Treatment of Finance Leases of Equipment in Rate-Making Determinations

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I. INTRODUCTION

Leasing as a method of acquiring equipment has achieved remarkable popularity over the last quarter century in American business. Of the two basic lease categories, finance and operating, finance leases have created substantial confusion over their treatment in the balance sheet and in ratemaking determinations. The controversy arises when finance leases are treated like periodic business expenses, as the operating leases are, rather than being treated as a capital expense.

Sharp distinctions between the operating and the finance lease call for separate and different economic treatment. An operating lease is utilized by businesses where purchasing would be uneconomic for various reasons, chiefly temporary need. A finance lease is employed as an alternative to purchasing, mainly due to financing considerations. The most prominent distinction between the two types is based on term length and cancelability. An operating lease lasts either for a short term or is cancelable at will, upon proper notice. A finance lease is not terminable at will and extends for a term approximating the useful life of the asset. Under a finance lease, the

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> lessee is generally committing himself on a noncancelable basis for substantially all the economic life of the property under lease, or possibly for a shorter period when the payments under the noncancelable commitment cover the full purchase price of the property. In either case, the lessor generally expects to receive under the lease terms the full normal sales price of the property after giving effect to the interest element in the lease rentals. The value of any future rights of the lessor at the time he enters into a [finance] lease are generally nominal.[1]

Finance leases, then, could be treated as purchases of equipment.

The issue which this article addresses is whether finance leases should be capitalized and included in the rate base of regulated industries, or whether such leased property should be excluded from the rate base and allowed only as an expense item.[1a]

II. Finance Leases in the Rate Base: Treatment by Regulatory Authorities

The treatment of leased assets by regulatory authorities for ratemaking purposes is lacking in consistency. The reported decisions do not reflect a detailed, analytical inquiry into the economic realities of finance leasing. Either a blind reliance upon precedent or a coin-flipping approach seems to dominate the judicial reasoning.

Traditionally, regulatory authorities have tailored the allowable "rate of return" to what is referred to as the "rate base". Guidance given by the courts in determining these two concepts began with *Chicago, Milwaukee, and St. Paul Railway v. Minnesota*:

> The question of the reasonableness of a rate or charge for transportation by a railroad company, involving as it does the element of reasonableness both as regards the company and as regards the public, is eminently a question for judicial investigation, requiring due process of law for determination. If the company is deprived of the power of charging reasonable rates for the use of its property, and such deprivation takes place in the absence of an investigation by judicial machinery, it is deprived of the lawful use of its property, and thus, in substance and effect, of the property itself, without due process of law and in violation of the Constitution of the United States; and insofar as it is thus deprived, while other persons are permitted

1. Wyatt, *Accounting for Leases*, 1972 Ill. L.F. 497.

1a. It should be noted that guidelines for the treatment of finance leases have been established by the American Institute of Certified Public Accountants, the Internal Revenue Service, and the Uniform Commercial Code. A complete discussion of these guidelines can be found in *Symposium: Commercial Leasing*, 1972 Ill. L.F. 433; Professional Standards, Accounting (CCH), § 5351.01 *et. seq.* (1975); Hawkland, *The Proposed Amendments to Article 9 of the U.C.C.—Part 5: Consignments and Equipment Leases*, 77 Com. L. J. 108 (1972); Landis, *Tax Aspects of Leasing*, 79 Com. L. J. 8 (1974). Guidelines of the Securities Exchange Commission impliedly recognize that finance leases are substantially identical to purchases and should be reported in a similar manner on financial statements. 17 C.F.R. § 210.3-16(q) (1974), *but see Interpretation of Accounting Series Release*, No. 132, Federal Securities Law Reports (CCH) ¶72, 154 (1973).

> to receive reasonable profits upon their invested capital, the company is deprived of the equal protection of the laws.[2]

Various methods of calculating this reasonable rate of return have been embraced by the Supreme Court. In *Smyth v. Ames* the Court asserted "that the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the fair value of the property *being used* by it for the convenience of the public" (emphasis added).[3] The above case indicated what is in effect the "rate base" for regulated industries. In *Federal Power Commission v. Hope Natural Gas Co.*[4] the Court indicated that the proper rate of return should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. In *Bluefield Water Works and Improvement Co. v. Public Service Commission*, the Court laid down a comparable business standard:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties . . . .[5]

It could be inferred that a proper rate of return, then, will be comparable to similar businesses, as well as be sufficient to attract capital.

In implementing the mandates of the Supreme Court with regard to ratemaking, generally,

> regulatory authorities continue to use the traditional procedure of fixing a percentage rate of return to be applied to a rate base which represents property value, investment in property, cost of property, or some other attribute of property.[6]

A. THE FEDERAL REGULATORY ENVIRONMENT

1. *Interstate Commerce Commission*

In 1918, the Interstate Commerce Commission confronted the lease treatment issue for railroad equipment in *Texas Midland Railroad*.[7] It distinguished between leased property which was "merely incidental" to the business, such as rented space for ticket offices, and tracks which are not incidental. The former were excluded from the rate base, whereas the

2. 134 U.S. 418, 458 (1890).
3. 169 U.S. 406, 546 (1898).
4. 320 U.S. 591, 605 (1944).
5. 262 U.S. 679, 692 (1923).
6. Nichols and Welch, *Ruling Principles of Utility Regulation, Rate of Return* Supplement A, 1, 2 (1964). *See e.g.*, Carolina Water Co., 32 P.U.R.3d 462, 469 (N.C. Util. Comm'n 1960); City of Cleveland v. Public Utilities Comm'n, 164 Ohio St. 442, 132 N.E.2d 216 (1956). Simms v. Round Valley Light & Power Co., 80 Ariz. 145, 294 P.2d 378 (1956) (standard for establishing common equity). *But cf.* LaSalle Tele. Co., 17 P.U.R.3d 466 (La. Pub. Ser. Comm'n 1956).
7. 75 I.C.C. 1 (1918).

latter were included. With regard to other than incidental property the Commission stated: "[i]t is now universally accepted that it is the fair value of the property used by the public service corporations in serving the public which is to govern in fixing rates."[8]

This holding was followed in *Excess Income of Jonesboro, Lake City & Eastern Railroad Company*, where leased freight cars were included in the rate base:

> The respondent is entitled to a fair return upon the value of property employed by it in the public service. The equipment which a carrier leases for its own use . . . is obviously property used by the lessee in the service of the public and its value, therefore, should be included in the rate base.[9]

2. *Civil Aeronautics Board.*

In a statement of general policy issued in 1971, the Civil Aeronautics Board indicated how leased aircraft would be considered for the purpose of ratemaking: "[i]n determining the appropriate treatment of leased aircraft for ratemaking purposes, it is the Board's policy to recognize actual rental expenses."[10] In cases of corporations with unusually large amounts of leased aircraft, a slight profit element would be added. In its notice of proposed rule-making,[11] the Board rejected the constructive ownership approach as not recognizing the carriers' true revenue requirements.[12] The reason given for not adopting the capitalization method is muddy—it is expressed to be that the theory of such treatment is invalid:

> [T]he underlying theory [of capitalization of leasehold interests] appears to the Board to be of questionable validity. The carrier does not have to raise capital to acquire the leasehold interest, since the owner lessor provides the necessary capital. Thus, inclusion of a capitalized interest leasehold interest in the investment base would result in compensating the carrier for a cost of capital which it does not incur. Of course, the rental expense reflects the capital costs of the owner-lessor and, since the carrier would be reimbursed for rental payments expense as an operating cost item, the public would in effect be required to pay twice for capital costs.[13]

Although it is true that the lessor provides the capital, the omitted point by the C.A.B. is that through higher rental payments the carrier lessee pays the lessor for providing this capital. The service of providing financing offered by the lessor is no different than a conditional sales contract vendor providing financing by allowing periodic payments. In the

8. *Id.* at 23.
9. 175 I.C.C. 786, 794 (1931).
10. 14 C.F.R. §399.43 (1971).
11. Civil Aeronautics Board Policy Statements, Docket No. 21866-2, (Sept. 10, 1970).
12. The Board was correct in this contention. It is irrelevant, except perhaps for coincidence, what the lessor paid for the property. It is the cost to the lessee (regulated) firm which is relevant.
13. Civil Aeronautics Board Policy Statements, Docket No. 31866-2, (Sept. 10, 1970).

latter case, the vendee pays a higher price in interest charges for the same service the lessor renders, that is, providing capital. This C.A.B. statement failed to make this distinction, although it would not seriously be contended that aircraft purchased through a conditional sale contract would be excluded from the rate base.

The second difficulty in the above-quoted passage is that by allowing a rental expense, the public would pay twice for capital costs. The proper treatment would be to disallow the rental payment as an expense item; it should only be used as capitalized for rate base inclusion. This way there would be no double payment. The method adopted by the C.A.B., expense only treatment, prohibits the carrier from being allowed a return on capital equipment used in its business in a situation where the carrier is paying the cost of capital employed by it. Clearly, this result is unfair and should be deemed confiscatory.

3. *Federal Maritime Commission.*

The Federal Maritime Commission has indicated that it subscribes to the "expense only" theory previously encountered: "[i]n the earlier decision in this case (6 F.M.B. 14) the Board determined, correctly we think, that the value of terminal facilities used but not owned by the carriers should not be included in the rate base."[14] The Federal Maritime Commission then justifies its conclusion using the same reasoning applied by the Civil Aeronautics Board. "The carriers are not devoting their capital to the public use insofar as such property is concerned."[15] The Commission failed to recognize that, in financing equipment acquisitions by employing finance leases, the capital costs of carriers are paid over a period of time by being included in the rental payments.

The Commission then proceeded to recognize the impropriety of both allowing rentals as an expense and including them in the rate base:

> It is proper to include as expenses the rentals paid and other expenses of the carriers which arise by reason of the use of the facilities. However, to include the value of non-owned property in the rate base and owner's expenses, instead of rentals as expenses, results in a windfall to the carriers at the expense of the shipping public.[16]

This contention is correct; no double *counting* should be allowed. It is the expense items, however, which should be disallowed, not the inclusion of the leased property rate base.

The Federal Maritime Commission employed this reasoning again in *General Increases in Alaskan Rates and Charges*:

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14. Atlantic & Gulf—Puerto Rico General Increase in Rates and Charges, 7 F.M.C. 87 (1963).

15. *Id.* at 110.

16. *Id.* at 110.

> Only owned property will be considered for inclusion in the rate base . . . . Expenses in the form of rent or charter hire of ships are allowable charges to shippers for non-owned property but shippers should not, in addition, pay for a return on such property where no investment is at stake.[17]

Thus, although it might appear that this erroneous reasoning is well entrenched at the FMC, the Commission could change its position in a case now pending. In *Significant Vessel Operating Common Carriers in the Domestic Offshore Trade: Reports of Rate Base and Income Account*,[17a] an initial decision by an administrative law judge considered various alternatives to the Commission's past rulings that leases should not be capitalized. The initial decision offered only the equivocal position that no rule should be applied generally, but rather a case-by-case approach should be used in evaluating leases. Several comments on this decision are appropriate.

The Commission should not follow the decision's recommendation that no rule be adopted: "Any recognition of the capital cost of leasing assets which the Commission may deem desirable can best be achieved on an individual basis rather than by a rule uniformally applicable to different capital structures."[17b] To the contrary, a case-by-case determination deprives the regulated firm of knowing in advance the regulatory treatment of its investment decisions regarding leasing as an acquisition method. This treatment causes uncertainty and precludes rational management decisions on how best to employ limited resources to obtain optimal firm, and ultimately, public benefit.

Another flaw in this decision is its apparent one-sided reliance on business risk as a component of allowable rate of return:

> The risk of business, whatever it may be, is to be compensated for by the allowed rate of return. If the risk of utilizing a leased asset increases the risk of the equity investor then the Commission can properly take that increased risk into account in determining an appropriate rate of return for the equity investment without necessarily including the leased asset in the rate base.[17c].

This approach overlooks the fact that the business risk is not the only component of allowable return; value of assets employed in the business is included as well. A firm that leases ninety percent of its assets may not increase its risk by so doing, but certainly increases the value of the assets employed in the business. Moreover, the risk associated with leasing an asset for its total economic life under a noncancelable finance lease is virtually identical to the risk associated with owning that asset—particularly owning it under an installment sale contract.

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17. 7 F.M.C. 563, 582 (1963).
17a. 14 S.R.R. 1063 (1974).
17b. *Id.* at 1086.
17c. *Id.* at 1085.

In response to the contention that the tax benefits received by the lessor enable him to reduce rental payments to the lessee, the administrative law judge expounded his double rate of return theory:

> What is beyond argument is that the builder/lessor is charging a rental which will return his capital investment (rate base) plus a return thereon. To that extent the rate payer is being charged for the dedicating of that property to the public service. If in addition the cost of the lease is to be included in the carrier's rate base and a return be allowed thereon then the rate payer is burdened with a double rate of return for the same asset dedicated to serving him.[17d]

This theory ignores the fact that lessors are not *sui generis* in charging a price which will return capital investment and a return thereon—*vendors* do exactly the same. Whenever a regulated firm purchases an asset from any vendor, and uses it in his business, the vendor presumably has made a return on its investment in manufacturing the asset, and the regulated firm is allowed a rate of return on its use. The theory is specious. Furthermore, significantly omitted from this opinion is an explanation for the disparate treatment of installment sales as opposed to finance leases that arises from not allowing capitalization of finance leases.

Another myopic view expressed in the decision should not be followed by the Commission: "No discernible benefits to the rate payer by capitalizing leased assets appear in this record, and accordingly, no discernible reason exists to issue a rule permitting it."[17e] Beyond the fact that it is highly questionable whether the rate payer does not benefit by lease capitalization (the cited record may have been deficient), this logic completely ignores the benefit to the regulated firm providing service. It is fundamental that the interest of both the regulated firm as well as the rate payer should be considered in setting fair rates.

B. *State Utility Cases*

1. *Inclusion in Rate Base.*

As early as 1927, the New York Department of Public Service indicated that there was a split of authority regarding inclusion of leased equipment within the rate base. *United Traction Co.* stated:

> There are differences of opinion as to the proper treatment of physical property under [lease]. The trend of decisions indicates, however, that property leased by a public utility, used exclusively in its business, proved to be used and useful, should be valued upon the same basis as the other property, the rental for such property under lease being excluded from operating costs.[18]

In that case, the Commission adopted the proposition that if the

17d. *Id.* at 1083.
17e. *Id.* at 1086.
18. P.U.R. 1927D, 637, 648 (N.Y. Pub. Serv. Comm'n 1927).

rentals were not included in the operating expenses, then the rented property should be included within the rate base.

This case was followed by *Yonkers Railroad Co. v. Public Service Commission of New York*, which cited *United Traction* in elucidating its standard: "[e]ither the rented equipment should be ommitted from the rate base and the rent included as an operating expense or the equipment should be treated as a part of the rate base and the rental eliminated from the operating expenses."[19] The Court then made its choice from what it apparently considered equally viable alternatives:

> The statute says that the rate shall be fixed upon the value of the property actually used in the public service. These cars were actually used in public service and it seems fair to have included them in the rate base and to have excluded the rental from the operating expenses.[20]

The majority opinion failed to critically examine the economic realities of leasing, nor did it consider policy reasons for choosing either of its alternatives. It simply picked one alternative because it seemed "fair," neglecting to state whether the other alternative was likewise fair. The dissenting judge appeared to give the problem more thought in arriving at his novel solution:

> It is stated in the opinion of Justice Crasper that the value of these cars and equipment should be included for the reason that the statute says that the rate shall be fixed upon the value of the property actually used in public service. It seems to me, however, that in determining the value of property actually used in the public service, the statute and decisions have reference to the property of the operating company. It seeks a return upon its capital invested, not upon the capital or property of some other concern. So far as these rented cars and equipment are concerned, the petitioner has invested or expended only the amount of the rentals paid by it and such rentals constitute all of the property of the petitioner devoted to public use, in relation to such cars and equipment. The reasonable rental value thereof should, therefore, be included and the actual value of the property itself should be excluded.[21]

Judge Rhoades appears to have recognized the problem of treating rentals as expenses, but his solution is still inadequate. He does not advocate capitalizing leases for inclusion in the rate base, but only shifting the rental amount paid from an operating expense to inclusion within the rate base.

A different result was reached in *Residents of Binghamton v. Triple Cities Traction Corp.*[22] There the New York Public Service Commission capitalized leases of omnibuses whereby annual rental was slightly more than 25 percent of the cost of the buses, with an option to purchase at the

19. 6 P.U.R. (n.s.) 1, 3 (Pub. Ser. Comm'n 1927).
20. *Id.* at 4.
21. *Id.* at 8.
22. 15 P.U.R. (n.s.) 94 (N.Y. Pub. Serv. Comm'n 1936).

end of five years for $5 each. The Court reasoned that "in practical effect, these leases constitute nothing other than a conditional sale of the buses with payments spread over a period of five years. . . ."[23] This was a quite accurate consideration by the Commission, generated by the facts which virtually demanded this result.

The North Carolina Utilities Commission in *Citizens of Bryson City v. Smoky Moutain Power Co.*[24] recognized that a power plant leased by the power company for thirty years should be included in the rate base. The Court indicated that such treatment was in accord with the trend of decisions, but neither cited cases, nor gave reasons for its choice.

In the case of *Pennsylvania Public Utility Commission v. Equitable Gas Co.*,[25] it is unclear whether the Commission felt the treatment of leases was so well settled that it did not merit discussion, or whether it did not feel it made any difference. At any rate, it treated the gas company's eighty percent leased property as if it were 100 percent owned by the company, with little clue as to its reasoning.

The issue of whether to include leased buses in the rate base was faced in *Minneapolis Street Railroad Co.*[26] By the terms of the lease, annual rental would equal the cost of the buses in four years, hence the Minneapolis Ry. and Warehouse Commission refused to allow the rent as an expense item, ordering the value of the buses to be included in the rate base. This result obtains from employing a constructive ownership theory.

A foggy treatment of the lease issue was presented in *North Carolina Telephone Co.*:

> The Company is presently leasing (apparently on a "rental puchase" plan) certain plant properties from its president. We find that these properties are used and useful in rendering service to the public and that title, perhaps only equitable title or a lesser estate than fee simple, is vested in the company . . . . Accordingly, we shall add the simple average cost of these properties to the average gross book investment . . . .[27]

The Commission's view of the nature of the interests here involved is probably due to its belief that any property "used" should be included in the rate base.

The New Mexico Public Service Commission follows the "used in public service" tests as illustrated in *Moyston*: "[a]s this property is used and useful in the public utility operation, it should be included in the rate base. The rental expense . . . should be eliminated from the expenses to be allowed in this proceeding."[28]

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23. *Id.* at 96.
24. 18 P.U.R. (n.s.) 344 (N.C. Util. Comm'n 1937).
25. 60 P.U.R. (n.s.) 99 (Pa. Pub. Util. Comm'n 1945).
26. 10 P.U.R.3d 356 (Minn. Ry. & Warehouse Comm'n 1937).
27. 35 P.U.R.3d 88, 91 (N.C.Util. Comm'n 1960).
28. 65 P.U.R.3d 481 (N.M. Pub. Serv. Comm'n 1960).

Without indicating why, the Pennsylvania Public Utility Commission included in the rate base of a light company the original cost of a plant which was leased to the company for 99 years. While not allowing the rental payment as an operating expense, it did, however, allow this payment in the "other income deductions" category, which appears to have the same result as allowing it as an operating expense. This inference, if true, leads to the erroneous result of allowing the item to appear both in the rate base and as a subtraction item from current income.[29]

2. *Exclusion from Rate Base.*

Union Electric Light & Power Company[30] involved a pole yard leased by the utility which was excluded from the rate base because the rentals were included as an expense item. No explanation was given to the leasing matter. In *Princeton Water Co.*, the New Jersey Commission, with no explanation, stated: "[t]he Board is of the opinion that the amount represented by the leased lands . . . should be deducted . . ." from the rate base.[31]

The *Parkville Water Company* case represents the classic reason for excluding leases from the rate base. A water reservoir and main were leased by the water company. The court held that "[s]ince this property does not represent any capital outlay on the part of the company . . . we do not consider it a proper element of the rate base, but will allow the rental paid to the lessor as an operating expense."[32] This case represents the reasoning of the "expense only" regulatory authorities.

V. Conclusion

Leasing should not be discouraged in regulated industries by failure to allow a return on leased equipment when identical owned equipment is allowed a return. Moreover, the economic reality of finance leasing transactions affords no valid basis for distinguishing them from treatment accorded to purchase transactions.

The accounting profession, the Uniform Commercial Code, the Internal Revenue Service and the Securities and Exchange Commission have indicated that the form of a lease transaction should not govern the legal consequences arising therefrom. If the economic characteristics of such a transaction cannot distinguish the transaction from a purchase, it should not be treated differently from a purchase. Regulating authorities should borrow from these fields the ability to characterize leases correctly.[33]

29. 60 P.U.R. (n.s.) 99 (Pa. Pub. Util. Comm'n 1945).
30. 17 P.U.R. (n.s.) 337 (Mo. Pub. Serv. Comm'r 1937).
31. 90 P.U.R. (n.s.) 181, 183 (N.J. Bd. of Pub. Util. Comm'n 1951).
32. 12 P.U.R.3d 239, 244 (Md. Pub. Serv. Comm'n 1956).
33. *See generally* Symposium, *Commercial Leasing* 1972 Ill. L.F. 433, 446, 482, 497.

The regulated industry opinions examined are split: some include leases in the rate base whereas others do not. Although this article lauds the inclusion of finance leases in the rate base, and concludes that those authorities who only allow "expense only" treatment are erroneous, it appears that even those decisions including leases in the rate base are not always well-reasoned. Many of these cases appear to rely upon the "being used by it for the convenience of the public" standard enunciated long ago by the Supreme Court. This vague guideline must be employed with caution. Certainly, the court meant to include within that phrase only capital items—not pencils, rented telephones or other non-capital equipment.

It is recognized that capitalization of finance leases presents problems of implementation. Determining the proper interest rate will be challenging for regulatory authorities. Determining where to draw the line between operating leases and finance leases which occupy opposite ends of a continuum is a formidable task. These problems, however, are not insurmountable, and should not stand in the path of according finance leases their proper position in ratemaking proceedings.

There is a wide variety of reasons for leasing rather than purchasing equipment. Some, such as unavailability of credit, can be considered "pure" reasons. Others, such as passing of tax advantages, might be deemed "artificial", at least from a policy viewpoint. It should be recognized that both pure and artificial reasons for leasing are legitimate, because they are based upon rational business judgments.[34]

It could be claimed that by capitalizing leases in regulated industries, encouragement of leasing will result, and consequently, the public will pay more for its goods or services in order to compensate the unnecessary third party, the lessor. This would not be correct. The regulated firm will choose to lease rather than purchase only if there is a rational business reason for so doing. This reason may be due to an overall lower cost (*e.g.*, where tax benefits traded to lessor make lease terms more attractive than purchase) or may be due to a legal restriction (*e.g.*, indenture restrictions on future borrowing). So long as the expected return from the lease is greater than the opportunity cost of not leasing, the public will benefit from the firm's lease decision. The lessor is not a featherbedding third party, but a contributor to the public benefit by the service he performs for the regulated firm. His service may well decrease the overall costs of the regulated firm, allowing a lower cost to the public.

34. *Id.*