an "Alice in Wonderland" world, but I thought this was precisely the principle for which some of us had been contending in opposition to the Dirksen amendment, that each concern should stand on its own feet, and that the losses of the nonregulated company should not be charged against the earnings of the regulated company. It seems to me what you are saying now is precisely what we have been contending for and is really an argument against the amendment rather than an argument for it.

Mr. DAVIS. I do not see your point, Senator Douglas, if I may say so. Certainly in the using of tax losses of a nonregulated company to reduce the taxes of the regulated company does not put that result which is being used for ratemaking purposes on the basis of the regulated company standing on its own feet.

Senator DOUGLAS. No; the exact reverse of that. What it does is to have the regulated company make a payment to the unregulated company for the losses incurred by the unregulated company and, therefore, it falls upon the consumers of the regulated company to subsidize the nonregulated company.

Mr. DAVIS. I am sorry, if I may say so with due deference to your views, but I disagree that there is any subsidy, and I also feel that the payment is recognition of the tax losses which the nonregulated company has produced so that the end result is precisely the same as if the regulated company were separate, aside, and standing on its own feet.

I have a discussion here of the *Cities Service* case. I will skip over that since that has been gone into at such length up to the present time, and I am sure the committee is familiar with the fact behind that case.

There has been some discussion in the press as to the effect of the proposed amendment to H.R. 7502 on Tennessee Gas Transmission Co. and Gulf Pacific Pipe Line Co. It has been said that the amendment would shift some of Gulf Pacific's tax burden to Tennessee Gas

with the implication that an additional cost would be borne by Tennessee Gas customer in New York, Pennsylvania, and in the Midwest. This is in error.

Gulf Pacific Pipe Line Co.'s proposed——

Senator DOUGLAS. In your statement you say it was completely in error. You say it was completely in error——

Mr. DAVIS. Yes, it was completely in error. Sometimes I leave out words to save time.

Senator DOUGLAS. I wanted to find out whether you meant partially in error or completely in error.

Mr. DAVIS. Completely in error. The statement is correct as written.

Gulf Pacific Pipe Line Co.'s proposed project would have two customers, the Department of Water and Power of the City of Los Angeles, and Southern California Edison Co., a regulated electric utility. It has contracted to furnish these utility customers a natural gas transportation service for an amount equal to its costs of service, plus a fixed return on the net equity capital invested in the project. This is commonly known as a cost-of-service contract under regulation by the Federal Power Commission. The contract includes income taxes as one component of the cost of service, and provides that such charges for taxes shall be net of any savings arising from the inclusion of Gulf Pacific in a group filing a consolidated tax return.

I include in the statement the specific contractual provision which deals with it so that the committee will have it before it. But since it is rather lengthy I would not read it at this point.

Yesterday Senator Bennett was asking Chairman Swidler, of the FPC, about the Gulf Pacific project and a possible $29 million increase in costs to the gas customers of the Tennessee Gas Transmission Co. if this amendment No. 426 becomes law. I believe that a misunderstanding of this matter was left by Chairman Swidler. Since the *Gulf Pacific* case is still before the hearing examiner for decision and has not gone before the full Commission, it is understandable that Chairman Swidler is not familiar with the full details of the Gulf Pacific proposal. For the benefit of anyone who might have misunderstood, I would like to explain the $29 million figure, and emphatically state that there is no possible increase or decrease in Tennessee's charges to its customers in this connection.

The $29 million figure obviously came from exhibit 341 in the proceedings involving the *Gulf Pacific* case now pending before the Federal Power Commission, and is simply a portion of the investment tax credit generated by Gulf Pacific translated into reduced revenue requirements which result from the assumed use of $14.5 million of Gulf Pacific's investment tax credit in a consolidated return.

It is assumed that this additional investment tax credit may be used in a consolidated tax return. This assumption will be realized if the other members of the affiliated group otherwise have a consolidated tax liability equal to four times such amount or $58 million during the 5-year carryover period.

Since these are cost-plus-fixed-fee service agreements, Gulf Pacific has agreed to flow through the full benefit of the investment tax credit in the form of reduced charges to its customers. It is only fair that these customers should receive the benefit of the investment tax credit generated by the qualifying investment which is made

possible and supported by their 20-year contractual commitments to purchase the transportation service to be made available by Gulf Pacific Pipe Line Co.

It would be illogical to assume or propose that such benefit would, under any circumstances, be used to reduce the rates to the customers of other pipeline systems not even physically connected with Gulf Pacific's Texas to California pipeline. In view of the requirement contained in section 203(e) of the 1964 tax bill which provides that investment tax credits may not be used to reduce rates without the consent of the taxpayers, surely no one would expect the Gulf Pacific to consent to the use of its investment tax credit to reduce the rates charged by any other pipeline.

I want to state again that Gulf Pacific's tax credits and its inclusion in the consolidated tax return will not affect, either increase or decrease, rates charged the customers on the entire systems of the Tennessee Gas Transmission Co., East Tennessee Natural Gas Co., or Midwestern Gas Transmission Co.

In concluding this discussion of the Gulf Pacific project, I would like to point out to the members of this committee that the estimates presented in evidence before the Federal Power Commission indicate that the construction and operation of the project will, despite the full use of the investment tax credit, generate increased tax revenues to the U.S. Treasury approximating $100 million during the first 20 years following construction, plus over $11 million of State income taxes, and over $76 million of other taxes comprised primarily of ad valorem taxes paid in the States of Texas, New Mexico, Arizona, and California.

In view of the limited time, I would like to skip over now and comment on a statement Mr. Swidler made. He stated:

> The amendment could have a drastic impact if the regulated companies generally accepted it as an invitation to restructure their form of doing business. As I have stated, transfer of the benefits of the interest deduction alone from consumers to shareholders of natural gas pipeline companies would permit rate increases in excess of an eighth of a billion dollars per year.

Those were his statements in his presentation.

That is a big "if" in Mr. Swidler's statement, since his suggested "restructuring" would require the refunding of the debt of the sixth largest industry in this country which, at the end of 1964, had more than $9 billion invested in plant.

However, in my opinion, this "restructuring" is only a phantom possibility which would be given no serious consideration by any pipeline company because even Mr. Swidler does not testify that rates would be increased if the industry refinanced itself and this proposed amendment were effective. His alarming suggestion of the possibility of "rate increases in excess of an eighth of a billion dollars a year" is bottomed on his assumed condition that there be "a transfer of the benefits of the interest deduction alone from consumers to shareholders * * *."

In my opinion, such a transfer is certainly not authorized, required, or even permitted by the application of the provisions of this amendment under any regulatory principles with which I am familiar.

As an officer of the Tennessee Gas Transmission Co., I want to assure the members of the Senate Finance Committee, the Federal Power Commission, and all other interested parties that any such

result is not at all contemplated within the scope of the purpose and intent of this company in supporting this proposed legislation. It is not our purpose or intent to obtain a windfall for our shareholders at the expense of our customers, nor is it our purpose or intent to favor the customers of one company at the expense of the customers of another company in our affiliated group.

In order to make this assurance meaningful to you, we suggest that this committee consider adding a provision to this amendment which would specifically preserve existing jurisdictional authority of all governmental agencies with respect to tax savings arising from the filing of consolidated returns by reason of deductions and tax credits directly related to any activity regulated by such agency or instrumentality.

In this manner you can allay the concern of those who fear, as Mr. Swidler does, that this part of amendment 426 is drawn with such breadth and generality that it could have wide and unforeseen consequences.

With the change herein suggested, the regulatory aspects of amendment 426 would be clear, to the point, and limited to the issue on which the 10th Circuit Court of Appeals reversed the Commission.

(The prepared statement of Mr. Davis follows:)

STATEMENT ON BEHALF OF TENNESSEE GAS TRANSMISSION CO. ON AMENDMENT NO. 426 TO H.R. 7502 (DIRKSEN AMENDMENT)

My name is N. Knowles Davis. I am a vice president of Tennessee Gas Transmission Co. Tennessee Gas Transmission Co., a Delaware corporation (herein called "Tennessee"), and two of its subsidiaries, Midwestern Gas Transmission Co. and East Tennessee Natural Gas Co., own and operate pipeline systems for the transmission and sale or delivery of natural gas for resale under certificates of public convenience and necessity granted by the Federal Power Commission. Tennessee's multiple-line natural gas transmission system extends from the gas-producing areas of Texas and Louisiana into the northeastern section of the United States. Midwestern Gas Transmission Co.'s system serves the Chicago metropolitan area and portions of Minnesota and Wisconsin. East Tennessee Natural Gas Co.'s system serves portions of Tennessee and Virginia.

Tenneco Corp., all of the common stock of which is owned by Tennessee, owns all of the stock of, or a controlling interest in, various subsidiaries. Certain such subsidiaries are engaged in exploring for, producing, processing, refining, and marketing petroleum and petroleum products. Others own and operate various chemical plants for the manufacture and sale of a wide range of agricultural and industrial chemicals, naval stores, and plastics. Another, Packaging Corp. of America, manufactures and sells paperboard, corrugated and solid containers, cartons, molded pulp products and other packaging products. Other subsidiaries of Tenneco Corp. operate related business of a minor nature.

Prior to my present employment, I was associated with the Georgia Public Service Commission for some 23 years as chief of its staff concerned with the regulation of the rates of all electric, gas, telephone, telegraph, and urban transit companies operating within the State of Georgia. During that period, I served on numerous committees of the National Association of Railroad & Utilities Commissioners (the national organization of State public service commissions), which committees were concerned in one manner or another with the regulatory aspects of accounting and cost allocation, including the treatment of Federal income taxes in rate cases. My discussion of the proposed amendment to H.R. 7502 will be limited to the regulatory treatment involved.

It is my opinion that this proposed amendment should be enacted. This amendment provides that an adjustment of earnings and profits may be made to reflect payments pursuant to a consolidated return agreement, by one member of an affiliated group to another member to the extent that losses, or tax deductions of the recipient, have served to reduce the consolidated income tax liability of the group. Simply stated, this is no more than giving credit where credit is due, rather than an arrangement under which the tax cost of one member of the group is reduced because another member suffered a tax loss.

In the regulation of public utilities, the principle of determining tax cost based upon the separate tax responsibility of the individual company under review has been recommended, recognized, or adopted on numerous occasions. This is the principle involved in the proposed amendment to H.R. 7502.

Let me cite a few instances. In the first instance, the Federal Power Commission itself adopted this principle in the *Olin Gas Transmission Company Rate* case (17 FPC 695) decided in 1957. For the year 1954 Olin filed a consolidated Federal income-tax return with the parent corporation (Olin Oil & Gas Corp.) on which no tax was paid. The absence of any income tax liability by the consolidated system for that year arose from the unrelated exploration and development program carried on independently by Olin's parent, Olin Oil & Gas Corp. The staff of the Commission proposed that nothing be allowed for Federal income taxes in the cost of service on the ground that the company, as a result of its inclusion in a consolidated return, had paid no tax in 1954. The Commission rejected the staff's position, observing that the staff's proposal "would penalize Olin as an affiliated member of a corporation system." The Commission allowed Olin Federal income taxes in the total amount of $897,537, stating, "The reason the consolidated return reflects no income taxes for Olin was in part due to losses generated by Olin Oil & Gas Corp. from unregulated business activities unrelated to Olin's natural gas operation." In my opinion, this was a correct and appropriate conclusion.

In another instance, Examiner Joseph Zwerdling (now Chief Examiner) of the Federal Power Commission, in a decision issued on May 28, 1962, upheld the principle embodied in the proposed amendment to H.R. 7502. This was a rate case involving Tennessee Gas. Again the FPC staff advocated using losses generated by nonregulated members of an affiliated group in the determination of income tax liability of the regulated member. Examiner Zwerdling rejected the staff's proposal, stating "The staff proposal thus does violence to the basic principle that every operation should stand on its own feet." This entire case was settled by agreement among the parties so the issue did not come before the Commission for decision.

In another instance, the FPC staff again raised the issue in the *Cities Service Case*, docket No. G–18799. In this case, the FPC staff devised a "consolidated effective tax rate" of 10.53 percent to be used for ratemaking purposes instead of the then statutory rate of 52 percent in calculating the income tax allowance so as to reflect so-called tax savings.

In this instance, Mr. Leon H. Keyserling testified against the FPC staff proposal. Mr. Keyserling is recognized as an outstanding economist having had broad and varied experience in government and private economic work. Mr. Keyserling testified at one point, "I yield to no one in my concern about the consumer interest." In concluding his testimony he stated, "I do not take easily the responsibility of opposing so vigorously a staff proposal within this Commission, which is advanced with the utmost sincerity. Yet I am profoundly convinced that the national economic interest, as well as the fair interest of investors, producers, and consumers, including those most proximately connected with Cities Service Co. and its subsidiaries, will be served well by abandoning the staff proposal. I, therefore, urge this course."

As another instance, the examiner in the *Cities Service* case upheld the principle as sound. He concluded that the gas company subsidiary was not entitled to the tax credits resulting from losses incurred by nonutility subsidiaries and in his decision he states, "At the very outset, wonderment arises as to the justice of permitting gas company's customers to receive a windfall from losses occurring in businesses utterly unrelated to that of the regulated natural gas company whose rates are here involved, merely because gas company and the corporations having the losses happen to have a common corporate owner. Furthermore, the wonderment becomes astonishment when it is shown that the losses, which are the basis of the staff's calculation of its 'consolidated effective tax rate' of 10.53 percent, may under tax laws be actually much less, or possibly entirely eliminated by a mere change in the business fortunes of the loss subsidiaries in early subsequent years. Considering the fact that gas company would be routinely granted an income-tax allowance calculated at the statutory rate of 52 percent, if it were not for the common ownership of it and these loss subsidiaries, there can be no justice to reducing gas company's tax allowance on the basis of losses, the extent of which may not be known definitely for 5 years."

In yet another instance, Professor Bonbright, an eminent authority on utility regulatory matters, characterized as "not square shooting" a similar proposal by the FPC staff in the *Natural Gas Pipeline Company Rate* case, docket No. RP61–8 (Tr. 2084).

In a further instance, the Separations Manual adopted by the NARUC and recommended for use by all State commissions, subscribes to the principle of determining tax liability on the basis of the individual revenues and expenses assigned to the service being regulated, which is consistent with the intent of the proposed amendment to H.R. 7502. This manual is used by State commissions and by the Federal Communications Commission in the determination of the reasonableness of telephone rates. The manual sets forth the procedures for dividing costs including income taxes between local and toll services, and among State and Federal jurisdictions for the Bell Telephone System.

And in addition to the above there are numerous State Commission decisions, the views of Mr. Robert Nathan, an eminent economist, here presented, as well as the decision of the 10th Circuit Court in the *Cities Service* case, each of which agree with the principle that each company should stand on its own feet in the determination of tax costs assignable to each member of a consolidated group. In this connection it should be emphasized that no regulatory commission allows a rate level sufficient or intended to absorb losses, if any, from nonregulated operations, and it logically follows that the rates should not be fixed at a level which uses such nonregulated losses to reduce the regulated tax allowance.

THE REGULATORY PROBLEM

In the fixing of rates the Federal Power Commission determines a "cost of service" for the pipeline involved. This cost of service is the sum of operating expenses, depreciation, taxes, and an amount for return on the rate base. In other words it represents revenue requirements. Often the company together with affiliates render nonjurisdictional service, or have nonregulated activities. In these cases it is necessary for the Commission to separate expenses, depreciation, etc., into the regulated and nonregulated categories in order to see if the regulated rates and revenues are reasonable in amount as compared to the revenue requirements of the regulated business. There should be no magic in determining the amount of income taxes associated with the regulated operation especially when the nonregulated activities are under a separate company.

When you know the amount of the regulated revenues, expenses, and tax deductions the tax computations, direct and simple. That is as it should be. The problem is created when the Commission takes into account tax deductions,or tax credits which arise from nonregulated operations in order to reduce the tax allowance to be included in the regulated cost of service.

The proposed amendment would make it clear that transfers and receipts of funds, pursuant to a consolidated return agreement, or, with respect to past periods only, pursuant to a consistent practice having a similar purpose and effect, are to be treated as payments and refunds of Federal income tax by all Federal agencies or instrumentalities for the purpose of establishing the cost of service, for determining the overall rate of return or for determining the net income from the regulated activities or services of a member of an affiliated group.

For a number of years, Congress has provided incentives to taxpayers designed to encourage investment in new enterprises through the filing of consolidated returns in which the initial losses or credits of the new enterprise could be combined with other taxable income thereby reducing the overall tax liability of the affiliated group when such a consolidated group includes a regulated corporation, some Federal regulatory agencies have thwarted this incentive by requiring that the tax savings realized because of the losses or credits of nonregulated affiliates be used to reduce the overall rate of return of the regulated taxpayer, and thus they are overreaching their responsibilities and by indirection are regulating activities which Congress never authorized.

Compare, for example, the relative incentives available to an ordinary manufacturing corporation and a partially regulated corporation, such as Tennessee, each of which desires to diversify by establishing a computer manufacturing subsidiary. The manufacturing company's risk is reduced by the fact that, if the computer company is operated at a loss in its formative years, or if the business fails, 48 percent of the loss is saved as a tax reduction. This happens because the manufacturer is able to employ that loss in a consolidated return to reduce its taxes without reducing the revenue it receives from manufacturing and selling its other products. However, in the case of the regulated company, any tax saving resulting from the operations of the computer company will, under the theory pursued by the FPC, be used to reduce the price that it can charge for its regulated goods and services. Therefore, if the computer business operates at a loss, the group that includes the regulated company will have to absorb the loss

at 100 cents on the dollar rather than 52 cents on the dollar as is the case with the competing ordinary manufacturing company.

Accordingly, groups that include regulated taxpayers are deprived of the incentive to invest in new enterprise and to diversify that is provided under the law to all. This places groups that include regulated taxpayers at a distinct competitive disadvantage. Surely the Congress did not intend that Federal regulatory agencies should exercise their regulatory authority in such a way as to bring about this result. The proposed amendment would remedy this situation in those cases where intercompany transfers in the nature of taxpayments are made as described above.

THE CITIES SERVICE GAS COMPANY CASE

The error and failure of regulatory agencies to consider the separate tax liability of regulated companies, alluded to above, is perhaps no better illustrated than in the decision of the Federal Power Commission in the case of Cities Service Gas Company (opinion No. 396, issued on July 15, 1963), in which two Commissioners strongly dissented and another, apparently somewhat reluctantly, joined two others to form what became the majority. The record in the case indicates quite clearly that the examiner for the Commission could find no authority to support the theory that "consumers of natural gas sold in interstate commerce should have the benefit of 'tax savings' derived from business losses of unregulated corporations whose business activities are entirely unconnected with and dissimilar to those of the regulated natural gas company transporting and selling such gas." Nevertheless, the official ruling of the Commission embraced this theory. However, the decision of the Commission in the Cities Service case was reversed in a unanimous decision by the U.S. Court of Appeals for the 10th Circuit on October 9, 1964 (337 F. 2d 97).

The Court of Appeals in its opinion in the Cities Service case observed that "it is legally fallacious to calculate the gas company's tax allowance on the basis of the consolidated tax liability of the parent company. This approach cannot be justified by the actualities of the case." The court went on to state that it is "plain that the apportionment of the total tax liability among the regulated companies fails to comply with the jurisdictional requirement for the separation of regulated and nonregulated profits and losses which Congress wrote into the act and which the Commission prescribed for itself."

Since the Federal Power Commission did not seek review of the *Cities Service* case by the U.S. Supreme Court, it might appear that the Commission had accepted the decision of the 10th Circuit as representing a correct interpretation of the law. Such, however, is not the case; for the Commission is still seeking to impose its will upon regulated companies and extending its control into areas never intended.

By the adoption of the proposed amendment to section 1552 of the Internal Revenue Code of 1954, the Congress can clarify and indicate postively a principle that the Court of Appeals has already declared to be the present state of the law.

THE GULF PACIFIC PIPELINE MATTER

There has been some discussion in the press as to the effect of the proposed amendment on H.R. 7502 on Tennessee Gas Transmission Co. and Gulf Pacific Pipeline Co. It has been said that the amendment would shift some of Gulf Pacific's tax burden to Tennessee Gas with the implication that an additional cost would be borne by Tennessee Gas customers in New York, Pennsylvania, and in the Midwest. This is completely in error.

Gulf Pacific Pipeline Co.'s proposed $314 million pipeline will have two customers, the Department of Water and Power of the City of Los Angeles and Southern California Edison Co., a regulated electric utility. It has contracted to furnish these utility customers a natural gas transportation service for an amount equal to its costs of service plus a fixed return on the net equity capital invested in the project. This is commonly known as a cost of service contract. The contract includes income taxes as one component of the cost of service and provides that such charges for taxes shall be net of any savings arising from the inclusion of Gulf Pacific in a group filing a consolidated tax return. The specific contractual provision involved, insofar as Southern California Edison Co. is concerned, appears in paragraph 12.1(c) of its agreement with Gulf Pacific dated February 1, 1963. The agreement with the department of water and power contains the same provisions which read as follows:

"Accruals recorded for the month with respect to income, ad valorem, and other taxes reasonably associated with the operation of the Gulf Pacific project, and general corporate, franchise, and other taxes reasonably applicable to services rendered by transporter through the Gulf Pacific project and adjustments of accruals for such tax expense previously billed and for any such taxes paid but not previously billed. There shall be taken into account in computing taxes and accruals thereof any tax savings or credits, including investment credits arising under the Internal Revenue Act of 1962, arising from transporter's construction and operation of, or rendition of service through, the Gulf Pacific project. It is contemplated that transporter may, for 1 or more years, file a consolidated Federal income tax return with other corporation or corporations. In this connection, it is recognized that present rules for allocating such investment credits among members of a group filing consolidated Federal income tax returns are uncertain at this time. For the year or years, if any, for which transporter so files a consolidated Federal income tax return: (i) if regulations promulgated by, or a ruling obtained from, the Internal Revenue Service permit or approve an allocation which will not be detrimental to any coproration in the consolidated group or the shareholders thereof, the net accumulated tax savings resulting therefrom, if any, shall be taken into account in such computations, and for this purpose 'net accumulative tax savings' shall mean the accumulative net amount the tax liability of the consolidated group, excluding transporter, exceeds the tax liability of the consolidated group including transporter for such years; or (ii) in the absence of such regulations or ruling, the net accumulated tax savings, if any, arising from investment credits will be passed on to transporter in the same manner and at the same time that transporter could use such credits if it were filing a separate Federal income tax return. Transporter agrees to use due diligence in seeking, or causing to be sought, such a ruling from the Internal Revenue Service.

"Anything contained herein to the contrary notwithstanding, the tax accruals provided for herein shall not be increased or decreased by reason of taxable income or tax losses or other taxes arising from activities or businesses of transporter, or the consolidated group, other than the construction and operation of, and rendition of services through, the Gulf Pacific project" (see Federal Power Commission Docket CP63-204, et al., exhibit 13).

Yesterday, Senator Bennett was asking Chairman Swidler of the FPC about the Gulf Pacific project and a possible $29 million increase in costs to the gas customers of Tennessee Gas Transmission Co. if this amendment No. 426 becomes law. I believe that a misunderstanding of this matter was left by Chairman Swidler. Since the *Gulf Pacific* case is still before the hearing examiner for decision and has not gone before the full Commission, it is understandable that Chairman Swidler is not familiar with full details of the Gulf Pacific proposal. For the benefit of anyone who might have misunderstood, I would like to explain the $29 million figure and emphatically state that there is no possible increase or decrease in Tennessee's charges to its customers in this connection. The $29 million figure obviously came from exhibit No. 341 in the proceedings involving the *Gulf Pacific* case now pending before the FPC, and is simply a portion of the investment tax credit generated by Gulf Pacific translated into reduced revenue requirements which result from the assumed use of $14.5 million of Gulf Pacific's investment tax credit in a consolidated return. It is assumed that this additional investment tax credit may be used in a consolidated tax return. This assumption will be realized if the other members of the affiliated group otherwise have a consolidated tax liability equal to four times such amount or $58 million during the 5-year carryover period. Since these are costs plus fixed fee service agreements, Gulf Pacific has agreed to flow through the full benefit of the investment tax credit in the form of reduced charges. It is only fair that these customers should receive the benefit of the investment tax credit generated by the qualifying investment which is made possible and supported by their 20-year contractual commitments to purchase the transportation service to be made available by Gulf Pacific Pipeline Co. It would be illogical to assume or propose that such benefits would, under any circumstances, be used to reduce rates to the customers of other pipeline systems not even physically connected with Gulf Pacific's Texas to California pipeline.

In view of the requirement contained in section 203(e) of the 1964 tax bill which provides that investment tax credits may not be used to reduce rates without the consent of the taxpayers, surely no one would expect Gulf Pacific to consent to the use of its investment tax credit to reduce the rates charged by any other pipeline. I want to state again that Gulf Pacific's tax credits and its inclusion in the consolidated tax return will not affect, either increase or decrease,

rates charged the customers on the entire systems of Tennessee Gas Transmission Co., East Tennessee Natural Gas Co., or Midwestern Gas Transmission Co.

In concluding this discussion of the Gulf Pacific project, I would like to point out to the members of this committee that the estimates presented in evidence before the Federal Power Commission indicate that the construction and operation of the project will, despite the full use of the investment tax credit, generate increased tax revenues to the U.S. Treasury approximating $100 million during the first 20 years following construction, plus over $11 million of State income taxes and over $76 million of other taxes comprised primarily of ad valorem taxes paid in the States of Texas, New Mexico, Arizona, and California.

RESPONSE TO FEDERAL POWER COMMISSION

Chairman Swidler of the Federal Power Commission, in his statement before this committee quoted a single sentence appearing at lines 11–23 of page 2 of amendment No. 426 as being the provision which concerns the Federal Power Commission and then stated as follows:

"As we read this sentence, in its context, it would allow regulated companies which participate in a consolidated tax return and thereby reduce their taxes to allocate the tax savings in such manner as they may wish, which presumably would be in the way which would achieve maximum returns for their stockholders."

This statement by Mr. Swidler is inaccurate. The manner in which such savings may be allocated is specified by the provisions of section (2) of the amendment commencing at line 24 of page 2 and continuing through line 9 on page 4 and allow no such latitude as presumed by Mr. Swidler.

Later in his statement, Chairman Swidler states:

"The danger, as we see it, is that funds transferred to a private company and not in fact paid to the U.S. Treasury will become the basis for charges to the ratepayer as a result of the statutory fiction that the transfer is a payment of Federal income tax."

To me there is no apparent harm in a statutory finding that such payment is tax. This simply reinforces the present requirement of law as enunciated in the *Cities Service* decision which rejected the course still being pursued by the Federal Power Commission.

Mr. Swidler stated, "The amendment could have a drastic impact if the regulated companies generally accepted it as an invitation to restructure their form of doing business. As I have stated, transfer of the benefits of the interest deduction alone from consumers to shareholders of natural gas pipeline companies would permit rate increases in excess of an eighth of a billion dollars a year."

That is a big "if" in Mr. Swidler's statement since his suggested "restructuring" would require the refunding of the debt of the sixth largest industry in this country which at the end of 1964 had more than $9 billion invested in plant.

However, in my opinion, this "restructuring" is only a phantom possibility which would be given no serious consideration by any pipeline company because even Mr. Swidler does not testify that rates would be increased if the industry refinanced itself and this proposed amendment was effective. His alarming suggestion of the possibility of "rate increases in excess of an eighth of a billion dollars a year" is bottomed on his assumed condition that there be a "transfer of the benefits of the interest deduction alone from consumers to shareholders * * *."

In my opinion, such a transfer is certainly not authorized, required, or even permitted by the application of the provisions of this amendment under any regulatory principles with which I am familiar.

And as an officer of Tennessee Gas Transmission Co., I want to assure the members of the Senate Finance Committee, the Federal Power Commission and all other interested parties, that any such result is not at all contemplated within the scope of the purpose and intent of this company in supporting this proposed legislation. It is not our purpose or intent to obtain a windfall for our shareholders at the expense of our customers, nor is it our purpose or intent to favor the customers of one company at the expense of the customers of another company in our affiliated group.

In order to make this assurance meaningful to you, we suggest that this committee consider adding a provision to this amendment which would specifically preserve existing jurisdictional authority of all governmental agencies with respect to tax savings arising from the filing of a consolidated return by reason of deductions and tax credits directly related to any activity regulated by such agency or instrumentality.

In this manner you can allay the concern of those who fear, as Mr. Swidler does, that this part of amendment 426 is "drawn with such breadth and generality that it could have wide and unforeseen consequences * * *."

With the change herein suggested, the regulatory aspects of amendment 426 would be clear, to the point, and limited to the issue on which the 10th circuit court of appeals reversed the Commission.

Senator LONG. May I just ask this question; As I understand it, both Senator Douglas and the previous witness and myself all seem to agree on one thing, but we all seem to disagree as to what the conclusion would be. You contend that each pipeline out to stand on its own bottom what regard to the rates of its customers; is that correct?

Mr. DAVIS. That is correct.

Senator LONG. Now, if I understand what you are contending for, it is that insofar as one company uses the tax credits or the tax deductions of another company they ought to pay them back for it to put them back where they started out from.

Mr. DAVIS. That is correct.

Senator LONG. Let us take this Gulf Pacific case you are talking about. Assuming that there was this $23 million tax credit. Now, as I understand it, under the law you are not required to flow that through, but you have a contract where you agreed you would do it.

Mr. DAVIS. The Gulf Pacific would do it, yes; that is correct.

Senator LONG. Gulf Pacific would do it.

Assuming you built the pipeline in 1965, and you serve no customers in 1965, you would have a tax credit, but no taxes to take the credit against; would that be correct?

Mr. DAVIS. That is right.

Senator LONG. So in that year then Tennessee Gas would, and its other subsidiaries would, be using the tax credit that properly belongs to Gulf Pacific.

Mr. DAVIS. In a consolidated return that would happen.

Senator Long. That is right. They would be using Gulf Pacific's tax credit, and Gulf Pacific would thereby lose its tax credit.

Mr. DAVIS. That is correct.

Senator LONG. Now, you are saying, if I understand it correctly, that as between two sets of customers, the people who are entitled to the flow through of that tax credit are the people who are using the Gulf Pacific pipeline, not the people using the pipeline of the East.

Mr. DAVIS. That is correct.

Senator LONG. Now, if you arrive at any other conclusion, if I understand it, here are these other people who do not have a contract to flow through their tax credit, and you are flowing it through to the wrong set of customers.

Mr. DAVIS. That is exactly right.

Senator LONG. Now, in the absence of building that new pipeline, if I understand it, the customers in the East would have no claim whatever on a tax credit that belongs to Gulf Pacific.

Mr. DAVIS. There would be no investment tax credit when the investment had not been made.

May I interrupt for just 1 minute? I believe Mr. Nathan has an appointment this afternoon, and if he could be given just a few minutes at this point to present his statement, I will be happy to return after lunch or at any time.

Senator DOUGLAS. Before that is done, Mr. Chairman, I would like to ask the witness a question.

The CHAIRMAN. What is the pleasure of the committee? Senator Douglas?

Senator DOUGLAS. A brief question. Well, you say you would consider a further amendment. Now, what about amending this by eliminating lines 11 to 23 on page 2?

Mr. DAVIS. No. I did not suggest that, Senator Douglas. I am suggesting that——

Senator DOUGLAS. What kind of an amendment?

Mr. DAVIS. I am suggesting that the amendment——

Senator DOUGLAS. What kind of an amendment?

Mr. DAVIS. To clarify the situation so that it would not be interpreted as taking away from the Federal Power Commission or the Federal Communications Commission any of the regulatory authority which they now have, as stated——

Senator DOUGLAS. The big question is as to what authority they now have. Let me ask you this qusetion.

Mr. DAVIS. May I answer that?

Senator DOUGLAS. I wish you would.

Mr. DAVIS. I consider, under the 10th Circuit Court of Appeals, they do not have the authority to take losses from loss subsidiaries, subsidiary companies and reduce rates of regulated companies; so we are not taking an authority away from it; we are just stabilizing a situation as it should be.

Senator DOUGLAS. In other words, you are saying that what you interpret as the 10th circuit decision is law; what you interpret the 10th circuit decision to be.

Mr. DAVIS. Well, yes; that is the way I read it.

Senator DOUGLAS. Let me ask you this: Are you contending that payments made by a regulated company to a nonregulated company must be accepted as an item of expense for the regulated company and, therefore, must be borne by the consumers of the regulated service?

Mr. DAVIS. Yes. I consider this accomplishes what the 10th circuit states.

Senator DOUGLAS. Just a moment. That is the point at issue. In other words, you are not willing to concede on the essential point at issue. This is merely a face-saving amendment that you propose.

Mr. DAVIS. No; I do not agree at all, if I may say so, Senator, that this is a face saving. This is intended to clarify the situation. There has been some question raised about the effect of the amendment, as Chairman Swidler stated.

Senator DOUGLAS. As to transfers between regulated companies. The issue is as to whether you can siphon off earnings from the regulated to the unregulated and, therefore, strengthen your case for an increase in the cost of services of regulated consumers or strengthen your case against a decrease.

Mr. DAVIS. There is no increase in cost of service involved under the 10th circuit court decision. These tax credits cannot be taken into account now.

Senator DOUGLAS. I am not at all clear as to what that decision is. It appears in fact, that a very able attorney, Mr. Grove, who gave his opinion as to what that meant, gave an opinion precisely along the lines of what we are contending for. He was the most valuable witness which we have had, and there are sections of your statement would sound exactly like that.

Senator LONG. If I understand what you are saying here, what you are saying, if I read your language correctly, it would specify preserving jurisdictional authority of all governmental agencies with respect to tax savings arising from the filing of a consolidated return by reasons of deductions and tax credits directly related to any activity regulated by such agency.

If I understand what you are saying it is you do not complain for a moment of the Commission's taking into account every tax saving and every deduction that has to do with your regulated activity of that company. But you do complain about them taking into account tax savings that have to do with a completely unregulated activity or tax savings that have to do with another regulated activity.

Mr. DAVIS. That is precisely correct.

Senator LONG. You are contending for the same rule that Senator Douglas says he is contending for, although he might not like the conclusion of it, that you would treat this just as though it were one company, you treat Gulf Pacific just as though it were one company, you treat Tennessee Gas just as though Tennessee Gas were one company for regulation purposes.

Mr. DAVIS. That is correct.

Senator DOUGLAS. I am not familiar with it, but I think both of those are regulated companies.

Mr. DAVIS. That is right.

Senator DOUGLAS. So this Tennessee Gas case differs from the principle which we are developing in our discussion.

But the point which we have been fearful of is that you can siphon off earnings from the regulated to the unregulated and strengthen your case for earnings in the regulated. That is the point.

I did not know there was a dispute between Tennessee Gas and El Paso when I first went into this question. I considered it regardless of its effect upon this particular dispute. I am not concerned with it except if it is something which might lead to an increase in rates for some consumers, and subsidized rates out in the Pacific Coast. My mind is open on that point.

But my mind is pretty clear that we should not take earnings from the regulated companies for taxes not paid; and that you should not count the noncosts as costs for regulatory purposes. Whatever you do inside a corporate structure is something else again.

We have come up against a clear issue at stake on which there is confusion on this matter.

Senator LONG. What the witness is saying, as I understand it though, and frankly on this point the Federal Communications Commission testified exactly the same way, as I understand it, I found no objection whatever from the Federal Communications Commission, that is from the testimony of that witness, in his saying that as long as he was able to look at all of the activities of the regulated company he did not care to take into account the activities of a nonregulated company.

Senator DOUGLAS. The words are very difficult to follow as they come. What we object to is the possible siphoning off of earnings from the regulated to the unregulated, diminishing the net earnings of the regulated and, in effect, the consumers of the regulated being called upon to subsidize the financial position of the unregulated.

If all the companies were nonregulated, I do not think we would have any objection, but it is this fact that some have their earnings guaranteed by the public utility laws, depending upon the cost of service and the valuation of the properties.

We do not want to have the cost of service inflated by fictitious charges, that is the point. We do not want to have the cost figures inflated by charges which do not occur.

Senator LONG. That is not going to happen. But let Mr. Nathan make his statement.

Senator DOUGLAS. Yes, surely.

Mr. NATHAN. Mr. Chairman and members of the committee, I appreciate the opportunity of presenting this summary statement, and I believe that this is related to Senator Douglas' point.

Attached to my statement, gentlemen, is the testimony which I prepared and submitted before the Federal Power Commission in March of 1961, and I would like to ask that this testimony be included as a part of the record with my statement.

Let me just briefly try to say as quickly as I can what my point is. When we were approached by the attorneys and officials of the Tennessee Gas Transmission Co. back in 1961 to consider the subject and possibly testify, we gave it very thorough study, as we do with all the problems that come before our consulting firm and decide whether or not we will take the case and prepare and submit testimony in evidence.

On reviewing the fact we felt that Tennessee Gas Transmission in this particular case, dealing with the issue that is involved in this amendment, had a meritorious case.

Frankly, we were surprised that the Federal Power Commission staff took the position that it did, and it was our conviction that we ought to support the contention of the Tennessee Gas Transmission in that case, which would allow it to take advantage of the tax savings in the filing of a consolidated return without passing those tax savings on to the customers of the utility.

The issue involved relates primarily to consolidated returns and to the benefits to be derived from consolidated returns. And, as I read and study and understand the proposed amendment, it is designed primarily to permit affiliated corporations to enter into agreements to assure that benefits from filing of consolidated returns will accrue to those affiliates that show tax losses and whose tax credits reduce the consolidated tax liability.

It is on this point that my testimony before the Federal Power Commission was concerned, and that I am testifying on today. It seems to me that, in essence, the opposition to this proposal is saying that the benefits of consolidated returns shall not be made available to public utilities. If that is the intention of Congress, I think that intention ought to be made clear. There have been many legislative tax policies and executive decisions which have provided incentives to stimulate investment, including profit-and-loss carryforward and carryback allowances, the filing of consolidated returns, the investment credit, accelerated depreciation, the depletion allowances for mineral resources, expensing research costs, and the like, and the Congress has enacted these incentives. Whether all such inventives are appropriate or not, gentlemen of the committee, is a question, and I must say to you that I myself have expressed opposition to some incentive

tax schemes. But, however, once a policy is adopted, it seems to me equitable and proper that the purpose and benefits of the legislation and policies should be consistently applied to all appropriate corporations.

Senator DOUGLAS. Without regard to whether they are regulated or not?

Mr. NATHAN. That is correct, Senator Douglas, unless it is the intent of Congress that the benefits of consolidated returns should not be available to public utilities——

Senator DOUGLAS. That is the issue.

Mr. NATHAN. That is correct; and I think Congress is now being called on to make its position clear; and, Senator Douglas, I honestly feel that this is not a decision that ought to be left to the Federal Power Commission. They have no authority over incentives.

Senator DOUGLAS. Of course, you know that under existing law corporations are assured a fair rate of return——

Mr. NATHAN. That is correct.

Senator DOUGLAS (continuing). On fair value.

Mr. NATHAN. That is right, sir.

Senator DOUGLAS. And subject to review by the courts.

If losses are incurred by affiliated but nonregulated companies, why should the companies be allowed to pocket an extra return over and above the fair rate of return already guaranteed to them?

Mr. NATHAN. Well, presumably the Congress intended this or it should have excluded——

Senator DOUGLAS. Wait a minute, this is the measure before us now. The Congress has not passed on this issue yet. It is the same question that I raised with the previous witness. We may have passed on the investment credit issue, but we have not passed on this issue yet. This is still a matter of public policy to decide, and our position is that consumers should not be asked to pay for taxes not paid; that noncosts should not be counted as costs.

Mr. NATHAN—But the noncosts derive from an incentive provision and I read the legislative record, Senator Douglas, and I did not see any indication that this legislated incentive should be denied to utilities and allowed to all other companies. This, I think, is the issue, Senator Douglas, and I think to leave up to the Power Commission to decide whether an incentive provision ought to be beneficial to the utilities or it should be passed through to the rateholders, it seems to me, Senator Douglas, is an improper problem to be posed to a regulatory agency.

Senator DOUGLAS. Well, there is certainly a vital difference between a competitive industry or industries where prices are subject only to the market forces, and regulated industry. Because of the natural monopoly, it is felt that this control over supply in the absence of regulation, permits excessive profits. And yet while regulation is intended to prevent excessive profits, it is also intended to guarantee a fair rate of return. Both the principles are there.

Now, if the existing rates are not fair, suit can be started to reduce them. That recourse is still open. But if existing rates are fair, then to give an added bonus to the company for costs which it did not incur and for taxes which no one paid, well, this is like the smile of the Cheshire Cat which continued after the Cheshire Cat disappeared from sight. It is a nonsubstantial, nonexistent, alleged item of expense which does not exist in reality.

Mr. NATHAN. But, Senator Douglas, must we not ask ourselves why the tax of the utility was not paid. It was not paid because an utterly unregulated company had a loss and, therefore, the rate goes down because a nonregulated company had a loss, and then the next year if the nonregulated company had a big profit the rates to the utility users goes up. This is capricious.

Senator DOUGLAS. I think you should take a long-term average, and I think, as a matter of fact, that is what a sensible regulatory commission would do. It would not take each year and it would not go up and down like these rides in the amusement park. You take a longtime average, and any sensible commission would do that.

Mr. NATHAN. Well, the issue still is there, Senator Douglas, that you have a capricous force of a nonregulated activity affecting the rates. You are absolutely right, the utility does not pay the tax when a consolidated return is filed and the nonregulated company or even another regulated company has a loss or a tax credit.

Senator DOUGLAS. Let me say I would tend to agree with you in what I understand to be your contention that the profits of a nonregulated company should not be transferred to——

Mr. NATHAN. One way or the other.

Senator DOUGLAS. To a regulated company, or that the profits of a nonregulated company should not be transferred to a regulated company. If the Federal Power Commission maintained to the contrary in that case I would offhand think that they were wrong.

But similarly I do not believe that the losses of a nonregulated company or corporation should be made a charge against the profits of the regulated company for regulatory purposes.

Mr. NATHAN. Yes. But the contrary is exactly what is taking place, Senator Douglas. When the nonregulated company loses money, and the regulated company makes money, what happens is that you are then permitting the regulated company's rates to be affected by the nonregulated company's losses, and I think, my own feeling is, that what we ought to do is treat the regulated companies just as though they were independent companies. The filing of consolidated returns is a tax concept.

Senator DOUGLAS. But they are not independent companies. They are part of a holding company system commonly owned completely, 100 percent, or to a very large controlling interest, and they are managed as one company. It is purely a corporate fiction that they are separate, and——

Mr. NATHAN. But the utility company that might be, say, Washington Gas Light Co. happened to be a subsidiary of a company that owned, as I illustrate in my testimony here a little later, an oyster boat company down in Chesapeake Bay, they really are separate operations. The fact that the oyster boat company loses money ought not affect my rates as a customer of the Washington Gas Light Co. But under the——

Senator DOUGLAS. It should not affect them.

Mr. NATHAN. It should not affect them at all, and yet that is exactly what happens when you deny to the holding company the right to treat the Washington Gas Light Co as a separate entity. When the oyster companies lose money, Senator Douglas, this ought not to affect my rates. But according to——

Senator DOUGLAS. But it will.

Mr. NATHAN. It does under the Federal Power Commission.

Senator DOUGLAS. It will under the Dirksen amendment precisely.

Mr. NATHAN. It will under the Federal Power Commission, not under the Dirksen amendment. No, Senator Douglas, what in essence the amendment does, as I understand it, is to put the Washington Gas Light Co. in a position as if it were filing its own return unrelated to the oyster company, and does not allow this other company to have any impact on the operations of the utility, and that, I think, is logical.

Now, of course if, Senator Douglas, you want to say that the utilities in the United States ought never benefit from consolidated returns or accelerated depreciation or whatever other incentives, this is Congress' right, and it may be absolutely appropriate.

But if Congress says that there is a benefit of consolidated returns or other incentives, I do not believe that until Congress denies it to a group, regulatory commissions should deny it to that group.

Senator DOUGLAS. Well, I listened to your argument. It reminds me of the passage in Benjamin Franklin's autobiography in which he said:

> So excellent a thing it is to be a reasonable creature because this permits us always to find a reason for what we want to believe.

Senator LONG. May I just ask a question about that, to try to understand the same problem as I understand you are trying to illustrate, and it seems to me we can ever understand we are talking about the same thing we can agree. Let us assume you have a $100 million pipeline. You are entitled to make, let us say what would be a fair return, 6 percent or more?

Mr. NATHAN. Six percent on the total investment, $6 million.

Senator DOUGLAS. The actual rates of return are higher than that.

Mr. NATHAN. Not for total investment; maybe 7.

Senator DOUGLAS. Eight percent is an average rate of return.

Mr. NATHAN. What amount did you say?

Senator DOUGLAS. Pardon?

Mr. NATHAN. What amount did you say?

Senator DOUGLAS. I said isn't the average rate of return permitted nearer 8 than 6?

Mr. NATHAN. On total investment?

Senator DOUGLAS. On physical investment.

Mr. NATHAN. On equity investment it is higher, but on total investment it is not.

Senator DOUGLAS. You mean the bonds are simply charged in the costs?

Mr. NATHAN. That is right.

Senator DOUGLAS. That is a principle for which I contended 40 years ago, which was denounced at the time as a wild and revolutionary idea, and which the courts have later adopted.

Senator LONG. Before you leave, and I would like to ask you this question, I am sorry Senator Douglas cannot be here to hear it, but I would like to point out to him in the record, you have $100 million pipeline, you are entitled to make, if it is 6 percent on that $100 million, that is your overall investment, but in order to make 6 percent, that 6 percent is after taxes, so to make 6 percent after taxes you have to make 12 percent.

Mr. NATHAN. That is correct.

Senator LONG. So to make the $6 million, to be able to earn $6 million and keep it, you have to make $12 million.

Mr. NATHAN. Correct.

Senator LONG. When you make $12 million, $6 million of that is taxes, but if you are in a consolidated return with somebody and that year he is building his pipeline, and he has got about a $97 million investment there with the result that he has a $6 million tax credit, the company does not owe—the two companies together owe zero because the existing company uses the tax credit of the new company, that is the new pipeline company, under their consolidate return, so that actually you have two companies, but a consolidated return treats them as one company.

Mr. NATHAN. Right.

Senator LONG. So instead of having one company pay $6 million and Uncle Sam owe the other company $6 million at such time as they make $6 million, you simply say the tax liability is zero, the tax credit wipes out the tax owed.

Now, as far as that consumer is concerned, anything you make above the $6 million he is entitled to ask for a rate reduction, and the Federal Power Commission has that duty to get him that rate reduction, and they should do it.

But what you are saying is that they have no right to get him the rate reduction by taking it away from the other company which generated that tax savings.

Mr. NATHAN. And which had nothing to do with the operation of that utility.

Senator LONG. Now, in the case of this particular company, when they build that pipeline and get that tax credit that is a multimillion-dollar asset, and they do not propose to keep it in their case, they have got a contract to give it to those customers who are being served by that pipeline.

Mr. NATHAN. Yes.

Senator LONG. And what you are testifying to, as I understand it, and what these people are saying, is that the existing pipeline has no claim whatever on that tax savings that is generated by that new pipeline.

Mr. NATHAN. That is correct.

Senator LONG. The customers of the new pipeline are the ones who would get it, if anybody does.

Mr. NATHAN. That is right.

Really what we are saying is, I would say two or three points, Senator Long. One, I think the consolidated return is allowed for the purposes of incentive savings, and nothing else and, therefore, I do not believe that filing a consolidated return ought to affect the utility or the regulatory aspects of any subsidiary.

Secondly, I would say it is just as though Uncle Sam taxed the profitmaking affiliate and gave it to the loss affiliate, that is, in essence, the basis of it.

What is the purpose of a consolidated return? It is to say to business, "If you will invest and lose we will let our money be used as part of the risk." That is in essence what the Government is saying. It is saying, "We will allow the profits of one, the taxes on the profits of one, to offset the loss on the other."

So it strikes me that Uncle Sam is saying, "You pay this $6 million," you are suggesting, Senator Long, "from the one utility company because you made the profit. We encourage the other utility company or whatever you want to invest in to come into being and through this consolidated return, we take your $6 million and we give it to them to make up their loss."

I think this is logical, I think it is sound economics. I think it does not allow different entities to get fouled up in relation to each other, and I think it is a perfectly logical position unless, Senator Long, Congress wants to say, "Utilities, you shall not benefit from these incentives."

As I read the legislative record, there is nothing there which indicates an intended denial of the benefits of consolidated incentives, or other incentives, to utilities, nothing.

Senator LONG. If you apply the idea of consolidated returns, the whole idea of it, to unregulated companies, the idea of what you are saying is here is an unregulated company. He can be in the oil business or any other business, but you would like to encourage him to take the money he has got and invest it in other activities, so when he invests it in other activities, when they lose money, even though they are a separate corporate entity, they can reduce their taxes by losses.

Mr. NATHAN. That is correct, and if it is to be an inducement, it ought to be an inducement to all companies, regulated or not.

Senator LONG. If this is a regulated company, he can reduce his taxes by the subsidiary's loss, but he cannot charge his customers for the loss of that subsidiary.

Mr. NATHAN. That is correct.

Senator LONG. That is the point.

Mr. NATHAN. That is correct. He certainly cannot.

Senator LONG. That is what the amendment is all about.

Mr. NATHAN. That is correct.

(The prepared statement of Mr. Nathan follows:)

TESTIMONY OF ROBERT R. NATHAN

Gentlemen, I appreciate the opportunity to appear before this committee on behalf of the Tennessee Gas Transmission Co. I ask that there be included in the record of this committee the testimony which I presented on March 27, 1961, before the Federal Power Commission in docket G–19983, which testimony directly relates to the subject matter of this hearing. Also, I should like to describe briefly the background of said testimony and to summarize its contents as concisely as possible.

Prior to preparing the testimony before the Federal Power Commission, I was asked by attorneys for the Tennessee Gas Transmission Co. to study a complex tax matter and then to testify on the company's behalf. My first reaction was one of hesitation because of my frequent statements and testimony on behalf of consumer interests. My associates and I have undertaken many assignments on behalf of airlines, shipping companies, industrial corporations, and other private parties; but we also have declined many assignments, and we always review the issues and the facts prior to deciding whether the matter merits our interest and our efforts.

In this particular case I spent considerable time discussing the problem both with attorneys and officials of Tennessee Gas Transmission Co. and with my associates. Not only did the company appear to us to have a meritorious case, but we were rather surprised that the Federal Power Commission staff was taking the policy position which it pursued. It was our conviction that the position of Tennessee Gas Transmission Co. was compatible with the public interest as Congress has defined it in the tax laws and with sound economic principles.

Therefore we undertook to prepare and submit the testimony which I have requested be incorporated in this record.

The issue involved before this committee relates primarily to consolidated returns and to the benefits to be derived from consolidating returns of affiliated companies. The proposed amendment No. 418 to H.R. 7502 is designed primarily to permit affiliated corporations to enter into agreements to assure that the benefits from the filing of consolidated tax returns will accrue to those affiliates that show tax losses and whose tax credits reduce the consolidated tax liability. It is particularly on this point that my testimony before the Federal Power Commission was focused and my appearance here today is pertinent.

First, let me note that numerous legislated tax policies and executive decisions have provided incentives to stimulate investment. Among such incentives are profit and loss carry-forward and carryback allowances, the filing of consolidated returns, the investment credit, accelerated depreciation, depletion allowances for mineral resources, expensing research costs, and the like. Whether all such incentives are appropriate and in the public interest can be and is debatable. I, myself, have expressed opposition to some incentive tax schemes. However, once a policy is adopted it seems to me equitable and proper that the purpose and benefits of the legislation and policies should be consistently applied to all appropriate corporations.

When I learned that the Federal Power Commission was applying rate rules to natural gas pipeline companies, which rules used tax reductions resulting from tax losses and tax credits arising from unrelated business activities to reduce rates, I agreed to prepare and submit testimony before the Federal Power Commission. Before summarizing that testimony let me say, Mr. Chairman and members of the committee, that I do not appear here to testify on the general methods used to establish the level of public utility user rates nor on the adequacy of rates of return to shareholders in the public utility industry. Rather, I am here to testify specifically on the issue involved in the proposed amendment No. 418 to H.R. 7502 as it affects taxes and their role in determining utility rates.

If a public utility is completely independent and engages exclusively in a regulated activity, the taxes it actually pays are counted as a cost in determining user rates. This is entirely proper and is consistent with the general principle of allowing only actual outlays to be recognized as costs for setting utility charges.

If a utility company happens to be part of a multicompany operation filing a consolidated return including affiliated company operations which suffered losses or generated tax credits, then naturally taxes are reduced because of the filing of a consolidated return. The Federal Power Commission insists that this reduction in taxes for the complex of affiliated firms should be reflected in lower rates for the customers of the utility.

As illustrated in my testimony before the Federal Power Commission, if an independent utility company earned $10 million a year before taxes and paid, let us say, $5 million in corporate income taxes, the Federal Power Commission would accept the $5 million payment in taxes as a cost to be included in determining user rates. On the other hand, if that utility company were affiliated with a company engaged in a purely private activity which showed tax losses of $10 million, the consolidated return would require that no taxes be paid. Under these circumstances the Federal Power Commission would deny any taxes as a cost in determining user rates of the utility. Likewise, if the consolidated return covered one public utility which made profits and another which suffered losses or generated tax credits, the user rates of the profitable public utility would be lowered by the Federal Power Commission because of tax savings resulting from the losses of the other and the filing of the consolidated return. So the losses of one public utility would result in lower user rates for the customers of a profitable affiliate; on the other hand, if later the losses were turned into profits then the user rates would rise for the customers of the company that had made profits all along. These are arbitrary and capricious and illogical consequences.

Thus with respect to income taxes as a component of the "cost of services," the Federal Power Commission fails to look at a regulated utility as an entity in and of itself, but insists on taking into consideration the tax results of operations of affiliated companies, whether utilities or firms engaged in totally unrelated functions. It would seem to me that in setting rates or in judging performance or in dealing with rate of return on investment of a public utility, a regulatory agency should look to that company alone and not to any unrelated activities. Otherwise, the impact of nonjurisdictional operations on public utility user rates would be capricious. Also, companies owning public utilities are discriminated against as compared with those owning only nonutility companies.

It would seem necessary for proper ratemaking purposes that each public utility should be treated as an independent entity, irrespective of whether separate or consolidated returns are filed by its parent company. Tax savings resulting from losses and tax credits of affiliates, whether these be utilities or nonutilities, should not affect user rates of any given public utility. This is not to say, however, that regulatory agencies must not be careful and thorough to protect the public from any improper practices in intercompany relationships between affiliates which could prejudice the interests of the public.

Mr. Chairman and members of the committee, I sincerely believe that the present regulatory procedure as pursued by the Federal Power Commission seeks to deny to utilities the benefits associated with the filing of consolidated returns. It discriminates against companies which include public utilities among their affiliates or subsidiaries.

I believe the legislative history clearly indicates that the filing of consolidated returns was legislated for the purpose of permitting corporations to offset losses and gains among affiliates. It had the same impact as though the Government were to collect full taxes from each profitmaking affiliate and refund taxes to the losing affiliates, depending on the size of profits and losses. In effect, the Government agreed to share the risks and losses of companies up to the amount of taxes that profitable affiliates would have to pay if they were filing independent returns. This was designed as an inducement to invest. It was not unlike carry-forward and carry-back provisions, the investment credit and other inducements.

To insist that any tax savings resulting from offsetting the profits and losses of affiliates should be reflected in lower user rates for public utilities is clearly to deny these incentives and benefits to utilities and their affiliates. I find no evidence that this was the intent of Congress. In fact, the 1964 enactment of the investment credit provisions seeks to accomplish the exact opposite, namely, to assure that such legislated benefits are not taken away through regulatory decision. Once enacted, such incentives should be available to all companies unless it was the intent of the Congress to exclude certain sectors of our economy. There is no evidence that the Congress ever intended to exclude public utilities. The present legislation would assure the same treatment for public utilities as other companies.

I think just another word or two about the capricious nature of present practices of the Federal Power Commission as they affect utility user rates should be sufficient. It strikes me as absurd economics to have user rates of a given public utility go down because affiliated companies lose money. It is equally absurd to suggest that user rates should increase when affiliated companies shift from losses to profits. It seems to me only fair and proper that user rates ought to depend on the performance of the particular public utility and nothing else. As a customer of a public utility in Maryland, I believe my rates should depend on the operations of my supplying company, including its tax liability, as if it were an independent company. My rates should not be increased or decreased because of the success or failure or the tax credits of an affiliated company which might operate oysterboats in the Chesapeake Bay or an affiliated company which might operate a hotel in Puerto Rico or an affiliated company which operates a public utility in Oregon. As a noncustomer and noninvestor in these affiliates I don't see why my utility rates should rise or fall because of the profits or losses of such unrelated business activities.

As far as discrimination is concerned, I see no reason whatsoever for permitting industrial and commercial and trading corporations to enjoy the benefits of filing consolidated returns and saving the taxes derived from offsetting profits and losses of affiliates, while denying this benefit to utilities and their affiliated and holding companies. If Congress wants investment generally to be encouraged by the privilege of filing consolidated tax returns, administrative rules should not discriminate against public utilities unless Congress clearly intends such an exception. I repeat that there is no evidence of such congressional intent. In fact, legislative records and history would appear to indicate the opposite.

The proposed amendment would result in transfers of funds from profitmaking affiliates to loss affiliates so that each affiliate would in effect be responsible for the tax on its own taxable income and thereby the benefits of filing consolidated returns would be assured. It is much the same as though the Federal Government collected the full taxes from the profitable affiliates and refunded appropriate amounts to the losing affiliates, thus sharing their losses up to the amount of taxes otherwise payable on the profits of the profitable affiliates. It would result in public utility user rates being determined solely on the basis of the performance of the public utility itself. Its tax cost used to determine user rates would be unaffected by unrelated business activities.

Let me conclude by emphasizing that I believe laws should be administered indiscriminately and equitably and that in the issue at hand the amendment appears to me to assure that the benefits of consolidated returns will be made available without discrimination and in accordance with the legislative intent.
Thank you.

PREPARED TESTIMONY OF ROBERT R. NATHAN BEFORE THE FEDERAL POWER COMMISSION, MARCH 27, 1961

Tennessee Gas Transmission Company, Docket No. G–19983

Q. Will you please state your name and address?—A. My name is Robert R. Nathan. My residence and office are both in Washington, D.C.

Q. What is your occupation?—A. I am a consulting economist, serving as President of Robert R. Nathan Associates, Inc., of Washington, D.C.

Q. Would you list your academic training?—A. I received the degree of Bachelor of Science in Economics from the Wharton School of Finance and Commerce, University of Pennsylvania in 1931. I received the degree of Master of Arts in Economics from that Institution in 1933. I received the LL.B. degree from Georgetown University in 1938. In addition, I took graduate work in economics at Georgetown University.

Q. Would you please describe briefly your working experience in the field of economics?—A. I served on the research staff of the Industrial Research Department of the University of Pennsylvania while taking graduate work, primarily conducting unemployment surveys in the City of Philadelphia. On coming to Washington in the summer of 1933, I was employed first as an analyst in the Economic Research Division of the Department of Commerce and then became Chief of the National Income Division which I headed for five years. There was an interim period in 1934 when I was Assistant Director of Research of the State Emergency Relief Board of Pennsylvania and consultant to the President's Committee on Economic Security, which formulated the unemployment compensation and old age pension program.

Starting in 1940, I served the National Defense Advisory Commission, the Office of Production Management and the War Production Board, moving from the initial assignment of Chief of Military Requirements to Assistant Director of Research and finally to the position of Chairman of the Planning Committee of the War Production Board.

In 1943, I entered the Army. After receiving a medical discharge late in 1943, I was self-employed as an economic consultant and writer until April 1945 when I returned to government service as Deputy Director for Reconversion of the Office of War Mobilization and Reconversion.

At the beginning of 1946, I organized the firm of Robert R. Nathan Associates, Inc., Consulting Economists, of which I have been President ever since. I also service as director of several corporations.

Q. What is the nature of the work of Robert R. Nathan Associates, Inc.?—A. Robert R. Nathan Associates, Inc. has served as economic adviser to many foreign governments, helping prepare plans for economic development and helping formulate and implement economic policies, including the important area of taxation. These countries include Burma, Korea, Vietnam, Israel, Colombia, Iran, Ghana, France, and El Salvador. The firm has carried on extensive work for the Commonwealth of Puerto Rico over a period of many years. We have conducted many studies of an analytical and policy nature for American corporations in the fields of manufacturing, distribution, transportation, foreign trade, and the like. Also, we have served trade unions and various nonprofit organizations in advisory and consulting capacities. Finally, we have served various U.S. Government agencies, including the Department of Justice, the Defense Department and the Department of Commerce.

Q. Have you yourself undertaken or supervised such studies?—A. Yes. I take final responsibility for all of the work of the company and personally supervise a substantial portion of the surveys and projects. In many administrative proceedings, I myself have appeared as expert witness for clients.

Q. Have you been the author of any publications?—A. Yes. I was author of "National Income in the U.S., 1929–35", U.S. Government Printing Office, 1936; "Mobilizing for Abundance", McGraw-Hill Publishing Co., New York, 1944; "National Wage Policy for 1947", AFL–CIO, 1946; "National Economic Policy for 1949", AFL–CIO. I was coauthor of the following: "Unemployment

in Philadelphia", U.S. Department of Labor, 1931; "Palestine—Problem and Promise", Public Affairs Press, Washington, D.C., 1946.

In addition, I have contributed articles to many professional journals and have testified frequently before Congressional Committees on taxation, fiscal policies, foreign economic policies, and the like.

Q. Are you a member of any professional organizations?—A. Yes, I am a member of the American Statistical Association, of which I am a fellow and of which I was a vice president in 1940; American Economic Association; National Planning Association of which I was a trustee in 1939-41; the Society for International Development, of which I am a member of the council; and the Council on Foreign Relations. Also, I am a member of the National Commission on Money and Credit, which is in the process of completing a comprehensive 3-year study of America's money, credit, and fiscal system.

Q. Have you read the testimony of Mr. John Raymond on the treatment of income taxes in Tennessee's cost of service?—A. Yes, I read his testimony.

Q. Did you hear Mr. Raymond's testimony on cross-examination?—A. Yes, I did.

Q. Then, I take it you are aware of Mr. Raymond's statement on transcript page 2596 in his direct testimony, that the basis for his proposed Federal income tax treatment is, and I quote, "the regulatory principle that a utility should be allowed only actual taxes payable in its cost of service"?—A. Yes, I am.

Q. Are you aware of Mr. Raymond's statements on pages 3715–3716, and 3722–3723 of the transcript that in following this "regulatory principle", as he calls it, he did not consider the implications of its possible or probable economic effects on gas rates and related economic matters?—A. Yes, I am.

Q. In this connection, did you read the statement of Mr. Spalter, who stated on transcript page 3727, in answer to a question by the presiding examiner, that the staff had not given consideration to these implications?—A. Yes.

Q. Do you believe that the general application of this so-called regulatory principle in the manner proposed by Mr. Raymond would have any economic effects?—A. Yes, I believe its application would have an impact on our economy.

Q. Would the impact, in your judgment, be beneficial or detrimental?—A. In my opinion, it would have detrimental effects on our economy.

Q. Would you please state your principal reasons for this conclusion?—A. The effects, by discouraging investment, would tend to inhibit the fulfillment of the objectives of national economic policy, particularly as set forth in the Employment Act of 1946. They would not serve the best interests of consumers of natural gas. They would tend to be destabilizing to the industry. They would be harmful to the interests of investors in the natural gas industry.

Q. In what sense would the effects be contrary to the objectives of national economic policy?—A. In the sense that if such a rule were generally followed, the effect would be to discourage investment and this would tend to retard economic growth, and growth is one of the prime objectives of our national economic policy.

Q. What do you mean by "national economic policy"?—A. In our free enterprise economy, we do not engage in precise economic planning but we do have economic goals and we do formulate and implement overall economic policies. The Employment Act of 1946 established the policy that the Government should take the necessary steps to achieve and maintain high levels of production, employment and purchasing power. Our national economic policy encompasses these goals plus the placing of responsibility on the government to adopt and implement specific policies to achieve these goals.

If there is one point of economic policy on which there is nearly unanimous agreement it is that economic growth—expansion in production—is a prerequisite of full employment, of a rising standard of living and of the greater fulfillment of domestic and foreign needs. The economy must provide for 1.5 percent more people every year.

We are adding nearly a million more people to the labor force each year. Output per worker—what we call productivity—is rising 2 or 3 percent a year. Unless the economy grows vigorously we will accumulate unemployment at an alarming rate. Moreover, Federal, State, and local governments depend on a growing national income to provide increasing revenues to meet the needs of a growing population.

Our national economic policy, which is broadly accepted, at least in principle, embodies more jobs, more investment and more efficiency toward the end that our needs and wants at home as well as our international commitments will be more fully met.

Q. Do the factors which influence our economy have external effects as well?—A. Yes. The maintenance of our own defense program and our ability to meet our international security and economic obligations depend on the production, on the strength, and on the health and vigor of our economy. The higher the level of output and the greater the rate of economic growth, the less burdensome it becomes to support adequate defense and international trade and development programs.

Q. Mr. Nathan, what has this to do with principles underlying the determination of the tax allowance in the cost of service in a rate case?—A. Just this: The regulator of rates for a public utility must strive to protect the consumer from improper costs and from excessive profits derived from public utility operations. But, he must also take into account a fair rate of return on the stockholders' investment. He should pursue these objectives in relation to tax and other economic policies established by the legislative and executive branches of our government. Tax policies are among the most potent of all instruments which can and do influence investment and growth. Taxes affect income distribution, private expenditures, incentives, economic growth, governmental financial resources, and other crucial economic factors. They also involve the matter of equity. Mr. Chief Justice Marshall said more than a century ago that the power to tax is the power to destroy. We have also learned that the power to tax is the power to create, both by offering incentives to productive investment and by affecting the levels of private savings and expenditures.

The significance of investment in our economy is far-reaching. Investment is necessary not only to finance added plant and equipment and to finance exploration and exploitation of natural resources like gas and oil, but it is also in itself a major component of economic growth. Continued investment is a necessary condition of increased employment and production. And in recent years special importance has attached to foreign investment by Americans, as a means of implementing our international economic policy of helping friendly nations to develop their economies and of increasing international trade.

Q. Would you elaborate on how this bears on this case?—A. The rate of investment in a free society such as we enjoy in the United States, is very importantly influenced by incentive. Every individual or corporate investor weighs the profit-loss calculation before deciding whether or not to invest in a given venture. The prospect of gain is one element in this equation; the risk of loss is the other. Prospective demand for the output resulting from investment is essential. Also, the investment decision is greatly influenced by the manner in which profits and losses are treated taxwise.

We have here the case of a dynamic and expanding enterprise which has evidenced a willing and venturesome desire and capability to extend its area of activity by making new and additional investment. Clearly, the tax effect on gains or losses from these ventures is of major significance. Accordingly, at issue here are key economic considerations. The proposal set forth by Mr. Raymond, if applied, would deny certain well-established tax incentives to the Tennessee Gas Transmission Co., would be discriminatory against companies which engage in a regulated public utility function as compared with companies engaged in other pursuits, and would tend to discourage investment. In these respects, the proposal appears to me to be economically unsound and contrary to our national economic policy.

Q. Do you mean to imply that tax considerations enter into this case in ways other than as a sum of dollars paid to the Government?—A. Yes, indeed. Just as we look at ratemaking in the light of all its purposes, so we must look at taxes in the light of the various important purposes they are intended to serve. Obviously, taxes provide revenues for Government; possibly less obvious is the fact that taxes have been designed specifically as instruments of economic policy. The schedule of a protective tariff is one of the oldest examples of a tax designed for an economic purpose. The same has been true from time to time of selective excise taxes designed to curb consumption in circumstances where national policy required it—as during wartime. Taxes can be designed to influence savings or expenditures, to encourage or discourage investment, to favor selective groups or industries or to achieve any number of general or specific objectives.

The level and structure of taxes strongly influence the total level of economic activity. Of all the taxes now part of the American tax system, income taxes are by far the most powerful and effective instruments of economic policy. Quite apart from the large revenue it yields, the individual income tax is a built-in economic stabilizer. It is an effective force in the economy for restraining excessive increases in purchasing power on the upswing and cushioning purchasing

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power when it is on the downswing. Moreover, the steep graduations themselves have provided an intentional means of narrowing the range of incomes and of redistributing income and benefits within the economy. It is important, therefore, to note and emphasize that economic as well as equitable considerations influence tax policy decisions.

Q. Is this true also of the corporate income tax?—A. The corporate income tax is pretty much a flat rate tax, but because corporate profits are volatile, being so to speak a residual, the corporate tax liability fluctuates much more sharply than the level of economic activity. This has a strong stabilizing effect. In fact, the wide swings in corporate tax liability make this tax one of the most effective of the built-in stabilizers.

But the corporate income tax is designed to serve other economic purposes. I refer to the various ways in which the corporate tax serves to encourage investment. The most general provision of this kind is that which permits the recovery of the invested principal through depreciation allowances, but there are many others designed to mitigate prospective losses or enhance prospective gains explicitly for the purpose of stimulating more investment at a given level of risk.

From the point of view of economics and public policy, these provisions are appropriately regarded as incentives to encourage action in ways that will further the public interest, rather than as concessions to taxpayers.

Q. What are some of these provisions?—A. The most general provision is the privilege of offsetting operating losses against operating gains in a corporation, by which, in effect, the Government agrees to waive the tax liability accruing from gains to the extent that the taxpayer has suffered equivalent losses. In other words, the Government agrees that it will assume 52 percent (in most cases) of the losses to the extent that this can be met from the tax liability accruing from the taxpayer's gains. Capital losses can also be offset against capital gains. This principle of offsets is sometimes thought of as inherent in tax equity, but this should by no means be taken for granted. It is easy to imagine plausible circumstances in which the Government would wish to discourage certain kinds of investment and would not share losses on such investments.

Usually, however, it works the other way around: if the Government wishes to encourage certain kinds of investment for reasons of public policy, it offers specific tax inducements to achieve these ends. This is an old practice in our country, beginning with the granting of public lands for homesteading or granting credits and subsidies for railroad building. Even today there are subsidies for ocean shipping and airlines, but the more common method of offering special inducements is through tax incentives. However, the principle is the same: The allowance is not intended to be a windfall or an inherent right but rather a designed benefit for engaging in certain activities which the Government wishes to encourage.

Other examples of tax incentives include offsetting losses against gains for tax purposes by the use of the consolidated return and the carry-forward, carry-back provisions. Then, there are examples of accelerated depreciation, percentage depletion, and the expensing of intangible drilling costs and of research and development.

Q. Is there a possible conflict between the objectives involved in providing these incentives and the objectives of regulation under such statutes as the Natural Gas Act?—A. Not at all. As I see the economic policy underlying utility regulation in a private enterprise economy, such regulation is intended as a substitute, so to speak, for competition, that is, for the functioning of the competitive market if such a market were possible. When we lay down criteria like "fair prices to consumers," "fair returns to investors," "assurance of adequate supplies and service," and "economic allocation of capital and resources," we are really describing the functions which a competitive market is expected to serve. Because of limited or nonexistent competitive markets in public utility operations, those functions normally performed by the market are sought to be performed by regulation.

In performing these regulatory functions, public authority intervenes only to the extent necessary. In lieu of the self-regulating competitive market, it regulates rates, returns, and service. But it does not undertake to regulate, for example, the terms on which utilities compete in the market for manpower or capital—to cite two examples in which utilities operate essentially the same as any other private enterprise. Nor does it seek to regulate or in any way control the terms on which utilities enter into nonutility activities not related to their utility functions. These must be regulated by competition in the market. I am now speaking, of course, of the economics of regulation. And, of course,

regulation does not invade what is generally considered to be the domain of management.

Q. Speaking in economic terms, would you say that the so-called regulatory principle propounded by Mr. Raymond was or was not consistent with economics of regulation?—A. I do not think it is consistent with the economics of regulation because it introduces an element that is foreign to the economics of regulation. Mr. Raymond merges nonutility tax losses with utility tax profits in computing utility taxes. In other words, he merges negative nonutility taxes with positive utility taxes. The economics of regulation has nothing to do with nonutility operations.

To the extent that the taxes in question, whether positive or negative, arose from nonutility functions not related to the service of supplying gas to consumers, I do not see how Mr. Raymond's proposal fits into the criteria of a "fair price to consumers." Rates should be set so as to permit the investors in public utilities to recover all reasonable costs incurred in supplying the service, plus a fair return on their investment, simulating as nearly as possible a competitive situation. Nonutility debits or credits should not be imputed to the utility business.

Q. Please state your view as to whether the funds invested in nonutility undertakings by the Tennessee Gas Transmission Co. or its subsidiaries were in reality supplied by the stockholder or by the utility customer or by the Government?—A. In a real sense, investment is made by a corporation out of funds which are provided by the stockholder through equity investment or retention of profits which belong to the shareholder. Even when borrowed, in the final analysis it is the stockholder who bears the burden of the loan because loans are obligations of the corporation and repayment takes priority over the equity of the stockholder in claims upon the net assets of the corporation.

When the Government adopts policies designed to stimulate investment, which policies permit offsets of losses against profits in determining tax liability, the Government is, in effect, sharing losses with the stockholders of the corporation. In other words, as I said earlier, the Government is covering 52 percent of the losses up to the amount of the profits available to offset these losses. It is the Government that is sharing these losses, not the customers of the profitable segment of the corporation. Applying these principles in the present case, Tennessee's gas customers should be neither favorably nor unfavorably affected, in terms of rates, by Tennessee's nonutility activities.

Q. Do you mean to say that nonutility activities should be regarded as entirely separate and not permitted to have any impact on the utility rates or returns?—A. Yes. Gains or losses incurred by investors in the use of their capital for purposes other than providing the utility service are extraneous to that service. The capital so employed is not part of the investment in the utility service. The costs so incurred are not part of the cost of the utility service and therefore not part of the price. The gains or losses so derived are not part of the return for the utility service. To permit these gains or losses to enter into the price of the utility service would be to cause utility rates to vary capriciously, as a result of activities foreign to that service.

To do this would be to distort the competitive situation in which the stockholders should be free to invest outside the utility in the same manner as investors in wholly nonutility enterprises.

Q. Mr. Nathan, how would the staff's proposed treatment of income taxes have any effect on Tennessee's competitive situation with respect to its nonutility operations?—A. It would have a material effect. Under the staff's proposal Tennessee would be at a great competitive disadvantage in its nonutility operations. An illustration will make this point clear. The tax laws grant special tax deductions to companies engaged in oil exploration. Part of tax losses are often due to these special deductions such as intangible well drilling. If a competitor of Tennessee, say for purposes of illustration Standard Oil of New Jersey, explores for oil, only 48 percent of any loss would be borne by the corporation and 52 percent would be borne by the Government. However, in the case of Tennessee, under Mr. Raymonds' proposal the entire loss would represent a cost of the oil operations. Obviously Standard Oil, with its lower cost, would be in a much more favorable position competitively than Tennessee. This result in my opinion would nullify for Tennessee the economic incentives built into our income tax structure.

We might take an even more glaring, but realistic, situation. When Tennessee decides to invest in a rental parking building, under Mr. Raymond's proposal, it is at a distinct disadvantage as compared with a bank or a factory or a foreign trading corporation which invests in a rental parking building. If the parking

venture lost money, the latter investors would bear only 48 percent of the loss, provided they earned more profits in other operations. But Tennessee would bear 100 percent of the loss. This certainly has a distinct and discriminatory adverse effect on Tennessee's competitive situation with respect to nonutility operations.

Q. Is your conclusion the same whether or not a consolidated tax return is filed?—A. Whether the nonutility activities are included in a consolidated tax return or in separate tax returns should be, from the economic point of view, entirely irrelevant to the utility rates. The true test goes to what are utility operations and what are nonutility operations. It seems to me, as an economist, wholly arbitrary and capricious to charge lower utility rates just because a consolidated tax return is filed rather than separate tax returns, when nonutility departments or subsidiaries operate at a loss. The circumstances directly affecting the utility operations are exactly the same in both instances.

Q. How do these general economic principles and economic criteria specifically apply to the allowance of income taxes in the cost of service in this case?—A. The staff proposals with respect to taxes in the cost of service in this case would violate the economic principles, both of a fair price to Tennessee's customers and equality of opportunity to Tennessee's stockholders. Returns to Tennessee's stockholders would be lower than returns to stockholders in wholly nonutility companies similarly situated. This would discourage investment in such companies as Tennessee. It is clear that if all costs of providing gas service remained the same, gas rates would vary downward if Tennessee suffered losses on its nonutility investments and upward if these losses were reduced and would vary even further upward if these losses were later recouped. Indeed, in years when rates were increased to reflect such recoupment, sales of gas for industrial use may be adversely affected because such rates might price the gas out of the market.

Let me give an illustration. Assume there are two gas companies serving two neighboring cities with exactly the same investment, the same volumes and the same costs. We would expect under these situations that the rates in the two cities would be the same. Let us assume further that one of the companies engaged in oil operations in Venezuela or produced movies in Hollywood from which it experienced tax losses and gains at different times, whereas the second company engaged in no nonutility business. Under Mr. Raymond's theories the rates in the first city would not be the same as in the second city but would go up and down depending upon the results of operations of the oil properties in Venezuela or of the movie business. Such ratemaking, in my opinion, could only lead to capricious, and in extreme cases, to absurd rate differentials.

Q. More specifically, what would be the effect of Mr. Raymond's proposal on the consumers of gas?—A. Such variations in the price of gas would in the first instance shift from Tennessee's stockholders to Tennessee's customers the tax benefits accruing from nonutility losses. The tax liabilities accruing from the recoupment of those losses would also fall on Tennessee's customers. The net effect might appear to favor the customer, but more likely he will be hurt. The stockholders, being deprived of a proper return on their investment in the corporation through denial of the tax benefits resulting from nonutility losses, to which they are entitled as investors in the competitive open market, may be discouraged from further investment in the company and this could work to the disadvantage of gas consumers. It would discourage nonutility investments by Tennessee and similar companies and thereby hurt the economy, including gas consumers.

Tennessee's customers can reasonably expect, and be expected, to pay the full reasonable and fair costs of the gas service they receive, including the taxes accruing from it. Asking them to pay this full tax accrual is not asking them to pay part of the nonutility losses of Tennessee's stockholders but only the full cost of the gas service they receive. My whole background is filled with experience and efforts designed to protect consumers and to support the public interest. Consumers need to be protected, especially where competition is absent and that is why regulation of public utilities is proper. However, I believe Mr. Raymond's proposal is not in the interest of the consumers for the reasons I have given.

Q. Does this mean then that you disagree with Mr. Raymond's testimony on pages 3668 to 3676, where he concluded that the customers are putting up part of the money through tax savings?—A. Yes, I do disagree because it is really the Government that is giving up the tax revenue by sharing in the losses to the extent of 52 percent, and not the customer. The proposal made by Mr. Raymond in actuality denies to the investors in this company the benefits of Government

participation in the loss resulting from other investments, which benefits were intended for investors and which benefits are available to other companies. Mr. Raymond would give the Government's share in losses to the customers, rather than to the shareholder. The customer thereby gets a windfall because the shareholder took a risk with his own capital in an unrelated venture and suffered a loss in taking that risk. The Government's sharing in losses is designed to stimulate investment by mitigating the impact of loss operations. To pass this benefit on to customers is contrary to the intent of the tax provisions and certainly would serve to defeat the purposes of these provisions.

Q. Does Mr. Raymond's proposal impose 100 percent of the losses in nonutility ventures on the shareholder rather than 48 percent of the loss which is the proportion suffered by shareholders in other industries, up to the amount of profits that can be offset?—A. It is clear to me that the procedure proposed by Mr. Raymond does impose 100 percent of the burden of losses in nonutility ventures on the shareholders of Tennessee. A simple illustration will clearly demonstrate that this is what actually happens. Let us assume that a commercial or industrial company or a department of that company has a profit of $10 million on which it has a tax liability of $5,200,000. If a subsidiary operation of the company or another department has a $10 million loss, the consolidated tax return would show no profit or loss and no taxes would be paid. The company enjoys the full benefit of the tax offset.

Let us look at a similar situation for Tennessee under Mr. Raymond's proposal. If Tennessee's jurisdictional operations show a profit of $10 million and its nonutility operations show a $10 million loss, there would be no profit or loss and no taxes paid. But, and this is the important difference, the cost of service, and therefore the utility rates, would be reduced by $5,200,000 because no taxes were actually paid by Tennessee as a corporation. Clearly, this would mean that the shareholder would bear the full cost of the nonutility loss and that the Government's share of 52 percent intended for the investor as an incentive would be diverted as a windfall to the customer. Under the recoupment principles proposed by Mr. Raymond, an added burden would be imposed on the customers in future years if the nonutility operations were profitable.

It seems clear to me that this system is definitely contrary to the intent of tax policy which permits losses to be offset against profits and that it would discourage investment because it would take away from the shareholder the expectation that losses will be shared by the Government to the extent that profits are available.

Q. Mr. Nathan, assume a natural gas company with a $10 million profit before taxes. Assume the company is engaged in the gas business only. Using a tax rate of 52 percent the net profits from the gas operations would be $4,800,000, is that not correct?—A. Yes, it is.

Q. Assume that in the following year the company engages in exploration for oil and as a result, among other things, of special tax deductions such as expensing intangible drilling costs, the company has a taxable loss of $10 million on the oil operations but has precisely the same investment, the same revenues and same other costs of service of the gas department as in the previous year. Would you say that in the year in which the company engaged in oil operations that the gas operations as such were more profitable and that in that year the company made $10 million net profit from gas operations instead of $4,800,000 as in the previous year?—A. No, not at all. In any realistic sense involving genuine economic analysis there could not be said to be any change in the prosperity of the gas department in the 2 years. Looking at the matter from the viewpoint of economic analysis, with particular emphasis on the incentives written into the tax laws, the oil operations had a tax loss as to which the Government suffered 52 percent and the company suffered 48 percent. However this in no way affected the profits derived from the utility operations as such. Businessmen and institutions are constantly making economic and business decisions which involve this tax problem. They go into ventures with the knowledge that the Government will share 52 percent of any taxable loss resulting from such ventures. They go into such ventures with the knowledge, supported by proper analysis, of the special tax benefits which the laws afford. Only in a very superficial approach, namely one looking to the corporation only and not to economic causes and effects could such answer be obtained.

Q. Are Tennessee's investments on which the losses were incurred, and presumably from which the tax benefits would flow, of the kinds included within the purposes which, in your opinion, were intended by the Congress?—A. Yes, they are; because the Internal Revenue Code encourages all kinds of investment by

allowing offsets of losses against gains for all kinds of investment. Congress allowed special tax benefits for oil drilling and for foreign investment, both of which are included in Tennessee's nonutility operations. The nonutility losses in the main were incurred by Tennessee's investments in production other than providing gas service under the jurisdiction of the Federal Power Commission. These investments were aimed at increasing production. They thereby stimulate the growth of the economy. The investments had the effect per se of providing employment. Some of them were aimed at increasing the resources available to the U.S. economy in the form of oil, exactly as contemplated by the code in providing tax incentives. Many were made in other nations and were therefore consistent with the intent of Congress to encourage economic development of friendly nations and to add to the resources directly or indirectly available to the economy of the United States.

There is no doubt that in taking the risks inherent in these investments, Tennessee was acting in conformity with established economic policies and that they are therefore entitled to the incentive benefits, i.e., the Government's willingness to share in the risk through permitting losses to be offset against gains for tax purposes. To deprive Tennessee stockholders of these benefits merely because Tennessee also engages in a regulated utility business and files a consolidated return would negate the intended effects of the Internal Revenue Code. It would discriminate against Tennessee's stockholders as compared with stockholders in companies which did not engage in a utility business.

Q. Suppose that instead of a tax benefit, as an incentive Tennessee had been paid a subsidy by the Government for every foot of drilling for oil, or for every barrel of oil brought into production, or for investing in ventures in remote fields of endeavor. Do you believe that these subsidies paid by the Government would be properly included as credits in the cost of service of the regulated gas utility in such a way that the cost of service would be reduced and the price of gas reduced?—A. Of course not. Clearly these subsidies would have nothing to do with the price of gas subject to the jurisdiction of the Federal Power Commission. These subsidies would be, so to speak, a direct transaction between Tennessee's stockholders and the Government of the United States in consideration for the risks incurred by the stockholders in pursuing activities which the Government wished to encourage for reasons of public policy. As a matter of fact, subsidies of this kind have been paid, for example, in the form of premium prices on the production of uranium and, during the war, on the production of other minerals. This is only an alternative way by which the Government can make effective its policy of encouraging production. The subsidy is merely a more direct way than through taxation of encouraging the production of specific commodities or services.

Q. Would you say that from the economic point of view, there was any difference between the payment of a subsidy and the tax policy of permitting losses to be offset against gains?—A. In economic terms, no. In practice, the tax abatement is a general form of incentive just as the subsidy is a specific form. Some tax abatements are very specific and closely analogous to subsidies. For example, in the drilling for oil the expensing of intangible drilling costs and the statutory depletion allowances are for specific purposes. The offsets permitted by consolidated returns and by carry-forward carry-back provisions are more general but in principle they have the same effect of encouraging investment.

Q. Some of the nonutility losses in question were sustained by subsidiary companies included in the consolidated return. From the economic point of view, does the filing of a consolidated return affect the operation of the incentives?—A. The filing of a consolidated return merely effectuates the intent of Congress to allow investors to offset losses against gains in determining tax liability. It affords the same incentives to affiliated corporations that it affords to different departments of one corporation. The Internal Revenue Code has recognized the consolidated return privilege since the 1918 Revenue Act. Its intent is clear. The Senate Finance Committee pointed out that the consolidated return "merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. Unless the affiliated group as a whole in the conduct of its business enterprise shows net profits, the individuals conducting the business have realized no gain * * *. The provision embodies the businessmen's conception of a practical state of fact" (Senate Finance Committee, 70th Cong., 1st sess., S. Rept. 960, pp. 13–15).

In other words, this is a privilege which is conferred on the taxpayer as a matter of practical commonsense without intending that he shoud in any way be penalized.

The same principle was extended in the adoption of the carry-forward, carry-back privilege which instead of offsetting profits and losses horizontally, so to speak, within a company, offsets them lineally, over a period of time. When the loss carryover was reintroduced in 1939, the Ways and Means Committee, in recommending it, said "New enterprises and the capital goods industries are especially subject to wide fluctuations in earnings. It is, therefore, believed that the allowance of a net operating business loss carryover will clearly aid business and stimulate new enterprises" (House Ways and Means Committee, 76th Cong., 1st sess., H. Rept. 855).

Q. Does the tax issue in this case concern different types of incentives?—A. So far as selecting incentives are concerned, it should make no difference whether Tennessee's stockholders wish to claim them by offsetting nonutility losses against utility earnings in a given year by a consolidated return, or by offsetting current nonutility losses against future nonutility earnings by tax carryover provisions. The incentive is operative in either case and the taxpayer should be free to elect the method under the terms provided in the Internal Revenue Code, without discrimination. To attempt to differentiate between these in such a way as to penalize Tennessee's stockholders for electing to claim their incentive benefits through the consolidated return, is to penalize them for their enterprise, to discourage nonutility investment, and to frustrate the intended effects of the tax laws.

Q. You mentioned earlier the effects of regulation on the allocation of capital resources to industry. In your opinion, would the general application of the staff proposal for the treatment of income taxes as an allowance in Tennessee's cost of service affect the capital attractiveness of the natural gas industry and of Tennessee in particular?—A. Yes; I think it would.

Q. Would it affect it favorably or adversely?—A. I think it would impair the capital attractiveness of the industry and of the company. The natural gas industry, like other growing industries, in the past has attracted considerable new capital. Most of the industry, as we know it now, has developed since World War II. In that period, because of the attractiveness of gas as a fuel, it has expanded very rapidly. The natural gas utilities in the money markets have been able to offer both the appeal of public utilities with an assured return and the growth characteristics of a new industry.

The gas industry may be approaching a stage of slower growth. The most accessible sources of gas may have been explored and developed. The densest markets may have been reached and developed. New sources of gas may involve higher costs and new sales relatively more remote and competitive. Economically speaking the gas industry may no longer enjoy to the same degree the ability to attract capital which is associated with rapid growth.

Q. How is this situation affected by the staff's proposal for the treatment of income taxes in the cost of service?—A. Gas utilities cannot price the products of their business to generate internally the capital sources for expansion of production and markets. Other industries, like oil and steel, since the war have sought to include in their price structure a margin explicitly for expansion of facilities and production. Regulated gas companies, on the other hand, must go to the money markets for the capital required for expansion. In order to retain their reputation for income plus growth, they would do well to engage in nonutility undertakings to add to their profitmaking capabilities. The more successful the nonutility enterprises, the more plentiful the supplies of capital available to them in the money markets and the more advantageous the rates on which it can be attracted. This is to the advantage of both customers and stockholders. At the same time, the gas companies need to protect the return on their investment in regulated activities to assure a fair rate of return to stockholders. If the effect of efforts to expand their nonutility activities is to apply tax savings associated with tax loses on such nonutility investment to the utility part of the enterprise, then the stockholders would suffer greater losses on the nonutility endeavor than stockholders in nonutility companies similarly situated, and the company would be under a distinct disadvantage in its effort to attract capital.

Q. Would you please summarize briefly your views on the economic consequences of Mr. Raymond's proposal?—A. The proposal is economically unsound because it would serve to discourage risk taking and investment in nonutility activities by companies which are engaged in regulated utility operations; it would discriminate against companies, part of whose activities are in the regulated utility area as compared with other companies; it would result in capricious variations in rates between years and between competitors and between areas; it would arbitrarily deny to Tennessee and similar companies the benefits in respect

to tax incentives designed to stimulate initiative and new enterprise; it would subject customers to uncertainties and variations in rates which could be harmful to stable operations; above all, it would be contrary to our national economic objectives of sustained high-level employment and production and of vigorous economic growth.

Senator LONG. We will be back this afternoon. I suggest that we come back at 3 o'clock. Did you want to say something?

Mr. DAVIS. I just wondered if it was necessary for Mr. Nathan to return.

Senator LONG. No. We will have to excuse Mr. Nathan.

Mr. NATHAN. I have a speech at 3:30, Senator Long.

Senator LONG. If you wanted to come back we might come back earlier. If you think you have testified to what you wanted to say, Mr. Nathan——

Mr. NATHAN. I would just like to help clarify it if Senator Douglas is here.

Senator LONG. We will insert in the record the statement of Mr. Hedrick at this point.

(The prepared statement of Mr. Hedrick follows:)

STATEMENT OF F. CLEVELAND HEDRICK, JR. ON BEHALF OF TENNESSEE GAS TRANSMISSION CO. REGARDING AMENDMENT NO. 426 INTENDED TO BE PROPOSED TO H.R. 7502

The following statement is made on behalf of Tennessee Gas Transmission Co. in support of the proposed amendment No. 426 to H.R. 7502, for the purpose of adding a new subsection (c) to section 1552 of the Internal Revenue Code of 1954.

Tennessee Gas Transmission Co. believes that the proposed amendment will provide a more equitable treatment of certain payments under a consolidated return agreement by treating them as Federal income tax payments in determining earnings and profits and for other purposes. The amendment will be in conformity with policies previously enunciated by the Congress.

Consolidated returns are a realistic approach to the equal treatment of two types of corporate structure, the corporate entity with many divisions that files only a separate return, and the corporate entity composed of many corporations, rather than divisions, that files a consolidated return.

The major benefit of filing a consolidated tax return arises from the right to apply the losses or credits of one member of the affiliated group against the taxable income of other members of the group. The result is that Federal income tax is reduced currently rather than at some future time as may be the case if separate returns are filed.

It is generally understood that a major purpose of the statute permitting the filing of a consolidated income tax return is to encourage diversity of investment, and that the purpose of the statute granting the investment credit is to provide an incentive to the taxpayer to make qualified investments. These purposes are best and most equitably accomplished by providing prompt reimbursement for the losing corporation and current increased cash flow and earnings for the qualifying investor; not by providing additional profits and increased cash flow for the taxpayers who sustained no loss or made no qualifying investments.

In response to existing incentive provisions of the Internal Revenue Code, increasing numbers of corporations are enlarging their contribution to our national economy bymaking investments which qualify for the investment tax credit and accelerated depreciation rates and methods. Resulting high levels of depreciation expense combined with initial low levels of revenue during the development period of new enterprise usually combine to cause a new corporate enterprise to show a tax loss during such period. However, by filing a consolidated tax return with a profitable affiliate, such losses are offset. By such consolidation, the new enterprise is denied the right to use the deductions and credits, which its operations and investments generate, to reduce its own tax liability in future years.

It is this appropriation of the expenses and credits of the new enterprise by the profitable affiliate without compensation that gives rise to the problem. Strangely enough this situation is not only condoned but actually caused by the limited approach of section 1552 of the Internal Revenue Code as presently administered.

The new enterprise that is denied the use of its expenses and credits to reduce its tax liability in future years often has shareholders, creditors, and customers who have no interest in the profitable affiliate.

When stockholders and creditors of the members of an affiliated group have varying interests in different members of the group, none of the provisions of section 1552(a), as presently administered, provides a workable formula for accomplishing an equitable result. In addition, the allocation of taxes alone for purposes of adjusting earnings and profits cannot under any method, accomplish an equitable result, without some means of allocating the tax savings resulting from filing a consolidated return. Many corporate groups have found that an agreement between the corporations to attain this result is necessary, equitable, and proper. Transfers of funds pursuant to such agreements give rise to questions regarding their proper tax treatment.

The proposed amendment provides that an adjustment of earnings and profits may be made to reflect the transfer of funds, pursuant to a consolidated return agreement, by one member of an affiliated group to another member whose investment credit or other credits or deductions have brought about a reduction in the consolidated tax liability (or increase in the net operating loss) of the group. This new subsection (c) would make it clear that tax savings are to be retained by the corporation whose investments and operations generate the credits and deductions that reduce consolidated tax liability. The proposed subsection (c) also provides that such transfers are to be treated as payments or refunds of Federal income tax, as the case may be in determining earnings and profits and for other purposes.

Restrictions initiated by the Treasury Department are included in the proposed amendment. The Department has indicated that these restrictions may be necessary to prevent the use of the intercorporate payments as a means of consolidated earnings in subsidiary corporations and perhaps, securing artificial tax advantages for the owners of consolidated corporate systems. These restrictions are described as having the general effect of permitting the shift of parent corporation earnings to subsidiaries only in those situations where a net earnings deficit exists in the subsidiary system as a whole. The Treasury has further indicated, however, that it plans to make a study of these restrictions in operation to determine where they are, in fact, necessary. We support the amendment as presently drafted, but believe that further study will show that these restrictions are not at all necessary.

The substantive provisions of this amendment have been under study for several years. In fact, the basic provisions of this amendment were brought before the Committee on Finance in December of 1963 as a proposed amendment to H.R. 8363 (subsequently enacted as the Revenue Act of 1964). Amendment No. 348, introduced by Senator Long of Louisiana on December 9, 1963, would have provided for reductions and increases in earnings and profits of members of an affiliated group where transfers of funds are made between the members representing tax benefits derived from the filing of a consolidated income tax return.

The Long amendment was not acted on by the committee because the Treasury advised that it needed time to study the matter before it was in a position to report to the committee. Consequently, the amendment was not pressed before the committee at that time.

The principles of the amendment offered by Senator Long in 1963 were supported in statements filed with this committee by the Transportation Association of America and by David W. Richmond of the Washington law firm of Miller & Chevalier. (See hearings before the Committee on Finance, U.S. Senate, 88th Cong., 1st sess., on H.R. 8363, pt. 4, p. 1890 at 1898 and p. 1887, respectively.)

In 1964, Tennessee Gas requested a ruling on its consolidated return agreement from the Internal Revenue Service. Tennessee believes that an excellent case can be made under existing law for treating these intercompany payments and receipts as payments and refunds of Federal income taxes for purposes of determining the earnings and profits of the members of the group. The members that make payments incur an expense (which they would have incurred otherwise as a tax expense, if they had filed separate returns) in consideration for benefits surrendered by members receiving such payments. These funds are paid to the recipients (1) for forgoing their legal right to file separate returns and to avail themselves of potential loss and credit carryovers, and (2) for assuming the obligation to pay taxes which, on a separate return basis, would be solely that of members having taxable income. These items of expense and income are in the nature of items that, under normal principles of tax law, require appropriate adjustments of

earnings and profits. These transfers are made for legal considerations of substantial value; they are not contributory or voluntary in any real sense.

Nevertheless, the Internal Revenue Service's administrative practice has been to treat these transfers as contributions to capital or voluntary dividend distributions, depending upon whether the transfer is "downstream" (parent to subsidiary) or "upstream" (subsidiary to parent). The Treasury Department has concluded that it would not overturn this practice of the Internal Revenue Service administratively and instead is supporting the objective of the proposed amendment.

The enactment of the proposed subsection (c) would not only clarify present law with respect to this tax treatment, it would, in addition, have other indirect beneficial effects. While the most recent State court case[1] involving the question has upheld the validity of consolidated return agreements of the type described above, some State courts have declined to recognize the validity of these agreements, partly because of the failure of Federal tax law to recognize specifically the principle upon which such agreements are based. Therefore, enactment of the proposed amendment would help to remove the cloud of uncertainty from another area of the law.

In addition, it would contribute to better accounting practices as between members of affiliated groups in that the profitable operating results of one member would no longer be overstated as a result of appropriating the deductions and tax credits of another member to reduce its tax liability. Conversely, the losses of the loss member would no longer be overstated—having been reduced by the receipt of payment for use of such deductions and credits.

When section 1552 was first enacted in 1954, one of the major factors motivating its enactment, as stated in the report of the Ways and Means Committee, was the protection of minority shareholders in affiliated groups. This amendment furthers that original purpose.

Senator LONG. We will try to get the committee back at 2:30, if I can get the committee back that soon.

(Whereupon, at 1 p.m., the committee recessed, to reconvene at 2:30 p.m. on the same day.)

AFTERNOON SESSION

Senator LONG. I have this problem. Mr. Davis, if you want to testify further for the record, you can summarize your statement. Otherwise, if Mr. Nathan would care to elaborate upon his statements he can do that. Senator Douglas is supposed to be along after a while. What is your preference in this matter? Do you feel that you have made your position clear now as far as your testimony in chief is concerned, or do you want to testify further on your summary and presentation of your presentation?

STATEMENT OF N. KNOWLES DAVIS, TENNESSEE GAS TRANSMISSION CO., ACCOMPANIED BY ROBERT R. NATHAN, AND F. CLEVELAND HEDRICK, WASHINGTON, D.C.—Resumed

Mr. DAVIS. I believe it is fully covered. I am here available for questions if there are any.

Senator LONG. How about Senator Dirksen. Do you care to ask any questions of these witnesses, Senator Dirksen? Mr. Davis here is testifying for Tennessee Gas Transmission Co. He is accompanied by Mr. Nathan and Mr. Hedrick.

Senator DIRKSEN. No, Mr. Chairman. I would like to make this suggestion to the Chair. Mr. Hyde of the FCC suggested that his staff would be willing to work with the committee staff on a suggested amendment. My colleague from Illinois suggested striking out lines

[1] *Case, et al.* v. *New York Central Railroad Company, et al.* (232 N.Y.S. 2d 702 (1962), reversed, 243 N.Y.S 2d 620 (1963)).

9 and 23 of page 2. Others may have done likewise. I think it would be a great idea if the committee staff could be in contact with staff members of all of the regulatory agencies, and probably initiate some work this afternoon, so that if we do go into executive session, the spadework will be done, and some language——

Senator LONG. Won't you gentlemen take those three seats there for the moment if you would please, sirs.

Senator Dirksen, if I do say so, Mr. Nathan I think, made a fine summary statement of his position in support of your amendment. He stated that in his judgment—Senator Douglas was not here during Mr. Nathan's statement. I wanted him to hear it, but he was courteous enough to stay until he was late for his appointment which I think was very gracious of the Senator from Illinois. Mr. Nathan pointed out that what the amendment really means is simply that a regulated concern could have the benefit, the same benefit of a consolidated tax return that was intended for nonregulated companies. With regard to nonregulated companies the idea was to make it possible for those companies to diversify and go into other businesses, and the incentive there was that in the event that the new business was either not making money in its early years or losing money in its early years, that with regard to the taxes that the established concern could write off against tax losses occurring in that subsidiary or the affiliated company, which would help to cover the cost of the losses in the earlier years and they could take advantage of the tax losses. Now this amendment would permit for a regulated company, they would have the same benefit as far as being able to take advantage of tax losses in the affiliated concern insofar as the regulated company would on taxes, but it does not in any way affect the earnings after taxes and that is what we are talking about now, and I take it from your statement, Mr. Nathan, that your point is that that is why in no event could it adversely affect the consumer, because it is the earnings after taxes that the consumer has a right to insist be reduced to a fair return on investment, and the taxes that the person pays is not a part of the fair return.

Mr. NATHAN. I would say this. That if you took a utility and a nonutility that were affiliated and you treated the utility as though it were completely independent, looked only to its operations, I cannot see how the utility customer can be hurt by treating it as a complete entity. It would not be affected favorably or unfavorably by the profits or the losses of a nonutility affiliate.

On the other hand, if you give to the customer of the utility the benefit of the reduction in taxes resulting from the consolidation, but you do not allow that benefit to return, then it is imbalanced, because the utility customer is getting a reduction due to a nonutilities activities, and not due to the utilities activities. I think it is an unbalanced result if one insists that tax savings from consolidation go to customers rather than to the investors.

Senator LONG. What you are saying, as I understand it, is that the customer of the regulated company should not have his rates reduced and should not have them increased because of the profits that are made in the affiliated company?

Mr. NATHAN. That is correct.

Senator LONG. Which is a nonregulated company?

Mr. NATHAN. That is correct.

Senator LONG. And the same thing would be true of two regulated companies, that with regard to two regulated companies, the customers of one regulated company should neither have their rate increased nor should it be reduced?

Mr. NATHAN. That is right.

Senator LONG. By virtue of the profits or losses in the other company?

Mr. NATHAN. For ratemaking purposes I believe that each public utility ought to be treated as an independent entity, complete, and its operations, its activities, its performance, its results determine its rates to its customers and not what happens to another company in the family.

Senator LONG. Well now generally speaking isn't that the whole history of rate regulation? For example, back in the olden days when they had this problem of a railroad owning a coal mine, you would insist on separating those two activities.

Mr. NATHAN. That is right, being sure that there is a relationship which is honest and there is integrity in the relationship so that you don't benefit one from the other. Otherwise, they are treated completely separately.

Senator LONG. The idea being that the railroads should not make any profit at the expense of the coal mine and the coal mine should not make a profit at the expense of the railroad.

Mr. NATHAN. That is correct.

Senator LONG. That insofar as one buys coal from the other the price ought to be at the going market price?

Mr. NATHAN. That is right, arm's length dealing.

Senator LONG. Are there other questions? Senator Douglas?

Senator DOUGLAS. Yes. The discussion constantly moves into new channels, even more complicated channels. One question that has emerged is the relative ability of a group of affiliated companies to enter the consolidated group, to have a consolidated return filed for them in certain years and then for it and other companies to move out of the consolidated group. Some of us have contended that this is not a difficult thing to do. Senator Bennett has contended that it is a difficult thing to do. I would like to ask, in the history of the Tennessee Gas Transmission system, have some companies been included in the consolidated return and later withdrawn, or has the system filed consolidated returns for the same set of companies throughout the period?

Mr. DAVIS. Tennessee Gas has filed a consolidated return for the utility group and for the Tenneco group separately. I don't know of any instance where the company has withdrawn as you suggested, Mr. Douglas.

Senator DOUGLAS. I am not acquainted with your corporate structure. What is the Tenneco group?

Mr. DAVIS. The Tenneco group is generally in the production refining and marketing of petroleum products.

Senator DOUGLAS. Is it true that the Tenneco group or individual companies in the Tenneco group at one time participated in the consolidated returns?

Mr. DAVIS. Yes.

Senator DOUGLAS. They participated. In what years did they participate?

Mr. DAVIS. Through the year 1961, I believe.
Senator DOUGLAS. And was it discontinued in 1962?
Mr. DAVIS. Yes.
Senator DOUGLAS. Have they returned since 1962?
Mr. DAVIS. Yes.
Senator DOUGLAS. So they were in, they were out, they were in again. Now for how long were they out? They started out in 1962.
Mr. DAVIS. About 3 years I believe they were out.
Senator DOUGLAS. They were out in 1962, 1963, 1964?
Mr. DAVIS. Yes.
Senator DOUGLAS. But came back in in 1965?
Mr. DAVIS. I believe they actually came back in on November 1, 1964.
Senator DOUGLAS. 1964. So they were in, they were out, they are in again. Now what were the factors which led to the decision first for them to be included, then to be excluded, then to be included again?
Mr. DAVIS. I am not sure I can answer that question fully and completely, Senator Douglas.
Senator DOUGLAS. Suppose I turn to——
Mr. DAVIS. The tax matters of Tennessee Gas are not within my area. The ratemaking of Tennessee Gas is my specialty, and I would hesitate to give you an answer that might be inaccurate.
Senator DOUGLAS. Suppose I turn from the discussion of motive, which is always ungracious, to the discussion of results, which can be objective. I believe the law is moving more and more in the direction of considering the results rather than attempting to attribute motives.
During the years in which the Tenneco companies were originally involved in the consolidated tax return, did this result in a net tax saving?
Mr. DAVIS. I am sure it must have or they would not have decided to file a consolidated return.
Senator DOUGLAS. Very good; and when they went out, did that result in a tax saving?
Mr. DAVIS. No; I don't know that it did.
Senator DOUGLAS. Well, if they went in because of a tax saving, what other effect would there be by their going out except a tax saving? If this was a result of their entrance into consolidated return, was it not the result of their departure from a consolidated return?
Mr. DAVIS. It is my understanding that its tax bill did increase when we filed separate returns for the Tenneco group and Tennessee Gas, the overall tax cost was higher.
Senator DOUGLAS. You mean you did this in order to pay the Government more taxes?
Mr. DAVIS. We were facing a rate case before the Federal Power Commission, Senator Douglas, with the Federal Power Commission taking away from Tennessee Gas the tax credits which were generated by Tenneco, and which had absolutely nothing to do with the natural gas business. The only alternative that we could see, it is my understanding of the situation, was to file a separate return in order to protect Tennessee Gas.
Senator DOUGLAS. What was the——
Mr. DAVIS. When the 10th circuit court of appeals decided that the Commission was wrong, we felt that we were not exposed as we

had feared we were when we were in the process of a rate case before the Commission in which they threatened, the staff seriously advocated reducing Tennessee's income taxes very substantially because of the consolidated return. Incidentally I might say that the chief examiner in that case, Joseph Swerdling, did not agree with the staff and concluded that it was not proper. But yet we felt we had an exposure on account of the Commission's decision in the *Cities Service* case.

Senator DOUGLAS. Let me ask you this. Perhaps I violated my own injunction as to what the motive was. The point is it was not difficult to go in or out, was it?

Mr. DAVIS. I would rather Mr. Hedrick might answer that. That is a question of tax, and he is our tax expert, and I am really——

Senator DOUGLAS. As a matter of fact you had Tenneco in, you had Tenneco out, you had Tenneco in again. This indicates that it is not an indissoluble marriage. That is when you enter you don't take the pledge that you stay until death do you part?

Mr. HEDRICK. I might say that in order to get the Tenneco group out, Tennessee Gas had to dispose of enough of its stock interest to break the control test.

Senator DOUGLAS. How much?

Mr. HEDRICK. It meant it had to dispose of enough to get down below 80 percent control.

Senator DOUGLAS. How much did you have before?

Mr. HEDRICK. Well, I guess we had, with Tenneco, a hundred percent.

Senator DOUGLAS. You guess?

Mr. HEDRICK. I know we did.

Senator DOUGLAS. You sold 20.5 percent.

Mr. HEDRICK. About 25 percent.

Senator DOUGLAS. But if you had had 83 percent you could have gone down below on 3/10 percent.

Mr. HEDRICK. You could have Senator Douglas, but there are other considerations. I was unable to attend the hearings yesterday because of prior commitments at the Internal Revenue Service, but I have read Mr. Stone's testimony in response to questions by Senator Bennett on the same question, and it appears that the Treasury Department is making a very extensive study of this aspect of the consolidated return regulations, which they have not yet published, according to Mr. Stone's statement. I am not at liberty to say what I know about it, but Mr. Stone testified the Treasury Department had in mind tighter rules about this business of going in and out, and I think you should take that into consideration.

Senator DOUGLAS. This is in contemplation?

Mr. HEDRICK. Immediate contemplation.

Senator DOUGLAS. It is in possibility but not in being. And there can be many a slip between good intentions and concrete realization.

Mr. HEDRICK. But I might add, Senator, that going out of a consolidated group has a lot of complications as well as supposed blessings, because there are lots of theories about accounting for some of these intercompany transactions when you leave the group that can bring a great deal of grief to a company that just thinks it can go in and out and it is not that simple. It is not that simple at all.

Senator DOUGLAS. Legally you can do this by the transfer of a relatively small fraction of the stock, isn't that true?

Mr. HEDRICK. Provided you are on the margin of control.

Senator DOUGLAS. When you went back in, how much stock did you acquire?

Mr. HEDRICK. Enough. I am not real sure on that, Senator.

Senator DOUGLAS. Did it go up from 75 percent to 100 percent?

Mr. HEDRICK. I am not sure that they reacquired the full 100 percent, but they have acquired enough to file a consolidated return.

Senator DOUGLAS. How much stock is it necessary to acquire?

Mr. HEDRICK. Maybe Mr. Davis can answer that. We can supply that, Senator Douglas. It was in a preferred stock class with special voting rights, and it is a little complex, but I can give you the answer to that and I will before the day is over.

(The following information was subsequently submitted for the record:)

TGT commenced operations in 1944. Beginning in 1956, and continuing to the present day, it has filed a consolidated income tax return continuously. As stated at the hearing, in February 1961, Tenneco became disaffiliated from the TGT group, and from that date, until November 1964, Tenneco as a common parent, together with its affiliates, filed a consolidated return. In November 1964, Tenneco became reaffiliated with the TGT group and, since that date Tenneco and its affiliates have been included in TGT's consolidated return.

The disaffiliation of Tenneco from the TGT group in February 1961 was motivated primarily by the position of the Federal Power Commission that tax savings generated by nonregulated affiliates and realized by the filing of a consolidated return should be flowed through to the customers of the companies providing regulated activities and services. As a result of this position, it was necessary for TGT and its affiliates to eliminate the exposure which this position entailed in order to maintain their ability to compete on equal terms with others not subject to such exposure. This disaffiliation resulted from the issuance by Tenneco of 165,000 shares of 6 percent voting preferred stock in the amount of $16,500,000 to 11 unrelated insurance companies. The preferred stock issued represented 25 percent of the voting shares of Tenneco; the remaining 75 percent of voting stock being represented by Tenneco common stock, all of which was held by TGT.

It was decided to reaffiliate Tenneco with the Tennessee group in November 1964, after the decision of the *Cities Service* case by the U.S. Court of Appeals. It was believed at that time that the exposure to which Tennessee and Tenneco had been previously subject was substantially reduced.

The reaffiliation was accomplished by the issuance and sale by Tenneco of additional voting preferred stock to Midwestern Gas Transmission Co., an affiliate of Tennessee, for $5,500,000. This additional stock was 55,000 shares of 5¾-percent voting preferred; it represented 6¼ percent of the voting stock of Tenneco. After such purchase, 81¼ percent of the voting stock of Tenneco was owned by TGT and its affiliates, and 18¾ percent was owned by unrelated investors.

(See p. 201 for further discussion of this project.)

Senator DOUGLAS. Thank you very much. Now let me ask you this. Suggestions have been made, in fact I made the suggestion, that the bill might be acceptable to some of us if lines 11 to 23 were eliminated on page 2. Would you still be for the bill if lines 11 to 23 were eliminated?

Mr. HEDRICK. I defer to Mr. Davis on that.

Mr. DAVIS. Senator Douglas, I think that takes out from the bill the very essence of what we believe is wrong and what we believe Congress should clarify through expression of its intent with respect to tax losses from nonregulated enterprise being taken into account in the regulated business of a separate company.

Senator DOUGLAS. In other words, you want the right to include the nonregulated in the consolidated returns for the regulated and the nonregulated?

Mr. DAVIS. I am not sure I understand your question.

Senator DOUGLAS. I simply was trying to give what I thought was your statement that you want to have the nonregulated companies included in the consolidated return as well as the regulated.

Mr. DAVIS. Yes.

Senator DOUGLAS. And you want the management of the system as a whole, the holding company system, to determine under these conditions the allocation of expenditures or savings resulting from taxes between the ingredient members?

Mr. DAVIS. We want proper and appropriate treatment for tax costs to be recognized.

Senator DOUGLAS. Those are question-begging terms. You want the management to determine the apportionment of expenditures or refunds?

Mr. DAVIS. I don't believe there is any latitude in management's hands in that connection, Senator Douglas. Certainly our books and records are audited by the Federal Power Commission in the minutest detail. The auditors come into our office and stay for months on end going into the details of all the books and records, and if the agreement and the payments thereunder were not correctly calculated, were not appropriate, were not in line with the intent of this amendment that is being proposed, I am sure the Commission would find that they were not reasonable, not appropriate, and not correct. I don't feel that the management has any latitude in that connection. It just gives management the opportunity to transfer the payments in recognition of the tax credits which have been realized.

Senator DOUGLAS. Section 1 of the bill beginning in line 4 at page 2, consolidated return, going back to line 7—perhaps I had better go back to the beginning:

> Each member of the affiliated group is bound for the taxable year by a consolidated return agreement described in paragraph 2 the earnings and profits of each member of such group for such year shall be determined by allocating the tax liabilities of such group for such year in the manner provided by subsection (a), and reducing the earnings and profits of a member who transfers funds to another member or members in accordance with such agreements in the amounts of such transfer increasing the earnings and profits of the member who receives funds from another member or members in accordance with such agreement in the amount of such receipts.

Then "transfers of receipts to which the preceding sentence applies" and omitting the statement in parentheses which covers this trifle—

> transfers receipts to which the preceding sentence applies shall be treated as payments all refunds of Federal income tax as the case may be by all Federal agencies or instrumentalities.

I pause here to say that this clearly refers to the regulatory agencies.

Mr. DAVIS. Yes.

Senator DOUGLAS. I continue the quotes:

> For the purpose of establishing the cost of service, of determining the overall rate of return, of determining the net income from the regulated activity or services or member of such affiliated group.

They are not allowed to consider these in determining the cost of service, not allowed to consider them in determining the overall

rate of return, "of determining the net income." There can be deductions, which will be approved and which the regulatory commission will have to abide by, if this does not produce a fair return upon the capital value, and rates will have to be increased. So that language gives management the power to arithmetically determine the amount of taxes not paid and which can be transferred, and if the arithmetic is correct the remaining question is whether this should operate to pull down the earnings and therefore strengthen the case for an increase in rates or strengthen the case against an increase in rates. I take it your answer is yes, that it should be.

Mr. DAVIS. That is a pretty long question if I may say so.

Senator DOUGLAS. I know it. I may say, sir, that this language is long too.

Mr. DAVIS. I would like to say yes qualified in this manner. That it is my interpretation of this language that it does no more than express the conclusion of the 10th Circuit Court in the *Cities Service* case.

Senator DOUGLAS. Then if you are confident that this is the existing law, why seek you to change it?

Mr. DAVIS. Well, if we could depend on it, Senator Douglas, I don't think we would be bothered so much. The Federal Power Commission, however, is in two other cases still advocating, and one is before the Fifth Circuit Court in New Orleans, the use of nonregulated tax savings, tax credits, to reduce the rates of the regulated business.

Senator DOUGLAS. And you are afraid that the courts may say that the Federal Power Commission is right?

Mr. DAVIS. Well, I don't know.

Senator DOUGLAS. So in order to prevent the courts from making the ruling in this case you would forestall them by legislation?

Mr. DAVIS. No, that was not my statement.

Senator DOUGLAS. Of course it isn't your statement, but it is the purport of your position.

Mr. DAVIS. I don't know that it is my position either.

Senator DOUGLAS. Well, the purport of Tennessee Gas?

Mr. DAVIS. Well, that is no different from mine.

Senator DOUGLAS. I see. Then it is your position. So you are not going to stand for the elimination of lines 11 to 23. I thought we were near agreement yesterday, but I am afraid we are not.

Mr. DAVIS. We are suggesting that a modification be made, a proviso if you wish, which would stipulate that nothing in the language above stated would serve to deny the regulatory agencies from taking any tax credits, from not being able to use any tax credits in the fixing of rates which are directly related to the entity or the enterprise being regulated, any regulated activities.

Senator DOUGLAS. In other words, you can switch between regulated companies? Could you switch between regulated companies or not switch between regulated companies?

Mr. DAVIS. Well, if this were—I don't believe, if it were to modified, there would be any limitation as between regulated companies. It seems to me this would provide that——

Senator DOUGLAS. But you also want, however, the power to switch as between regulated and nonregulated?

Mr. DAVIS. Sure.

Senator DOUGLAS. Then what you want is the present lines 11 to 23.

Mr. DAVIS. That is the whole purpose.

Senator LONG. May I just see if I can put this thing together the way I think I understand it. As Mr. Nathan testified here this morning, the whole idea of companies filing a consolidated return is not to increase their earnings. The idea is to reduce their taxes, because in a group you have some companies in which a consolidated return is encouraging to diversify investment by investing profits and investing earnings and creating new enterprises. So you have got some new enterprises and you have got some old enterprises. And during the early years of your new enterprises you can take the losses or the tax credits generated against earnings, against taxes, not earnings but against the taxes on the earnings. So if you have got a new enterprise, and you have got a loss in there, you can take that loss against your profit in the old company, and for tax purposes only you treat that just as though it was one company and that is the amount of tax you pay. Now everybody seems to agree, and even I believe Senator Douglas indicates that he feels that if you have got a company, whether it is a power company or whether it is a gas pipeline or a telephone company, that what that company is entitled to make and keep for that company should depend upon, should be a fair return on that company's investment.

Now let us take a company that is a hundred million dollar company. That company, on a 6 percent return, is entitled to make $6 million after taxes. But to do that under existing tax law, it has got to make $12 million so it can pay 6 in taxes and have 6 left over. Now that is what we are talking about. And the purpose of filing a consolidated return would be not to reduce that $6 million that is the profit, and if you made $7 million not to keep from giving back the $1 million that exceeded the 6, but to reduce that $6 million that you owe in taxes by virtue of the fact that you got another affiliated company that might have lost $6 million. And against that loss you are entitled to a reduction of your tax liability by $3 million because the other company lost the 6.

Mr. NATHAN. That is right.

Senator LONG. And so what you are saying is that a regulated company would like to have the benefit of the tax savings of a consolidated return. Now in answer to Senator Douglas' question, you further demonstrated that the company dares not use the consolidated return. It could benefit everybody but the regulated company, in the event that that regulated company were required to take the tax credits and the tax deductions of its affiliate, and pass those on down through to its customers, because if you did that the affiliate would thereby lose its carryforward privileges, which would be worth dollar for dollar subsequently, and pass those through to the company that had not earned it. So what you say is that in return for losing your carryforward privileges under a consolidated return, we would like to pay you what it was worth to us, out of taxes, not out of what the consumer has a right to look at. Now as far as that consumer is is concerned he has no claim on what Uncle Sam would receive in taxes and you would just like the benefit of the consolidated return of your corporate group insofar as taxes are concerned without any reference whatever to the earnings otherwise. As far as profit and

taxes is concerned, that would be a constant figure as I understand it. It would not change at all.

Mr. NATHAN. It would not change. Actually it seems to me, Senator Long, and Senator Douglas, what has happened here I think is that the Federal Power Commission has decided that utilities shall not be beneficiaries of tax savings deriving from consolidated returns. That is in essence the principle of it.

Senator DOUGLAS. That is your interpretation. I would interpret it that consumers shall not be forced to pay for taxes not paid. Amounts not expended shall be counted as a cost which consumers are to pay for. The cost of service plus fair return is to govern.

Now let me say if I may that I was much interested in Mr. Swerdling's suggestion. He kept insisting that all he was saying was that the consumer should share in the reduction of costs affected by tax saving, and it should be entirely—I watched him very carefully and wrote down on sheets of paper this word "entirely," repeated that many times—that the consumer should not be entirely deprived of this. And he kept referring to Justice Jackson's decision. I have not had the time to research that case, but my very incomplete memory of the case is that Jackson suggested, and I am not a lawyer, about a 50–50 basis of division. Whether it would be worth our while to take a horseback judgment on this and enact it into law I don't know. But certainly I agree with him that the full benefit should not go to the regulated, or the owners of the regulated utility when they are already guaranteed a fair rate of return. That is quite a privilege given. They always emphasize the hardships and disadvantages which they suffer. But they get a fair rate of return. There is very little control over the amount of capital invested, and if they invest, whether wisely or not wisely, the rates are such as to give them a fair rate of return. So that they occupy in a sense a favored position. They don't admit that they do but they really do. Now to say in addition to this the consumers should pay not only a fair rate of return but pay for all taxes not paid because of financial juggling between companies is pretty rough.

Mr. NATHAN. Could I just comment on that, Senator Douglas? Let's take a hypothetical case of a public utility which earns say 6 percent on its investment.

Senator DOUGLAS. Well now wait a minute.

Mr. NATHAN. Yes.

Senator DOUGLAS. That 6 percent on the investment applies to two elements.

Mr. NATHAN. Let's say 10 percent on equity.

Senator DOUGLAS. Eight to ten percent on their equity.

Mr. NATHAN. Let's even say 10 percent on equity.

Senator DOUGLAS. That is 4, 4¼, 4½ on their bonds. Now the old argument used to be that they should earn 8 to 10 percent on the capital structure.

Mr. NATHAN. Yes.

Senator DOUGLAS. And that meant 10 to 12 percent on the equity.

Mr. NATHAN. Yes.

Senator DOUGLAS. I was opposed to that, and my battle was with Mr. Insull in Chicago. This is one of the positions which I took. Now I am glad to see that the courts have slowly come around to my point of view, which others held, after 30 or 40 years. I predicted they

would come around on this point in time, but the intervening period was pretty painful.

Mr. NATHAN. Could I follow through with an example, Senator Douglas, which I think you may agree on. Let us say the equity owners in a utility are even getting 10 percent return on their equity investment. They decide, because Uncle Sam says that the Federal Government will give incentives to new investment through consolidated returns, that they then take some of their capital or of the holding company and they put it into a brandnew enterprise, whether it is an apartment house or a parking lot, and they lose money on that second venture. They lose money on it. Now they have invested in that second venture because Uncle Sam says, "We will share with you your risks." Say they lose for a couple of years. Now what in essence, Senator Douglas, still it is true taking the utility as an entity there is a 10-percent return on equity. But because of the consolidated return and the loss on another investment, they are in essence—they are still getting that 10 percent, but now their loss in the other operation is reduced by the fact that the Government says, "We are going to take some of the taxes" or "All of them that you have paid in this utility and we are going to give it to your loss enterprise." Now what I say here is that if you don't permit that, you are giving to the utility holders a benefit through rate reduction which is absolutely unrelated to anything done by the utility. It is a reduction in taxes actually paid because Uncle Sam is bearing parts of the loss in a completely unrelated activity, and I think, Senator Douglas, that one can look at it that way, that what in essence happened is that the owners of this utility, and their affiliates, put money into a new adventure which lost, and it is not that they are paying less taxes. It is that some of the taxes they are paying are coming back to offset the losses. I honestly believe this is the concept of a consolidated return, or carry forward and carryback. We have had years, Senator Douglas, when I have gotten taxes back from the Government on carry forward. I have paid the Government in one year and they give it back to me in another year. I think the consolidated return in practice is Government taking from the profitmaking company and giving back to the loss company, and I don't believe therefore one can say this is a book cost rather than a real cost.

Senator DOUGLAS. Well, we could keep arguing this for a long time. I merely say that there is no legal requirement that taxes not paid should be invested in new enterprise. This is not given prospectively but retroactively on the basis of the past. It is true that it does offer an inducement for utilities to go into nonrelated enterprises. Now, Mr. O'Connor thinks that is a good thing. I am not at all certain that it is a good thing. I subscribe to the theory that each set of enterprises should stand on their own feet, that its venture enterprises should stand on their feet and regulated enterprises on their feet. I still think that is very good doctrine.

Senator LONG. I would like to ask just two very simple but I think profound questions and I think that is the basis and that is the whole argument we have here.

The first is this: Is there any reason why a regulated company should have to pay more taxes on its earnings than a nonregulated company? Now, if you think about it can you think of any reason why on a given amount of earnings, whether it is $100,000 or a hundred million dollars,

that a regulated company should have to pay more taxes than a nonregulated company?

Mr. NATHAN. Not under present law.

Senator LONG. The present law treats them both the same?

Mr. NATHAN. Yes.

Senator LONG. But if you let one use the consolidated return and you deny the other one the use of that consolidated return, then you are discriminating against nonregulated companies. Now these companies are already limited on how much they can make, which is not true of a nonregulated company. You are further then imposing a higher tax rate on a regulated company than you impose on a nonregulated company, and I challenge anybody to show me any reason why a nonregulated company should be required to pay the Federal Government more taxes than a regulated company. That is my first question.

Now, No. 2.

Mr. NATHAN. You mean why a regulated company would have to pay more than a nonregulated?

Senator LONG. As far as I am concerned the answer should be the same either way. In other words, there is no reason why a regulated company should receive a tax preference over a nonregulated company and no reason why it should be the other way around, and that is the way the law treats them both as I understand it. We try to at least, and I know of no arguments that a regulated company should pay a lower tax to the Government on earnings than a nonregulated company.

Now that leads me to my second question. Is there any reason why a company that has affiliates should be required to charge rates either higher or lower than a company that does not have affiliates?

Mr. NATHAN. If the facts are exactly identical in both cases?

Senator LONG. Yes.

Mr. NATHAN. In other words, if you have a utility which has this price, this income, this loss, this cost, everything exactly the same as another one, one has affiliates and one does not.

Senator LONG. Yes.

Mr. NATHAN. Both are utilities?

Senator LONG. Yes.

Mr. NATHAN. I think there should be no difference in rates.

Senator LONG. Let's take it this way. Here is one company that has a pipeline, a complete pipeline service. It pipes its gas from, let's say Texas, to a consuming market anywhere, be it the east coast or the west coast. It has no affiliates. It is a simple gas pipeline company regulated every step of the way. Now here is another company. Let us assume that that company starts at the same point and delivers to the same point.

Is there any reason at all why the company that has affiliates should be required to charge rates for its service either higher or lower than the company that has no affiliates?

In other words, let's take the second company that has affiliates. Maybe it owns a refinery. Maybe it owns something totally unrelated to oil and gas. Maybe it owns a newspaper. Goodness knows what all, a chicken farm. But is there any reason at all why the company that has affiliates, providing a service, should be required to pay rates either higher or lower than the company that has no affiliates?

Mr. NATHAN. There is no reason.

Senator LONG. Now if you take the answer of the Federal Power Commission to those two questions, their answer would have to be "Yes, that a regulated company should have to pay higher taxes than a nonregulated company," and their answer to the second question would be "Yes, a company with affiliates should be required to pay higher taxes than a company without affiliates under a consolidated return."

Mr. NATHAN. And charge lower rates.

Senator LONG. So in both instances they would have to come up with the wrong answers to those two questions, and I would defy them to explain the reason why.

But I would say that in the last analysis, when you understand what we are talking about, their answer has to be very involved, very confused, and very illogical.

Mr. NATHAN. There could be only one reason, Senator Long, and that I think would be up to the Congress to say that utilities shall not be allowed the privileges of consolidated returns.

If Congress made that position clear, then the FPC rules are correct. But as I find in the legislative intent, we looked through carefully when we prepared this attached testimony, we found no evidence of any intention—or rather any intention to deny the privileges of filing consolidated returns to utilities or their affiliates.

Senator LONG. Now, when Mr. O'Connor was sitting where you are sitting right there now, he testified that you are kidding yourselves to think you are going to make any money for consumers by imposing the kind of tax liability that Mr. Swidler wants to impose on regulated companies filing a return, because he said that that is what you are going to do to them, they are not going to file a consolidated return.

Now, isn't that the point that Senator Douglas went to pains to bring out while you were testifying here?

Mr. HEDRICK. Exactly.

Mr. DAVIS. That is correct, Senator.

Senator LONG. Thank you very much.

Senator BENNETT. May I ask a question or two?

Senator LONG. Yes.

Senator BENNETT. I am sorry I got tied up this morning and didn't hear your direct testimony, but I am interested in talking to someone who has the practical experience of managing this kind of situation. Do you have a copy of the bill before you?

Mr. DAVIS. Yes.

Senator BENNETT. On the first page, and we have read this over and over again—

> If each member of an affiliated group is bound for the taxable year by a consolidated return agreement described in paragraph two—

and then it goes on and says earnings, profits, and so on.

Two describes the conditions of an agreement.

Is it your interpretation of paragraph 2 that these conditions are mandatory or that management is perfectly free to make any kind of an agreement it pleases among its various affiliates and carry them out? In other words, can management, by its own choice, so rig the agreement that the burden can be thrown on the regulated company for the benefit of the nonregulated company?

Mr. DAVIS. No; I don't think so. I think the conditions are mandatory.

Senator BENNETT. And that it is the way the pattern of profits falls that determines the way the benefits of the consolidated filing will fall.

Mr. DAVIS. Precisely, just as the corporation accounts for its profits and losses. It is mandatory that it put down the exact dollars it receives and the exact dollars it pays out in expenses. The payments under this agreement would be mandatory as outlined in the proposed amendments.

Senator BENNETT. I am asking these questions for the record. If the pattern of profit changed from 1 year to another, could the management change the agreement so as to still continue benefits to the nonregulated companies?

Mr. DAVIS. I think not, under no circumstances.

Senator BENNETT. So if they elect a consolidated return basis, they are bound by the limitations of this agreement.

Mr. DAVIS. That is my interpretation of it, if they elect to use the agreements.

Senator BENNETT. Well, now, are they allowed to elect not to use the agreements?

Mr. HEDRICK. May I address myself to that?

Senator BENNETT. Yes, I want to get this straightened out.

Mr. HEDRICK. I think you have two things involved here. You have the business of electing or consenting to file consolidated returns generally.

Now in addition, this new provision would allow that group to also elect to enter into one of these agreements. But you could enter into a consolidated return situation, but not elect to use the agreement. It is not a mandatory thing. This is one of the things the Treasury is studying.

Senator BENNETT. Then what happens if you do not elect to use this agreement?

Mr. HEDRICK. Then you fall where you fall under what is going on in the regulatory agencies and in whatever the tax practices of the Internal Revenue would be without this provision of law.

That is why the Treasury is studying to see whether this should not be the exclusive way of handling this, and the best way and the only way, but here it is elective for the time being until they have had a chance to make a study.

Senator BENNETT. This I am glad to get, because it wasn't clear in my mind. Suppose you do not elect to use this agreement. The management does not escape by failing so to elect, the responsibility of letting the variation or the adjustment of taxes between the members of the consolidated group fall automatically.

Mr. HEDRICK. I think that is right. He would have to just comply with the general rules of allocating taxes, and if the Power Commission follows what Senator Douglas is suggesting they should, you might get a different result at the Power Commission, if you don't have this agreement, than if you did.

Senator BENNETT. But management can't change its patterns from year to year.

Mr. HEDRICK. They cannot. Once the group elects this agreement, and as long as you have that group together, you have got to follow this agreement.

Senator BENNETT. But if you fail to elect as long as you have the group together, you are bound by another pattern.

Mr. HEDRICK. Yes.

Senator BENNETT. Just as tightly as you are bound by this one.

Mr. HEDRICK. This is right.

Senator BENNETT. So there are two possible ways to make distribution, but each one of them is binding, depending on which one you elect.

Mr. HEDRICK. I think that is right. You cannot switch back and forth each year depending on what you think is the most advantageous.

Senator BENNETT. You cannot say "I don't like either of them, I would like to make a special arrangement for this year."

Mr. HEDRICK. I think this is right. This is right.

Senator BENNETT. I was just curious when Senator Douglas was questioning you about how Tenneco went in and out, how long was Tenneco in the consolidation before it went out?

Mr. HEDRICK. I think we would have to look that up, but I think historically it has all been one consolidated group. But as Senator Long pointed out in his interrogation, when it appears that the losses in the nonregulated group would be absorbed over in the regulated group, and taken by the Power Commission and passed off to consumers, and you wouldn't have it in this other group, they decided to break it, and take their chances on using it in that group at a later time.

Now, there was a temporary tax increase in the regulated—well, I wouldn't say that. They just paid their regular taxes over in the regulated group.

Senator BENNETT. That is right.

Mr. HEDRICK. And it didn't affect rates one way or the other. All we are asking here is just keep that situation that Mr. Nathan is talking about.

Senator BENNETT. During that period of 2 or 3 years when two were not in the same consolidated group, did you have two consolidated groups?

Mr. HEDRICK. Yes, we did.

Senator BENNETT. Two separate consolidated groups?

Mr. HEDRICK. Two separate consolidated groups.

Senator BENNETT. So you had the benefits of consolidation to the extent that each group could generate those.

Mr. HEDRICK. That is right, one of regulated group and one of nonregulated groups.

Senator BENNETT. So during that period you did not pick up any carrybacks or carryforwards.

Mr. HEDRICK. We had to stand on our own in there, whatever we could do in each group we had to do.

Senator BENNETT. But your decision was made on the basis of a decision by the regulatory agency which seemed to create a situation which would damage you, and you took that way out?

Mr. HEDRICK. At the time it appeared that we would be hurt by having the losses in the nonregulated utility appropriated by the regulated group, and not available to offset those losses that they were actually incurring.

Senator BENNETT. I think that is all, Mr. Chairman.

Senator LONG. Senator Dirksen?

Senator DIRKSEN. Mr. Chairman, I would like to ask Mr. Hedrick a question. Yesterday Chairman Swidler stated that the reason the Federal Power Commission did not seek a writ of certiorari and go to the Supreme Court to appeal that 10th Circuit decision was because it involved, as I remember, language on a minor or a narrow point. Are you familiar with the *Cities Service* decision?

Mr. HEDRICK. I am familiar in the sense that I have read it. I am not qualifying myself as a Federal Power Commission practitioner, but I am familiar with it.

Senator DIRKSEN. Well, I have a simple question. Is it your belief that that was a minor or a narrow point?

Mr. HEDRICK. Well, if I understand what he had in mind, the narrow point was that the 10th circuit was dealing with the proposition of using losses generated in a nonregulated activity to reduce the tax costs in the regulated utility.

Now if he thinks that that is a minor thing, it escapes me. But it did not involve the other phase of this, which was the subject of discussion in my presence this morning between the Senator from Louisiana and the Acting Chairman of the FCC, and that is what is the proper role of the regulator with respect to regulated activities.

Now maybe he is talking about that. Now it is quite possible that this United Gas thing pending down in the Fifth Circuit involves this problem of between regulated companies, which may be more important to the Power Commission than the 10th Circuit case point. I have said more than I should on the basis of my qualifications.

Senator DIRKSEN. It isn't so much a question of importance as it is whether they thought this was a minor and a narrow point, and therefore timely forfeited the opportunity to go to the Supreme Court on appeal after the elapsed 10 months or whatever it was. I do not believe that that was a minor point.

Mr. HEDRICK. I thought it was sort of related to what has consumed 2 days of very interesting and thoughtful deliberations by this committee.

Senator DIRKSEN. Mr. Chairman, while Senator Bennett, Senator Williams, and Senator Douglas are here, I don't know whether my colleagues heard this this morning. On the basis of the suggestion made by Commissioner Hyde of the Federal Communications Commission, he said his staff would be glad to work with the committee staff on some amendments that they might have in mind. I suggested to the chairman that in the interests of time and economy, we might have the staff do exactly that, because it is possible, if we have an executive session tomorrow, that at least some language which may have gotten together might be under consideration in the committee session.

Senator LONG. I hope that will be done, and I will try to arrange it, if I can. Are you through, Senator Dirksen?

Senator DIRKSEN. Yes.

Senator LONG. May I ask you this question? Did I understand you to say historically the whole Tennessee Gas group was in one group rather than two?

Mr. HEDRICK. I believe this is so. I can check it out, but I think this is accurate.

Senator LONG. But at the time this problem arose, you separated and so you filed two consolidated returns, one for the regulated group and the other for the nonregulated group.

Mr. HEDRICK. That is right.

Senator LONG. The thought just occurs to me when you say that, that insofar as the Federal Power Commission takes from one of the regulated groups tax credits and deductions that belong in the other, they are more or less robbing Peter to pay Paul, taking from the group of customers that from your point of view deserve it, and giving it to another group of customers that don't deserve it, but as far as you are concerned, your profits and earnings for the group would be the same?

Mr. HEDRICK. You mean, among the regulated?

Senator LONG. Yes.

Mr. HEDRICK. That is right. Now let me add this: Even though Mr. Davis has indicated that the type of thing that is being discussed here that should be considered as an amendment—that is to leave the regulatory agency with the things that it has, that is regulated companies, I wouldn't expect the Power Commission, when it is dealing between two regulated groups, to favor customers in one part of the country over customers in another part, and that it would follow this rule that is involved in this amendment, because they are not snatching money from the outside to pass on to the people for whom they feel they are guardians.

Senator LONG. Frankly that is just the thought that occurs to me. It seems to me that under a consolidated return, you tax a number of companies as though they were one company, but now as far as those companies are concerned, particularly as far as minority stockholders are concerned, that own stock in one company but not in the other, you have got to unscramble those companies.

Mr. HEDRICK. That is right.

Senator LONG. So that you can give to one set of minority stockholders what they had coming to them, and give to the other set of minority stockholders what they have coming to them, and if you don't do that, any set of minority stockholders are entitled to file a lawsuit against you.

Mr. HEDRICK. I think this follows whether they are regulated companies or nonregulated companies. The principle is exactly the same.

Senator LONG. Now it is also the burden on the Power Commission to try to see to it that even though these companies are scrambled up together for purposes of arriving at the tax liability, that they unscramble them both with regard to the customers and with regard to the stockholders.

Mr. HEDRICK. Yes.

Senator LONG. So all of them wind up getting what they are supposed to have.

Mr. HEDRICK. This is right. There is a principle involved here, Senator, that applies across the board.

Senator LONG. Now as I understand it, that is what you want to do. You want to unscramble them to put them back where they belong.

Mr. HEDRICK. That is right.

Senator LONG. For example, as I understand it, you people would like to build a pipeline out from the Houston area out to Los Angeles

area, as I understand it, and that pipeline would generate large amounts of tax deductions which could be carried forward, if that was in a single company, and generate tax credits and tax deductions in large amounts because it would be a big operation.

Now under a consolidated return, the other companies would get the benefit of all those tax savings until this new company got into full operation and began to earn their money back, were they not?

Mr. HEDRICK. That is right.

Senator LONG. Now as I take it, what you want to do is to simply be able to put—and you would be willing not just to do it on an optional basis—I take it you would be willing to do business on a mandatory basis where you would be required to simply put back in the new company what the old company exacted from it.

Mr. HEDRICK. That is a very good way to describe it, Senator.

Senator LONG. Now, for example, I saw this article that appeared in the Washington Post, an editorial, and I am sure they were in good faith in writing this, trying to suggest that what you are trying to do here is to take from a group of Eastern customers and give it to a group of Western customers.

Now a good tax lawyer pointed this out to me. He has no relationship whatever with your group, and a good tax student. He said as between those two groups of customers, with regard to this operation, where you want to build a pipeline to the west coast, and you already have one to the east coast, it is these west coast consumers who ought to have the benefit of a tax saving generated by their pipeline, not the east coast consumers, and that insofar as someone would contend that these east coast consumers are due for a reduction because you build a pipeline to the west coast, they are totally in error.

If that newspaper was suggesting that, then they are the ones who are guilty of giving the savings to the wrong group of customers not those of you who are supporting this amendment.

Mr. HEDRICK. I think only the newspapers are willing to give away that kind of business.

Senator LONG. I didn't hear you.

Mr. HEDRICK. I would rather withdraw the remark.

Senator LONG. But the point is as I understand it, as far as your regulated companies are concerned, to you it is very important that you do give the rate reduction to the group of customers that are entitled to it.

Mr. HEDRICK. This is right.

Senator LONG. And that you not be taxed more taxes just because you are a regulated company than you would if you were a nonregulated company.

Mr. HEDRICK. I think Mr. Nathan, who is not a tax lawyer, has expressed it better than any of us. That is you want each to stand on its own bottom and not get an advantage or be penalized by some other corporation with a separate business activity.

Senator LONG. I saw my friend Senator Douglas throw his hands in the air. He keeps saying the same thing to me, and for some reason he doesn't get through to me. I keep giving the same answers to him, and I don't get through to him.

Thank you very much.

Senator DIRKSEN. Just one thing. Mr. Hedrick, if you know, what would be the cost of this pipeline that would run from somewhere in Texas out to California?

Mr. HEDRICK. I think Mr. Davis testified about $315 million, something of that kind.

Senator DIRKSEN. Have you an estimate as to the number of jobs both onsite and offsite that will be created?

Mr. HEDRICK. I don't. We will try to get that information though. We did have some figures as to the amount of taxes, and that is some indication of the extent of activity, and it will be a fairly substantial business operation, and an important contribution to the economy.

(The following information was subsequently submitted:)

While considerations of time have not permitted a full development of the answer to this question, the following classifications of major initial costs of the Gulf Pacific project indicate the extensive economic activity and resulting employment that would result from the approval of the Gulf Pacific application:

Cost of steel for pipeline	$156, 612, 500
Installed cost of compressor stations	57, 714, 000
Cost of laying pipeline	72, 158, 700
Miscellaneous material, equipment, and supplies	27, 437, 800
Total	313, 923, 000

The laying of the pipeline by itself would involve an average of 200 workers for each of 18 spreads for 200 workdays. It is estimated that the permanent employees of Gulf Pacific would be 334. Estimated annual operating and maintenance cost for the Gulf Pacific pipeline would be approximately $8 million. The above indicators of economic activity and employment, together with the immense contributions which Gulf Pacific would make in the form of Federal, State, and local tax payments, referred to in our testimony today, helps to provide some insight regarding the impact of the Gulf Pacific project on our national economy.

We believe that the information supplied above provides additional reasons why amendment No. 426 should be adopted.

Senator DIRKSEN. When I say on-site and off-site, I mean fabrication of pipe and everything off-site that is necessary to construct a pipeline, and whatever you have to put in the right-of-way, and then finally the men who are actually on the job to do this work, and ultimately make the connection out in California. If you don't have an estimate I would like to——

Mr. HEDRICK. We don't have it, but a great deal of work has gone into this by other persons within the company, and we will certainly try to get it.

Senator DIRKSEN. If you can find that estimate, I would like to see it go in the record.

Senator WILLIAMS. Mr. Hedrick, did I understand that you are now filing one consolidated return for all of your operations, both the regulated and nonregulated?

Mr. HEDRICK. We are, sir.

Senator WILLIAMS. And some time ago you did file two consolidated returns, one for your regulated and one for your nonregulated?

Mr. HEDRICK. That is right, Senator.

Senator WILLIAMS. When did you make that last change?

Mr. HEDRICK. Senator Douglas inquired of this in your absence, and if I may I will restate the answer that we gave to him.

Before 1961 there was one consolidated group and one consolidated return. In 1961 in February, near the beginning of the year, there was a disposition by Tennessee Gas of 25 percent of the stock of Tenneco Corp., which is in effect a parent company of the nonregulated group of companies, so that that broke Tenneco's association with the group—the 80 percent requirement—and thereafter the Tenneco

group filed a separate consolidated return until November 1, 1964, when Tennessee Gas then acquired directly or indirectly more than 80 percent of the stock of Tenneco once more, and the whole group is now back together.

Does that answer your question, Senator Williams?

Senator WILLIAMS. Yes. Then it is possible for a company to go on out of the consolidated return, even though they may have an agreement, by changing, by a slight change in the ownership of one of the affiliates.

Mr. HEDRICK. With respect to a particular company, yes; but with respect to parent company and those that are still affiliated with it, they have to continue this agreement.

But as I told Senator Douglas, there are a great many complications in going in and out of these things, and you have to think carefully before you do that, for some reason that isn't a good business reason.

Senator WILLIAMS. What percentage of Tenneco did they own prior to 1961?

Mr. HEDRICK. They owned 100 percent.

Senator WILLIAMS. And how much did they own after the drop?

Mr. HEDRICK. About 75, I believe.

Senator WILLIAMS. What is the status today?

Mr. HEDRICK. I am going to supply that for the record to Senator Douglas. I am not sure. We are more than 80 percent, but I am not sure that it is back to 100.

(See p. 187 for this information.)

I am sure it is not, but I will give you the exact figures on it. I think you missed part of the colloquy with Senator Long and Senator Douglas about this. The reason that the Tenneco group went out of the consolidation was the threat by the Federal Power Commission to take tax reductions resulting for the losses being generated by some of the companies in the nonregulated group and pass them on to consumers. This would have meant that there would not have been any compensation to the loss companies for the tax benefits appropriated by the utility group.

So really the rate payments were not affected one way or the other. Temporarily the taxes of the group were greater, but through carry forwards we will ge them back eventually, but it makes for awful complications, unless you have got the kind of a rule this amendment provides.

Senator WILLIAMS. I wasn't raising that point. I was merely asking to get the dates straight in my mind.

Mr. HEDERICK. Yes.

Senator LONG. Thank you very much.

The next witness will be Mr. Kenneth Smith of the American Public Power Association and Massachusetts Municipal Electric Association.

STATEMENT OF KENNETH SMITH, AMERICAN PUBLIC GAS ASSOCIATION, AMERICAN PUBLIC POWER ASSOCIATION, AND MASSACHUSETTS MUNICIPAL ELECTRIC ASSOCIATION

Mr. SMITH. Mr. Chairman, members of the Senate Finance Committee, my name is Kenneth L. Smith. I am a public utility consultant associated with the firm of Van Scoyoc & Wiskup, Inc., of

Washington, D.C. I am appearing on behalf of American Public Gas Association, American Public Power Association, and the Municipal Electric Association of Massachusetts. During the past 28 years my work has been concerned with regulatory problems in the areas of accounting and rates. I am a certified public accountant (Illinois and Colorado) and for some 16 years was employed by the Federal Power Commission in such capacities as Assistant Chief Accountant, Assistant Chief, Bureau of Natural Gas, and supervisory auditor. I testified in a substantial number of important rate cases and supervised many cases in which I did not testify. I studied accounting and economics and obtained B.S. and M.S. degrees at the University of Illinois.

I have studied amendment 418 to H.R. 7502 and concluded that it would enable regulated utility companies to recover in charges to consumers an amount for taxes larger than the tax paid by the consolidated system when a consolidated return is filed. Such a procedure would be very unfair to consumers of gas and electricity and other utility services, since it would require them to pay for a fictitious tax cost which would be accounted for as a utility operating cost but would not actually represent a payment to the Government. The recorded cost would exceed the cost actually incurred. A payment would be made, however, by the utility to one or more affiliates, the receipt of which would represent a profit to the affiliate. An affiliate receiving these special benefits might be another regulated utility, but would be more likely to be a holding company or nonutility company.

It is clear, therefore, that amendment No. 418 would virtually assure that any federally regulated utility's affiliate which had a tax loss would always be in a position to convert such losses into income at the expense of utility consumers. If such affiliates filed separate income tax returns their chance of accomplishing such an unusual feat would be much less likely. Certainly the Federal Government does not make payments to tax loss companies to alleviate their plight, although it does provide the opportunity for them to use the tax losses under the carryover and carryback provisions of the Internal Revenue Code. Legislation which would confer this special, unusual benefit selectively to those companies having tax losses which are affiliated with federally regulated utilities invites the closest scrutiny.

The dubiousness of the proposal is heightened by the fact that these special benefits thus given to the tax loss affiliates would be borne by utility consumers under the guise of being tax costs, but such costs actually would not exist.

Amendment 418 would enable certain companies regulated by the Federal Power Commission to circumvent the service at cost policy, which provides a fair return on investment, utilized by that agency since its inception.

To digress for a moment from my prepared statement, I would say, after listening to Commissioner Hyde that I believe the method of regulation of the Federal Communications Commission is substantially the same service at cost type of regulation, including a fair return on investment, which has always been used by the Federal Power Commission.

This allowed fair return is after allowance for all taxes, including income taxes. In applying its cost principle FPC rejected a claim by a natural gas company which was a party to a consolidated Federal

income tax return for an income tax allowance in a rate case computed on the assumption that the company filed a separate income tax return. The Commission squarely held that—

> if, by filing a consolidated return, a reduction is this [tax] cost is effected, such reduction should be reflected in the cost charged to consumers.

I cite there *In the Matter of United Fuel Gas Company* (12 FPC 251, 265 (1953)). It became common practice to reflect such a tax saving in an "effective" tax rate. *In the Matter of Hope Natural Gas Company* (12 FPC 342, 347 (1953)). The FPC rule is in harmony with a 1936 decision of the U.S. District Court, W. D. Arkansas, in *Arkansas-Louisiana Gas Company* v. *Texarkana* (17 F. Supp. 447, 464; affirmed 96 F 2d 179 (CA 8, 1938); cert. den. 305 U.S. 606). The Court said specifically:

> In confiscation cases a utility should be permitted to charge into operating expense only that amount of income taxes which would be payable after the utility has taken advantage of every deduction from gross income allowed by law. Confiscation should not be predicated upon an item of expense where the expense is never incurred.

The same standard was applied by the Illinois Commerce Commission, *Commerce Commission* v. *Public Service Company* (4 PUR (NS) 1 (1934)); Kentucky Public Service Commission, *Re United Fuel Gas Co.* (8 PUR 3d 340 (1955)); *Re Central Kentucky Natural Gas Co.* (Case No. 2800, May 18, 1955); Indiana Public Service Commission, *Re Indiana Water Corp.* (No. 28260, April 8, 1960); Kansas State Corporation Commission, *Re Southwestern Bell Telephone Co.* (34 PUR 3d 257, 294 (1960)).

Senator DOUGLAS. Mr. Smith, have these cases been upheld or at least not reversed by the appropriate courts?

Mr. SMITH. It is my information that if there had been any further—well, to answer your question directly, they have not been reversed by the courts. As a matter of fact, I think in most instances they were not even attacked in court except where the citations so indicate.

Senator DOUGLAS. Do you think the principle is firmly established that a regulated utility service should be at cost plus a fair rate of return on value?

Mr. SMITH. Yes, sir.

Senator DOUGLAS. And the utility commission is supposed to fix the rates with that in view?

Mr. SMITH. Yes, that is correct.

Senator DOUGLAS. And if it does not do so the courts may order an increase in rates? The courts may order an increase in rates if the utility commissions do not fix——

Mr. SMITH. Yes. The courts might take appropriate action to see that an increase is granted.

Senator DOUGLAS. Do you think the principle is also established that consumers should not pay for expenses not incurred?

Mr. SMITH. Yes, sir.

Senator DOUGLAS. They should not be required to pay for alleged but fictitious cost?

Mr. SMITH. That is firmly established as a principle.

Senator DOUGLAS. That is what I think some of us are contending for.

Mr. SMITH. I did not quite get your last statement.

Senator DOUGLAS. I said I think that is what some of us are contending for. We agree with you in this instance.

Mr. SMITH. The Louisiana Public Service Commission refused to permit the stockholders to retain tax savings which resulted from Southern Bell Telephone & Telegraph Co.'s participation in the consolidated Federal income tax return of American Telephone & Telegraph Co. and subsidiaries. For ratemaking purposes the commission disregarded the consolidated tax arrangement voluntarily entered into by Southern Bell with its parent providing that virtually all of the advantages therefrom would flow to A.T. & T. *Ex parte Southern Bell Telephone & Telegraph Company*, 26 PUR 3d, 55, 111 (1958), cited *Re New Jersey Bell Telephone Company* (N.J.) Docket No. 7519, January 14, 1954, approved and followed in *Re New Jersey Bell Telephone Co.* (N.J. 1957) 22 PUR 3d 166, 170. The Virginia State Corporation Commission made no specific provision for a consolidated income tax saving to be treated as a direct reduction of cost of service but lumped such savings against other offsetting items. *Lynchburg, et al.* v. *Chesapeake and Potomac Telephone Company of Virginia* 28 PUR 3d 368, 377 (1959).

Although the principle applied in the *United Fuel* case *supra* has been used in many rate cases decided by the Federal Power Commission, United Gas Pipe Line Co. recently attacked the Commission's use of an "effective" tax rate claiming in effect that the Commission had exceeded its jurisdictional authority. This matter is pending in the U.S. Court of Appeals for the Fifth Circuit (Nos. 21,872, 21,958, 22,031, and 22,041). The amount in dispute in United's appeal is in the order of $800,000 per year. An intervenor and the Commission contend that the decision of the U.S. Court of Appeals (10th Circuit) in *Cities Service Gas Company, et al.* v. *Federal Power Commission*, 337 F. 2d 97 (1964) is both erroneous and distinguishable from the *United Gas Pipe Line* case. The consolidated tax issue is also involved in *Florida Gas Transmission Co.* v. *FPC* pending on review in the Fifth Circuit (No. 21,957, et al.).

It has not been possible for me to estimate the total additional burden which amendment No. 418 would would add to the annual amounts paid by consumers for utility services. An examination I made of a limited number of reports on file with the Federal Power Commission disclosed that for the year 1964 the reduction in Federal income taxes resulting from filing a consolidated tax return amounted to approximately $2,500,000 for eight Columbia Gas system companies; $4,670,000 for Tennessee Gas Transmission Co. and its affiliates; and $2,200,000 for Lone Star Gas Co. and its affiliates. This list is not intended to be all inclusive.

Senator DOUGLAS. It does not take into account any additional gains which might be made from restructuring the financial setup of the holding company empires; isn't that true?

Mr. SMITH. No; it does not. This is purely the consolidated tax savings that were reported by these companies for the year 1964 that they actually realized, according to their reports to the Federal Power Commission.

Senator DOUGLAS. Thank you.

Mr. SMITH. Amendment No. 418 conflicts with the public interest in other respects. It would provide a stimulus for nonregulated members of an affiliated tax group which included federally regulated utili-

ties to engage in risky ventures since the tax effect of any losses could be made up by charges to utility operations borne by consumers. This would mean that utility consumers could be required to underwrite nonutility losses in part.

The engagement of utility systems in nonutility ventures would affect the cost of capital. Whenever the parent of the affiliated group was the vehicle for financing both the utility and nonutility operations, as frequently is the case, the effect of engaging in nonutility ventures would be to increase the cost of capital obtained to finance utility operations. Thus the detriment to the utility consumers might actually be compounded since they would be required to pay both the fictitious taxes never actually incurred in addition to a higher cost of capital reflected in the allowable rate of return.

I earnestly question the practical necessity of amendment No. 418 from still another angle. Its proposal would have the effect of amending or restricting, through tax legislation, the application of standards for determining just and reasonable utility rates which have been written into such enactments as the Natural Gas Act, Federal Power Act, and so forth. Court review of regulatory commission action is available to any party which may be aggrieved thereby. Thus, within the broad outlines of statutory authority as delegated by Congress, the Commissions carry out the detailed day-to-day operations of regulating the utility companies, subject to court review. Traditionally the regulatory agencies and courts have the primary responsibility for carrying out the legislative policy that rates are to be just and reasonable. Policies of necessity have to correlate with the very broad objective of protecting the public interest rather than devising the mechanics of achieving any particular objective.

The final overall major objective of the regulatory process is a fair and reasonable balancing of investor and consumer interests so that both groups are treated fairly. The process is technical and factual as well as legal. Moreover, it is tedious and complex. The regulatory agencies are well equipped to carry the burden of achieving this objective. One who has had practical experience in the regulatory process can only conclude that legislative enactments aimed at dealing with certain selected specifics of ratemaking techniques involved in the process of balancing investor and consumer interests will only impede and possibly defeat the major purposes of regulation. Amendment No. 418 forcefully illustrates this point because it would strip the Federal regulatory agencies of the power to prescribe equitable allocations to utility operations of such items as tax deductions for interest incurred and paid by a holding company where the debt financing was through a holding company instead of an operating utility.

In my judgment the power delegated to regulatory agencies to require the fullest possible utilization of lawful tax deductions in order to minimize utility operating costs should be expanded rather than contracted. It has come to my attention in numerous instances during my service with the Federal Power Commission and as a consultant that utility managements tend to regard tax deductions and tax credits as legitimate sources of additional profit to the utility, and I mean in that sense additional profit over and above the fair rate of return. There should be adequate regulatory authority to

prevent their achievement of such a goal. It is not fair to consumers, and utility rates are not just and reasonable, when the utilities are allowed to obtain profits over and above a fair rate of return.

Accompanying herewith are tables Nos. 1 and 2 which illustrate with hypothetical data, in a simple example, the effect on utility costs of accounting for Federal income taxes on an actual cost basis and the comparable effect on such costs when the tax expense is inflated under the method sanctioned by amendment No. 418.

There are notes attached to table No. 1 which, I think, are self-explanatory, and then table No. 2 is simply an analysis of how the payments would be made, contemplated in the hypothetical illustration shown in table No. 1.

(The attachments referred to follow:)

TABLE 1.—*Illustrative example showing comparison of tax charges, actual tax accounting versus amendment No. 418*

Line No.	Type of company comprising consolidated tax group	Amount of taxable income (tax loss)	Amount of tax, 48 percent	
			Actual tax accounting	Amendment No. 418
	(1)	(2)	(3)	(4)
1	Operating utility	$10,000,000	$4,320,000	[1] $4,800,000
2	Holding company	([2] 300,000)	0	(144,000)
3	Affiliates with tax losses	(700,000)	0	(336,000)
4	Consolidated total	$9,000,000	[3] 4,320,000	[3] 4,320,000

[1] Under amendment No. 418 the utility would pay only $4,320,000 to the Government for actual taxes but would pay $144,000 to the holding company and $336,000 to affiliates having tax losses. This accounts for total of $4,800,000 per line 1, col. (4) above.

[2] Tax loss of holding company would be due to such items as administrative expenses and interest on debt. Dividend income from affiliate is not taxable in a consolidated return.

[3] The amount of tax actually payable to the Government is $4,320,000 (48 percent of $9,000,000) when actual tax accounting is followed, as illustrated in col. (3) as well as when the operating utility would include tax loss reimbursements to affiliates in tax expense under amendment No. 418 as illustrated in col. (4).

TABLE NO. 2.—*Comparison of payments by operating utility, actual tax accounting versus amendment No. 418 (based on illustrative example shown on table No. 1)*

Line No.	Explanation	Actual tax accounting	Amendment No. 418
	(1)	(2)	(3)
1	Payment to Government	$4,320,000	$4,320,000
2	Payments to affiliates:		
3	Holding company	0	144,000
4	Tax loss companies	0	336,000
5	Total payments	4,320,000	4,800,000
6	Recapitulation of total payments:		
7	Outside the affiliated group, Government	4,320,000	4,320,000
8	Within the affiliated group	0	480,000
9	Total payments	4,320,000	4,800,000

Senator LONG. Mr. Smith, let me see, you represent the American Public Power Association here today, I take it, by your statement?

Mr. SMITH. I represent them and two other associations.

Senator LONG. Yes; I notice that.

Now, you also represent the Municipal Electric Association and the American Public Gas Association. How much do those associations pay in Federal income taxes?

Mr. SMITH. I do not know.

Senator LONG. Well, would you say $1 million all of them put together, the whole bunch, the whole big group of them? I mean would they pay $1 million, their companies in income taxes? Wouldn't it be nearer zero?

Mr. SMITH. I do not know. You mean the companies that comprise the association or the associations themselves?

Senator LONG. I mean the companies that comprise the association.

Mr. SMITH. Not necessarily companies. They are actually utilities——

Senator LONG. Well, my impression of the American Public Gas Association, being as how it is a public outfit, my impression would be that they do not pay any income tax. Would that be correct; generally speaking?

Mr. SMITH. I would assume, I do not know, and Mr. Wheatley would be the witness, I think, who follows me, according to the schedule, and I think he can answer that. But my impression is that most public power, municipally owned departments, would not pay income taxes.

Senator LONG. Zero. Wouldn't that be correct, zero, just your impression would be that they pay nothing?

Mr. SMITH. That is what I say.

Senator LONG. Well now, all right, now the Municipal Electric Association, wouldn't that be true of them also, the companies that comprise that association?

Mr. SMITH. That is a possibility. I am not certain on that.

Senator DIRKSEN. Let me ask just for the information of the committee, Mr. Smith, who comprise the American Public Power Association? Are these cities that have municipal powerplants?

Mr. SMITH. They are, some of the members, I am not certain who all the members are.

Senator DIRKSEN. You say you do not know?

Mr. SMITH. I do not know who all the members are.

Senator DIRKSEN. Well, are there many or are there few?

Mr. SMITH. I think it has a great many members.

Senator DIRKSEN. Couldn't you supply a list?

Mr. SMITH. I am sure that my people whom I represent in my testimony would be glad to reply and supply that.

(The following letter was subsequently submitted:)

AMERICAN PUBLIC POWER ASSOCIATION,
Washington, D.C., September 2, 1965.

Senator HARRY F. BYRD,
Chairman, Senate Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: During hearings held by your committee Wednesday September 1, 1965, on amendment No. 418 to H.R. 7502, Mr. Kenneth L. Smith, appearing on behalf of the American Public Power Association, the Municipal Electrical Association of Massachusetts, and the American Public Gas Association, was asked to supply for the hearing record information on (1) the composition of the membership of the American Public Power Association and the Municipal Electric Association of Massachusetts and (2) tax payments made by municipally owned electric systems. We are pleased to supply this information, which was requested by Senators Long and Dirksen.

1. American Public Power Association is a national service organization representing 1,200 local public power systems in 45 States and Puerto Rico. These electric utilities are mainly municipally owned systems, but the association's

membership also encompasses public utility districts, electrical districts, irrigation districts, and county and State groups which own and operate electric systems. Twelve rural electric cooperatives are members of APPA.

There are 1,997 local publicly owned electric systems in the United States and they serve an estimated 13.5 percent of all ultimate customers of electricity in the Nation.

Enclosed for the information of the committee is a copy of a directory of local public power systems published by our association in January 1965.[1]

The Municipal Electric Association of Massachusetts is an organization of the officials of 40 municipal electric plants which distribute and sell electricity within Massachusetts to retail customers within their communities.

2. Local publicly owned electric systems do not pay Federal income taxes, which are based on profits. Publicly owned systems operate on a nonprofit basis. Furthermore, under our dual system of government, the Federal Government does not tax the operations of State and local government.

Policy owned utilities reporting to FPC on a new schedule of "taxes, tax equivalents, contributions and services during the year" had aggregate revenues from sales to ultimate consumers of $907 million in 1962, the most recent year for which such figures are available. Of this amount, $18,173,954 was paid in taxes, $19,233,154 in tax equivalents, $46,869,639 to general funds of municipalities, $3,884,895 in other contributions and $7,285,162 in services.

By comparison, the private utilities reported that in 1962 they paid 9.8 percent of operating revenues in "taxes other than income taxes," 10.9 percent of revenues in Federal income taxes, and 0.5 percent of revenues in other income taxes. Assuming that all non-Federal taxes went to State and local governments, the power companies paid an average of 10.3 percent of revenues in the form of such taxes, or slightly less than the publicly owned systems contributed to the communities they served.

I hope that this information satisfactorily answers the questions raised during the hearing.

Sincerely,

ALEX RADIN.

Senator DIRKSEN. What about the electric association?

Mr. SMITH. You mean the Massachusetts——

Senator DIRKSEN. Yes. What companies comprise that?

Mr. SMITH. I am not sure of that either, but I believe that they would be willing to undertake to make that available.

Senator DIRKSEN. Surely there must be an association letterhead that would have the constituent members carried on it.

Mr. SMITH. There may be. I have not seen it if there is.

Senator DIRKSEN. Well, it is surprising then, I must say. I would think if you, a consultant to them, or if you are in their employ, you would know who your employer is.

Mr. SMITH. Well, I am here as an employee of the firm of Van Scoyoc & Wiskup, Inc., and they, this firm of consultants was engaged to give testimony before this committee on the principles involved on this amendment, and that assignment was given to me.

I did not have as part of my assignment to familiarize myself with the structure of the American Public Gas Association or the American Public Power or the other association. I am appearing here on behalf of——

Senator LONG. Let me make the point I have in mind, and that is the reason why I asked the question. It seems to me that you come here representing people who pay no tax, and I have voted to keep it that way, and I see no reason why I should change it. But I voted to fix it up so that your people do not pay any Federal income tax. If you are paying anything let me know and I can see whatever little that may be, we will give you some relief before that.

[1] The directory, submitted for the information of the committee, was made a part of the committee files.

Here you come in representing people who pay no tax and you compete with some of the very people whom you testify against. They pay taxes which help to contribute to the overall cost of government, and some of those taxes find their way into the loans which are subsidized loans to help the REA people and various others whom I support and try to help.

I just got through voting for a bill the other day to tell these REA people that they would not be regulated by the Federal Power Commission, take them out from under it, and do not tax them at all, and then you come here and testify that you want to heavy up on taxes and bare down on regulation on these people with whom some of your folks may compete.

Now, let me ask you this: Do you know of any reason why a regulated company should have to pay more taxes on its earnings than a nonregulated company would pay on the same amount of earnings?

Mr. SMITH. No, I do not know any reason. I am not advocating that they should.

Senator LONG. All right. Now, if you permit one, if you, as a practical matter, fix it up so one can use a consolidated return and get the full benefit of that tax saving, and the other, if he uses a consolidated return loses the benefit of that tax savings, are you not, in effect, taxing that regulated company at a higher rate than you are taxing the nonregulated company?

Mr. SMITH. No. I do not believe that follows from what I am suggesting here. I think that you may have misinterpreted my testimony actually.

I am saying that where the cost is actually incurred for taxes, that there should be a fair allocation of that cost, and I am saying that assumed taxes or hypothetical taxes are not properly a part of the rate structure, and I do not think that my testimony could be reduced to your language, fairly.

Senator LONG. All right. Let me ask you this: Do you claim to have any opinion at all as to how much taxes a regulated company ought to pay?

Mr. SMITH. Yes. They should pay their fair share of the taxes actually incurred, and pay them.

Senator LONG. Suppose a company is not a part of an affiliated group. Do you have any idea, any contention, as to how much taxes that company ought to pay if it is not a part of an affiliated group, just a simple regulated company? Do you have any idea as to how much taxes that company ought to pay?

Mr. SMITH. I would not distinguish between that company and any other company that had the same amount of taxable income.

Senator LONG. Then you are, in effect, saying that a regulated company should pay the same amount of taxes on the same amount of income as a nonregulated company.

Mr. SMITH. Just as a general proposition each should pay the same rate on a given amount of income.

Senator LONG. Let me ask you this: Do you know of any reason why a company, a regulated company, which has affiliates, should be required to charge rates either higher or lower than the rate that that company would charge if it had no affiliates?

Mr. SMITH. Given a reason for a difference in rates, yes; because I think the very fact of having affiliates is going to have an effect on costs.

As long as you are on a cost method of regulation, and that is pretty fully imbedded in the Federal Power Commission, and apparently in the Federal Communications Commission, based on the statement I heard yesterday, as long as that is true, why, I think, you would have to make fair and reasonable allocations of the costs that are actually incurred in good faith by management, which they would have to follow a criterion, and an excellent criterion, that I recall was laid down by the Fifth Circuit Court of Appeals in August 1960, in a case involving the El Paso Natural Gas Co., and in which it stated that these companies, these regulated companies, are obligated to take the fullest benefit of tax savings, with the presumption of a pretty definite statement by the court that those savings, benefits, would be used to be reflected in rates, and it could possibly mean lower rates insofar as that ultimate cost as to rates is concerned, and that is a very good rationale of the regulatory philosophy, as I see it, because of the fact that a regulated company is entitled to the opportunity, at least, and possibly has almost something equivalent to a guarantee, to earn a fair rate of return, and that rate of return——

Senator LONG. Well now, you say they have got to earn a fair rate of return. They have to compete with some of your outfits, do they not? Don't they have to compete with some of the people you represent here, for business?

Mr. SMITH. I do not think any of these federally regulated utilities here have to compete with any local distributors that I am aware of.

Senator LONG. Well, you and I know the competition between some of these REA's that you are representing here and some of these private power companies for their market and for their customers. You are familiar with some of that?

Mr. SMITH. Yes. I am not representing any REA's here. As far as I know, I am not aware of any REA's belonging to these associations.

Senator LONG. When you said American Public Power Association, I assumed that you might have represented some REA groups, I did not know that.

Mr. SMITH. Well, it may be. It may be that there are some REA's. I would not say there are or are not because I really do not know.

Senator LONG. Well now, do you contend that the regulatory commissions should require that earnings of a nonregulated company or earnings of an affiliated company be passed on through to the customers of another regulated company?

Mr. SMITH. Well, as far as a statement of that general principle, no, I do not advocate that. I am aware of the practical problems of regulation, and I know from my years of experience that when regulated companies and nonregulated companies are put together into one affiliated group, that the matter of separating them in terms of bookkeeping and accounting and making each stand on its own feet is more theoretical than it is actual in many ways and in many respects. In other words, the very nature of things means that there are combinations and complications. I think that the techniques of accounting and regulatory techniques generally have been well enough developed so that regulatory agencies do a pretty good job, and they can continue to do a good job if they have the power of investigation, if they can find out what kind of a situation they are dealing with, if they can get the information, if they can get the facts.

But when the regulatory agencies are denied that, then regulation becomes a farce. You just might as well not have it.

Senator LONG. Well, you make the statement here, and I take it, and as far as I am concerned, the only way I know to talk about these things is not by talking about them as though you had one confused Gordian knot. It is just by separating these things, and that is what you have to do when you try to regulate them. As I understand it, you have to try to separate and untangle this thing and set it out there so you can understand it.

If I understand your answer you said that you should not require a regulated concern to pass on to its consumers the earnings of a non-regulated affiliate.

Mr. SMITH. That is right. I would strive very hard not to do that if I were the regulator.

Senator LONG. I take it that you disagree to the extent that you would require them to pass on to their users certain tax savings generated by their affiliate insofar as that affiliate generated that tax saving.

Mr. SMITH. Well, you are putting it in a way with which I do not agree. The tax saving is generated not by the affiliate alone, but by the act or the fact that you can combine the tax loss affiliate and the other corporation that has its income, otherwise there would not be any tax saving insofar as the consolidated return is concerned.

Now, it is true, and as I pointed out in my statement, if I may continue, please——

Senator LONG. Yes.

Mr. SMITH (continuing). That the ability to carry foward a loss is built in for a loss company if it filed a separate return. That carry-forward provision will expire in time.

Senator LONG. Ten years.

Mr. SMITH. Yes, or whatever it may be, and I was under the impression it was less than that, unless it has been changed recently.

Senator LONG. I was wrong, 5 years forward and 3 years back.

Mr. SMITH. Yes; I think that is more accurate.

Another thing is that there is no assurance that any loss company is ever going to be able to cover that loss in itself if it is on a separate return basis. You can see it is a contingent matter that it will.

Senator LONG. But you would recognize this, that that loss company should never make any money, that insofar as there is a tax saving that is the tax saving against what would be owed to Uncle Sam, that is not a tax saving against what that consumer has some claim on.

Mr. SMITH. Well, sir, you have now injected something that I would like to comment on. If that company remains a loss company forever or continually, we will say, and is a part of a holding company system, I assume that there is a common vehicle of financing; in other words, the stock, the bonds that are used to finance the one company, particularly the common equity, would be used to finance the other.

Now, if a loss company continues within an affiliated group for an indefinite amount of time, it is bound to have an effect on the cost of capital, utility capital.

I have been connected with regulatory matters for well on to 30 years, and I have not come across a situation yet where it was possible in those situations where the financing is a complex arrangement of

many types of companies, where it is possible to separate the fair rate of return for the utility operation alone. The fair rate of return, it is not something you pick out of the air, it is not something, say 6 percent or six and a half. Many, many man-weeks, man-months of study and testimony in every rate case go into arguments and facts and in presenting opposing points of view as to what shall be the fair rate of return. I do not know of any cases before the Federal Power Commission where the Commission did not allow to the utility the fair rate of return as they were able to calculate it from the overall structure of the company.

If you have some "cats and dogs" in there, utility consumers, it seems to me, are certain to be burdened by a larger fair rate of return than they would be otherwise. To keep that utility company sound and operating and so that it can continue to render service, that is very vital, and it is one of the things that regulators pay a lot of attention to, and I certainly know that——

Senator LONG. I take it you are contending now that regulators do not know what they ought to do, and that is that if regulators have a loss, if a company has a loss affiliate over here, they are not entitled to raise their rates to cover that loss or that loss affiliate, they are not entitled to raise their rates to do that, and no good regulator ought to do that. Are you saying that regulators do that?

Mr. SMITH. No, sir; I am not saying that. I am saying if the cost of capital that is provided to utility operation along with others is burdened by these loss companies, I am saying to you as a practical regulatory matter that the regulatory agencies cannot separate the cost of utility capital, particularly the equity capital, from the other and, as a practical matter, they simply cannot do it. If they did, in my opinion, they would be reversed in the courts. And so the result is, if you have this continuing loss situation it is not a one-way street at all. Usually as a practical matter, it is not a continuing situation where it is an actual economic loss, it is usually a temporary situation, and in my experience with the Federal Power Commission, I do not recall of a single instance in which a nonutility operation, loss operation, that was known to be temporary, was ever taken, and the tax benefit passed over to the utility operation.

Mr. Davis, I believe it was pointed out this *Olin* case, this morning, although he did not mention the fact that it was a sui generis decision pronounced by the Commission in which they stated clearly that it was not to be a precedent. But in order to bend over backward in that case and not to do a wrong, under the special conditions in that case, they departed from the rule which I have indicated here they followed generally in the *United Fuel Gas* and many subsequent cases.

So, it is not as simple, quite, as reducing it to your chicken farm situation like you mentioned this morning. I am sorry to have to mention that, but that is the way I feel about it.

Senator WILLIAMS. I have no questions, except to clear the record. A question was asked earlier if you felt that regulated or nonregulated companies could both be taxed under the same formula. The fact is under our law they are taxed under the same formula.

Mr. SMITH. Yes.

Senator WILLIAMS. So there is no question about that. Until the law is changed they will remain so taxed.

Mr. SMITH. Yes, sir; that is correct.

There was maybe one minor exception to that which I do not think now applies, and that is in a consolidated return. I think the utility company's income would be taxed at 52 percent, and the nonutility company's income would be taxed at 54 percent as a penalty, but I believe even that difference has been removed.

Senator WILLIAMS. Yes. Thank you.

Senator LONG. Thank you very much.

Mr. SMITH. If I may, Mr. Chairman, I would like to request that the written statements that have been supplied by Mr. Alex Radin, general manager, American Public Power Association, in opposition to amendment No. 418 to H.R. 7502 be included in the printed record.

Senator LONG. I do not want to put it in sight unseen. Where is the statement? I will be glad to insert it in the record, but I am not going to put anything in the record that I have not seen.

Mr. SMITH. The same situation applies to the statement of Mr. James E. Baker, chairman of the Legislative Committee of the Municipal Electric Association of Massachusetts.

Senator LONG. I will be glad to do that if you will get me copies of the statements you have in mind, and I will decide after I have seen them whether to put them in the record. I am not going to put anything in the record I have not seen. I hope you understand, Mr. Smith, that—I have no objection to that. That will be inserted.

(The prepared statements referred to follow:)

STATEMENT ON AMENDMENT NO. 418 (SENATOR DIRKSEN, AUGUST 24, 1965) TO H.R. 7502, SUBMITTED BY ALEX RADIN, GENERAL MANAGER, AMERICAN PUBLIC POWER ASSOCIATION

My name is Alex Radin. I am general manager of the American Public Power Association, a national service organization representing more than 1,200 local public power systems, mainly municipally owned electric utilities, in 45 States and Puerto Rico. The association's offices are located at 919 18th Street NW., Washington, D.C.

APPA is opposed to amendment 418 to H.R. 7502 and to any other legislation designed to weaken or destroy effective regulatory protection of the customers of public utility companies.

ANALYSIS OF AMENDMENT 418

Amendment 418 would reopen the possibility of the kind of financial abuses which were first corrected by the Public Utility Holding Company Act of 1935. Its provisions would permit companies in an affiliated group of companies which files a consolidated income tax return to allocate the total tax liability of the group among themselves according to an allocation formula of their own choosing. Profitmaking members of the group would make payment to loss-contributing members of the group in recognition of the tax savings made possible by the loss-contributing members and realized through the device of the consolidated tax return. The amount of such transfer payments would be determined by the excess of a hypothetical separate return tax liability of the profitmaking members of the affiliated group, over their allocated share of the consolidated tax liability. The actual tax liability of the consolidated group would not be changed from what it would be under existing law.

The change worked by the proposed amendment would come about through regulatory treatment of the intragroup transfer payments made in recognition of tax savings.

Amendment 418 provides that all Federal agencies or instrumentalities shall treat all such transfers and receipts "as payments, or refunds, of Federal income tax, as the case may be * * * for the purposes of establishing the cost of service, of determining the overall rate of return, and of determining the net income from the regulated activities or services of a member of such an affiliated group." In making a cost-of-service study, a regulatory agency would be required to treat a transfer of funds between members of an affiliated group of companies just as

though it were a legitimate tax paid into the U.S. Treasury. Intragroup transfer payments would therefore be treated as a legitimate cost of service. Once incorporated in the cost of service the intragroup transfer payments would be reflected in the rates charged customers of public utility companies. Federal regulatory agencies would be forced to permit public utilities to charge their customers for a phantom tax, a tax which would be paid directly into the coffers of the sister companies of the utilities. Ratepayers would be required by law to subsidize loss-producing companies from which they receive no good or service and over the management of which they have no control.

For purposes of illustration let us assume two affiliated companies, A and B. Company A is a regulated public utility which realizes a profit on its operations and company B is an unregulated loss producing firm. Filing separately, company A pays income taxes on its earnings and company B pays no income taxes because it has no taxable income.

Suppose then that companies A and B should decide to file a consolidated tax return. The losses of company B are thereby converted into a profit offset for company A—company A's apparent taxable income is reduced, thus reducing its tax liability. Under existing law company A, a public utility, has realized a reduction in its total cost of service in the amount of the tax saving. Federal regulatory agencies may then require company A to pass the tax saving on to its customers in the form of a rate reduction.

Under the terms of amendment 418, company A would be able to pay company B a sum equivalent to the amount of tax saving. Federal agencies would be required to treat this payment as though it were actually paid to the Government as income tax. This phantom tax would then be included in company A's cost of service and reflected in the rates paid by company A's customers. The tax saving resulting from the consolidated tax return would not be flowed through to consumers but would be retained by the affiliated companies A and B.

CAPTIVE CUSTOMERS MUST ULTIMATELY PAY PHANTOM TAX

Public utilities provide essential services and their customers are for the most part captive customers. Amendment 418, if enacted into law, would force those captive customers to pay millions of dollars of phantom taxes in return for which they would receive no benefit whatever. The device of the consolidated tax return, which has in the past reduced the tax liability of many public utilities and which has in turn resulted in lower rates to the customers of those utilities, would be turned to the sole advantage of the affiliated groups of companies of which the utilities are or might become members.

Almost half of the Nation's 2,000 municipal or other local publicly owned electric systems purchase all or part of their power requirements from private power companies subject to the jurisdiction of the Federal Power Commission. The FPC regulates the terms and conditions under which these systems purchase wholesale power. Under existing law the FPC can protect these systems against having to pay rates which are in excess of a just and reasonable level. Under the provisions of amendment 418 the FPC would be required to force these systems to pay not only just and reasonable rates which fully cover the actual cost of serving them, but also a share of a phantom tax the proceeds of which would go to subsidize the losses of companies in which they have no interest as customers, managers, or stockholders.

The National Power Survey reports that there are presently 11 electric holding company systems that remain subject to all provisions of the Holding Company Act. These systems account for 21 percent of all sales of electric energy by the investor-owned electric power industry. Assuming that these 11 holding companies have a porportionate share of all wholesale sales of electric energy, they would have realized about $260,898,079 in revenues from sales for resale in 1963. The price which municipal and other local public power systems must pay for their wholesale power supply is of necessity reflected in the rates which they must in turn charge their millions of customers. The addition of a "tax" representing a small percentage of the current rates of only the presently existing holding companies would result in millions of dollars of rate increases to electric consumers. There is, of course, no reason to believe that many other privately owned electric utilities would not immediately seek ways in which to get in on the private taxing privilege offered by amendment 418; should it become law the ultimate cost to consumers can only be guessed.

USE OF PRIVATELY GATHERED "TAX" UNREGULATED

As to what use such privately gathered "tax" revenues might be put, no one can say with certainty. All that is known is that moneys extracted from captive consumers would flow into unregulated uses—there isn't even the assurance that such moneys would be expended with reasonable prudence. The entire arrangement has the odor of pre-1935 days when unscrupulous speculators built "groups of affiliated companies" with reckless abandon—built tall but shaky holding company structures with other people's money. It was just that situation that led to the Holding Company Act of 1935 and some much needed regulation of intercompany financial arrangements. The proposal that consumers be forced to pay a "tax" to supply risk capital to unregulated enterprises over which the contributing consumers have no control and in which they have no financial interest, seems to be a proposal to reinstitute the old abuses with an even more outrageous modern twist—regulatory agencies are to pretend that the entire transaction is merely a matter of Federal income tax payments.

POSSIBLE INTERFERENCE WITH FREE MARKETS

In the case of two regulated and affiliated companies it is entirely possible that tax losses and compensating payments might be so arranged that consumers of company A, which is secure in its markets, might be required to subsidize the consumers of company B, which is in a more competitive market situation. It might even be possible for a parent company with two subsidiaries dealing in competing energy sources to shift the competitive balance in favor of the subsidiary with the higher profit margin and to do it at the expense of the consumers of the subsidiary with the lower profit margin. The possibilities for abuses and consequent disruption of rational, market-controlled, economic allocation of investment capital go far beyond the immediate obnoxious fact that consumers would be required to pay a phantom tax and thereby contribute capital to enterprises in which they acquire no proprietary interest.

PRIVATE TAXING PRIVILEGE INCONSISTENT WITH PUBLIC INTEREST

The private taxing privilege which amendment 418 would bestow on public utility companies is inconsistent with the interests of both the millions of consumers who would pay the tax, and that of effective regulatory protection of the broad public interest inherent in utility operations. The requirement that regulatory agencies be a party to the exaction of such tribute from captive consumers would make a mockery of those agencies' historic role as defenders of the public interest.

The passage of amendment 418 would result in a giant step backward—a step backward toward an era wherein, absent regulatory control, the public interest ran a poor second to interest in private gain at public expense.

APPA believes that no beneficial public purpose would be served by passage of amendment 418. On the contrary, the placing of an unregulated private taxing privilege in the hands of public utility companies would immediately injure the customers of those companies. Federal regulatory agencies would be rendered unable to discharge their primary responsibility to consumers. For all of the above reasons, APPA opposes passage of amendment 418.

STATEMENT SUBMITTED BY THE MUNICIPAL ELECTRIC ASSOCIATION OF MASSACHUSETTS AND THE SHREWSBURY MUNICIPAL PLANT IN OPPOSITION TO AMENDMENT PROPOSED BY SENATOR DIRKSEN TO H.R. 7502

My name is James E. Baker. I am manager of the Municipal Electric Plant of the Town of Shrewsbury, Mass., and chairman of the Legislative Committee of the Municipal Electric Association of Massachusetts.

My purpose is to express the opposition of this association to the amendment proposed by Senator Dirksen to H.R. 7502 which would require the Federal Power Commission, and other Federal regulatory agencies to accept for ratemaking purposes interaffiliate corporate income tax transferrals irrespective of whether such transferrals represent what the FPC considers to be a fair sharing of consolidated income tax savings between regulated and unregulated affiliated businesses. We believe that this is the type of ratemaking problem which should be left to the discretion and judgment of the particular regulatory agency. We think it unsound for Congress to select out of the multitude of ratemaking factors, one such factor and circumscribe the Commission's authority thereto.

Fair, overall regulation of interstate wholesale electric rates by the FPC is vital to the ability of the members of this association to bring about a reduction in the high level of electric rates in New England. The association is, therefore, opposed to the placing of restraints on FPC's authority, particularly with reference to a cost factor having a direct impact on rates in New England.

The Municipal Electric Association of Massachusetts is an organization of the officials of 40 municipal electric plants which distribute and sell electricity within Massachusetts to retail customers within their communities. The object of the association is to assist its members in providing electric service at the lowest rates consistent with sound business principles.

All but two of these systems are more than 50 years old, and many were founded prior to the turn of the century. Most of these plants were constructed to bring electric energy into the communities for the first time. Thirty-four of the 40 municipal electric systems purchase all of the power they sell from private power companies, while three of the systems purchase part of their power requirements and generate the balance. Only three plants generate their total requirements.

In 1964, these municipal electric plants had approximately 227,000 separately billed customers. They purchased approximately 1.4 billion kilowatt-hours for a purchased power bill of over $19 million.

New England retail rates are the highest in the country, and Massachusetts has the highest in New England.

The matter of wholesale electric rates in Massachusetts, however, is even more serious. For example, in 1963, the average cost paid for purchased power by the municipal distributors ranged from 1.23 cents per kilowatt-hour to 1.71 cents per kilowatt-hour, while Potomac Electric Power Co. was selling to distributors at wholesale for an average rate of 0.902 cents. In 1963 the Potomac Edison Co. in Western Maryland sold the town of Thurmont power for redistribution at an average rate of 1.03 cents per kilowatt-hour, while Shrewsbury, with 10 times as large a load, paid an average of 1.48 cents per kilowatt-hour for its power supply from Massachusetts Electric Co. In general, the rates paid by Massachusetts municipalities range from 50 to 100 percent higher than what municipal distributors pay to many other comparable private power companies in other parts of the country.

These high wholesale rates have always been a source of concern to the municipal distributors, and a serious economic detriment to their electric systems and communities. We are now bringing our problems to the Federal Power Commission, and see a realistic prospect of improving our situation as a result of the Commission's regulatory activity.

During the last year alone, FPC action in four cases has produced savings of close to $500,000 per year to members of our association. In addition, we are hopeful that the Commission's current studies of wholesale rates in New England will produce even greater savings during the coming years. We do not wish to see FPC's authority circumscribed in any manner.

Five of the six major electric utility systems in Massachusetts would be affected by the proposed tax amendment which would enable the operating affiliates to increase their allowable costs of service for ratemaking purposes. These systems are as follows: New England Electric System, New England Gas & Electric Association, Eastern Utilities Associates, Holyoke Water Power Co., and western Massachusetts Co.'s. The amount of consolidated tax savings involved for these companies is in the order of $3 million per year, based on 1964 data.

Thus, at a time when all efforts in Massachusetts and the rest of New England should be focused on reducing the cost of electricity, we do not believe Congress should be passing legislation the effect of which is to countermand these efforts.

The association, therefore, urges the committee to reject this proposed amendment as not in the public interest.

Mr. SMITH. In the case of Mr. Baker, he had intended to come to Washington and testify in person, but he released his time so I could have as much time as possible to testify on behalf of these associations.

I want to thank you very much.

Senator LONG. You are very welcome.

Mr. Wheatley?

STATEMENT OF CHARLES F. WHEATLEY, JR., GENERAL MANAGER-GENERAL COUNSEL, AMERICAN PUBLIC GAS ASSOCIATION

Mr. WHEATLEY. Mr. Chairman, my name is Charles F. Wheatley, Jr., and I am general manager-general counsel of the American Public Gas Association which is an association of some 200 municipal gas systems whose members are geographically distributed throughout 25 States of the Union, and I appreciate the opportunity to appear before the committee today in opposition to amendment 418 to H.R. 7502.

In view of the lateness of the hour, we would be willing to submit our statement for the record, if that would satisfy the committee.

Senator LONG. That will be printed at this point.

Mr. WHEATLEY. Fine.

(The statement referred to follows:)

STATEMENT OF CHARLES F. WHEATLEY, JR., GENERAL MANAGER-GENERAL COUNSEL, AMERICAN PUBLIC GAS ASSOCIATION, ON AMENDMENT NO. 418 TO H.R. 7502

Mr. Chairman, my name is Charles F. Wheatley, Jr., I am general manager-general counsel for the American Public Gas Association, an association of some 200 municipal gas systems whose members are geographically distributed throughout 25 States of the Union. I appreciate the opportunity to appear before the committee today in opposition to amendment 418 to H.R. 7502.

The American Public Gas Association is keenly interested in insuring that the gas-consuming public is protected against excessive rates, and it is for this reason that it joins the Federal Power Commission, the Federal Communications Commission, the Securities and Exchange Commission, the American Public Power Association, and the other organizations and public agencies sharing a similar concern in urging you to reject this amendment.

The bill is complex, the variety of ways its provisions could be applied, virtually endless; and many of these applications could result in the consumers paying millions of dollars per year in unreasonable rates. This is the basis for our opposition. We do not believe that large utility companies should be allowed to manipulate their cost of service simply by transferring funds to another member of their own business family. This bill permits exactly that sort of practice. In effect it requires that the Federal regulatory agencies treat a transfer of money from the left pocket to the right as a payment or refund of taxes for rate purposes. Thus, the management of these enterprises is given virtually power to charge the consumer for a phantom cost of service.

Amendment 418 is designed to prevent the Federal Power Commission and other Federal regulatory agencies from allocating to the regulated utility, to be paid by its customers, the fair share of the actual Federal income taxes paid stemming from that activity. Under the amendment the Federal Power Commission would be required to have the customers of the regulated company pay an item for Federal income taxes as a part of the cost of service when in fact no such taxes were paid to the Federal Government. Thus, the ratepayers, through the guise of paying for Federal income taxes, would be providing interest-free capital to the consolidated group embracing the regulated company.

A brief examination of the structure of the natural gas industry will illustrate the opportunities for exploitation of the consumer which this amendment will provide. It is a well-known fact that many of the companies regulated under the Natural Gas Act are either the parent or a subsidiary of a vast and highly diversified business enterprise. These business families include both companies engaged in the transportation and sale of natural gas and those engaged in exploration and production. In addition, there are also companies engaged in a variety of unregulated businesses. For example, Tennessee Gas Transmission Co. is head of a family of 55 companies which includes pipeline companies, domestic and foreign exploration companies, plastic corporations, chemical companies, a restaurant, and several other enterprises. The production companies and many of the unregulated companies would bring substantial tax losses to a family, while taxable income is contributed by the regulated natural gas pipeline companies. By filing a return as an affiliated group under the consolidated return provisions

of the internal revenue code, these families can offset the tax losses of companies having them against the income of the group as a whole, thus realizing a substantial tax saving.

Amendment 418 does not affect the tax liability of the group. However, it does allow the income-producing companies to transfer the difference between the amount they would have paid in taxes had they filed separate returns and their share of the group's tax liability to the companies who brought deductions or credits to the group. Within these broad limits the management of the group has discretion to make these transfers in any manner it sees fit.

Since the regulated natural gas pipeline companies need only be certified by the Federal Power Commission to be assured a market with limited competition and the opportunity to earn fair return on their investment, with possible but rare exceptions these companies will always increase the tax liability of the group. In most cases even as presently organized they will be in a position to transfer the maximum amount of funds to other members of their group. Furthermore, should this amendment become law it will provide incentive for the creation of loss subsidiaries and other affiliates which will insure that the total savings of consolidated return can be realized at the expense of the consumer.

The use to which these funds will be put is, of course, entirely a management decision. They may be used by all unregulated members to stimulate their economic growth. In the case of a regulated company competing for certification to serve another area of the country, they may be used to lower its own cost of service and thus its rates so as to capture a market. They may be distributed as dividends or used in a variety of other ways. The point is that no matter how they are used that activity will be subsidized by the consumers using the gas of the company from which the funds are transferred.

The Federal Power Commission in administering the Natural Gas Act has the statutory duty to insure that the pipelines it regulates charge only a just and reasonable rate. Under the standard cost-of-service method of rate determination this means a fair return on the companies' net investment. In discharging its duty under the statute the Commission has required that only the taxes actually paid be included in computing the cost of service. It is difficult to see how the Commission could deviate from this standard without abdicating its responsibility; for if moneys not actually expended are included as a cost-of-service item, the consumer—who is a captive market—must be providing the pipeline or its affiliates with interest free capital, not a return of its costs.

The requirement of just and reasonable rates is contained in virtually every Federal statute which regulates an industry. It has its antecedents in the common law rule that those businesses known as public utilities must provide service at reasonable rates. The requirement recognizes that a company which is protected from competition must be limited in its rates if the consuming public is to be protected. Thus, the only reason for rate regulation is the protection of the consumer, and the industrial history of this country amply demonstrates that Government has a duty to give the public this protection.

The only practicable way Congress can insure the public a just and reasonable rate is through a dedicated and conscientious regulatory agency. And to be effective this agency must have the power to insure that the companies it regulates receive a return only on the actual net investment. Any statute which allows a company to charge the consumer for money it does not have to expend to provide service frustrates the ability of the agency to discharge its statutory duty and, quite frankly, represents an abdication of the duty which Congress has long recognized it owes to the consuming public.

Any argument that the economic impact of this amendment upon the consumer will be de minimis is at odds with the facts. The Federal Power Commission has reported that in 1963–64, 19 natural gas pipeline companies saved over $11 million by using the consolidated return provisions. A complete study would undoubtedly substantially magnify this figure. It seems clear, therefore, that when the total effect of this amendment is considered the effect upon the consumer is by no means de minimus.

We believe it is not in the public interest for Congress at this time to make this inroad into the just and reasonable rate principle as developed by agency and court decisions. In the first place, the question of allocation of tax liability among the members of affiliated groups is now before the Court of Appeals for the Fifth Circuit. The courts are traditionally the initial tribunal to decide these questions, and we believe that Congress should withhold any action on the question until a final decision has been made by the judiciary.

Secondly, the Commerce Committees of both Houses, to which Congress has assigned the primary responsibility of dealing with such matters, should also have

the opportunity to fully consider the complex questions raised by this amendment before it reaches the floor. The amendment is in effect a sub silento amendment of the Natural Gas Act and Federal Power Act. Since proposed as an amendment to an unrelated finance bill which passed the House, this would preclude the appropriate House committees from having an opportunity to study the bill and report thereon before consideration by a conference committee. In view of the complexity and impact of the amendment we submit that the public interest requires that the provisions of this amendment not become law until they have been thoroughly studied by both Houses of Congress.

In conclusion, the American Public Gas Association believes that the proper method of dealing with the complex business of rate regulation in a highly and intricately organized industry is not by a categorical prohibition upon commission inquiry into the allocation of tax liability within a business family. Rather the regulatory agencies, subject to judicial review, should be left free to examine these allocations to insure that they do not burden the public with excessive rates. For this reason we respectfully urge the Commission to reject amendment 418.

On behalf of the American Public Gas Association may I again thank you for the opportunity of presenting these views.

Mr. WHEATLEY. At this time also I would like to bring to the attention of the chairman a letter sent by Mr. William M. Bennett, chairman of the National Committee for Fair Gas Prices to Chairman Byrd of the Senate Finance Committee.

Senator LONG. I will have that printed in the record. It will be made a part of the record.

(The letter referred to follows:)

NATIONAL COMMITTEE FOR FAIR GAS PRICES,
San Francisco, Calif., September 1, 1965.

Hon. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The National Committee for Fair Gas Prices urges the Finance Committee to reject the Dirksen-Long amendment (amendment 426) to H.R. 7502.

The National Committee for Fair Gas Prices is a nationwide organization of public officials and organizations devoted to the protection of the gas-consuming public against excessive gas rates. The committee has studied this amendment and concluded that its regulatory provisions are inimical to the interests of the public. For this reason it believes that the provisions should not be reported as a committee amendment.

Amendment 426 is a complex piece of legislation so far as its tax effect is concerned. The regulatory effect is, however, clear enough to be simply stated. It would permit transfers of funds within a group of companies linked together as a single business unit by 80-percent stock ownership to be treated for the purposes of rate determination as taxes paid to the Federal Government. Thus, a federally regulated gas company could, simply by transferring funds to a wholly owned unregulated subsidiary or to a parent company with tax losses or unused investment credits, place itself in a position to charge the consumer with a cost of doing business which has in fact not been incurred.

The gas consumer has a right to be protected against fictitious items in a utility's cost of service. The large regulated pipeline companies provide a needed service and have a protected market due to the necessity for certification by the Federal Power Commission before service can be undertaken and the fact that they are frequently natural monopolies. Because of the advantages of their position in relation to the consumer, the law requires that their rates be just and reasonable and delegates to the Commission the power to enforce this standard. If the Commission is deprived of the power to look behind the dealings of a regulated company with the members of its own business family and to segregate actual from fictitious costs, it follows that the company is granted the power to impose an unreasonable rate upon the consumer.

For the above reasons we submit that this amendment is contrary to the public interest and respectfully request you not to adopt it.

Respectfully submitted.

WILLIAM A. BENNETT, *Chairman.*

Senator LONG. I have no further questions. Thank you very much.

Mr. WHEATLEY. Thank you.

Senator LONG. That concludes these hearings.

Thank you very much.

(By direction of the Chairman, the following is made a part of the record:)

COLUMBIA GAS SYSTEM SERVICE CORP.,
New York, N.Y., August 31, 1965.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: It has come to our attention that by letter dated August 25, 1965, a majority of the Federal Power Commission has forwarded to you comments with respect to amendment No. 418 to H.R. 7502 sponsored by Senator Dirksen, and that such letter uses the Columbia Gas System as an illustration of the potential effect on consumers throughout the country.

We submit this letter in order that the committee may be more fully advised and see the Columbia illustration in proper perspective. Without attempting to make an attack on the figures used by the Commission on page 4 of its letter, we would respectfully advise the committee as follows:

1. Attached hereto is a computation of the Columbia Gas System's Federal income tax for the year 1963 on the basis of the filed tax return figures. You will note that on a separate return basis there would be taxable net income to the system of $96,012,902, and an income tax of $46,074,239 (line 18). On a consolidated basis, the taxable income is $86,868,960 with a tax of $41,693,255 (line 23) or a tax saving resulting from the filing of a consolidated return of $4,380,984.

2. It should be noted that part of the tax savings results from the loss incurred by Columbia Hydrocarbon Corp., a nonregulated company, (line 19) and from the operations of the Preston Oil Co., which is in the business of producing oil and gas and whose tax loss stemmed in large part from extensive exploratory and development costs on- and off-shore in southern Louisiana (line 20). The gas customers of regulated companies of the Columbia Gas System do not pay any part of these losses and there is no reason why, in good conscience, they should get the tax benefit stemming from these losses.

3. It should also be noted that a substantial part of the savings results from the tax loss of the parent corporation. This tax loss of the parent corporation arises from many costs, none of which costs are borne by the gas customers. For example, the cost of maintaining stockholder records, etc., paid for by the parent corporation amounted to $823,024 and contributed $395,052 to the reduction in the consolidated tax. The regulated utilities do not pay any of these costs. However, expenses of this nature would have to be borne by each of the utility companies if they were not part of the Columbia Gas System since, presumably, they would have stock in the hands of the public and be required to maintain these kinds of records. Although the parent corporation pays these costs, the customers of the regulated utilities are relieved from the burden of such costs, under the Commission's theory and present practice, these customers would also get the tax benefit arising from the deductions. There are many other items of costs incurred by the parent corporation of a similar nature, none of which are paid for by the customers of the regulated utilities. There is no sound reason why the gas customers should receive the tax benefits stemming from these costs and expenses which are paid solely by the parent corporation.

4. On page 4 of the Commission's letter, the statement is made that under the amendment, "the holding company device could deny the ratepayers a fair share of the tax saving due to interest on long-term debt even though the ratepayers supply all the cash to pay the interest." Under SEC authorization, the operating utilities of Columbia Gas System borrow money from the parent corporation on long-term notes and make interest payments on these notes which are substantially equivalent to the interest paid by the parent company on its long-term debt.[1] Thus, the operating company has the benefit of the

[1] Public debt financing by the parent corporation results in lower interest rates than could be obtained if the operating companies were forced to finance their own debt requirements individually. The benefit of these lower rates is reflected in the interest charged by the parent to the operating utilities. The operating utilities maintain debt ratios approximating that of the parent corporation and the interest charged to the operating utilities is approximately the same as the cost incurred by the parent in its public debt financing.

interest deduction even when the tax is calculated on a separate return basis. In the attached computation a total of $23.5 million in deductions reflecting interest paid to the parent corporation was used in determining the tax payable by the operating utilities on a separate return basis.

5. To establish a proper frame of reference for consideration of the problem it is necessary to know that in 1963 the System's total revenues from sales of natural gas by its regulated subsidiaries totaled approximately $572 million. The total reduction stemming from the consolidated tax saving passed on to the customers results in a cost reduction to customers of only three-fourths of 1 percent.

6. The Columbia Gas System supports the views expressed by Commissioner O'Connor in his letter to the committee dated August 25, 1965.

Very truly yours,

RICHARD A. ROSAN.

Computation of Federal income tax at 48 percent rate based on taxable net income per return and reduction in tax due to filing a consolidated return, year 1963

Company (a)	Taxable net income (b)	Amount of tax (c)
Subsidiary company income taxes based on separate returns:		
1. Amere Gas Utilities Co	$159,590	76,603
2. Atlantic Seaboard Corp	8,761,894	4,205,709
3. Columbia Gas of Kentucky, Inc	868,782	417,015
4. Columbia Gas of Maryland, Inc	217,259	104,284
5. Columbia Gas of New York, Inc	[1] 606,311	290,884
6. Columbia Gas of Pennsylvania, Inc	4,611,525	2,213,532
7. Columbia Gas System Service Corp	74,792	35,900
8. Columbia Gulf Transmission Co	14,209,441	6,820,532
9. Cumberland & Allegheny Gas Co	1,139,688	547,050
10. Home Gas Co	1,589,295	762,861
11. The Inland Gas Co., Inc	1,104,639	530,227
12. Kentucky Gas Transmission Corp	973,865	467,456
13. The manufacturers Light & Heat Co	9,617,158	4,616,236
14. The Ohio Fuel Gas Co	[2] 36,009,397	17,274,298
15. The Ohio Valley Gas Co	34,614	16,615
16. United Fuel Gas Co	[3] 15,394,225	7,387,632
17. Virginia Gas Distribution Corp	640,427	307,405
18. Total	96,012,902	46,074,239
Reduction in taxes due to filing a consolidated return, subsidiary companies sustaining losses:		
19. Columbia Hydrocarbon Corp	(326,711)	(156,821)
20. The Preston Oil Co	(3,005,066)	(1,442,432)
21. Taxable loss of parent company	(5,812,165)	(2,789,839)
22. Capital gains differential, $35,254, at 23 percent		8,108
23. Consolidated return basis	[4] 86,868,960	41,693,255
24. Consolidated tax savings		4,380,984
$86,852,241, at 48 percent		41,689,075
$16,719, at 25 percent		4,180
Total tax savings, $86,868,960		41,693,255

[1] Includes long-term capital gain, $634.
[2] Includes long-term capital gains, $44,402.
[3] Includes long-term capital gains, $6,937.
[4] Includes long-term capital gains, $16,719.

NOTE.—No effect is given to the surtax exemption as 1 exemption only is available to an affiliated group whether or not a consolidated return is filed.

NATIONAL CONSUMERS LEAGUE,
Washington, D.C., August 31, 1965.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The National Consumer League wishes to go on record in opposition to amendment No. 418 to H.R. 7502.

This amendment would greatly weaken the regulatory powers of those Federal commissions which were expressly set up to protect the public interest at just the time when consumers find themselves increasingly in need of protection from

the growing concentration of power in giant corporations. As the Federal Power Commission has so aptly stated, this amendment "goes counter to the purpose of creating regulatory agencies which are entrusted with the duty of arriving at rate decisions in light of a specialized and detailed knowledge of the economics, prospects, and changing circumstances of the utility industry." The league agrees with the FPC that savings in Federal taxes achieved by filing consolidated returns should be passed on to consumers. Amendment 418, by requiring the regulatory agency to accept allocations of taxes between parent and subsidiary companies for rate setting and other regulatory purposes, would permit regulated affiliates to pay to unregulated affiliates for the "tax savings" due to deductions or losses contributed by the unregulated affiliates to the consolidated return. This could result in denying millions of dollars to consumers of regulated utilities, and would at the same time bestow an unfair competitive advantage to the unregulated affiliates.

Consumers, and indeed our whole economy, stand to benefit only when free and fair competitive practices are permitted. In those areas of our economy where monopolies do exist, it has long been the national policy to establish and maintain regulation in the public interest. Since we feel that amendment 418 would weaken, or even wipe out, such regulation, the National Consumers League strongly urges that the Finance Committee vote against the amendment.

We respectfully request that this letter be made a part of the record of your hearings on this measure.

Sincerely yours,

SARAH H. NEWMAN, *General Secretary.*

EL PASO NATURAL GAS CO.,
New York, N.Y., August 30, 1965.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: El Paso Natural Gas Co. (El Paso) is informed that public hearings are to be held by your committee on an amendment intended to be proposed by Senator Dirksen (Senate Amendment No. 418) to H.R. 7502, a bill relating to the income tax treatment of certain casualty losses attributable to major disasters, and wishes to submit this statement to the committee.

At the present time, El Paso is a party to proceedings pending before the Federal Power Commission involving competing applications for certificates of public convenience and necessity for authorization to supply natural gas to southern California. The first hearing conference in these proceedings was held on November 19, 1963, and the taking of oral testimony began on June 1, 1964. After 170, days of hearings, 897 exhibits, 75 items by reference and 28,078 pages of testimony by 169 witnesses, the hearing was concluded on March 17, 1965. Since that time briefs have been filed by all interested parties. The case is now in the hands of the hearing examiner awaiting initial decision.

Certain tax arrangements made by one of the competing applicants, Gulf Pacific Pipeline Co., a subsidiary of Tennessee Gas Transmission Co., were an issue in the above case, and were the subject of extensive direct and cross examination, and of briefing by the principal parties. The amendment proposed to be made by Senator Dirksen to H.R. 7502 would directly revise the rules of law as to tax arrangments of the type made by Tennessee and its subsidiary, and would do so after the hearing has been ended, after all the testimony has been taken, and after the record in the Federal Power Commission proceedings has been closed.

El Paso strenuously objects to any congressional action which would affect the questions involved in the pending Federal Power Commission proceedings, and believes that any change in the ground rules made retroactively applicable to a vigorously fought case presently awaiting decision would contravene basic American principles of fair play. Similar considerations, relating to the nature and pendency of the present Federal Power Commission proceedings, are the basis for El Paso's own conclusion, reached after careful deliberation, that it is not appropriate for it, as a contestant in such proceedings, to appear before your committee at this time and testify on this subject.

Respectfully submitted.

HOWARD BOYD.

GULF PACIFIC PIPELINE CO.,
Houston, Tex., August 27, 1965.

Subject: Amendment 418 to H.R. 7502.

Hon. HARRY F. BYRD,
U.S. Senate, Washington, D.C.

SIR: In view of the misinformation being disseminated through news media regarding the effect of taxes and tax credits on rates to be charged by Gulf Pacific Pipeline Co. for transmission of natural gas through its pipeline which it proposes to construct from Texas to California at a cost estimated to amount to over $314 million, we feel obligated to advise you of the following facts:

(1) The Gulf Pacific Pipeline Co., and the rates it will charge for services rendered (transportation of gas in interstate commerce) will be subject to the continuing jurisdiction of the Federal Power Commission.

(2) Gulf Pacific Pipeline Co.'s contracts with its two customers, Southern California Edison Co. and the Department of Water and Power of the City of Los Angeles, preclude any shifting of tax burden by effectively providing (subsec. (c) of sec. 12.1) that rates to be charged for services rendered "shall not be increased or decreased by reason of taxable income or tax losses or other taxes arising from activities or businesses of transporter" (Gulf Pacific), "or the consolidated group" (composed of Tennessee Gas Transmission Co., and affiliates), "other than the construction and operation of, and rendition of services through, the Gulf Pacific project."

(3) The contracts containing the foregoing provisions are of record at the Federal Power Commission as exhibit Nos. 13 and 14, docket No. CP63-204, et al.

It is most ironic that legislation worked out over a long period of time in close cooperation with the Treasury Department and designed to properly reflect the tax liability and financial results of the business activity of each taxpayer who is a member of a consolidated group has been maliciously attacked by erroneous statements implying that such legislation fosters "shifting of tax burdens." Such attacks are inconsistent with the purpose and intent of amendment No. 418 which is to give additional protection to consumers served by members of consolidated groups and to minority shareholders of such members.

We request that you give this proposed amendment your most serious consideration.

Very truly yours.

WM. W. WITMER, *President.*

STATEMENT ON BEHALF OF SOUTHERN CALIFORNIA EDISON CO. ON AMENDMENT NO. 418 (DIRKSEN AMENDMENT) TO H.R. 7502

The Southern California Edison Co. is a California corporation engaged as a public utility in the supply of electricity in the central and southern portions of the State of California and the western portion of the State of Nevada. The company is the fifth ranking electric utility nationally based on annual revenues. The company owns and operates an interconnected steam and hydroelectric generating system located in central and southern California.

In view of the incorrect statements which have appeared in newspapers suggesting that the enactment of the proposed amendment to H.R. 7502 sponsored by Senators Long and Dirksen would permit the Gulf Pacific Pipeline Co., which is to serve Southern California Edison Co. and the Department of Water and Power of the City of Los Angeles, to cut Gulf Pacific's rates by shifting its tax liability to its parent company, Tennessee Gas Transmission Co., Southern California Edison Co. desires to bring to the attention of the members of the Senate Finance Committee the facts demonstrating that such suggestion is completely in error.

GULF PACIFIC CONTRACTS

Under the contracts between Gulf Pacific and Southern California Edison Co. and between Gulf Pacific and the city of Los Angeles, it is contemplated in this connection only that the Gulf Pacific Pipeline Co. would pass on to such customers all available tax benefits generated by Gulf Pacific which would act to reduce the tax actually paid by Gulf Pacific; such provisions, of course, reduce the cost of service of Gulf Pacific to Southern California Edison Co. and the city of Los Angeles, but would not adversely affect in any way the cost of natural gas service performed by any other company.

The specific contractual provision involved, insofar as Southern California Edison Co. is concerned, appears in paragraph 12.1(c) of its agreement with Gulf Pacific dated February 1, 1963, which reads as follows:

"Accruals recorded for the month with respect to income, ad valorem and other taxes reasonably associated with the operation of the Gulf Pacific project, and general corporate, franchise and other taxes reasonably applicable to services rendered by Transporter through the Gulf Pacific project and adjustments of accruals for such tax expense previously billed and for any such taxes paid but not previously billed. There shall be taken into account in computing taxes and accruals thereof any tax savings or credits, including investment credits arising under the Internal Revenue Act of 1962, arising from Transporter's construction and operation of, or rendition of service through, the Gulf Pacific project. It is contemplated that Transporter may, for one or more years, file a consolidated Federal income tax return with other corporation or corporations. In this connection, it is recognized that present rules for allocating such investment credits among members of a group filing consolidated Federal income tax returns are uncertain at this time. For the year or years, if any, for which Transporter so files a consolidated Federal income tax return: (i) if regulations promulgated by, or a ruling obtained from, the Internal Revenue Service permit or approve an allocation which will not be detrimental to any corporation in the consolidated group or the shareholders thereof, the net accumulated tax savings resulting therefrom, if any, shall be taken into account in such computations, and for this purpose 'net accumulative tax savings' shall mean the accumulative net amount the tax liability of the consolidated group, excluding Transporter, exceeds the tax liability of the consolidated group including Transporter for such years; or (ii) in the absence of such regulations or ruling, the net accumulated tax savings, if any, arising from investment credits will be passed on to Transporter in the same manner and at the same time that Transporter could use such credits if it were filing a separate Federal income tax return. Transporter agrees to use due diligence in seeking, or causing to be sought. such a ruling from the Internal Revenue Service.

"Anything contained herein to the contrary notwithstanding, the tax accruals provided for herein shall not be increased or decreased by reason of taxable income or tax losses or other taxes arising from activities or businesses of Transporter, or the consolidated group, other than the construction and operation of, and rendition of services through, the Gulf Pacific project" (see Federal Power Commission Docket CP63-204, et al., exhibit 13).

BASIC TAX PRINCIPLES

In its letter of October 20, 1964, to the Commissioner of Internal Revenue requesting a ruling upon the contemplated allocation of Federal income tax expense in connection with the filing of a consolidated return by Tennessee Gas Transmission Co. and the members of the affiliated group, including Gulf Pacific Pipeline Co., of which Tennessee is the parent company, the basic principles to be applied were set forth as follows:

"In order that no member would be penalized as a result of joining in the consolidated return and being a party to the agreement, the parties included in the agreement the following limiting provision:

> " '2.C. (1) No member of the affiliated group shall have allocated any amounts to be paid by it, under the provisions of item (4) of subsection B of this section 2, on an accumulative basis, in excess of the amount by which such member's Federal income tax computed on a separate return basis and accumulated exceeds the portion of the group's consolidated tax liability allocated to such member in accordance with the provisions of item (1) of subsection A of this section 2 and accumulated.'

"The portion of any tax saving to which each member of the group is entitled is set forth in the following provision of the agreement.

> " '2.C. (2) Subject to the limitation contained in the foregoing item (1), the amount of the payment, if any, each member shall be entitled to receive under the provisions of item (4) of subsection B of this section 2 shall be the amount on an accumulative basis, by which the inclusion of such member in the affiliated group has resulted in decreasing the combined tax liability of such group.' " (See Federal Power Commission Docket CP63-204, et al., exhibit 785).

Where a consolidated tax return is filed with respect to subsidiaries in an affiliated group, some of which are owned in part by stockholders having no interest in the parent company or in any affiliated company, and where the mem-

bers of the affiliated group have different creditors together with common creditors whose claims on the assets of the different members vary, it is important to the creditors and especially to the minority stockholders that the increment from any joint undertaking of the members be allocated among the members on an equitable basis.

As indicated by the testimony before the Federal Power Commission, Gulf Pacific, in its arrangements with Southern California Edison Co. and the city of Los Angeles, has committed itself to pass on to such customers all of the benefits of its investment tax credit as well as any other tax benefits which it may receive from its operations of the project. (*See* Federal Power Commission Docket CP63-204, et al., testimony of William Witmer, tr. vol. 12, p. 2917-8.)

CLARIFYING AMENDMENT NEEDED

The amendment to H.R. 7502 proposed by Senators Long and Dirksen would clarify the present law so that such equitable allocation of the tax benefits to the members of the affiliated group whose operations generated such benefits could be effected. It would provide statutory recognition of agreements providing for such fair allocation of the benefits of current tax savings derived from filing a consolidated return to the members of the affiliated group whose operations contributed the deductions or credits giving rise to the tax saving.

CONCLUSION

Under the contractual arrangements between Southern California Edison Co. and Gulf Pacific, Edison would be given appropriate benefit of the investment tax credit generated by the Gulf Pacific operation and would be charged only Gulf Pacific's share of the amount of the actual tax paid. Since, under such allocation, the benefits to Edison would only relate to the tax savings generated by the Gulf Pacific project, it is the position of Southern California Edison Co. that it could not under the aforesaid contractual provisions be detrimental to any corporation in the consolidated group or to the shareholders or customers thereof.

We understand that the Treasury Department has no objection to the proposed amendment.

STATEMENT OF THE TRANSPORTATION ASSOCIATION OF AMERICA ON AMENDMENT No. 418 TO H.R. 7502

I. INTRODUCTION

For some years Congress has been utilizing Federal tax incentives as a successful stimulant to the Nation's economic growth. Today's prospering economy is a testimonial to the wisdom of Congress in not only reducing individual and corporate tax rates but also in encouraging expansion in production through the enactment of tax incentive legislation pertaining to consolidated tax returns, liberalized depreciation, and the investment tax credit.

To assure that the full effect of these tax incentives would be felt by all segments of American industry, including the massive transportation industry, the Transportation Association of America some 2 years ago adopted the following policy position:

"The purpose and intent of congressional legislation granting tax incentives to general and regulated industry for expansion and diversification should not be circumvented by any agency or instrumentality of the United States through interpretations and rulings by which the benefits of such legislation are denied or limited for regulated industries while fully enjoyed by all other industries."

The necessity of such a policy position was dictated by the actions of various Federal regulatory agencies which sought to deny stimulative effect of Federal tax incentives to the regulated transportation industry. In 1963, the TAA strongly supported the enactment of section 203(e) of the Revenue Act of 1964 which prohibited Federal regulatory agencies from denying regulated industry the tax incentive resulting from the use of the investment tax credit provisions.

There is now a real danger that the Federal regulatory agencies likewise will seek to deprive the transportation industry of the incentive effect of filing consolidated tax returns. In fact, one such agency, the Federal Power Commission, already has thwarted the incentive and continues to do so by ignoring a decision of the U.S. Court of Appeals for the 10th Circuit to the contrary in *Cities Service Gas Company* v. *F.P.C.*, 337 F. (2d) 97 (1964).

This "regulatory" approach thwarts the intended incentive of utilizing consolidated tax returns, that is, encouraging established companies to diversify and engage in new ventures. It also gives to the regulatory agency a power to regulate the nonregulated activities of a regulated transportation company—a power not conferred by Congress.

Amendment No. 418 to H.R. 7502, now pending before this committee, reaffirms the intent of Congress that all industries, regulated and nonregulated, should be benefited by the incentives resulting from the filing of consolidated tax returns. the proposed amendment contains, in essence, two parts—the regulatory provision and some tax allocation provisions. The tax allocation provisions are of a highly technical tax nature. The TAA has a policy position only upon the regulatory features of the amendment and this statement is offered in support of the enactment of that feature.

II. THE TRANSPORTATION INDUSTRY STAKE IN SUCH LEGISLATION

A. *Size and scope of the transportation industry*

Transportation is a common denominator of America's ingenious industry and commerce—the one indispensable factor present in all economic activities. And it is a foundation of our national defense.

Our domestic economic growth, productivity, and progress is dependent on whether our transportation system is strong and healthy. The American transport system must keep pace with the rest of the economy, so that economic and social progress is stimulated, not held back.

Another vital consideration is that the users of transportation in America continue to enjoy the benefits of provately owned and privately operated transport facilities—the free enterprise transport system which has helped the United States to develop the most bountiful economy in history.

Total transportation expenditures by U.S. citizens during 1964, including outlays for both private and for-hire transport, reached an estimated $127 billion, a gain of 7.2 percent over 1963. Such outlays outpaced total national output, or gross national product, which rose by 6.7 percent. Thus, transport expenditures constitute more than 20 percent of GNP. In fact, such lutlays have accounted for approximately a fifth of GNP for the last 7 years.

As further indicative of the unassilable fact that transportation is an important keystone of progress and a significant part of the U.S. economy are the following highlights:

1. Transportation is a heavy user of basic products, e.g., 62 percent of rubber, 50 percent of petroleum, 29 percent of steel, 50 percent of lead, 23 percent of aluminum, 24 percent of cement, and 19 percent of copper.
2. Transportation generates about 18 percent of all the taxes collected by the Federal Government.
3. Transportation provides 13 percent of the Nation's total civilian employment, or about 9.1 million jobs.
4. Transportation investment in privately owned and operated plant equipment and facilities—over $139 billion in 1963—represents almost 10 percent of the value of the Nation's wealth in terms of tangible assets.

Transportation is, therefore, a vital factor to every businessman in the cost of doing business, and to every citizen in the cost of living.

B. *Transportation Association of America policy position*

The Transportation Association of America is a nonprofit research and education organization made up of users (i.e., shippers), investors, and carriers of all modes which collectively devote their efforts to the development and implementation of sound national policies aimed at the creation of the strongest possible transportation system under private ownership and operation. Users comprise approximately half of the TAA membership.

The policy positions developed by TAA are studied carefully by eight permanent committees, or panels, composed of representatives from users, investors, and air transport, freight forwarder, highway, oil pipeline, railroad, and water carriers. These panels make individual recommendations to the TAA board of directors which approves final policy positions.

The TAA 115-man board of directors includes not only top executives of all carrier modes mentioned above, but also senior officials of leading banks, insurance companies, investment companies, manufacturers, suppliers, agricultural interests, and professional persons. A list of the directors is attached to this statement.

With specific reference to the subject tax incentive legislation, the TAA board of directors on October 15, 1963, voted to approve the policy position quoted in

the introduction hereof. Seven of the eight TAA panels—user, investor, air, freight forwarder, highway, pipeline, and domestic water carrier—supported the position. The railroad panel did not oppose.

III. REGULATORY TREATMENT OF CONSOLIDATED INCOME TAX ALLOCATION

Under the consolidated return provisions of the Internal Revenue Code[1] corporations which are "affiliated"; that is, corporations whose stock is 80 percent or more held by a member corporation,[2] may elect to file a consolidated income tax return rather than having each corporation file a separate return. The filing of a consolidated tax return affords the opportunity for those members of the affiliated group which had taxable income to offset their taxable income against and to the extent of the tax losses of other member companies.

Since most new businesses have tax losses in their initial years, many established companies have been encouraged to diversify and invest in new enterprises because the taxable income, and resulting Federal income tax liability, of the established company would be offset to the extent of the new company's tax losses. This has acted as a great inducement for established companies to undertake new enterprises, creating more jobs, more goods and services, and a dynamic economic environment.

Our concern is that the diversification and investment in new enterprise involving regulated companies is being and can more widely be thwarted by Federal regulatory agencies, by requiring that the tax incentives realized by such companies, derived from the contribution of losses or credits of nonregulated affiliates, be used to reduce the overall return of the regulated taxpayer. Such a regulatory policy works to the detriment of an investor who has a capital interest in both regulated and nonregulated activities vis-a-vis an investor who has placed his funds solely in nonregulated companies.

The effect of this regulatory treatment can be best understood by an example. Let's assume a desire to enter the hotel business by a nonregulated business corporation and by a regulated transport carrier, each of whom wishes to diversify its activities in this respect. The nonregulated company's risk is reduced by the fact that if the hotel business is operated at a loss in its formative years, or if it in fact fails, such operating losses may be employed to reduce its own taxes without reducing its revenues derived from existing sources. However, in the case of the regulated carrier, any tax saving it might derive (via the consolidated tax return) from the hotel operation would be treated by the regulatory agency as a reduction in its own expense and, therefore, to be reflected in reduced rates or charges for its transport services.

Thus, the corporate group which includes such a regulated carrier must sustain and absorb 100 percent of the hotel operating loss. This seriously jeopardizes the competitive position of the companies associated with a regulated company, as compared with competing companies which do not have a regulated company included in the consolidated return.

It is important that this result be completely understood. The regulated company would bear 100 percent of the loss as a result of this regulatory treatment. However, if the profit company were not a regulated one but was instead a bank, factory, or foreign trading corporation, the latter's investors would bear only 52 percent of the loss. Yet, both the regulated and nonregulated corporate enterprises took the same risks and invested the same amount of dollars.

A more drastic but very probable result may eventuate by reason of this regulatory treatment. A regulated company may refuse to take the risk of engaging in a new, nonregulated business. By the same token, a nonregulated company might forgo the risks of expanding into a regulated venture. Certainly, this is precisely the opposite result desired by Congress. Congress has not conferred the power, and we do not think that it would, to a regulatory agency for controlling the decision of a regulated company desiring to expand into a nonregulated business.

The likelihood of the Federal regulatory agencies adopting a regulatory method, the effects of which would be as discussed above, is shown by recent decisions of the Federal Power Commission. In the landmark *Cities Service Gas Company* case (30 F.P.C. 158 (1963)), a bare majority of the FPC devised a complex allocation formula, the effect of which was to deny regulated companies the incentive resulting from the filing of consolidated tax returns. That is, the FPC utilized the tax losses of nonregulated companies in calculating the tax allowance

[1] Internal Revenue Code of 1954, sec. 1501, et seq.
[2] Id. at sec. 1504(a).

includible in the cost of service of the regulated company joining in a consolidated return. The impact of the FPC's method of regulation is exactly as has been discussed above.

The FPC's action was unanimously reversed by the U.S. Court of Appeals for the Tenth Circuit. The court held that "* * * it is legally fallacious to calculate the gas company's tax allowance on the basis of the consolidated tax liability of the parent company."[3] The court reasoned that by applying the tax losses of nonregulated companies to reduce the tax profits of the regulated company the Commission had transgressed the jurisdictional lines which Congress wrote into the Natural Gas Act.

Yet, the FPC refuses to follow the principle of law enunciated by the court. We understand that the Commission presently is pursuing through litigation this same issue in *United Gas Pipe Line Co. et al.* v. *F.P.C.*, case Nos. 21872, et al., in the U.S. Court of Appeals for the Fifth Circuit. In this latest case the Commission's brief, in reference to the 10th circuit's *Cities Service* decision, states that "We believe that the decision, which fails to recognize the reasonableness of the Commission's classification of all regulated companies as a group, is unsound and, accordingly, urge this court not to follow it."

We submit, therefore, that the enactment of amendment No. 418 to H.R. 5702 would eliminate any existent doubt about congressional intent, would prevent the incipient spread of the FPC regulatory method to transport regulatory agencies, and would reaffirm the consolidated tax return provisions of the code which nowhere provide for different treatment of regulated and nonregulated companies.

IV. Conclusion

Congress, by enacting the consolidated tax return provisions of the Internal Revenue Code, created a powerful and effective force to encourage established companies to diversify and engage in new ventures. If the purpose of Congress in enacting this tax incentive is not to be thwarted, then the full effect of the stimulant to both regulated and nonregulated industries should be encouraged, and no Federal regulatory agency should be allowed to obstruct a national tax policy by substituting its judgment for that of Congress.

The likelihood of the Federal regulatory agencies adopting a regulatory method which would obstruct this national purpose, by depriving regulated companies of the tax incentives and discouraging their ability and desire to engage in new enterprises, is demonstrated by the recent actions of the Federal Power Commission. We submit that such an approach would be prejudicial to the regulated transportation industry, and that it gives a regulatory agency unintended power over nonregulated business beyond its scope of authority, and that it interferes with our national economic interests as promulgated by Congress.

In section 203(e) of the Revenue Act of 1964, Congress prohibited regulatory agencies from thwarting the intent of Congress with respect to the use of the investment tax credits generated by regulated companies. The proposed amendment is consistent with the purpose of section 203(e), since the proposed subsection also would prohibit regulatory agencies from thwarting the intent of Congress with respect to the use of consolidated tax returns by companies related to regulatory companies.

It is thus seen that the general principle contained in the proposed amendment has already been recognized by the Congress and by the judiciary. It will serve to clarify the intent of Congress in this somewhat confused area.

NATIONAL ASSOCIATION OF MANUFACTURERS,
New York, N.Y., August 30, 1965.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The National Association of Manufacturers supports the enactment of amendment No. 418 to H.R. 7502. This amendment permitting the reimbursement of tax loss affiliates by a profit company for the use of the tax losses in a consolidated return will assure equitable treatment for all industry, regulated and unregulated, and will protect the interests of minority shareholders, creditors, and consumers.

[3] *Cities Service Gas Company* v. *F.P.C.* (337 F. (2d) 97, 100 (1964)).

The present law is not clear and the passage of this amendment will not only assure equitable treatment for these groups but will also provide the certainty necessary for the effective conduct of business operations. Its enactment will be beneficial to all segments of the Nation's industry.

We urge your support of this amendment.

Respectfully yours,

GEORGE H. KITENDAUGH,
Chairman, Subcommittee on General Tax Revision, Taxation Committee.

AMERICAN FEDERATION OF LABOR AND
CONGRESS OF INDUSTRIAL ORGANIZATIONS,
Washington, D.C., September 1, 1965.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: On behalf of the AFL-CIO, I wish to express our strong opposition to amendment No. 418, introduced by Senator Dirksen August 24, 1965, as an amendment to H.R. 7502, a bill unrelated to the amendment in question.

This amendment would seriously injure the consumer public by undercutting effective regulation of public utilities. It would enable some utilities to charge their customers for taxes owed to the Federal Government. Then, within a holding company structure, these utilities could shift and reduce their Federal tax obligation. Finally, the amendment would seriously weaken the authority of Federal regulatory agencies to regulate public utilities which are part of a holding company structure.

The whole purpose of amendment No. 418 is to provide an unjustifiable tax benefit to public utilities holding companies. The effect of this amendment would be injurious to the consumer public as the result of unnecessarily high utility rates. Therefore, we urge you and your committee to reject this amendment.

Mr. Chairman, I respectfully request that this letter be included in the record of hearings on amendment No. 418. Thank you.

Sincerely yours,

ANDREW J. BIEMILLER,
Director, Department of Legislation.

STATEMENT OF JACK BEIDLER, LEGISLATIVE DIRECTOR, INDUSTRIAL UNION DEPARTMENT, AFL-CIO, NO. 418 TO H.R. 7502

My name is Jack Beidler and I am legislative director of the Industrial Union Department, AFL-CIO, with an affiliated membership in excess of 6 million.

We wish to express our firm opposition to the adoption of amendment No. 418 in any form. In taking this position we join the Federal Power Commission, the Federal Communications Commission, and the Securities Exchange Commission, among Federal agencies, and we join with our parent organization the AFL-CIO and many other consumer groups.

Amendment No. 418 would require Federal regulatory agencies to accept the decisions of corporation officials on bookkeeping transfers of funds among affiliated companies and treat such arbitrary accounting decisions as final in determining the cost of service of a regulated utility. This amendment would eliminate the present authority and responsibility of Federal regulatory agencies to allocate to each regulated utility a fair share of the actual taxes paid pursuant to a consolidated tax return of affiliated companies and substitute for this authority and responsibility the practice of allowing private corporation officials to make these decisions.

This amendment is a partial but important abrogation of the power of agencies created to protect investors and consumers from abuse or exploitation by private monopoly. Moreover, it is an invitation to an acceleration, not of economic activity, but of bookkeeping activity. It would open the door for a variation of many of the abuses by unregulated utilities and their holding company and affiliated creatures prior to 1935. It would erect a curtain between the regulatory agencies of the Government and many of the activities of corporations subject to regulation.

Enactment of the substance of Amendment No. 418 would compel consumers of essential services to pay millions of dollars in excess of the "just and reasonable" earnings under which the electric, gas, telephone, and transportation companies have enjoyed enviable prosperity and stability. The amendment would eliminate the authority of Federal regulatory agencies to insure a utility (and its customers) against unfair discrimination by other utilities. Retroactive features of this amendment would, in the words of the Federal Power Commission, "prejudice a pending court case involving $2.8 million claimed by one utility in excess of rates fixed by the Commission."

There are no available figures by which we can measure the total burden enactment of this amendment might impose on consumers. However impressive such figures might be at the moment, they would by no means enable us to estimate the costs in the years ahead when this breach in the regulatiory wall could be fully exploited. We have confidence, based on the rich history of private monopoly, that once such a breach is made, the genius of the legal and accounting professions could be harnessed to move mountains of profits and tax-free dividends into the coffers of investors. Lest investors be lured by such prospects, we hasten to add that once the regulatory process is crippled, there is no assurance that the Hopsons and the Insulls would not enjoy financial reincarnation and make investors pay as dearly as consumers.

There is no evidence in the history of regulated utilities, nor in the recent and current history of their earnings, to indicate any need for this change in regulatory rules by the Congress. On the contrary, the available evidence indicates that the earnings of many of these corporations is in excess of what is commonly accepted as a fair and reasonable rate of return. There is need for strengthening and reinvigorating regulation, not for weakening it, as in the case of amendment No. 418 or in another bill pending in the House similar to S. 218 which was rejected by the Senate Commerce Committee this year.

The relative unimportance of public ownership of utilities in this country is in large part the result of a belief on the part of a majority of the people that regulated private monopoly is tolerable if not positively more desirable than public ownership, but if in the course of time the faulty regulatory machinery we have constructed is further weakened there is reason to believe that the people may very well insist on responsible public ownership rather than be subjected to the creeping corruption and endless legislative warfare which the monopolies wage in an effort to free themselves from effective governmental regulation.

We have read the report of FPC Commissioner L. B. O'Connor, Jr., supporting the enactment of amendment No. 418, and we are swayed neither by his logic nor his apparent conviction that the regulatory process should be adulterated in the name of accelerated economic growth. We submit that enabling private monopolies to engage in unregulated—and frequently unrelated—activities is not essential to economic progress, but in fact strikes at the vigor of the whole competitive system.

We urge rejection of amendment No. 418 as inimical to the interests of both consumers and investors.

(The letter referred to on p. 122 follows:)

FEDERAL POWER COMMISSION,
Washington, D.C.

Hon. HARRY FLOOD BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This responds to the request of Senators Douglas and Long, made at the September 1, 1965, hearing on amendment No. 426 to H.R. 7502, that we comment upon the statutory language submitted by the Federal Communications Commission, at the request of Senator Dirksen. We have examined the language submitted by Acting Chairman Hyde by letter of September 1, 1965, and offer the following comments:

1. We are in complete accord with the FCC's own recommendation that lines 11–23 on page 2 of amendment 426 be deleted in their entirety. This is FCC's preferred recommendation, and it is also ours.

2. We are not able to endorse the FCC language, drafted by request, because it is limited to the problems encountered by the FCC, as Mr. Hyde makes clear, and for our purposes fails to eliminate the prospect that a noncost may be converted by a statutory fiction into a cost to be borne by consumers of natural gas and electric power. We recognize that the requested draft may seem to cover the situations encountered by the FCC to date, but these situations differ from the experience of the Federal Power Commission, as summarized below.

3. A characteristic situation in FPC experience involves a regulated pipeline company which achieves prosperity, and then ventures into business activities other than gas transmission. Commonly, the company explores for oil and gas and develops the oil and gas fields which it discovers. Commonly, also, exploration and development costs are included in the cost of service for ratemaking purposes, because the consumer is expected to receive a benefit if gas is discovered as a result of the exploration. Later when gas ventures of the pipeline company begin to prosper in significant measure, the company may transfer the activity as a corporate matter from its transmission corporation to a new oil and gas affiliate. The two companies continue to work together for practical management purposes as closely as when they were one. The management and control is the same for each company; many operations are jointly conducted by the two companies; and, of course, they file a consolidated tax return. In the case of an oil and gas affiliate, the 27½ percent statutory depletion privilege plus the intangible development cost deduction often result in net losses (i.e., tax deductions in excess of actual revenues) even though the company is prosperous by any other standard. An oil and gas producer commonly records a net loss, for tax purposes, every year, in which case it could never take advantage of the losses on a separate return basis no matter how far forward the losses are carried. The net losses for tax purpose are an economic asset to the extent that they create a tax credit. The tax credit, generated in large part by oil and gas properties which were explored for with the consumer's dollars, reduces the overall taxes in the consolidated return. The Commission believes that it should be permitted to make an appropriate allocation of the actual taxes paid after accounting for all the tax benefits, rather than to be required to impose upon the consumer constructive taxes which would have been paid if the pipeline company filed a separate return, when in fact no taxes were paid.

The pending *United Gas Pipe Line* case in the fifth circuit illustrates the pattern outlined above. There, the consolidated tax savings arose principally from the 27½ percent depletion and the IDC (intangible drilling costs) deductions available to Union Producing Co., a sister company of United Gas Pipe Line Co. Union sells 80 percent of its gas production to United. Over a 5-year period, used by the Commission to achieve a representative relationship, United and its affiliates paid $57 million to the U.S. Treasury under their consolidated returns. During this period, Union's net tax losses amounted to almost $4 million; these losses reduced the actual consolidated tax and under the Commission's method of allocation part of the savings went to reduce the rates to the customers. (It may be noted that Union is itself regulated by the Federal Power Commission on a cost-of-service basis in which the Commission treats Federal income taxes as zero, rather than subtracting a hypothetical negative tax from the cost of service.)

The proposed revision submitted by the FCC would allow the Federal Power Commission to examine the actual tax situation realistically only if a company in Union's situation is deemed to supply "services or facilities" to United. It is not clear that this language protects the consumer against paying for noncosts where Union supplies natural gas, commonly regarded as a commodity, to United. Moreover, in the practical situation of oil and gas operations the holding company management can divide up its system so that one corporation owns the gas wells supplying the pipeline while an affiliated corporation owns the oil wells discovered and those gas wells not connected to the pipeline. Under the proposed revision clearly the latter companies would be insulated from any effort to require tax savings to be shared with the regulated companies which contribute the money on account of taxes. The opportunities for holding company manipulation are numerous and a number of variations on the foregoing theme have actually been adopted by different pipeline companies. Disentangling these relationships in a manner fair to both consumers and investors constitutes a primary duty of the regulatory agency. This is a job which requires fair and flexible handling in accordance with the circumstances of each case, rather than rigid formulas spelled out either by statute or by a consolidated return agreement between affiliated companies.

4. Those natural gas pipeline companies which are part of a holding company group in fact conduct many activities, not just the filing of their income tax returns, on a consolidated basis. Thus, in the case of United Gas Pipeline Co. referred to above, a single accounting department serves United and all of its affiliates, both regulated and unregulated. In rate cases, the Commission insures that the costs of the accounting department are allocated fairly among all the companies. No contention has ever been made that the Commission should allow a hypothetical cost to the regulated companies based upon the greater expense they would have incurred for a separate accounting department. The

economies achieved by joint operations of affiliated companies are a fact of business life. The real problem, recognized by the agencies and the regulated companies alike, is how to allocate fairly the joint costs actually incurred.

Similarly, a well which produces both oil and gas has lower costs than if two wells were drilled, one for the oil alone and the other for the gas. Nonetheless, when the Commission regulates gas prices, it does not allow the hypothetical cost of producing gas in the absence of any oil. Instead, it allocates the savings of joint operations between the gas consumer and the nonjurisdictional oil business. *Phillips Petroleum Company*, 24 FPC 537; *Area Rate Proceeding* (*Permian Basin area*), 34 FPC —.

The Commission believes that the revision proposed is unduly restrictive in its approach to tax allowances, since it requires the agencies to allow hypothetical taxes, a noncost, as if they were a cost of doing business in those cases where the so-called tax losses arise from an affiliated company so structured as not to supply "services or facilities to the regulated" company.

5. While the proviso added by the proposed revision appears intended to deal with the problem of the interest deduction, it does not clearly achieve that objective. The proviso would reserve the authority of a Federal agency to adjust the amounts of transfers and receipts among affiliates only "to the extent that such amounts are affected by the capital structure of such regulated member." The vagueness of the quoted language makes it impossible to say what its bearing would be on the interest deduction problem.

6. The FCC provision does not meet the administrative problems credited by the intricate intertwining of a tax statute, administered by the Treasury Department, with regulatory statutes, administered by the independent regulatory agencies. The revision, like the original amendment, allows the Treasury Department to influence (or control) the result of a particular case before one of the agencies by promulgating new regulations from time to time. The Commission is of the unanimous opinion tha this is a fundamentally unsound administrative arrangement.

7. The Commission believes that the proposed revision, like the original version, would encourage regulated companies to turn from their public service responsibilities to risky unregulated ventures, on the strength of the right to retain all the tax savings under a consolidated return. The diversion of executive and financial resources of regulated utilities to such ventures is not in the interest of the public which depends upon the public service operations of the company when they are denied any share of the tax savings arising from consolidation.

For the foregoing reasons the Commission recommends that amendment No. 426 not be enacted either in its present form or with the changes in the draft prepared by the FCC. Commissioner O'Connor does not join in this comment, except for paragraph 6, but adheres to his earlier views.

Sincerely,

JOSEPH C. SWIDLER, *Chairman.*

(Whereupon, at 4:50 p.m., the committee was adjourned.)