COMMONWEALTH OF PENNSYLVANIA
HOUSE OF REPRESENTATIVES
HOUSE CONSUMER AFFAIRS COMMITTEE

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PUBLIC HEARING IN RE: HOUSE BILL 1436

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BEFORE: HONORABLE ROBERT GODSHALL, MAJORITY CHAIRMAN
HONORABLE ELI EVANKOVICH
HONORABLE ROB. W. KAUFFMAN
HONORABLE KURT A. MASSER
HONORABLE CARL WALKER METZGAR
HONORABLE TINA PICKETT
HONORABLE THOMAS QUIGLEY
HONORABLE PETER J. DALEY, MINORITY CHAIRMAN
HONORABLE RYAN BIZZARRO
HONORABLE TINA DAVIS
HONORABLE MARK A. LONGIETTI
HONORABLE ROBERT MATZIE
HONORABLE BRANDON NEUMAN
HONORABLE PAT SCHWEYER
HONORABLE PAM SYNDER

HEARING: Tuesday, September 29, 2015
Commencing at 9:16 a.m.

LOCATION: Main Capitol Building
Room B-31 MC
Harrisburg, PA

WITNESSES: Terrance J. Fitzpatrick
Charles V. Fullem
Mark Kempic
Mark Kaplan
Rod Nevirauskas
Tanya J. McCloskey
Elizabeth Rose Triscari

COMMITTEE STAFF PRESENT:

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I N D E X

P R O C E E D I N G S

CHAIRMAN GODSHALL: In having arrived, I'd like to call the meeting hearing to order. This is a hearing on House Bill 1436 of which I am a sponsor. We'll get started by having the members --- now, I'm going to get away from that at this point. I don't think we need it. We all have our nameplates. House Bill 1436 requires a utilities income tax expense for ratemaking purposes be considered on a standalone basis. I want to reassure the Committee that although the term tax is used in the bill, the bill does not address how taxes paid to the Commonwealth or the IRS are calculated. Rather, the bill solely addresses the issue of a tax expense applied to a utility for ratemaking purposes.

Currently, a ratemaking policy dictated by the Courts and not the General Assembly requires a consolidated income tax expense approach. Under this approach, the combined tax expense of the regulated utility and its unregulated affiliates is used when setting rates through a base rate case at the PUC. While this method may seem to benefit utility ratepayers, general ratemaking policy prohibits consideration of actions of an unregulated affiliate when setting rates of a regulated entity and effectively results in a subsidy to utility ratepayers by an unregulated entity. I know that's a lot of words in there. House Bill 1436 would eliminate the consolidated tax approach and adopt a standalone approach used by a majority of the states and the Federal Energy Regulatory Commission. I believe there are 45 states that do it the way we're proposing here.

This is a session day and we must conclude this hearing by 11:00 a.m. I ask both presenters and members to be aware of the time constraints and keep your presentations, questions and answers as succinct as possible. And Chairman Daley, do you have any comments at this point?

CHAIRMAN DALEY: Nothing.

CHAIRMAN GODSHALL: No comments. I wish sometimes that would be the same for me, but anyway, we're going to start. Utility Panel. Okay. First, we're going to open with the Utility Panel. Terry Fitzpatrick, President and CEO, Energy Association of Pennsylvania; Charles Fullem, Director, Rates and Regulatory Affairs of First Energy; Mark Kempic, President, Columbia Gas of Pennsylvania; Mark Kaplan, CFO, Duquesne Light Company; and Rod Nevirauskas, Director, Rates and Regulations, Pennsylvania American Water Company. Gentlemen. After this panel, we're going to have an advocate panel doing the same thing as what we're doing here. Terry, when you speak, introduce yourself, you know, as you go along. Okay. You're going to open, Terry?

MR. FITZPATRICK: Yes. Good morning, Chairman Godshall and Chairman Daley, members of the Committee. I'm

Terry Fitzpatrick, President and CEO of the Energy Association of Pennsylvania. We're a trade group that includes the electric and the natural gas utilities operating in Pennsylvania, and thanks for the chance to be before you today. Just by way of introduction, I'm going to give an overview of this issue and try to summarize it for you. I'm sitting here, frankly, with folks with the rate departments generally of the utilities, and they can explain some of the details of this better than me, but I'll give an overview and then turn it over for them for a little more explanation and maybe example of how their companies are particularly affected by this issue.

The hearing today is on House Bill 1436. It would amend the Public Utility Code to require that in rate proceedings before the PUC, the federal tax expense of a utility must be calculated on a standalone basis. And that is, the tax expense must be based on the utility's own operations, expenses, and investments, and not on those of the utility's unregulated affiliates or parent company. We support this legislation and request that the Committee approve it at the earliest opportunity.

The background of this is that the Federal Internal Revenue Code allows a group of affiliated companies to file returns on a consolidated basis, and what that does is it allows the losses of one affiliate to offset the income earned by another, so that if you look at the entire group, they pay less in tax than they would if they each filed individually. In a utility ratemaking proceeding where a utility is part of that consolidated group, that raises the question of how to determine the utility's share of that group tax liability. And I want to emphasize, that's what has to be done here in that kind of a case. You need to determine what's the responsibility of each of those affiliates for the --- you know, for the tax return and the tax liability.

Now, a strong majority of states and the federal government, the Federal Energy Regulatory Commission, addressed this issue consistently with how they handle other financial issues involving utility and its unregulated affiliates. They seek to keep them separate. They calculate the utility's tax expense based on its own operations, investments, and expenses, and not on those of the unregulated affiliates, and this is what we call the standalone approach, and this is of course what House Bill 1436 would do.

In Pennsylvania, however, the state appellate courts have mandated a policy followed by a small and shrinking number of jurisdictions and have required the PUC to make a consolidated tax adjustment so that the rates of the utility are reduced to reflect the tax benefits arising from the business activities of the unregulated affiliate.

We submit that the majority of states and the Federal Energy Regulatory Commission have it right in that the standalone basis should be used. The approach is fair and consistent with general regulatory requirements that utilities and unregulated affiliates maintain separate books and records, and that's a policy that's designed to prevent utility customers from subsidizing unregulated businesses. Well, the reverse is true. Fairness requires that subsidies from the unregulated businesses to utility customers should also be prevented just as utility rates may not be increased to recover losses of an unregulated affiliate, so too the rates of a public utility should not be decreased based upon tax losses arising from the activities of these unregulated affiliates.

This approach, we believe, fairly allocates benefits and burdens. So if utility customers bore the burden of an expense, they would also receive the benefit of a tax deduction related to that expense, but they would not receive the benefit of a tax deduction that arose from an expense that was borne by the shareholders of an unregulated affiliate.

This standalone approach also, in addition to being more fair, it also has the advantage of encouraging investment. Currently because of this consolidated tax adjustment, an unregulated affiliate of a Pennsylvania utility is at a competitive disadvantage relative to other companies that do not have utility affiliates in the Commonwealth. And this is so because the unregulated affiliate of the Pennsylvania utility is forced to give back to utility customers some of the tax benefits related to its activities, while a competing company that does not have a utility affiliate in Pennsylvania can retain and can reinvest those tax benefits.

Just to give an example, a company that was engaged in natural gas production in Pennsylvania that's affiliated with a Pennsylvania utility is at this type of competitive advantage that I talked about because while the company that has the utility affiliate in PA has to flow back some of the tax benefits to utility customers, its competitor can retain those benefits and can reinvest them in gas exploration and production. And this isn't just a theoretical issue that I'm raising, because the reason the Federal Energy Regulatory Commission changed its policy and adopted the standalone approach back in the '80s was because at that time, it was trying to encourage gas production, and the pipelines that it regulated had affiliates that were involved in gas exploration and production.

Now, over the past several decades, there's been a clear trend away from making this consolidated tax adjustment. As I said, FERC began moving away from it in the '70s and '80s. In addition to that, in 2007, Virginia adopted a statute providing that the utility's federal tax expense has to be treated on a standalone basis. In 2013, the Texas legislature amended their law to prohibit the use of a consolidated tax adjustment for electric utilities. And finally, just last year, the New Jersey Board of Public Utilities entered an order modifying its CTA policy and greatly reducing the subsidy to utility customers.

Now, if it weren't for the Appellate Court decisions here, frankly, this is an issue we would take up with the PUC. It really should have been left with the PUC in the first place, but because the courts have now mandated this, this is why we need to come to the legislature to have this policy changed.

So in summary, to encourage investment in PA and align the Commonwealth with the policy followed by a strong majority of other states and the federal government, we would respectfully request the General Assembly to enact House Bill 1436 which adopts this standalone approach in rate proceedings and eliminate the consolidated tax adjustment. Thanks very much.

CHAIRMAN GODSHALL: Thank you. What we're going to do is we're going to hold off questions until --- because a lot of questions will probably be answered by the future speakers, so you can continue with the next speaker. Identify yourself and go forward.

MR. FULLEM: Good morning, Chairman Godshall, Chairman Daley, and members of the Committee. I'm Chuck Fullem, Director of Rates and Regulatory Affairs in Pennsylvania for First Energy Service Company, which is a direct subsidiary of First Energy Corporation. The Pennsylvania Rate Department of FirstEnergy Services provides regulatory support for each of the FirstEnergy's wholly-owned Pennsylvania operating companies, which include Met-Ed, Penelec, Penn Power, and West Penn Power. Today, I am here to support House Bill 1436.

CHAIRMAN GODSHALL: Excuse me. For the members, all of this testimony is in your folders. I'm sorry. Go ahead.

MR. FULLEM: Just to reiterate what Chairman Godshall started the meeting with today, to be clear, House Bill 1436 does not change the amount of taxes paid to the federal government or to the Commonwealth of Pennsylvania by any of our companies. And as Mr. Fitzpatrick explained, House Bill 1436 addresses what is known as a consolidated tax adjustment, which is purely a regulatory construct used in Pennsylvania in a small and shrinking minority of jurisdictions to appropriate the tax benefits generated by a nonregulated affiliate and hand them over to customers of a regulated utility in the form of lower rates.

The Pennsylvania Competition Act resulted in traditional electric utilities being split in the regulated distribution companies and unregulated generation companies. Since the passage of the Competition Act, our distribution companies have kept separate books and records from our generation companies, and the distribution and generation companies must issue their own debt. These actions help assure, in fact, they result in, the rates of a public utility will not be increased in any way to recover the losses of the generation company. Likewise, the rates of a public utility should not be decreased based on the losses --- tax losses arising from the operation of the generation company.

In Pennsylvania, the Public Utilities Commission has had their hands tied and are unable to create that balance because of a 30-year-old court case that predates the Competition Act that mandates the imposition of the consolidated tax adjustment. House Bill 1436 would eliminate the CTA by specifying that the calculation of the allowable federal income tax expense for ratemaking be established based on the expense and revenue of each individual EDC. House Bill 1436 is therefore consistent with the structure of electric distribution regulation created by the Competition Act. It will also benefit the citizens of the Commonwealth of Pennsylvania by supporting increased cash available for EDCs to support their long-term infrastructure improvement plans, which are designed to increase investment to improve service to our Pennsylvania customers. Thank you.

MR. KEMPIC: Good morning. My name is Mark Kempic. I'm president of Columbia Gas of Pennsylvania. I wanted to thank Representative Godshall and Daley --- Representative Daley, as well as all of the other representatives for listing to our positions here this morning. Just as a means of introduction, Columbia Gas of Pennsylvania is one of seven different companies within the family of companies called NiSource. We operate in seven different states. Pennsylvania is the only state that does consolidated tax adjustment for ratemaking purposes in such a heavy-handed manner as we're discussing here today. I'm here today to talk about why this is so important to Pennsylvania, why it's so important to Columbia Gas of Pennsylvania, and the practical impact that it's going to have on companies like Columbia Gas of Pennsylvania. I'm doing it a little bit differently than the other --- the other panelists. You'll see that I have a presentation as opposed to words. I tend to talk through things and I encourage a lot of questions, but I respect Chairman Godshall's request that all questions be held until the end, so please write them down as you think of the questions.

If you go to the presentation on the second page, we believe the current system is arbitrary, outdated, and really irresponsible. As Terry Fitzpatrick said, it's arbitrary because it allows this commingling of unregulated funds with regulated funds. It's out of sync with traditional standard ratemaking processes where you do what they call wing fencing to keep all of the utilities, expenses, and revenues in one bucket. This incorporates unregulated dollars, expenses, into that bucket. We believe that's incorrect.

Second reason that it's arbitrary is it's really out of sync with reality. The utilities do not actually get the benefit of the taxes. It's done for ratemaking purposes. You don't actually get the benefit of the tax. This works simply to lower the return on equity that the utility is able to achieve, making it more difficult to attract investment in Pennsylvania, which I'll talk about in a second.

Third, I'd like to point out, I agree with what Terry said about investing in unregulated activities like Marcellus shale. As we know, we need midstream investment in Pennsylvania, eliminating this --- supporting House Bill 1436 will actually encourage utilities to get into that type of business as it did at the federal regulatory --- federal level. However, more importantly, there are currently situations like Columbus Gas where we do our financing through an unregulated affiliate. There are consolidated taxes mixed with Columbia Gas of Pennsylvania's revenues, and it impacts us in a negative fashion, as we'll discuss today. So it's no only about investing in the unregulated pipelines, it's about investing in Pennsylvania's regulated utilities as well. It's outdated. I won't go into the detail about how many --- only five other states do this this way. I would argue that Pennsylvania's is the most heavy-handed method in all of the 50 states.

Finally, it's really irresponsible because it shakes the investor's credibility in utilities. You don't know, as I'll discuss in a second, whether Pennsylvania is going to be a good state to invest in when it comes to the utility investment. If you flip to the next page, we're speaking about utility investment. You see Columbia Gas's investments since 2006. You see that we have increasingly invested in Pennsylvania so much that we are now at about $200 million of investment in Pennsylvania. The thing I love about this is if you look back at 2006, 2007, there we were investing basically at our depreciation rate, which is, you know, you invest basically just to keep the pipes replaced that you need to keep replaced. Because of the work done in Pennsylvania on the legislation that we know as DISC, we have been able to get investment in Pennsylvania to keep a lot of people working. We've created about 800 to 850 jobs. These are good-paying jobs. These are people that are doing construction services. These are welders. These are people paving streets after we replace pipes. These are all family-sustaining jobs. If we don't address the consolidated tax adjustment for ratemaking purposes, this could impact our ability to keep these jobs in place.

The thing I love about this investment, it's in Pennsylvania. It's literally in the soil in Pennsylvania. Not that we want to --- I'll be very clear. Not that we want to outsource this, but the beauty about utility investment is it's in the soil in Pennsylvania. You have to do it locally. In some of our poorer communities, that's what so essential about this and that's why we want to protect this.

So if you flip the page, you're probably saying, well, Mark, you've invested a lot in Pennsylvania over the past seven years or so. What's changed? This has been the policy in Pennsylvania for 20 years. We're hearing that. The point is, there's an interplay with what we call bonus depreciation of the federal government, and the consolidated tax adjustment is out of sync with that interplay. The bonus depreciation has masked the impact of consolidated tax adjustment on Columbia Gas of Pennsylvania, but you never know when you're making the investment whether you're going to have bonus depreciation. So what happens ultimately is you make a decision to invest, and then if bonus depreciation isn't passed, the consolidated tax adjustment comes back and it's a gotcha. Not a Godshall, it's a gotcha after the fact, and it destroys the viability of your investment after the fact. That's what's so insidious about how the consolidated tax adjustment is done through the ratemaking process.

So if you flip the page one more time, here are some of the concerns that we have. Those 850 or so jobs that we said that we've created, it would threaten those. Just to put this into context, the impact of the consolidated tax adjustment on Columbia Gas of Pennsylvania alone, the value of that is enough to fund our entire leak repair program for an entire year. So that's 3,400 leaks or so that we repair every year, that's the value that will be taken out of the company, impairing our ability to repair leaks, impairing our ability to replace pipe, impairing our ability to extend our service into other areas because it would lower our rate of return.

Just this past week --- I'm sorry, just this past month, I went to our corporate parent and we were awarded additional capital of over 12 million additional dollars to replace pipe in Pennsylvania. The very clear discussion was, we are getting that capital in Pennsylvania because of DISC, because we are a good investment, because again, we're above and beyond what's necessary to replace the leaking pipe. We're doing this because we want to get ahead of the leaks, we want to replace that pipe before it needs to be replaced. We want to do that while gas bills are low, which they are right now, so we want to get ahead of the game here. If the consolidated tax adjustment legislation is not passed, we're worried that it will no longer be a good investment for Pennsylvania, and we will have to fight much harder to maintain those very beautiful levels of investment and keeping all of those people in Pennsylvania employed.

So with that, I will conclude my comments, and I will be available for any questions. Thank you.

CHAIRMAN GODSHALL: What I'm going to do at this time, because we're running real good time-wise, I'm going to, you know, ask for questions on the previous three --- on the previous three people that had given us a report.

Terry, starting with you, it's been suggested that this is just an automatic rate increase. You know, even with --- if this would pass, everything would go to the PUC. And the overall picture would be what's looked at by the PUC. Maybe you can sort of clarify, you know, that statement or misstatement.

MR. FITZPATRICK: You're correct. It would not be an automatic rate increase, clearly, Chairman, and there's a couple reasons for that. First of all, this wouldn't take effect, if at all, until a company comes in and files a rate proceeding before the Commission. At that point, it would be one of the issues among the multitude of issues that are looked at in the case, and all of them can affect the rate recovery. Furthermore, not every utility is affected by this. Some may not file a consolidated tax return, or if they do, because of their peculiar circumstances, they just might not be impacted. I mean, we did survey our companies about the rate impacts and some said none. You know, it wouldn't have any effect at all. So clearly, there's no automatic rate increase built in here.

And I guess I'd also make the fundamental point, though, we think for all these years, frankly, the utility --- because of this issue, the utility shareholders have been subsidizing the ratepayers because the --- again, the tax benefit ---. In every case that I have looked at, and I have looked at cases in Pennsylvania and around the country, this always comes up in a situation where it's the utility that has the income and it's the unregulated affiliate that has the loss. And I think the reason for that isn't hard to understand. I mean, utilities are generally steady. They don't have exorbitant returns, that's regulated, but they have steady returns, so they have the income. It's the other businesses that are more risky that have the losses. It always comes up in that context.

CHAIRMAN GODSHALL: Another question that I have is on that bonus. I don't quite understand that bonus that you were talking about.

MR. FITZPATRICK: Right. I should have explained that a little bit better. Sorry for that. Bonus depreciation is a federal policy that encourages investment. It started in about 2006, 2007, when the economic downturn happened. And the way that it works, and I'm no tax expert, but the way that it works is it basically eliminates the impact of consolidated tax adjustments on at least Columbia Gas of Pennsylvania. So we have been able to avoid any impact of consolidated tax adjustment through the ratemaking process because of the existence of bonus depreciation. It is not passed for 2015 yet. We don't know if it will be. We think it will be for '15 and '16, but we're not sure. But the point is, our investment decisions had to be made prior to that. So if it's not passed, the consolidated tax adjustments will start to kick in for Columbia Gas of Pennsylvania, and when we go for a rate case, our rates will be lowered to the tune of probably well over $10 million, which will impact our ability to continue to fund our programs. So it's an interplay, it's a complicated interplay, but it essentially wipes out the impact of a consolidated tax adjustment for ratemaking purposes when it exists.

CHAIRMAN GODSHALL: Thank you. Representative Longietti?

REPRESENTATIVE LONGIETTI: Thank you, Mr. Chairman. And thank you, to all of you, for trying to explain as simple as possible, a somewhat complex but somewhat simple matter. And I know we're not here to talk necessarily about taxes. I understand the difference between the two, but just curious, in your mind, why is it fair to have consolidated tax return for tax purposes but that shouldn't be the case when it comes to rate cases? I don't know if anybody can answer that question.

MR. FULLEM: You know, I think for me, the easiest way to explain that is, you know, we've talked about how it --- it's talked about what we call or what's been referred to as the actual taxes paid doctrine where it's been known that Pennsylvania has attempted to follow the actual taxes paid. And I see that as flawed because it doesn't recognize the potential for the tax losses of an affiliate to actually be carried forward in the future years to offset future gains by that affiliate. You know, the corporate parent is making a decision to allow for that consolidation and to take that cash now to reduce their tax burden today, but if that affiliate --- we didn't take it at that time, they could have carried it forward to a future date, and at that time it would have been essentially to offset the costs of that affiliate that incurred the loss and would have accrued the shareholders. Because we've made essentially a cash decision, I don't see how that, and to manage that cash, means that ultimately those losses should then be passed through to an affiliate's ratepayers. So I think it ignores the fact that the affiliate that incurred the loss would have had the ability to capture the benefits of that loss in a future time frame.

REPRESENTATIVE LONGIETTI: And I assume that it's the federal tax that's probably the most concerning?

MR. FULLEM: Yeah. The consolidated tax adjustment is known in regulatory jargon that we're talking about today is all about federal taxes and it doesn't really apply to the state tax.

REPRESENTATIVE LONGIETTI: What's the carry forward on the federal basis? I know in Pennsylvania, we have limits on ---.

MR. FULLEM: There is a limit but I don't know what that limit is off the top of my head.

REPRESENTATIVE LONGIETTI: Thank you.

CHAIRMAN GODSHALL: Are there any other questions at this time? Mr. Fullem? Well, this would be spread across all --- this would be spread across all classes. We're not just talking about the consumer. It's across the board.

MR. FULLEM: Yes. I mean, the effect of the --- from a ratemaking perspective, the consolidated tax adjustment gets spread to all classes based on the same methodology that we use to assign federal income taxes to the industrial class, the residential class, and the commercial class. So it would be a burden that would be shared by all or passed on to all. And I have been told that the carry forward for federal income tax purposes is 15 years, so obviously those affiliates could carry that forward for a lengthy period of time. But yes, Mr. Chairman, it would be --- it's not just borne by the residential customer.

CHAIRMAN GODSHALL: Thank you very much. If there are no further questions, we are going to continue on with our testifiers.

MR. KAPLAN: Okay. Thank you. Good morning. Good morning, Chairman Godshall, Chairman Daley, and members of the Committee. My name is Mark Kaplan. I'm senior vice president, chief financial officer, and treasurer for Duquesne Light Holdings. Duquesne Light's utility serves about 600,000 customers covering about 817 square miles in Allegheny and Beaver Counties. For reasons stated in the testimony of Terry Fitzpatrick, president and CEO of Energy Association of Pennsylvania and other members of the panel, we support House Bill 1436 to eliminate the CTA as approved by the FERC in nearly every other state.

I'm not going to read in its entirety my prepared testimony. Rather, I'm going to spend some time just focusing on those things that are unique to Duquesne. Within our consolidated group, we have a nonregulated affiliate called DQE Communications, which has added nearly 50 new employees over the last five years. DQE Communications has been named in Pittsburgh's Top 100 Fastest-Growing Companies in the area. When computing the taxable income for this affiliate company, we are permitted to take a tax deduction for a large portion of this capital spend, the bonus depreciation that we just discussed here previously. When we do that, we reduce the tax cash paid to the federal government. DQE Communications will use this tax cash savings to invest in capital, expand the business, and create jobs. However, the current CTA imposed by the appellate courts results in Duquesne Light's customers receiving a portion of DQE Communications's tax benefits.

Through the CTA mechanism, any loss from DQE Communications will ultimately reduce utility customer rates even though its customers do not pay for the DQE Communications investment nor take any risk associated with a nonregulated business. By flowing a tax benefit associated with the affiliate's tax loss to the utility in the form of lower rates, the communications businesses denied the use of the tax benefit within its own operations. The affiliate is financially handicapped by the CTA because of its relationship to the regulated utility, whereas another communications business without a PUC-regulated affiliate suffers no such detriment and would be able to fully utilize any tax benefits generated from its own separate company operations. The utility is not permitted to increase rates to recover losses of its nonregulated affiliates. However, the CTA operates to only decrease rates based upon the tax losses arising from the nonregulated affiliates. This situation demonstrates the fundamental flaw in the CTA, and respectfully why it must be fixed through this legislation. Just to give you perspective in terms of what the CTA has meant to us in terms of our last couple of rate cases, on average, the CTA impact has been less than 50 cents per month per customer over our last couple of rate cases.

I want to thank you for the opportunity to present this testimony and I will be happy to entertain any questions that you may have.

CHAIRMAN GODSHALL: I was interested in --- believe it or not, I read this stuff last night. That was during the

Pirates game when there wasn't a lot of activity, but 50 cents per month, maybe you can expound, you know, on that exactly --- you know, just exactly where you're going there.

MR. KAPLAN: Yeah. So at least in our particular instance, when we look at what the impact of the CTA has been historically, it hasn't been significant to our customers. However, when you look at the CTA mechanism, that's highly dependent upon the profitability of the other companies that are within the consolidated tax group that we talked about, and also what the profitability is of the utility, whether it be bonus depreciation or not be bonus depreciation. And so while in our case it has not been significant in the past, it is a calculation that does have a good deal of variability associated with it that makes it difficult to plan around because there are so many variables that one has to consider in looking at what your CTA will be going forward.

CHAIRMAN GODSHALL: Is there anybody else? What is your projected impact on rates under a standalone --- under a standalone if standalone is approved?

MR. KAPLAN: Well, in our case, if we use our past rate cases as a predictor of the future, it would be about 50 cents per customer. So as a result of doing standalone calculations, customer rates would increase a little less than 50 cents per month per customer.

CHAIRMAN GODSHALL: Representative Longietti?

REPRESENTATIVE LONGIETTI: Thank you, Mr. Chairman. It's one of those mornings where I have another committee meeting, so I wanted to ask this question because I'm not going to necessarily be here for all of the next panel. So the advocate says in their testimony to eliminate the consolidated tax savings as proposed in House Bill 1436 would allow a utility to collect from ratepayers hypothetical taxes it never pays to the federal or state government. This would be a direct transfer from ratepayers to shareholders' profit. I just want to hear the other side of that statement.

MR. FITZPATRICK: I'll take a shot at it first, Representative. The important thing to remember here is, the utility is not paying the taxes itself, so the term actual taxes paid is a bit deceptive, frankly, because no matter which way you look at this, you've got to somehow allocate that tax responsibility among all of the affiliates. So in that sense, any way that you did it would be hypothetical, but that's the task that you have to do. The real question is, what's the most fair way to allocate that among all of the different affiliates? And we think it's look at each of their circumstances, look at their operations, their expenses, their investments, and determine what it would be for each of them on a standalone basis.

REPRESENTATIVE LONGIETTI: Thank you.

CHAIRMAN GODSHALL: No further questions? Thank you. We will continue with the next testifier.

MR. NEVIRAUSKAS: Good morning. My name is Rod Nevirauskas. I'm the director of rates and regulation for Pennsylvania American Water. I appreciate the opportunity to speak to the group this morning regarding this very important bill, House Bill 1436. Pennsylvania American Water provides water and wastewater service to more than 2.2 million people in 400 communities across the Commonwealth. We're the largest investor in water utility in the state, providing water and wastewater service to approximately 670,000 customers. We own and maintain more than 10,000 miles of pipeline in Pennsylvania.

I'm trying not to be too redundant with what you've already heard this morning, so I'm going to talk about a couple other things. The CTA is bad regulatory policy because it creates a commingling of funds. It has long been regarded as a sound regulatory policy not to commingle or combine the income and expenses of public utilities with those of nonregulated affiliates for fear that utility customers could end up subsidizing or being subsidized by non-utility operations.

Pennsylvania American Water customers do not subsidize losses of American Water's unregulated operations, nor should they. However, because of the Pennsylvania treatment of consolidated taxes, American Water's nonregulated subsidiaries are subsidizing Pennsylvania American Water customers for ratemaking purposes only at an estimated $5 million annually. That's the impact on Pennsylvania American right now, about $5 million annually, a little over $5 million, and then it averages out to about 45 cents per month per residential customer.

We've heard a little bit about investment. Pennsylvania American will invest approximately $250 million this year in infrastructure. This regulatory policy penalizes investors by passing a portion of the tax benefits of the unregulated losses to Pennsylvania American's water customers. Pennsylvania American Water competes for infrastructure dollars from our parent company. Needless to say, unfair regulatory policies detract from our ability to attract capital dollars to invest in Pennsylvania. Okay.

The customers don't shoulder the financial risks of American Water's unregulated affiliate companies. However, they do benefit from the allocation of the consolidated tax adjustment because the allocation reduces federal tax expense for ratemaking purposes. In other words, regulated utilities are not permitted to recover the expenses of their nonregulated affiliates. Therefore, Pennsylvania customers should not get the benefit of the tax loss. And as we've heard before, the adoption of House Bill 1436 would result in no reduction to the taxes paid to the state or federal government, adjustments for ratemaking purposes only.

If I could just summarize with one sentence, the consolidated tax adjustment takes the tax benefits that are earned by one company, in this case, a nonregulated affiliate, and gives those benefits to the customers of another company in the form of reduced rates, and we feel that's just unfair and inappropriate. Thank you.

CHAIRMAN GODSHALL: Thank you. Any questions? As I was reading through this testimony, you know, last night, as I said, it sort of reminded me of something I was involved in a number of years ago, and that was the DISC regulation or law that we put in place, and I heard at that time, and I know Representative Daley was also involved back then, but it's ---. We heard the sky was going to be falling and so forth, and I think the DISC legislation has helped an awful lot of companies, and I do know that as far as the --- especially down in the southeast, without naming names, but ---. Mark, I didn't look at you. You know, without naming names, I know that some of our gas companies are looking at pipes that are 50 years and 75 years and possibly even 100 years old and have to be, you know, replaced, and they just have to be replaced. And it is a problem. And I know that the DISC legislation has helped an awful lot to get, you know, away from some of that. You know, we haven't replaced all of those pipes, but there are still thousands of miles of pipes that have to be replaced and should be replaced very quickly. So you know, I look at this as a following, really, of that DISC legislation in modernizing what we're doing, you know, for our utilities. And I believe, as I did in the DISC legislation, that something is necessary. The PUC has given some comments that they are neutral on this whole thing, but they have also made some suggestions which I think should be looked at. So you know, I appreciate your testimony this morning. I appreciate your comments and your answer to the questions, and Pete, do you have anything?

CHAIRMAN DALEY: I don't. I do not.

CHAIRMAN GODSHALL: Okay. I do appreciate what you said, and we're going to go to our next group of testifiers. Is there anything anybody wants to say in conclusion to what we've done here today?

MR. FITZPATRICK: I would just add, I agree entirely with you that this has a lot of similarities to the DISC and it will encourage more investment to come to Pennsylvania, or to keep high levels of investment coming to Pennsylvania, and I just wanted to thank you for recognizing that and to thank you for the DISC and thank you for giving me an opportunity to comment today.

CHAIRMAN GODSHALL: Thank you. We have Tanya McCloskey, Acting Consumer Advocate, and Elizabeth Triscari, Esquire, Deputy Small Business Advocate. Ladies, when ready.

MS. MCCLOSKEY: Thank you. And good morning, Chairman Godshall, Chairman Daley, and members of the

Committee. My name is Tanya McCloskey and I'm the acting consumer advocate for the Office of Consumer Advocate. Thank you inviting me to give comments before this Committee regarding House Bill 1436.

House Bill 1436 concerns the computation of income tax expense for ratemaking purposes and would eliminate the longstanding consolidated tax savings adjustment. The Commission and the Courts have for decades established that just and reasonable rates under Section 1301 of the Public Utility Code require the consolidated tax savings adjustment. The adjustment reflects what has been called the actual taxes paid doctrine and is as simple as its name. Utilities may only collect from ratepayers the taxes that the utilities actually pay to the state and federal government.

It is basic ratemaking that the rates of the utility are to be set on the basis of providing a fair rate of return on the investment in plant used and useful in providing adequate utility service after the allowance for proper operating expenses, taxes, depreciation, and other legitimate items. While the Commission has discretion in considering what expenses incurred by the utility may be charged to ratepayers, the Commission cannot include hypothetical expenses that are not actually incurred by the utility. To eliminate the consolidated tax savings adjustment as is proposed in House Bill 1436 would allow a utility to collect from ratepayers hypothetical taxes that it never pays to the federal or state government. The additional expense included in rates would be a direct transfer from the ratepayers to the shareholders' profits.

If House Bill 1436 had been in place for the last several base rate cases filed by our major electric, natural gas, and water utilities, tax expense included in rates would have increased by $28.6 million annually for just these seven utilities. I provide a table in my testimony showing the tax expense savings for these seven utilities. The amount of the rate increase needed to collect this expense is much higher than the 28.6 million as there will be additional taxes on the revenue required for this additional expense. This is what is known as the gross up factor in ratemaking. When grossed up for ratemaking purposes, my office has calculated that the actual increase in rates for just these seven utilities is approximately $51.7 million per year.

Utility challenges to the consolidated tax savings adjustment are not new, extending back many decades. The Pennsylvania Appellate Courts, though, have been consistent and clear in rejecting all challenges. I have included an appendix with these cases dating back to 1956. Most importantly, the Courts have recognized that there is no place in ratemaking for claims for hypothetical expenses which are not actually incurred by the utility.

I do not often quote from the Courts in my testimony to this Committee, but in this instance, the Courts have perhaps said it best. For example, in 1980, the Pennsylvania Commonwealth Court captured the point as follows, and I quote, we cannot condone a plea which would allow a parent company to collect a phantom tax. In reality, it is never paid to the government, but retained by the company as profit and passed on to the ratepayer by way of a subsidiary-claimed non-existent tax expense, end quote.

The Pennsylvania Supreme Court put the issue firmly to rest in the landmark 1985 case, Barasch v. Pennsylvania Public Utility Commission. In that case, the Pennsylvania Supreme Court concluded that it, too, could not condone the inclusion of fictitious expenses in the rates charged to customers. The arguments against the consolidated tax savings adjustment mostly center around a perceived unfairness that ratepayers are not asked to pay for the losses of the affiliates, but they are able to receive the benefit of the tax loss. Many benefits accrue to the corporation through a holding company structure. In fact, approval of such structures for utility was intended to provide affirmative public benefits under the Public Utility Code. As to taxes, one of the key benefits from the use of the consolidated group tax return, which I must note is a voluntary choice on the part of the parent company, is that it allows the parent company to use the losses of some affiliates that otherwise they may have been unable to use or significantly delayed the use for purposes of reducing the overall tax liability of the corporation. Public utilities, because of the authorized rate of return in the regulation, most often generate positive income so that the losses of the other affiliates can be timely used by the parent company to its benefit.

The Pennsylvania Supreme Court also aptly described the serious flaw in this argument. While the quote is lengthy in my testimony and I will not read it here, the key point is that when a utility joins a larger group, for example, to increase its purchasing power and lower its costs, we would not condone including theoretical higher costs in the ratemaking process. There is no reason to treat taxes differently. If we allow our utilities to become part of multistate holding companies but then treat them solely as a standalone company for ratemaking tax purposes, the tax benefits of the holding company structure will simply be lost to Pennsylvania and its ratepayers.

Another argument that has been made against the consolidated tax savings adjustment is that there will be a loss of investment. Tax dollars collected from ratepayers are not intended to fund investment, and indeed, these hypothetical tax dollars are not required to be invested by the utility or in the utility at all. This hypothetical tax expense is paid to the parent company, and the parent company can retain it as a profit or invest the dollars in other affiliates if it so chooses.

Additionally, the General Assembly has already provided for further investment and infrastructure through the implementation of the Distribution System Improvement Charge in 2012. Allowing a hypothetical expense to further investment would simply go around the carefully crafted mechanism established by the General Assembly with its many consumer protections.

I do recognize that some states have moved away from the use of consolidated tax savings adjustment over the years. This does not provide support, however, for overturning decades of Pennsylvania Commission and Court precedent that have ensured that ratepayers pay only those costs that are actually paid or payable by the utility. I do find it interesting, though, that while our utilities would like to adopt other states' consolidated tax policies, they are not asking for the lower return on equity that is often granted to utilities in those states.

Thank you for the opportunity to testify here today on the impact of House Bill 1436 on ratepayers. I look forward to answering any questions you may have.

MS. TRISCARI: Good morning, Chairman Godshall, Chairman Daley, distinguished members of the House Consumer

Affairs Committee, participating utility companies, and other interested stakeholders that are here today. Thank you for this invitation to testify before your Committee today.

My name is Elizabeth Rose Triscari. I serve as Pennsylvania's Deputy Small Business Advocate. Small Business Advocate, John Evans, regrets that he wasn't able to join us here today, but he asked me to please come and give you our position, the OSBA's position, on House Bill 1436.

As many of you know, the OSBA is charged with representing the interests of Pennsylvania's small business utility customers. In order to protect those interests, we as OSBA must oppose House Bill 1436 because it seeks to overturn the Commonwealth's longstanding actual taxes paid doctrine and it would result in an inequitable increase in the utility rates of small businesses. I'm not going to go into what the actual taxes paid doctrine is. I think Ms. McCloskey covered that very well, but again, I just want to make the point that this doctrine does not allow a utility company to charge ratepayers hypothetical tax expenses that are not actually payable, that they're not liable for, that they will never pay.

In contrast, House Bill 1436 would permit a utility to calculate what taxes it would have paid if it had filed on a standalone basis instead of what taxes it actually paid by participating in a consolidated return with unregulated affiliates. If House Bill 1436 becomes law, the result would be the taxes the utility is not actually liable for, that it does not actually pay, will be charged to ratepayers. This is not sound ratemaking. It is a generally accepted ratemaking principle that utilities are permitted to recover through rates their actual cost of providing service to customers or earning a fair rate of return on the investment in plant used and useful in providing adequate utility service. A reasonable allowance for federal income taxes is included in this cost of service. However, House Bill 1436 goes well beyond this general principle and would permit utilities to recover from ratepayers taxes that are not payable. It would allow utilities to charge ratepayers for theoretical expenses for which the utility is not liable for and will never pay.

I also want to make a point as far as small businesses are concerned. This is going to be a double hit to them in their rates. They pay rates at home as residential customers and also as small businesses. Small businesses are job creators in the Commonwealth. They operate on very thin margins as it is, and as you've seen from Ms. McCloskey's testimony, we're talking about real dollars here and a real significant increase to rates if this bill were to go into effect. The OSBA does not believe it is fair to charge these small businesses who already pay well enough in federal taxes to also now have to be on the hook for federal taxes the utility company itself does not have to pay.

Thank you for your time and attention. I welcome any questions or comments you may have.

CHAIRMAN GODSHALL: I read the testimony, as I said, last evening, and I've heard it again, but Pennsylvania is one of only a few states, about four or five states, to continue to require a CTA approach, and why is a standalone policy that's been adopted by a large majority of the states including the Federal Energy Regulatory Commission not appropriate for Pennsylvania when it is for all of the other states?

MS. MCCLOSKEY: I think there are a lot of differences in other states as well, and one of the important points is that Pennsylvania, when it does mergers and consolidations and allows for these multistate holding companies, which has been occurring over the last several decades, has what's called an affirmative public benefits standard. Other states have a do no harm, I'll call it, type of standard. So in Pennsylvania, it's part of the compact, so to speak, of granting merger approval that these affirmative benefits be provided to ratepayers as part of the approval process. I think as well, as I pointed out, other states do provide much lower rates of return, authorized rates of return in their ratemaking process than what Pennsylvania has traditionally provided as well.

CHAIRMAN GODSHALL: I don't have a comparison on that, so you know, I'm just taking your word for it, but on another issue, you used the word hypothetical. In response to the OCA statement that when a CTA is used, a utility tax expense is hypothetical, according to written comments submitted by the PUC, quote, when consolidated tax returns are used by a parent corporation, each subsidiary of a parent corporation calculates its separate income deductions, tax liability, tax credits on a standalone basis. Each subsidiary then submit its calculations to the parent, end of quote. Based upon this statement, it seems that the tax expense of the regulated utility is not hypothetical but rather is calculated on a standalone basis, and then combined with the expenses of other subsidiaries. Why should this separately calculated figure not be used in favor of tax expense that incudes regulated and unregulated entities when setting the rates of a utility that effectively stands alone in all other ratemaking considerations?

MS. MCCLOSKEY: Well, I think there's a difference between the calculation of the tax liability and the actual expense that's paid. All of the companies do make a calculation based on a standalone basis, but when the parent voluntarily chooses to file a consolidated group to the mutual benefit of the corporation, it then combines those to determine its own tax expense and tax liability into one, and then that tax expense is what is --- the utility then that is allocated to it is what is paid up to the parent corporation. So I think that's a correct description of how it's calculated, and then when you get to what is actually paid, that's when the actual expense that each company is assessed by the parent corporation is determined.

CHAIRMAN GODSHALL: But it really wouldn't be hypothetical. I mean, it's actual.

MS. MCCLOSKEY: Well, no. If you use the standalone, it's hypothetical because they never pay that expense to the parent. They pay a different expense to the parent. They never pay the taxes calculated on a standalone basis to the parent company. And that's why the Courts have called it a hypothetical tax expense.

CHAIRMAN GODSHALL: Any other questions? Representative Daley?

CHAIRMAN DALEY: Thank you, Mr. Chairman. I just wanted to thank all of the panelists. I know it's a real complicated issue on both sides of the fence here, and I know my staff has worked on some questions here, and I know that they've had an ongoing dialog with every one of you. And I want to thank the Chairman for his questions. Thank you.

MS. MCCLOSKEY: Thank you.

MS. TRISCARI: Thank you.

CHAIRMAN GODSHALL: If there are no other questions, I just want to also thank all of the panelists for --- you know, and I do agree with my co-chairman that, you know, when I started on this last night, I kept going backwards to find out what some of these, you know, CTCs and OCAs and every --- all of the other ones that were in your testimony. So anyway, the public --- oh, the Public Utility Commission was not able to participate in today's hearing because all of their Commissioners are in some kind of do-hickey, I'm not sure what, and comments for the inclusion in the ---. They have submitted comments for inclusion. As I said, they were neutral on the issue, and they did submit a few suggestions, so we will take a look at it, and I'll say thank you very much and meeting is adjourned.

MS. MCCLOSKEY: Thank you.

MS. TRISCARI: Thank you.

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HEARING CONCLUDED AT 10:15 A.M.

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