In the

Supreme Court of the United States

FEDERAL POWER COMMISSION, Petitioner, v. MEMPHIS LIGHT, GAS AND WATER DIVISION, Respondent.	No. 72-486
TEXAS GAS TRANSMISSION CORPORATION, Petitioner, v. MEMPHIS LIGHT, GAS AND WATER DIVISION, Respondent.	No. 72-488

Washington, D. C.
March 27, 1973

Pages 1 thru 48

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Washington, D. C.,

Tuesday, March 27, 1973.

The above-entitled matters came on for argument at 10:08 o'clock, a.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM O. DOUGLAS, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice
LEWIS F. POWELL, JR., Associate Justice
WILLIAM H. REHNQUIST, Associate Justice

APPEARANCES:

SAMUEL HUNTINGTON, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D. C. 20530; for the Federal Power Commission.

CHRISTOPHER T. BOLAND, ESQ., Gallagher, Connor and Boland, 821 Fifteenth Street, N. W., Washington, D. C. 20005; for the Texas Gas Transmission Corporation.

GEORGE E. MORROW, ESQ., Union Planters National Bank Building, Memphis, Tennessee 38103; for the Memphis Light, Gas and Water Division.

RICHARD A. SOLOMON, ESQ., Wilner & Scheiner, 2021 L Street, N. W., Washington, D. C. 20036; for the Public Service Commission of New York.

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C O N T E N T S

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P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear arguments first this morning in 72-486 and 486, Federal Power against Memphis Light, and Texas Gas Transmission against Memphis Light; consolidated.

Mr. Huntington, you may proceed whenever you're ready.

ORAL ARGUMENT OF SAMUEL HUNTINGTON, ESQ.,

ON BEHALF OF THE FEDERAL POWER COMMISSION

MR. HUNTINGTON: Mr. Chief Justice, and may it please the Court:

These consolidated cases are here on writs of certiorari to the United States Court of Appeals for the District of Columbia Circuit.

The basic question presented is whether the Federal Power Commission is barred by Section 441 of the Tax Reform Act of 1969 from permitting a company, subject to its jurisdiction, to cease flowing through to the company's customers in the form of lower rates. The benefits derived from the use of accelerated depreciation on certain property. If the Tax Reform Act does not bar such action, the question arises whether the Commission's action in this case was proper.

Before I discuss the facts of this case, some introduction is appropriate.

It has long been established that federal income taxes are includable as an expense under the cost-of-service method used by the Federal Power Commission in ratemaking.

Accelerated tax depreciation was first authorized in 1954 with the adoption of Section 167 of the Internal Revenue Code. Under accelerated tax depreciation, deductions for a particular asset are relatively high in its early years and relatively low in its later years, compared to what they would have been had straight-line tax depreciation been used.

When the matter first came before the Commission in a ratemaking context, the Commission determined that the use of accelerated tax depreciation simply resulted in a tax deferral. Accordingly, the Commission decided that for ratemaking purposes a company's taxes should be normalized. That --

QUESTION: Mr. Huntington, you're talking historically, not about this particular proceeding?

MR. HUNTINGTON: That's right; historically. This is back in 1956 or so.

The Commission decided that for ratemaking purposes the taxes should be normalized. And by normalized, it means that they should be calculated as if the company had used straight-line tax depreciation.

The difference between the taxes actually paid and the higher normalized taxes claimed as a cost of service

was required to be placed in a special tax reserve account for the payment of future taxes.

Now, several years later, the Commission, in the Alabama-Tennessee case, reconsidered the matter. It concluded there that the use of accelerated tax depreciation resulted in a permanent tax savings.

This conclusion was squarely based on the Commission's finding that the natural gas industry would continue to expand rapidly for the foreseeable future. An assumption which is certainly not true today.

The Commission noted that when an expanding company uses accelerated tax depreciation, sufficient tax depreciation deducations on new property are available to offset declining tax depreciation deductions on old property.

The Commission thus ordered natural gas companies, using accelerated depreciation for tax purposes, to also use accelerated tax depreciation for ratemaking purposes. In this way the benefits of accelerated tax depreciation would be flowed through to the company's customers.

It's important to note that both the Commission's normalization order and its flow-through order were upheld by various Courts of Appeals as being within the Commission's discretion.

Other regulatory agencies are sharply divided on this issue. In short, the matter is a technical one, it turns in

large part on an analysis of particular facts pertaining to given industries, and is precisely the type of question which falls within the broad discretion that regulatory agencies have over ratemaking.

This brings us to Section 441 of the Tax Reform Act of 1969.

As the legislative history of the Act makes clear, Congress was concerned with the loss of revenues to the government resulting from the use of accelerated tax depreciation by public utilities.

Rather than prohibit the use of accelerate tax depreciation altogether, Congress chose simply to bar future shifts to faster methods of depreciation.

With respect to existing or pre-1970 property, the statute permits the use of,one,straight-line tax depreciation, two, accelerated depreciation with normalization if the utility had been using accelerated depreciation when the Act was passed, and, three, accelerated depreciation with flow-through if the company had been using flow-through when the Act was passed.

QUESTION: May I ask you a question: Does the record of the -- does the legislative history show why Congress' concern was limited to the impact of accelerated depreciation only with respect to public utilities?

MR. HUNTINGTON: No, it doesn't. Not that I'm aware

of. They did focus on the practice -- well, there's a double revenue loss when --

QUESTION: Well, that's the point.

MR. HUNTINGTON: Accelerated tax depreciation is flowed through --

QUESTION: Well now, that's what I want.

MR. HUNTINGTON: There's first the loss resulting from the increased --

QUESTION: The tax revenue.

MR. HUNTINGTON: -- deductions.

QUESTION: Because of the higher deductions and --

MR. HUNTINGTON: And then secondly there's --

QUESTION: -- a lower tax revenue.

MR. HUNTINGTON: -- lower rates due to the flow-through which means that there's less revenues to be taxed by the -- the utilities have less revenues coming in to be taxed. Because the benefits are passed on in lower rates.

QUESTION: I see. So there's, first of all, a -- I see, I think.

But lower rates to the consumer?

MR. HUNTINGTON: Lower rates to the consumer.

Now, similar rules apply to new or post-1969 property, but with respect to new property, which expands a company's capacity, an additional rule was adopted. Under Section 167(l)(4)(A) of the Code, regulated companies on

flow-through were given the right to elect not to have flow-through apply to their expansion property. As the legislative history of the statute indicates, the effect of this provision is to permit companies making the election to use straight-line tax depreciation without having to obtain the approval of the regulatory authority.

In an order upheld by the court below and not an issue here, the Federal Power Commission announced that as a general policy it would permit companies making the election to use normalization on their expansion property.

I come now to this case. After the Tax Reform Act was enacted, Texas Gas Transmission Corporation, a petitioner here, indicated to the Commission, in a pending rate proceeding, that it would make the election not to use flow-through on its expansion property.

The company sought the Commission's permission to use --

QUESTION: What was it going to use?

MR. HUNTINGTON: Well, it said that it would use -- it sought permission to use normalization on the expansion property as well as on its existing property. It said that if --

QUESTION: And did the Commission --

MR. HUNTINGTON: -- if the Commission did not give it permission to use normalization, it would use straight-

line --

QUESTION: Straight-line.

MR. HUNTINGTON: -- depreciation on its expansion property.

The Commission granted the permission, both with respect to expansion property and existent property. The Commission found that once Texas Gas had switched to normalization on its expansion property, tax depreciation on that property would no longer be available to offset declining tax depreciation on existing and replacement property.

The reason it would no longer be available is that under normalization, benefits from the use of accelerated depreciation on expansion property are placed in a deferred tax reserve account, and may only be used to pay future taxes on the expansion property.

The deferred tax reserve is the very essence of normalization, and is part of the statutory definition of normalization in the Tax Reform Act. That's Section 167(l)(3)(G), the definition section of the Act.

With expansion property out of the picture, the Commission concluded that the use of accelerated tax depreciation on existing and replacement property would no longer result in a permanent tax savings.

Under these circumstances, the Commission held that the use of normalization on all of the property of Texas Gas

would lead to more stable tax costs for ratemaking purposes and would be in the public interest.

The Court of Appeals did not reach the ultimate merits of the Commission's order, but held that Section 441 of the Tax Reform Act foreclosed the Commission from permitting switches from flow-through to normalization.

It is to that issue I will now turn.

There is nothing on the face of Section 441 which suggests that regulatory agencies may not permit shifts from flow-through to normalization. As I have noted, the statute merely list the permissible methods of tax depreciation in such a way as to bar shifts from slower to faster methods of depreciation.

Under the literal terms of the statute, companies on flow-through qualify for all three methods of depreciation; that is, straight-line depreciation, accelerated depreciation with normalization, and accelerated depreciation with flow-through.

The election provision simply gives the company the right to elect not to use flow-through on expansion property.

The legislative history of the statute confirms that the statute does not bar shifts from flow-through to normalization with appropriate regulatory agency approval.

The House Report on the initial version, which did not include the election provision, the House Report describes

the effect of the bill in three general rules, the House Report describes the three general rules.

The third rule in the House Report is that if flow-through is being used the taxpayer must continue to use flow-through, quote, "unless the appropriate regulatory agency permits a change as to that property."

Respondents argue vigorously that this third general rule referred to in the House Report was displaced by the election provision. The election provision was first added by the Senate to apply to all property, and later restricted in conference to apply only to expansion property.

It is our submission that the election provision does not affect a regulatory agency's authority to permit companies to abandon flow-through.

All the election provision does is to give utilities the absolute right, without having to go to the agency first, to get off flow-through.

This was not provided in the House bill. The only way an agency could get off flow-through under the House bill was to get the regulatory agency's approval.

Now, we have quoted the relevant excerpts of the Senate Report and the Conference Report in our brief, at pages 23 to 25, and we submit that a reading of those reports clearly supports our position.

In fact, respondents studiously avoid a direct

confrontation with the pertinent provisions of these two reports which we submit are very pertinent indeed.

Respondents also vigorously argue that certain language in the House and Senate Reports to the effect that the legislation would freeze existing depreciation practices supports their construction of the statute.

The House Report, for example, noted that a requirement that all regulated companies revert immediately to straight-line depreciation would place some regulated companies at a competitive disadvantage, and would result in widespread rate increases.

Accordingly, the House Committee had determined, quote, "in general to freeze the current situation regarding methods of depreciation."

The short answer to respondents' contention on this freeze language is that the freeze language appeared first in the House Report, and was largely copied by the Senate.

But the House Bill, as everyone acknowledges, had three general rules, so the freeze was obviously subject to the three general rules. And, as I have noted, the third rule explicitly acknowledges that the legislation permits the abandonment of flow-through with the approval of the appropriate regulatory authority.

MR. CHIEF JUSTICE BURGER: Thank you, Mr. Huntington.

Mr. Boland.

ORAL ARGUMENT OF CHRISTOPHER T. BOLAND, ESQ.,

ON BEHALF OF TEXAS GAS COMMISSION CORPORATION

MR. BOLAND: Mr. Chief Justice, and may it please the Court:

The fundamental error in the court below in this case has to do with whether or not the election which was provided by the Senate was in addition to the third rule of the House of Representatives or whether it was in substitution.

A careful reading of the opinion below and on rehearing will show that this is where the court fell in what we claim to be error.

The position of the respondents in this case is that it's a substitution; they're supporting the court below. Our position is that it's clearly an additional method provided to the taxpayer.

We think that's shown very clearly in the Senate Report. In this connection we've set forth the entire legislative history with respect to Section 441 of the Tax Reform --

QUESTION: What was Congress' concern that stimulated this whole change?

MR. BOLAND: It isn't expressed in terms, but it's our feeling that Congress had some concern as to whether the regulatory agencies would permit a change within the discretion of the agency, would permit a shift.

QUESTION: Well, why did Congress feel that the existing situation, as administered by the agency, needed some statutory revision?

MR. BOLAND: Well, this is clearly established in the reports of both houses, You Honor; that they were concerned about the gradual shift and trend to flow-through by companies that were not on flow-through, the biggest of which was the telephone company. They were on straight-line depreciation, and the Federal Communications Commission was threatening to impute flow-through for regulatory purposes, and the tax consequence of such an Act would be staggering. They were really concerned about the loss of tax revenues and in the report it shows that they had not intended, really, in passing the provisions of liberalized depreciation in the 1954 Code, to have had these benefits passed on to the consumer.

It was intended to give the utilities working capital in order to invest in new plants.

QUESTION: Well, why then wouldn't Congress have simply forced everyone off flow-through for old as well as new property?

MR. BOLAND: Well, this suggestion was made, Your Honor, by the then Chairman of the Federal Power Commission, Chairman White. And in the report it shows that the Congress is turning that down because of the objection of several of the agencies where competitive situations would put the

utility at a competitive disadvantage. They were also concerned about the fact that this would be mandatory, and would create widespread rate increases.

QUESTION: Well, if existing properties were suddenly put on straight-line or normalization, there would necessarily be rate increases, I suppose?

MR. BOLAND: Yes, Your Honor.

QUESTION: Then, you think this is what was on Congress' mind?

MR. BOLAND: Oh, I think the reports clearly establish that. They make it pretty clear that they were concerned, and --

QUESTION: But they weren't concerned enough to do anything but give the -- but give an option?

MR. BOLAND: Well, they had a dilemma, so to speak. On the one hand, they were --

QUESTION: Well, I know, but an agency that had been requiring or looking towards flow-through, what would they do about existing properties?

MR. BOLAND: Well, they were leaving it to the discretion of the regulatory agencies individually.

QUESTION: Well, under the views of the regulatory agencies, they were pretty clear, weren't they?

MR. BOLAND: Well, no, Your Honor, the --

QUESTION: Why not?

MR. BOLAND: Some of them were, the Federal Power Commission's position --

QUESTION: Yes.

MR. BOLAND: -- was fairly clear.

QUESTION: And that's this case.

MR. BOLAND: That's this case. But the legislative history shows that the State Commissions were about equally divided between flow-through and normalization. And that circumstances might change.

For example, here we're confronted in the natural gas industry, as this Court knows full well, that we've got a gas shortage, you just had the Louisiana Power and Light case here. And this is one of the fundamental premises that the Commission had when they originally directed flow-through in the Alabama-Tennessee case. They anticipated the continued expansion of the gas industry, and with recognition that gas reserves were here to last beyond the year 2000. Well, here we are short, in 1973.

And the very premise that the Federal Power Commission had anticipated has fallen by the wayside.

Yet, under the decision of the court below we would be forever barred from changing from flow-through, notwithstanding the change in the fundamental principle and concept, the basic premise of the Federal Power Commission.

But it is clearly shown that the suggestion had been

made to make it mandatory, that no utility could use liberalized depreciation from this point forward.

And they turned that down because of what it might do competitively.

QUESTION: And the rates.

MR. BOLAND: And the widespread rate increase. It would be automatic, all utilities involved would have to increase their rates.

Now, there might be some unique situations, like Texas Gas, where Texas Gas had a rate increase on file, where we had requested within the discretion of the Federal Power Commission to go to straight-line depreciation. The tax consequence, the rate level to the consumer is exactly the same as normalization. As a matter of fact, under the Commission's decision it's a little lower, because they deduct the reserve from your rate base, so you do get a lower rate.

QUESTION: Section 441 doesn't by its terms address itself to the utility rate base, does it?

MR. BOLAND: No, not -- except in one respect. They do make a comment that they do not intend to preclude the agency's discretion from deducting the reserve under normalization from the rate base.

QUESTION: Well, does the rate base question necessarily go the same way that tax liability question goes, then?

MR. BOLAND: No. In the strict sense, the rate base is the plant invested in utility, whereas here we're talking about an item of cost of service and expense, which is part of cost of service. That tax expense is included in the cost of service.

The only item in cost of service that directly relates to rate base is return. I suppose depreciation, book depreciation also relates to rate base. But other than that, you've got operating and maintenance expenses, you've got federal income taxes, state taxes, ad valorem taxes, which goes to the totality of your cost of service upon which your rates are based.

But if you were to turn to page 82 and 83 of our main brief, where we've set the legislative history of this entire Act here, and if you'll look at the lower portion of page 82, this is the key to the whole decision of the court below.

Both the House Bill and the committee -- this is the Senate Report; --

QUESTION: From what page are you reading?

MR. BOLAND: I'm reading from page 82 of our main brief, the white brief, which is part of our Appendix. And at the bottom, the last paragraph on the bottom. This is the Senate Report.

The Senate Report is here making clear"both the

House bill and the committee amendments" -- that is the Senate Committee amendment that they're sponsoring -- "provide that in the case of existing property the following rules are to apply:" "The following rules are to apply."

The third rule is shown on page 83: "If the taxpayer is taking accelerated depreciation and flowing through to its customers the benefits of the deferred taxes, then the taxpayer would continue to do so" paren "(except as provided under the committee amendments which are discussed below)" close paren, "unless the appropriate regulatory agency permits a change as to that property."

QUESTION: Was this addressed to the bill at the time?

MR. BOLAND: Yes.

What the respondents would do, Your Honor, is have us just write that out of the report, they ignore it. They attempt to make no explanation as to what happened to that language. Here is firm, clear language. The Senate is saying -- and this is identical, except for the parenthetical, to the third rule in the House, as to which the court below said that if the House bill had been passed the Commission in Texas Gas would have been clearly justified in doing what was done.

But here in the Senate Report is precisely the same provision, and they dissent from it, they disregard it as though it isn't there. And somehow the election that was

provided by the Senate is supposed to expunge this from the report. But we don't see it expunged, it's right there in black and white.

Now, the parenthetical; you might ask, "What is the parenthetical referring to?" The parenthetical refers to the fact, as you will see if you follow on page 84, they are referring to the one principal difference. "The committee amendments, while in most respects the same as the House provisions, differ in one principal area. The amendments permit an election to be made within 180 days."

So, it seems to be perfectly obvious that when it came out of the House the third rule was there, they all agree with the third rule. The court below said, had that been the law we would have been home free.

QUESTION: Do you need the consent of the Commission to do that?

MR. BOLAND: Oh, yes, under the third rule you need the consent of the Commission.

QUESTION: I know, but not under that language.

MR. BOLAND: Oh, yes, sir. Yes, sir.

Are you --

QUESTION: Well, not on the language you read me.

MR. BOLAND: Are you on page 83?

QUESTION: I'm on page 82.

MR. BOLAND: 82? Well, if you go over to 83, the

third rule is at the top of the page on 83, it's right opposite 173.

QUESTION: Yes.

MR. BOLAND: Now, if you'd look at the last part of that, it says "unless the appropriate regulatory agency permits a change as to that property."

In other words, somebody who is on flow-through, like Texas Gas was, that we would continue on flow-through under the third rule "unless the appropriate regulatory agency permits a change as to that property."

And that's exactly what's happened here. The Federal Power Commission has permitted a change. And this is precisely the same language as in the House, again, and I re-emphasize that in the -- the court below said that under the House language this rule would have --

QUESTION: Well, where is the language that requires the Commission to give its consent?

MR. BOLAND: At the tail end of the third rule on page 83. It says "unless the appropriate regulatory agency permits a change as to that property."

QUESTION: But it wasn't required to give its permission, the Commission?

MR. BOLAND: Oh, no. No, it was not required.

QUESTION: Yes.

MR. BOLAND: But this is the discretion, this is the

-- the whole argument before this Court is: did the election submerge, obliterate the discretion which the Federal Power Commission had theretofore clearly had under all the court decisions to decide what method of tax depreciation should be used for cost of services in rates.

And we say that under this language in the Senate Report, that the House version survived the election, it's a separate thing, it's not an absolute right as the election is, it needs the permission of the Commission; it was granted in this case, and, we submit, properly so.

My time is up. Thank you.

MR. CHIEF JUSTICE BURGER: Thank you, Mr. Boland.

Mr. Morrow.

ORAL ARGUMENT OF GEORGE E. MORROW, ESQ.,
ON BEHALF OF MEMPHIS LIGHT, GAS AND WATER
DIVISION

MR. MORROW: Mr. Chief Justice, and may it please the Court:

I agree with the counsel for the government, Mr. Huntington, that the issues in this case arise primarily under the Tax Reform Act of 1969.

The question -- the Commission has found that that Act required one result; the Court of Appeals has found that the Act required another result. Really, the question in this case is: Which of those two results is in conformity with the

purpose and intent of Congress in enacting the Tax Reform Act of 1969?

Specifically, was it the intent and purpose of Congress, in enacting that Act, to bring about a drastic and immediate change in the depreciation practices of most of the utilities in this country, a change which would result in prompt, substantial, widespread rate increases?

The Court of Appeals, the result reached by the Court of Appeals is that this was not the intent of Congress. The result of the Court of Appeals allows the utilities to take normalized depreciation with respect to their expansion property, but it leaves the rest of the property exactly the way it was before, with the same tax practices in effect as before.

This is precisely what Congress intended. You can see that from the face of the Act, and even more clearly it appears in the legislative history of the Act.

First, the Act itself specifically provides, as counsel has pointed out, for the election with respect to post-1969 expansion property.

But let me pause right here to point out that the Act very narrowly defines post-1969 expansion property. It is only that property acquired after 1969 which does not replace existing property; and which increases the operating or productive capacity of the utility.

Now, in the case of the pipeline industry, that means that this expansion property, starting at flat zero in 1970, will grow and, because of the gas shortage which was mentioned by counsel, this expansion property will probably grow very slowly. So the election with respect to expansion property will have very little practical tax effect or rate effect for a long time in the future.

Yet that's what's been latched on by the Commission as a very stubby tail to wag a very large dog.

The Tax Act also expressly provides for the retention of flow-through depreciation with respect to property to companies that had been using it in the past.

It twice, with respect to pre-1969 and with respect -- I mean pre-1970 and post-1969 properties, specifically provides that companies that have been flowing through may continue to flow through.

The Court of Appeals reached exactly the same result.

Now, the legislative history makes it clear that this was all that Congress intended to do. This and nothing else.

I think -- I'm agreed with my brothers on the other side concerning the reason for the passage of this Act. The utility commissions over the country had been trending toward flow-through, requiring their utilities to go to flow-through,

because this was the way that you minimized utility rates.

You made the companies pay -- charge their rates on the same basis that they paid their taxes; you didn't give them any fictitious tax in there, like normalization does.

The only thing wrong with this, from the Treasury's point of view, was that, as Mr. Huntington said, it also reduces the taxes paid by the companies. And the committee had found that it would soon result in a loss of a billion dollars and a half to maybe two billion dollars to the Federal Treasury.

What to do about that loss? The solutions proposed to the House was to freeze current tax situations, current depreciation practices right where they were. The trend was toward flow-through, freeze them. Stop it right there. And that was all they proposed to do. They did not propose to reverse the river, but just to freeze it right where it was.

QUESTION: About the language on page 83, that your friend was discussing a bit ago, "If the taxpayer is taking accelerated depreciation and flowing through . . . then the taxpayer would continue to do so . . . unless the FPC" --

MR. MORROW: "-- permits a change as to that property." Or it says "the appropriate regulatory agency".

Your Honor, there might be some circumstances under which a regulatory agency should take a utility off of flow-through and put it onto some other kind of depreciation.

Flow-through depreciation works, the principle works when a utility is in an expanding or stable condition, you see. As long as its plant is expanding or stable, the flow-through proposition works.

If a plant were winding down, then it would be appropriate for the regulatory commission to take it off flow-through.

So there are circumstances in which a regulatory commission should do that.

QUESTION: Well, isn't that exactly what this tells us? Did you seem to suggest some doubt about what regulatory agency it would be?

MR. MORROW: Well, I'm just saying that this applies not only to the Federal Power Commission, but it applies to all the regulatory agencies.

QUESTION: I see. But there's no doubt that it only means Federal Power in this case?

MR. MORROW: Oh, yes, sir. Yes, sir. It includes that.

But the Federal Power Commission, and the Court of Appeals recognized that there might be circumstances under which a change from flow-through would be justified. And I think that's all that the -- that this reference has to do with it.

As a matter of fact, on the face of the Act itself,

there is no such provision about a regulatory agency permitting the change. You don't find that in the Act. That's just a comment on the part of the people who were working on the Act. And --

QUESTION: But any change to flow-through would, of course, be beneficial from the point of view of Congress' concern at the time of the 1969 Act, because it would serve to increase taxes.

MR. MORROW: But -- yes, Your Honor.

QUESTION: Because it would be a change either to normalization or to straight-line.

MR. MORROW: But, Your Honor, Congress had two concerns, of equal value to it, at that time. One of the concerns was that we stop the trend to flow-through.

QUESTION: Right.

MR. MORROW: The other concern was that we do it without creating widespread, prompt, substantial rate -- utility rate increases.

Now, this --

QUESTION: But your position is that the Commission had no power to let this -- to permit a change?

MR. MORROW: We believe that it had no discretion to do what it did in this case, Your Honor.

QUESTION: Yes. And that rule (3) seems to say that it does have discretion. So you --

MR. MORROW: Not under the circumstances of this case.

QUESTION: So you must say, then, that this piece of legislative history just must be disregarded in terms of the plain language of the Act?

MR. MORROW: No, Your Honor, I don't say that. I say that that piece of legislative history has its place under a proper fact situation --

QUESTION: Well, then, --

MR. MORROW: -- but this is not a fact situation.

QUESTION: -- then are we just here reviewing the discretion of the Commission? I thought it was the power --

MR. MORROW: No, Your Honor, --

QUESTION: I thought it was a power question.

MR. MORROW: We -- under the circumstances of this case, the Commission had no discretion to do what it did.

QUESTION: But the Court of Appeals opinion wasn't phrased in terms of a review of discretion at all, as I read it. It simply said categorically the Commission couldn't do this.

MR. MORROW: Yes, Your Honor.

QUESTION: Now it seems to me you're taking a little different tack.

MR. MORROW: And it said so on two bases: first, on its reading of the Act itself; and, secondly, on the proposi-

tion that the Federal Power Commission has an absolute legal duty to allow in cost-of-service nothing more than actual taxes, the real tax expense.

And this, we say, is the principle that was violated by the Federal Power Commission in this case; and that's why the Commission is wrong.

QUESTION: And so that -- for the same reason Rule (3) is wrong?

MR. MORROW: Your Honor, I'm not saying that Rule (3) is -- of course it's not wrong; it's the law.

QUESTION: Or to put it another way: doesn't Rule (3) fly in the face of what you have just said?

MR. MORROW: No, sir.

Thank you, Mr. Justice Stewart, it doesn't. Because there are circumstances under which it might be proper for a utility commission to move a company off of flow-through, and then --

QUESTION: Again then, we are here just reviewing the decision of the Commission as to whether the circumstances are proper in this case?

MR. MORROW: Your Honor, --

QUESTION: Is that what the issue is here?

MR. MORROW: I believe that under the circumstances of this case, --

QUESTION: Perhaps you better tell us what the

Commission wanted to do in this case.

MR. MORROW: All right. Here's what the Commission -- well, all right.

What the Commission wants to do in this case -- and may I say something before I get to that? I definitely want to get to that.

But, you see, in the course of the legislation, the passage of the legislation through Congress, first, Chairman White of the Commission came up to Congress and said, "We'd like to have everything just put on straight-line depreciation."

The Congress turned down that request, for the reason that, in addition to the one mentioned by Mr. Boland, for the reason that, to put everybody on straight-line would result in prompt, substantial, widespread utility rate increases.

And Congress did not want prompt rate increases to come into effect, and so they turned him down.

Now, Mr. Justice White, if the Commission should win this case, under the Commission's decision in this case we reachalmost exactly the same situation that we would have reached under Chairman White's suggestion.

The utilities would charge their rates on the basis of straight-line depreciation, but pay their taxes on the basis of accelerated depreciation. And for rate purposes,

you would in effect have straight-line depreciation. It's not quite the same, but it's almost the same.

And this is what Chairman White suggested, and this is what they turned down.

Now, when they did that, they thought that they had accomplished their purpose without putting any rate into -- any law into effect which would cause rate increases in the utilities.

They said that the bill would forestall the revenue loss which the continuation of existing trends would make almost inevitable, and that it would do so, quote, "in a way which, with very few exceptions, will require no increase in utility rates because of the tax loss."

QUESTION: Well, isn't it one thing to say that the Tax Reform Act wasn't going to cause rate increases, and another thing to say that by its terms it prohibited Commission action which might have permitted rate increases?

MR. MORROW: Your Honor, I believe that it was the intent of Congress to accomplish the freeze and to accomplish it in such a way as to avoid rate increases.

I believe that the action of the Commission, not only unfreezes but it drastically revolutionizes utility practices, and does so in a way which causes rate increases.

In other words, the result reached by the Commission is precisely the opposite of the result which Congress sought.

Now, let me point this out: When the bill got into the Senate, someone in the Senate suggested, Let's give the pipelines or the utilities the power or election to change to, away from, to abolish flow-through depreciation with respect to all of their properties.

Abolish flow-through with respect to all the properties.

Now, if that had happened, you would have almost exactly the same situation that you have under the Act as it was passed -- I mean under the Act as it was construed by the Commission.

The Commission said this little election with respect to expansion property puts us in a position where, for all practical purposes, we've got to allow the pipeline to go on and normalize as to all its properties; we have no alternative.

That's the Commission's position in this case. We are forced into it by the practicalities of the situation.

So what the Commission is saying, that an election with respect to the expansion properties is tantamount, for all practical purposes, to an election with respect to all properties. This is precisely what the Senate proposed to put in the Act and which the Congress turned down.

So, twice this matter was considered. Twice, the Congress turned it down; the Commission has now reached the

very result which Congress turned down.

Let me address myself to the reason why I think that the Commission does not have the discretion to do what it did.

First, --

QUESTION: That gets us back, then, to the discussion of discretion and not power.

MR. MORROW: Well, --

QUESTION: Or are you -- did you misspeak yourself?

MR. MORROW: No -- all right, let's talk about --

QUESTION: -- on the legislation.

MR. MORROW: -- the Commission. In terms of the Commission's power.

The Commission is under the duty, as the court below said, to allow a tax cost in the cost of service which is no greater than actual taxes. The court said, There is nothing in the Tax Reform act of 1969 which modifies the Commission's duty under the Natural Gas Act to require regulated utilities companies, such as Texas Gas, to set rates which reflect actual expenditures with respect to such property. "To set rates which reflect actual expenditures."

Now, the Commission does not have discretion, then, to grant a utility a tax allowance in its cost of service, it doesn't have power to grant a utility a cost of -- an allowance in its cost of service for taxes which are not paid.

In other words, it does not have power to treat as a

cost something which in fact is not a cost.

QUESTION: That depends not at all on Section 441, to that part of your argument.

MR. MORROW: That's right, Your Honor. That is the law under the Natural Gas Act, as the Court of Appeals held. And as this Court held in United Gas Pipe Line vs. FPC, which was a tax case. And which Mr. Justice White is familiar with.

In that case the Court said that the Commission had the power and the duty to limit the cost of service to real expenses.

Now, in this case, Texas Gas' normalization on its little tag of expansion property is not going to increase its depreciation -- not going to decrease its depreciation by one dime. Now or ever. It's not going to increase its income taxes with respect to depreciation by one dime, now or ever.

The only effect that it will have will have will be to put more money in Texas Gas' pockets.

Texas Gas gets to charge a higher rate, because of normalization with respect to this little piece of expansion property, and it gets to pocket the difference.

And the Commission is in the position of saying that because Texas Gas gets increased revenues, with respect to its expansion property, therefore, in order to keep it even, in order to keep it whole, it's got to get increased revenues on a large scale with respect to its $600 million worth of

depreciable rate base.

There is no increase in Texas Gas' taxes as a result of its going to normalized depreciation on its expansion property.

Therefore, we say that the Commission had no power to give it an additional return or an additional amount in its cost of service to do this.

We say that if we do, that if you do you have accomplished precisely what Congress was attempting to avoid. Congress said, Let's freeze the situation and avoid tax rate increases; the effect of the Commission's decision is to unfreeze the situation and drastically change tax practices and do so at the cost of hundreds of millions of dollars of utility rate increases throughout the United States.

QUESTION: In your response to Justice White, then, just what did you have in mind when you said that under some circumstances they would have discretion, the Commission would have discretion?

MR. MORROW: Your Honor, this is just an illustration. The whole concept, as I'm sure Your Honor knows, because you were on the Panhandle case and the City of Chicago case, the whole concept of normalized depreciation is that it works when the company is in an expanding condition, or its depreciable base is at least stable. Then the principle of flow-through depreciation, where your new properties coming

in offset your old properties which are declining in value, that principle works.

It would not work with a pipeline which, because of the gas shortage or whatever, was winding down its activities. And therefore if a corporation -- if a tax -- if a utility, or particularly a pipeline, were caught in a winding-down condition, where its depreciable property was actually decreasing, then this would not be applicable.

But let me point out that there is not one shred of evidence in this case, not a shred of evidence that Texas Gas' property is going to be, is going to wind down or decrease.

As a matter of fact, there is -- the question of normalization was never even considered in the trial of this case. Texas Gas didn't ask for it, when it filed its return; nobody put in any evidence on it; there is not a shred of evidence in this case about the effects of normalization on Texas Gas.

So we say that what the Commission has done is to -- Your Honor, I thought I was going to be given a light; have I overstepped my colleague's --

QUESTION: You were given a red light at this minute.

MR. MORROW: I was going to be given a white light, and I didn't --

QUESTION: Oh.

MR. MORROW: -- see it. I hope I haven't over-

stepped my colleague's time, because I was to leave --

MR. CHIEF JUSTICE BURGER: You have not, he has ten minutes remaining. But if you have something important, we'll be flexible about this and enlarge your friend's time accordingly, if he needs it.

MR. MORROW: Thank you, Your Honor.

I just will summarize by saying this:

That Congress had a specific problem in mind, the problem was to avoid further tax losses by stemming the flow toward flow-through. It had two purposes in mind, the other one was to do so without causing utility rate increases.

The result reached by the Commission in this case causes enormous utility rate increases all over the country; the result reached by the Court of Appeals causes no increases, and exactly coincides with the intent and purpose of Congress.

Thank you.

MR. CHIEF JUSTICE BURGER: Mr. Solomon.

ORAL ARGUMENT OF RICHARD A. SOLOMON, ESQ.,
ON BEHALF OF PUBLIC SERVICE COMMISSION OF
NEW YORK

MR. SOLOMON: Mr. Chief Justice, and members of the Court:

There may be some confusion here as to what the issues in this case are.

There are two issues in this case, and they've been put into this case by the United States.

The first issue is whether the Court of Appeals was correct in construing the Tax Act as precluding the Commission from considering the request by Texas Gas.

And the second issue is whether, assuming the Commission has authority, continuing authority to consider the question, whether it considered it properly.

There are two issues here. They've been put into this case by the United States, and they have been accepted by us.

It is true that only one of them was decided by the court below, but both parties to this proceeding are suggesting that you can decide the second issue if you reach it.

Now, I haven't got enough time to spend much time on the basic decision of the court below, but I do want to say one thing in response to Justice White.

The Court of Appeals did not believe that if the situation had been left as it was at the time of that Senate Report, that Mr. Boland read you, that the Commission would have been precluded. The Court of Appeals decision is based on the entire history of what happened, and specifically based upon the limitation of the election by the conference.

QUESTION: So that the report really doesn't speak to

the Act as finally passed, you're suggesting?

MR. SOLOMON: The report speaks to the Senate Bill then before them.

QUESTION: Yes.

MR. SOLOMON: The conference limited it. And the Court of Appeals thought that was significant; and I think it's significant, but you'll have to look at my brief for that point, because I would really, in the limited time I have, like to go on to the exercise of power, assuming they had any power.

Now, the United States hasn't said very much about this. They would like you to believe that discretion is the end of the argument, that because an agency obviously has a great deal of discretion in general to decide what the parameters of its ratemaking principles are, that if they decide for flow-though, that that's all that has to be -- that you have to worry about.

But if there is one thing in this complex tax law which is clear, if an agency chooses to fix the rates of a utility on the conventional cost-of-service basis, it may include a tax allowance, but that tax allowance is to be to the extent it is possible to calculate it the actual taxes paid, and not theoretical taxes.

And when the Federal Power Commission and other agencies have from time to time attempted to include in the

rates of the company fictitious tax allowances, they have been regularly slapped down by the Court.

The problem with respect to liberalized depreciation is whether its use involves a tax deferral or a tax saving. If it involves a tax deferral, then the actual taxes are not what you pay in the particular year, the tax accrued is a higher amount, although you're allowed to defer part of it. And under such circumstances it would be appropriate to allow normalization.

But the fact of the matter is that you do not pay taxes on the basis of the situation with respect to individual pieces of property or individual groups of property. You pay taxes on the entire tax obligation of the regulated utility, and,from the depreciation standpoint, on the depreciation status of the entire utility. And this, as the Commission found in the Alabama-Tennessee case, means that with respect to a growing or stable company, the lower taxes on later vintages of property will be more than sufficient to counteract the higher taxes on earlier vintages of property, with the result that you will have a constantly growing tax surplus.

Now, that's what happened to Texas Gas, when it was allowed to normalize prior to 1967. As a result, it comes into this case with $13 million of reserve, which nobody can claim is not related to the old property.

It will, as a result of the right given it by

Congress, the special right given it by Congress, by Section 441, be entitled to accrue additional reserves, which are in fact interest-free loans, with respect to new expansion property.

But the fact that it is accruing additional interest-free reserves has nothing whatsoever to do with whether or not Texas Gas' use of liberalized depreciation on old property and new property, which is what it's been doing, will cease to be a tax saving. It was using liberalized depreciation on all its property, and because it was a growing company it resulted in tax savings.

It will use liberalized depreciation in the future on all its property, and if it is a growing or stable company, it will still be a tax saving.

Now, what about this gas supply shortage, and everything like that?

There are areas for Commission expertise. One area for Commission expertise could be a finding based on evidence, substantial evidence, but certainly one you give some weight to, saying that the industry has changed and this company or other companies are not going to be growing companies and therefore the factual situation is changed.

Now, if that was the posture in which this case came to you, then you obviously, unless the Commission's determination was clearly not based on the record, would have

a very difficult problem if you want to reverse them. But that is not the way this case comes to you.

On the contrary, the Commission assumes -- it more than assumes; they found, in Order 578, that Texas Gas was going to continue to grow.

And I am citing from page 110 of the record, about two lines, three lines below the numeral 2747, and here is what they say:

This is the Commission, this isn't me.

"While Texas Gas' pre-1970 properties may represent a declining net investment, the company will undoubtedly be adding to its entire rate base by post-1969 construction."

They didn't find that the gas supply shortage, or anything else, had changed the situation which meant this was a tax savings rather than a tax deferral.

What they found was that because the Commission now has the right -- pardon me -- because Texas Gas now has the right to keep a portion of the tax savings, i.e., the increasing amount on their new expansion property, that that somehow converted the situation from a tax saving to a tax deferral thing.

But we submit to you that there is nothing in the Act, nothing in the Commission's rules, and nothing in common sense which says that because a company has the temporary use of an interest-free loan, that means that its use of liberal-

ized depreciation is going to become a tax deferral rather than a tax saving. It only means that if, at some unforeseen and unexpected and certainly not found on this record, future date there was some need for use of this fund, and over and above the 13 million they already have for use, it only means that there would be additional ways of meeting this possible but not found future contingency.

So, our basic position in this case: Assuming -- assuming that the court below was wrong in saying that the Commission was precluded from considering this request, is that its resolution of the matter was in error. And if you will read the Commission's decision, you will find that its sole reason for finding there is no tax saving is this assumption that because part of the tax savings will be put into this fund, they're not available.

They don't have to be available, in the first place; and in the second place, if it was necessary they could be made available.

The only other thing I'd like to say is that Mr. Huntington says that normalization has to be put into a reserve fund. We will grant that, although the House Report suggests that isn't true.

But there's nothing in the bill or anything else that says when it goes into a fund it can't be used for future use. That's what deferred taxes are for.

MR. CHIEF JUSTICE BURGER: Mr. Huntington.

REBUTTAL ARGUMENT OF SAMUEL HUNTINGTON, ESQ.,

ON BEHALF OF FEDERAL POWER COMMISSION.

MR. HUNTINGTON: I'd like to talk first about the power issue. And then I have a few remarks to say about the Commission's exercise of discretion in this case.

When Mr. Morrow conceded that there may be certain circumstances under which the Commission could permit an abandonment of flow-through, with respect to existing property, I think he conceded this point.

That is precisely our position, that it's a matter of Commission discretion, that this is what the third rule in the House provided. It left this type of thing up to the Commission.

The only thing the election provision did was to give the companies an absolute right, without getting regulatory agency approval, to get off flow-through.

Now, the language in the Senate Report is pertinent, because it was the Senate that added the election provision. And the language in the Report shows that in adding it it did not mean to displace the third rule.

QUESTION: Now, you presented this argument to the Court of Appeals on rehearing, or -- this very argument here?

MR. HUNTINGTON: Yes, on power; oh, sure, we argued it to the Court of Appeals.

QUESTION: And the Court of Appeals specifically thought that the conference had run around this --

MR. HUNTINGTON: The Court of Appeals stressed certain language in the conference report, which I don't think I'll go into here, but it is -- we do come to grips with that issue rather squarely in our brief. And we think that it's just a total misreading of the conference report; and that we must rely on the Senate Report here. And that in merely narrowing the election from existing property to expansion property, the conference certainly did not mean to negate the general rule referred to in the House and the Senate Reports.

I would like to now turn to the -- assuming that the Commission has the power, was it properly exercised in this case?

Now, both respondents here and in their briefs talk about the actual-taxes doctrine.

Well, the actual-taxes doctrine has never been thought, or never been held to preclude the Commission from exercising its discrimination in how to treat liberalized tax depreciation for ratemaking purposes.

It is largely a question of whether the taxes result in a -- whether the use of liberalized depreciation results in a tax deferral or a tax savings.

Now, if we could consider all of Texas Gas' property

together, then we would have a different case than we have here. Then you would continue assuming that Texas Gas continued to expand, you would have -- you would be able to use the benefits from the expansion property with respect to the old property.

But Congress made the segregation. Congress said, With respect to expansion property you can get off flow-through; you can go to straight-line. And if you can get the agency's approval, you can go to normalization.

So Congress segregated these types of property. So you cannot consider the tax benefits from the expansion property in determining what method of accounting to apply to the existing property for ratemaking purposes.

The whole concept of normalization is that you take the benefits and you put them into a reserve account. They are not available for anything else. They are in that account so that you can pay future taxes with respect to that property.

QUESTION: When you say you put them in a particular account, does that connote an actual deposit of funds?

MR. HUNTINGTON: No, it's a --

QUESTION: It's an accounting.

MR. HUNTINGTON: It's an accounting thing. But you cannot -- those funds are not available --

QUESTION: But they're not funds. If you're just talking about an accounting of these.

MR. HUNTINGTON: Well, as far as -- in other words,

the company is required to maintain an account of sufficient size to pay future taxes with respect to that property.

As far as paying --

QUESTION: You've collected that and it's actual money in the sense you've collected it from --

MR. HUNTINGTON: You've collected it from the --

QUESTION: You've collected it from somebody.

MR. HUNTINGTON: That's right.

QUESTION: For ratemaking purposes it would be treated, would it, the same way as depreciation, or reserves of other kinds? How would it be treated?

MR. HUNTINGTON: Well, for ratemaking purposes the amount is deducted from the rate base, so that it essentially is --

QUESTION: No, but it's treated as a tax expense that you --

MR. HUNTINGTON: For ratemaking purposes, the --

QUESTION: It's treated as an expense, as taxes that you've actually paid, but you haven't.

MR. HUNTINGTON: As you've actually paid and you haven't paid. That's right.

But because Congress specifically said, All right, you can use this method on expansion property; it is Congress that has made this segregation. And therefore you have to look just at the existing property in determining what method

to use there. And there we say the Commission was correct in determining that the use of flow-through was no longer appropriate, and had full discretion -- this is a matter completely within the Commission's discretion to analyze these facts --

QUESTION: If they get so far within the discretion of the Commission, that it doesn't have to say why it did it?

MR. HUNTINGTON: It said why it did it.

QUESTION: Well, why did it?

MR. HUNTINGTON: It did it because, with respect to existing property, there would no longer be sufficient deductions to offset the declining balances on the existing property. From year to year the tax depreciation deductions would decline.

Therefore, instead of having a tax savings with respect to that property, it's merely a tax deferral. To pass it on in the form of lower rates now would simply mean that the present customers are paying a tax expense which the -- are getting a tax benefit at the expense of future customers, who would then have to pay the increased taxes.

Thank you.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen.

The case is submitted.

[Whereupon, at 11:14 o'clock, a.m., the case was submitted.]