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# Depreciation and Retirement Problems of Utilities

By M. L. Seidman

Because many light and power companies, railroads and other public-utility corporations, subject to government regulation, keep their books on the retirement-expense basis, some of them are deducting inadequate depreciation for operating and income-tax purposes. Correspondingly, their accumulated depreciation reserves are also inadequate.

Whatever advantage these companies claim for continuation of the retirement-expense basis, they would nevertheless like to obtain the benefit of an adequate and proper depreciation deduction for income-tax purposes—this, provided they can continue to keep their books and make their reports to the various regulatory commissions in the same manner as heretofore and provided, further, that such procedure will have no detrimental effect upon the rate base, that is, the investment upon which they are entitled to earn a fair return.

It is my purpose to show that regardless of the method of bookkeeping employed by such companies and their system of accounting for depreciation and retirements, they are entitled to and can obtain a proper depreciation deduction for income-tax purposes. Neither their method of accounting nor their depreciation deductions for income-tax purposes can have any bearing upon their rate base.

It will perhaps be best to review briefly the fundamental differences between depreciation accounting and retirement-expense accounting, purely as a bookkeeping proposition.

## Depreciation vs. Retirement Accounting

In a recent case before the interstate commerce commission, involving the question of annual depreciation, Commissioner Eastman, in distinguishing between depreciation and retirement accounting, concluded as follows:

"Most property used by telephone companies is retired from time to time for various reasons, the loss involved in such retirement being an expense of operation. Broadly speaking, there are three methods of accounting for such loss: (a) it may be charged in bulk at the time of retirement of the unit; (b) it may be anticipated and spread over the service life of the unit, or, (c)

it may be spread over a period subsequent to the retirement. Of these, (b) may be termed 'depreciation accounting,' (a) 'retirement accounting,' and (c) 'future accounting'."

That is a pretty good resumé of the subject.

The matter of depreciation against retirement expense has been a controversial one for some time and volumes have been written on the subject by engineers, accountants and public-utility experts. In general, it may be said that under depreciation accounting the loss caused by the retirement of a property unit is charged to operating expense over the estimated useful life of the unit; while, under retirement accounting, this loss is charged off in total against the year when the retirement occurs.

Retirement accounting is, therefore, a means of postponing charges for the loss resulting from depreciation to the time when such loss is completely realized. And, the accumulated depreciation reserve represents the extent to which the cost of property consumed in service has to date been charged off against operations, while the retirement reserve is nothing more than a renewal reserve to equalize from year to year, as nearly as may be, the charges to operating expense for fixed capital completely consumed and retired.

John Bauer, public-utility consultant, and a strong depreciationist, in his book *Effective Regulation of Public Utilities*, in discussing the effect of one policy as against the other, with regard to the accumulated reserve in each case, comments upon the subject thus:

"The proponents of this view (retirement accounting) draw a sharp distinction between such a retirement or renewal reserve and the depreciation reserve of our discussion. The latter would reach during the life of any company, especially as a fair average settled condition is reached, 25 to 40 or even 50% of the original cost of the properties in service. The opponents of depreciation insist that such large reserves are never needed for the purpose of actual renewals or retirements, and that their accumulation merely imposes upon the public an unjustified burden. Their counter-proposal of a renewal or retirement reserve would never result in the accumulation of a large amount. It would probably never exceed 5% of the original cost of the properties in service at any time. Its sole purpose would be to equalize approximately the actual renewals or retirements from year to year."

Taking two actual cases from experience for comparison, that of the New York Telephone Co., which is on the depreciation

basis, and the New York Consolidated Gas Co., which is on the retirement-reserve basis, the point of difference is made quite clear. Thus on December 31, 1929, the telephone company's depreciation reserve was approximately 26% of its fixed capital, whereas the gas company's reserve on the same date was less than 1% of its fixed capital.

So far as current depreciation charges and retirement-expense charges are concerned, it appears that in the telephone case the annual depreciation charges have come to approximately the amount of its annual retirements, so that the important effect of depreciation accounting is now more upon the company's balance-sheet than upon its operating statement. This is exactly the result to be expected in the case of a company whose properties have reached a fair average settled condition. Thus, during the eleven years ended December 31, 1929, the telephone company's depreciation reserve varied between 26% and 30% of its fixed capital, and its annual depreciation deduction averaged about 5% of its fixed capital.

In the case of the Consolidated Gas Co., since it is not on a depreciation basis, similar figures are not available, but from a review of such figures as are available, it appears quite probable that the same relationship between retirements and depreciation would exist in the gas company case were it on a depreciation instead of a retirement-reserve basis. Evidently, to a company whose property has reached a fair average settled condition, it makes little difference so far as net income is concerned whether it employs depreciation accounting or retirement-expense accounting. When its property is old enough, current retirements will equal or exceed a fair annual depreciation charge. That, however, is not true in the case of a young, rapidly growing property. Here, retirements in the early years are necessarily small as compared with an older property. Under depreciation accounting, such retirements are anticipated from the very beginning as the property is consumed in service from year to year, and the total cost is spread proportionately over the entire life of the property.

Although there may have been controversy in other quarters, there has been no disagreement over the necessity for an annual depreciation deduction, so far as our income-tax laws are concerned. Here, property partly consumed or worn down in one year's operations, can not be ignored for the time being and

charged off later against the income of another year when the complete unit is retired and the entire loss actually realized. For income-tax purposes, each year must give full effect to all deductible-expense factors, including a reasonable allowance for depreciation, applicable to that year's income. Furthermore, a depreciation deduction allowable in one year can not be taken in any other year. Each year is a distinct entity and must give recognition to all the income and expense factors applicable to its operations.

Let us, therefore, see exactly what is the status of companies which are on a retirement-expense basis in their accounting and desire to be on a depreciation basis for income-tax purposes.

### Depreciation for Federal Income-tax Purposes

Our income-tax law makes the following provision regarding an annual depreciation deduction:

> A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

The treasury department regulations, explaining and amplifying the law on the point, label the deduction as "depreciation" and explain that "the proper allowance for such depreciation is the amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property, equal the cost (or other basis). Thus, the law and regulations recognize that capital charges made at the time of the construction or installation of property represent expenditures for the benefit of the future, and that they should therefore be charged to operations gradually over the life of the property as the property is employed and consumed in service. This concept of an annual depreciation allowance, based upon cost and spread over the useful life of the property has, for tax purposes, been thoroughly adjudicated. The final word on the subject was spoken by the United States supreme court in the case of *United States* v. *Ludey* (274 U. S. 295), where it was held that

> The amount of the allowance for depreciation is the sum which shall be set aside for the taxable year in order that at the end of the useful life of the plant in the business, the aggregate of the

sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost.

While considering the annual depreciation deduction, it is well to repeat that each accounting period is a separate entity and must be charged with its proportionate share of the cost of the particular property consumed in service and reasonably applicable to the particular year. Any amount not deducted in one year, if applicable to that year, can not under the law be deducted in any other year. It is accordingly further provided that when property is retired, abandoned, sold, or otherwise disposed of, it is not its total cost that is chargeable against the income of the year in which such a disposition took place, but rather the cost, "less the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization and depletion, which have since the acquisition of the property been allowable in respect to such property."

Any amounts of depreciation so allowable from year to year, over the entire life of the property, whether or not such deductions were claimed by the taxpayer or formerly allowed, are not deductible in the year when the property is retired or other disposition of it is made. The depreciation allowable in prior years is not to be deducted in the year of complete retirement, no matter what such deduction is called when the property is retired. As far as the tax law is concerned, the deduction is either taken in the year when it is allowable, or it can not be taken at all at any time and in any form.

## Depreciation Deductions Need Not Appear on Taxpayer's Books of Account

The income-tax bureau, many years ago, was confronted with the question of the propriety of depreciation deductions on tax returns or through refund claims where such deductions have not been made on the taxpayer's books of account. This question came up particularly in the case of taxpayers who are subject to the regulation of various commissions and governmental departments, other than the federal income-tax department. It was decided to give recognition to any conflict existing between accounting practices required by the treasury department for income-tax purposes and those of other regulatory bodies. Voluntary accounting practices, although not consistent with treasury-department requirements, have also been recognized.

In the case of national and state banks, requirements of the various banking departments are often completely at variance with income-tax requirements, and the net income for tax purposes is often entirely different from that for banking-department purposes. The treasury department, recognizing this conflict, has provided that in such cases a memorandum record be kept of the differences. For depreciation accounting particularly, the treasury department provides that:

> Where the taxpayer desires or finds it necessary to maintain auxiliary records for this purpose, the use of such records is permissible and the amounts of depreciation entered thereon, if otherwise allowable, will be considered as having been sufficiently recorded, provided that such auxiliary records disclose all details essential to the determination of the allowable deduction for depreciation, are reconciled with the general books and are available to bureau representatives in the examination and audit of returns.

Quite evidently then, a proper depreciation allowance for income-tax purposes does not depend upon the method of bookkeeping employed by a taxpayer. If he is otherwise entitled to the deduction, it will be allowed; so taxpayers may, on their tax returns, deduct an amount of depreciation otherwise allowable, without the necessity of changing their present accounting practices and without in any other way altering their procedure regarding retirement expense and retirement reserve.

## Depreciation as a Factor in the Rate Base

What has undoubtedly added to the confusion of the retirement-expense and depreciation controversy, particularly in the case of utility accounting, is the fact that the various state commissions themselves have not had a definite policy on the subject. Thus, for instance, in the scheme of the New York public service commission, telephone companies are on the depreciation basis, while gas and electric companies are generally on the retirement-expense or retirement-reserve basis. The interstate commerce commission has been guilty of similar inconsistencies. Telephone companies, subject to its jurisdiction, have generally been on a depreciation basis. Railroads have been more or less on an optional basis, except for rolling stock which has been made subject to an annual depreciation provision. But steps have already been taken to eliminate these inconsistencies, at least so

far as the interstate commerce commission is concerned. Some years ago, of its own volition, it initiated hearings concerning the need for an annual depreciation provision in utility and railroad accounting. Primarily, the commission was seeking uniformity and accuracy in the determination of net income by all the companies coming under its jurisdiction.

Certain intermediate decisions were rendered on the subject. These were made the basis of further controversy and the whole matter was eventually consolidated into a single case (I. C. C. No. 14,700). Various ex-parte hearings were held in this case and a decision was rendered on July 28, 1931.

At these hearings many utility interests were represented in one form or another. Representatives of the National Electric Light Association and the American Gas Association opposed depreciation accounting, but advocated retirement accounting, coupled with an optional retirement reserve. The telephone companies contended for depreciation accounting as that most accurately reflecting current earnings, but they insisted that the accumulated depreciation reserve can not be a factor for rate-making purposes. Railroad companies contended quite generally for the retirement-expense basis for everything except equipment which, since 1920, has already been on a depreciation accounting basis. The commission, in its order effective January 1, 1933, places all companies coming under its jurisdiction on a depreciation accounting basis.

As already stated, this entire controversy before the commission in this case was not one of fixing a rate-base but for the purpose of determining accurately annual net earnings and to obtain some degree of uniformity so far as the depreciation factor is concerned. The question of depreciation as a rate-base factor has had the consideration of the United States supreme court on various occasions and is definitely determined. Thus, to begin with, it laid down the rule in the early *Consolidated Gas Co.* case (212 U. S. 19), the *Southwestern Telephone* case (262 U. S. 276), the *O'Fallon* case (279 U. S. 461) and in many others, that in determining the value of property for rate-base purposes, due consideration must be given to present or reproduction value.

In the *Indianapolis Water Co.* case (272 U. S. 400), as well as that of *Pacific Gas Co.* (265 U. S. 403), the principle was laid that the depreciation deduction from present value new must be based upon an actual examination of the property, and also that

the extent by which property has been reduced in value because of wear and tear and deterioration is a question of fact to be determined as of the date of the investigation, and not by a "Straight-line calculation based on the age and the estimated or assumed useful life of perishable elements."

In the *New Jersey Telephone Co.* case (271 U. S. 23) the court had before it the proposition of a company which had actually been deducting regularly in its accounts an amount of depreciation which upon an examination of the property for rate-base purposes was considered to have been excessive. The company had thus accumulated a reserve which was alleged to "result in an excessive amount of depreciation expense and so created in the reserve account balances greater than required adequately to maintain the property."

The commission in the first instance sought to deduct from the company's fixed capital, entitled to earn a fair return, the amount of the accumulated depreciation reserve shown by the company's books. The company contended for the smaller amount of observed depreciation as of the date of examination, regardless of the amount of the reserve shown by its books.

The court, in upholding the company, reiterated the principle that regulation may not deny the utility the chance to earn a reasonable rate of return upon the value of the property at the time of the investigation and emphasized the fact that there is no necessary relationship between annual depreciation deductions on a cost basis and actual observed depreciation for rate-base purposes. In refusing to consider the public service commission's contentions for the deduction from present value of the excessive amount paid by customers of the telephone company in the past, the court said:

> Customers pay for service, not for the property used to render it. Their payments are not contributions to depreciation or other operating expenses, or to capital of the company. By paying bills for service they do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company. Property paid for out of moneys received for service belongs to the company, just as does that purchased out of proceeds of its bonds and stock.

In the case of *United Railways Electric Company of Baltimore* (280 U. S. 234) the court laid down the rule that the allowance for annual depreciation for "fair return" purposes must also be

based on present value—this in spite of the fact that for income-tax purposes in the *Ludey* case, previously mentioned, the allowances for annual depreciation must be based on cost.

Thus, in the *United Railways* case, the court states:

> It is the settled rule of this court that the rate-base is present value and it would be wholly illegal to adopt a different rule for depreciation.

The court then continues:

> There is no principle to sustain a holding that a utility may earn on the present fair value of its property devoted to public service, but that it must accept and the public must pay, depreciation on book cost or investment cost, regardless of present fair value.

The United States supreme court is thus definitely committed to actual observed depreciation on present replacement value for rate-base purposes. And even for current operating purposes in the case of a utility, the annual depreciation allowance must be based on present reproductive value, not on cost. Any deduction, therefore, which a utility has taken upon its books or otherwise, that is based upon original cost, is not necessarily a proper deduction for rate-making purposes, yet it is the only proper deduction for income-tax purposes, as the court has said in the *Ludey* case. Logically, therefore, the court concludes in the *New Jersey Telephone* case that any accumulated depreciation reserve based upon original cost is not a factor to be considered in fixing the amount upon which a utility is entitled to earn a fair return.

. . . . .

From all of this it can undoubtedly be inferred that, regardless of the method of bookkeeping employed by public-utility companies and regardless of their system of accounting for depreciation and retirements, they are entitled to and can obtain a proper depreciation deduction for income-tax purposes; also, that neither their system of accounting nor the depreciation deduction on their tax returns can have any bearing upon the amount of their investment upon which they are entitled to earn a fair return.