

IN THE MATTER OF the Utilities Commission Act,  
S.B.C. 1980, c. 60, as amended

and

IN THE MATTER OF Inland Natural Gas Co. Ltd.

and

IN THE MATTER OF Order No. G-38-83 as  
varied by Order No. G-68-83;

and

IN THE MATTER OF Columbia Natural Gas Limited

and

IN THE MATTER OF Order No. G-48-83 as  
varied by Order No. G-69-83

DECISION

December 20, 1983

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ORDER NO. G-91-83	

## APPEARANCES

C.B. Johnson Patrick Lloyd	Inland Natural Gas Co. Ltd.
T.D. Tutti	Cominco Ltd.
R.B. Wallace	Council of Forest Industries B.C. Forest Products Ltd. B.C. Timber Ltd. Caribou Pulp and Paper Company Ltd. Prince George Pulp and Paper Ltd. Weyerhaeuser Canada Ltd.
K.E. Gustafson	Consumers Glass Company Limited Quesnel River Pulp Company
M.F. Shoemaker	B.C. Hydro & Power Authority
C.P. Griffin Roy Dyce	Pacific Northern Gas Ltd.
R.S. Morrice	B.C. Coal Limited
C.A. Jeffery	City of Prince George
R.J. Gibbs B.J. Wallace	Commission Counsel

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R.J. Fletcher J.A. Greiner W.J. Grant	Commission Staff
W.R. Harper	Hearing Officer
Allwest Reporting Ltd.	Court Reporters

## LIST OF EXHIBITS

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Direct Evidence of W.R. Waters on Income Tax Aspects of Revenue Requirements	A
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## I. BACKGROUND

This Decision is issued following certain action taken by the Commission in Orders No. G-38-83 and G-68-83, both of which flow from a Decision of the Commission issued May 25, 1983 in respect of Rate Applications of Inland Natural Gas Co. Ltd ("Inland"); and Orders No. G-48-83 and G-69-83 issued by the Commission in respect of Columbia Natural Gas Limited ("Columbia") following a Decision of July 12, 1983 (the "Columbia Decision").

The Decision of May 25, 1983, dealing with Inland (the "Inland Decision"), deferred a decision on the question of the method of accounting for income taxes to be utilized by Inland pending the receipt of additional evidence on the potential timing of the "crossover" point for Inland and the measurement of that future liability in discounted terms. The Columbia Decision of July 12, 1983 raised the same questions related to Columbia.

The Commission will deal first with those matters raised by Orders No. G-38-83 and G-48-83 issued following the Inland Decision and the Columbia Decision respectively. In those decisions similar wording directed that "the Commission wishes to hear evidence concerning the potential timing of the crossover point for Inland and Columbia and the measurement of that future liability in discounted terms." The Orders directed the filing of such information on or before August 31, 1983 and Inland and Columbia have complied with these orders by a joint filing.

The filing by Inland and Columbia comprises a study which dealt with both the potential timing of crossover and the measurement of that future liability in discounted terms for both companies. After review the Commission is satisfied that the information requested had been provided and the Commission considered that it might be possible to conclude the outstanding matters without a further public hearing and therefore issued Orders No. G-68-83 and G-69-83. These orders, dealing with both Inland and Columbia, directed service of the August 31st filing on all intervenors of record within one week of September 23rd and requested responses from such intervenors by October 15th.

The Commission has been advised of full compliance with the directions contained in Orders No. G-68-83 and G-69-83 respectively. The Commission received one response to Orders No. G-68-83 and G-69-83; that from the industrial intervenors represented by Mr. Wallace. Those intervenors reserved a right to argue the issue in the event the Commission proposed to accept the August 31 submission of Inland as supporting a continuation of deferred tax accounting. In the absence of objection to the procedure the Commission has concluded that it may act in respect of the outstanding issues which were raised by the direction in Orders No. G-38-83 and G-48-83 without further public hearing.

The Commission has further concluded that it is now appropriate to issue a decision on the outstanding matter of the method of accounting for income tax. This decision will apply to both Inland and Columbia as the central issues are similar in respect of the utilities.

After a review of the Inland submission of August 31, 1983 the Commission finds that the validity of utilizing the crossover point as a factor in determining income tax treatment for regulatory purposes is seriously undermined by the uncertainties in estimating future capital expenditures.

The submission also utilized work done in a recent study for the C.I.C.A. dealing with the matter of discounting. The study points out some of the hazards associated with the application of discounting to tax allocation. Generally the Commission agrees with the conclusion of the submission. It appears that a meaningful application of discounting to future tax liability may be largely theoretical. In any event, it is a route the Commission will not follow in the present circumstances.

## II. THE ISSUES

### (a) Accounting Authority

The Commission believes that the use by regulated companies of either the normalized or flow-through methods of accounting for income taxes is provided for in the C.I.C.A. Handbook and that both methods conform with the principle of matching costs and revenues as indicated in Section 3470 of the C.I.C.A. Handbook.

The C.I.C.A. Handbook prescribes normalized tax accounting in general but makes specific allowance for the taxes payable basis in the situation of a regulated utility where the regulating body only allows the recovery of taxes currently payable in the rates. In that situation the taxes payable basis matches costs and revenues provided there is "a reasonable expectation that all taxes payable in future years will be included in the approved rate or formula for reimbursement and recoverable from the customer at that time" (C.I.C.A. Handbook 3470.57).

The Commission believes, in the circumstances of Inland and Columbia, that the aforementioned proviso of "reasonable expectation" exists. It would appear therefore that recognized accounting authority would permit the use of either "normalized" or "flow-through" method of accounting for income taxes for Inland and Columbia.

### (b) Recovery of Legitimate Costs

Mr. H.W. Johnson testified that deferred tax would become a liability at "crossover" i.e. at the point in time when depreciation expense exceeds capital cost allowance (CCA) and hence current income taxes payable exceed normalized income taxes. Crossover would not occur so long as aggregate capital additions equal or exceed aggregate plant depreciation. Because assets must be replaced for the plant to be kept whole, in the long run capital expenditures will equal depreciation.

The incidence of inflation decreases the probability of crossover by increasing the cost of plant replacement in current dollar terms. To support his argument, Mr. Johnson adopted a study which concluded that,

"General inflation and specific price changes continue to increase the dollar amounts of replacement, generating larger dollar amounts of timing differences and making it less and less likely that deferred tax will ever be repaid." (1)

In weighing the evidence presented, the Commission has concluded that deferred tax presents a potential liability to these utilities which is more appropriately assessed in terms of probabilities than in absolutes. For Inland and Columbia, crossover is clearly not imminent. Furthermore, the correct measure of a future liability in current terms should be the discounted value of that liability. This approach has its own hazards as was discussed in the August 31 material. The Commission has therefore decided to view deferred taxes as no more than a contingent liability, for which the amount due and the timing are a matter of conjecture. Where there is a high degree of uncertainty that such costs will be incurred, the costs cannot be considered as legitimate and properly recoverable through the cost of service.

(c) Question of Inter-Generational Equity

Dr. W.R. Waters defined inter-generational equity as :

"... the assessment of whether or not pricing structure will require the customers in different time periods to pay different amounts, in real or purchasing power terms, for the same service. If the same purchasing power is required to obtain the same service in different periods, the pricing structure is considered to be equitable with respect to the various generations of users." (2)

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(1) Exhibit B, page 15 - C.S. Drummond, C.A. and S.L. Wingle, F.C.A.; C.A./Magazine, October, 1981

(2) Exhibit A, Page 4



He argued that two factors in the rate regulation model resulted in "front end loading" i.e. a heavier charge being placed on the early users of the system than on the later users. They are :

- (i) The inflation component of the return on rate base is in fact a return of capital. Ideally, the return on rate base should be the return on capital and depreciation should be the return of capital. The inclusion of an amount to compensate for inflation results in early users of the system repaying a larger share of the capital than later users.
- (ii) The "declining rate base" phenomenon, which is the consequence of depreciation, generally, causes early users of the system to pay more for the same service than the users of later years.

Flow-through taxes result in "back end loading" which would somewhat mitigate the above mentioned factors and hence result in greater inter-generational equity.

Mr. G.C. Watkins, appearing for the Applicant, introduced evidence in the form of computer simulation runs and concluded that :

"... while the impact of inter-generational equity of tax flow-through or normalization is relatively minor, the direction of the impact depends on the particular position a utility occupies, now and in the future." (l)

The Commission accepts Dr. Water's argument that inflation and the declining rate base phenomenon contribute to front end loading and that flow-through taxes mitigate this effect to some extent. Although Mr. Watkins' evidence was inconclusive because some of his assumptions were not totally applicable to Inland and Columbia, the Commission is satisfied that Mr. Watkins did demonstrate that the income tax effect on inter-generational equity is a relatively minor one.

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(l) Exhibit F, Paragraph (j)

(d) Cost of Collecting Deferred Tax

This Commission treats deferred taxes as a deduction from rate base and hence it is viewed as zero cost capital. Inland testified to the effect that :

"... the collection of deferred taxes resulting from additional rates to our customers will work to the advantage of the Company and its customers. I say this because the cash that will be generated from the collection of deferred taxes from customers will partially relieve us of the necessity of higher cost external financing in the near future. Higher cost financing will ultimately, of course, be reflected in rates to the customers." (1)

Mr. H.W. Johnson stated that :

"For every dollar of deferred income taxes recorded by a regulated utility it must recover from the customer two dollars (assuming a 50% tax rate) so that the after tax revenue is sufficient to provide the deferred income tax. This means that the customer of a utility on normalization not only provides the utility with funds based on the expectation that they will be needed at some future time to discharge a current tax liability but also pays an equivalent amount to federal and provincial taxing authorities the payment of which could have been deferred until some later date and part of which might not be payable at all." (2)

The Commission has concluded that although deferred taxes, when treated as a deduction from rate base, are zero cost capital to the Company, it is high cost capital to the customer for three reasons :

- (i) At the Company's income tax rate of 53.8% for each dollar of deferred tax collected, an additional \$1.16 must be collected for income taxes.
- (ii) All fees and taxes which are revenue based are increased by deferred tax and this increase is passed on to the consumers.

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(1) Exhibit E, Page 4

(2) Exhibit B, Page 16

- (iii) Most customers pay utility bills with "after tax" dollars whereas the utility is able to obtain its funds to finance needed capital additions with "before tax" dollars.

For the foregoing reasons the cost of capital raised by this method is high and therefore unduly expensive for the customer and an inefficient source of capital for the utility.

(e) Effect of Taxation Accounting on Credit Rating

The Applicant argued that flow-through tax accounting would reduce the pre-tax interest coverage ratio. This could reduce bond rating with the resultant higher cost of, and more difficult access to, long-term debt. Dr. Waters presented the view that for a utility, coverage ratios should be calculated on after tax earnings as opposed to the common practice of using before tax earnings. He postulated that deferred tax is "earmarked" for plant additions and therefore not available to meet debt obligations in the same sense as earnings. Because the after-tax coverage ratio is the same under both flow-through and normalized tax accounting, creditors should be indifferent as to the method of tax accounting.

The Commission accepts the argument that deferred taxes are "earmarked" for plant additions, as these funds are deemed to have been spent on rate base regardless of their actual disposition. They could, however, be used to service debt if the Company were prepared to accept the lower return on equity that would result from such action. The Commission concludes that deferred taxes afford the utility some coverage protection but not to the same extent as pre-tax earnings net of deferred taxes.

The Applicant argued that since its change to normalized tax accounting, it has been able to obtain less restrictive covenants for its debt. The Commission recognizes that normalized taxes contribute to the quality of

earnings. This, however, must be appraised in light of the financial burden that deferred taxes impose on customers. No benefit-cost analysis of this relationship was submitted in evidence.

Prior to 1977, the Company was on flow-through taxes. There was no evidence presented which would indicate that the Applicant during that time had experienced difficulty in obtaining financing for its capital requirements.

The Commission is of the opinion that creditors view the relative riskiness of a company based on a multitude of factors. These include, business risk, financial risk, regulatory risk, earnings, quality of earnings, management and long-term outlook. The Commission attempts to balance these factors in reaching a decision so that the overall risk profile of the Applicant will be favourably viewed by creditors.

(f) Impact on Shifting Patterns of Customers

Inland expressed concern that the industrial customers, which account for approximately half the sales volume, may switch to alternate fuels (eg. wood waste), if such fuels became a more economic purchase than natural gas. It was also argued that reduced sales volumes would have the effect of increasing unit cost to those customers who cannot readily change to other fuels, particularly when "crossover" might be reached and the taxes payable method was used previously.

The Commission suggests that if the Applicant continues to have concerns over shifts in, or the loss of, specific customers it should consider changes to its depreciation policy. The Commission is of the opinion that the accumulation of deferred tax credits is not a proper vehicle with which to provide or anticipate major shifts in customers. In fact the application of deferred taxes may, by causing higher consumer rates, only encourage fuel substitution and increase and accelerate shifts in customers.

(g) Changes in the Business Environment Since 1977

Dr. Waters testified that the business environment in which the Applicant operates today is significantly different from that which existed in 1977 when the Commission allowed Inland to adopt deferred taxes. The two principal changes he raised were :

- (i) fiscal 1983 when compared to 1977 is experiencing the most severe economic downturn in the last 50 years,
- (ii) fiscal 1983 saw interest rates rise to levels close to 20%, a phenomenon which has been embedded in the Inland debt structure by the issue of a 15 year debenture at 18 1/4%.

By adopting flow-through taxes at this time, front-end loading will be reduced resulting in lower tariffs. Lower energy costs are a factor in assisting industrial customers to compete for markets .

The Commission accepts the view that the economic circumstances of industrial and other customers should be taken into consideration in rendering a Decision on this question.


III. DECISION

For the reasons as discussed above, the Commission has found that the public interest will be best served with a return to "flow-through" accounting for income tax purposes for Inland and Columbia.

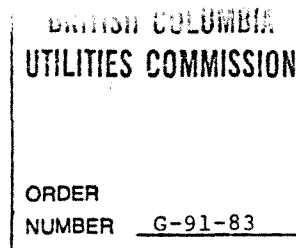
In order to allow time for the Applicant and the financial community to effect the transition with minimum disruption, the Commission will direct that both Inland and Columbia change to "flow-through" effective February 1, 1984.

The balance of deferred taxes as at January 31, 1984 will remain on the books of both Companies and will be applied as a reduction to rate base.

DATED at the City of Vancouver, in the Province of British Columbia, this 20th day of December, 1983.

  
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M. TAYLOR, Chairman

  
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R.J. LUDGATE, Commissioner



PROVINCE OF BRITISH COLUMBIA

BRITISH COLUMBIA UTILITIES COMMISSION

IN THE MATTER OF the Utilities Commission  
Act, S.B.C. 1980, c. 60, as amended

and

IN THE MATTER OF Accounting for Income  
Taxes by  
- Columbia Natural Gas Limited  
- Inland Natural Gas Co. Ltd.

BEFORE: M. Taylor, )  
Chairman; and )  
R.J. Ludgate, ) December 20, 1983  
Commissioner )

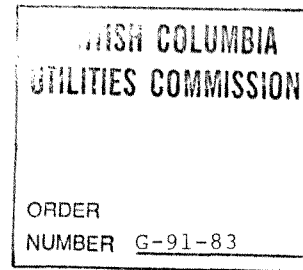
O R D E R

WHEREAS the matter of accounting for income taxes  
related to Columbia Natural Gas Limited ("Columbia") and  
Inland Natural Gas Co. Ltd. ("Inland") was heard in public  
during the period October 5 through 8, 1982, with final argu-  
ment December 7 and 8, 1982; and

WHEREAS a May 25, 1983 Commission Decision as  
amended June 21, 1983 pertaining to Inland, and a July 12,  
1983 Decision pertaining to Columbia deferred a decision on  
the method of accounting for income taxes to be utilized by  
both utilities; and

WHEREAS Commission Orders No. G-38-83 and G-48-83  
were issued to Inland and Columbia respectively and directed  
that "the Commission wishes to hear evidence concerning the  
potential timing of the "crossover" point and the measurement  
of that future liability in discounted terms", and directed  
the filing of such information on or before August 31, 1983;  
and

.../2



WHEREAS Commission Orders No. G-68-83 and G-69-83 as issued to Inland and Columbia respectively directed service of the August 31, 1983 filing on all Intervenor with responses to be submitted by October 15, 1983; and

WHEREAS filings responsive to the aforementioned Commission Orders were made and the Commission has considered the issues and related responses as outlined in a Decision issued concurrently with this Order; and

WHEREAS the Commission has concluded that it is in the public interest that Columbia and Inland change the method of accounting for income tax from the "normalized" method to the "flow-through" method effective February 1, 1984; and

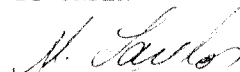
WHEREAS the matter of the method of accounting for income taxes in respect of both utilities was deferred in decisions related to a 1983 test period.

NOW THEREFORE the Commission orders Inland Natural Gas Co. Ltd. and Columbia Natural Gas Limited as follows:

1. The method of accounting for income taxes by both utilities will change from the present "normalized" method to the "flow-through" method effective February 1, 1984.
2. Inland and Columbia shall each file revised rate schedules to be effective February 1, 1984 which will reflect the adjustment necessary to provide for a reduction in unit rates based on the 1983 test period dealt with in the May 25, 1983 Decision, as amended, with respect to Inland and the July 12, 1983 Decision with respect to Columbia.
3. The balance of deferred taxes as at January 31, 1984 will remain on the books of both companies and will be applied as a reduction to rate base.

DATED at the City of Vancouver, in the Province of British Columbia, this 23<sup>rd</sup> day of December, 1983.

BY ORDER

  
Chairman



## DOCUMENT SUMMARY

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