BEFORE THE
House Consumer Affairs Committee

Hearing on House Bill 1436
Legislation requiring "standalone" calculation of federal tax expense of utilities in rate proceedings

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Testimony of

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Good morning Chairman Godshall, Chairman Daley and members of the House Consumer Affairs Committee. I am Terry Fitzpatrick, President and CEO of the Energy Association of Pennsylvania ("EAP" or "Association"), a trade association comprised of electric and natural gas utilities, which are also known as electric distribution companies (EDCs) and natural gas distribution companies (NGDCs), operating in Pennsylvania.[1] Thank you for this opportunity to appear before you today.

The subject of today's hearing is House Bill 1436. This legislation would amend the Public Utility Code to require that, in rate proceedings before the Public Utility Commission (PUC), the federal tax expense of a utility must be calculated on a "standalone" basis. 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. For reasons I will explain below, EAP supports this legislation and requests that the Committee approve it at the earliest opportunity.

By way of background, section 1501 of the Federal Internal Revenue Code allows affiliated companies to file income tax returns on a consolidated basis, so that losses incurred by one affiliate offset income earned by another affiliate, and the group pays less than it would if each company filed individually. In a utility ratemaking proceeding, when a utility is affiliated with non-regulated companies and the group files

[1] Citizens' Electric Company; Duquesne Light Company; Metropolitan Edison Company; PECO Energy Company; Pennsylvania Electric Company; Pennsylvania Power Company; Pike County Light & Power Company; PPL Electric Utilities; UGI Utilities, Inc.-Electric Division; Wellsboro Electric Company; West Penn Power Company; Philadelphia Gas Works; Columbia Gas of PA; Peoples TWP; Peoples Natural Gas Company; UGI Utilities, Inc.; UGI Penn Natural Gas, Inc.; UGI Central Penn Gas, Inc.; PECO Energy Company; and National Fuel Gas Distribution Corp.

a consolidated tax return, this leads to the question of how to determine the utility's share of the group's tax liability.

A strong majority of states and the federal government address this issue consistently with how they handle other financial issues involving a utility and non-regulated affiliates – they seek to keep them separate. They calculate the utility's tax expense based upon its own operations, investments and expenses, and not on those of its unregulated affiliates. In other words, these jurisdictions calculate the tax expense of the utility on a "standalone" basis.[i]

In Pennsylvania, however, the state appellate courts have mandated a policy followed by a small and shrinking number of other states[ii] and have required the Public Utility Commission to make a "consolidated tax adjustment" ("CTA"), so that the rates of the utility are reduced to reflect the tax benefits arising from the business activities of its unregulated affiliate.[iii]

We respectfully submit that the majority of states and the federal government have it right, and that the federal income tax expense of utilities should be calculated on a "standalone" basis. This approach is fair and consistent with regulatory requirements that utilities and unregulated affiliates maintain separate books and records – a policy that is designed to prevent utility customers from subsidizing unregulated companies. Fairness also requires that subsidies from unregulated companies to utility customers should be prevented. Just as utility rates may not be <u>increased</u> to recover losses of an unregulated affiliate, so too the rates of a public utility should not be <u>decreased</u> based upon tax losses arising from the activities of unregulated affiliates.

The standalone approach 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 the expense, but they would not receive the benefit of a tax deduction that arose from an expense borne by the shareholders of an unregulated affiliate.

The standalone approach also has the advantage of encouraging investment. Currently, because of the CTA, 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. 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 reinvest those tax benefits. For example, a company engaged in natural gas exploration and production that is affiliated with a Pennsylvania utility is at a competitive disadvantage relative to a competitor that does not have a utility affiliate in Pennsylvania, because the former must flow through some of the tax benefits arising from its activities to utility customers, while the latter retains those tax benefits and can reinvest them in gas exploration and production. In fact, one of the reasons why the Federal Energy Regulatory Commission (FERC) embraced the standalone approach in setting rates for natural gas pipelines was to encourage additional gas production by unregulated affiliates of the pipelines.[iv]

Over the past several decades, there has been a clear trend away from application of the CTA in utility ratemaking proceedings. The FERC began moving away from application of the CTA in the 1970s and 1980s.[v] In 2007, Virginia adopted a

statute providing that a utility's federal income tax expense "shall be calculated according to the applicable federal income tax rate and shall exclude any consolidated tax liability or benefit adjustments . . . "[vi] In 2013, the Texas legislature amended the Texas Utilities Code to prohibit the use of a consolidated tax adjustment for electric utilities.[vii] Finally, on October 22, 2014 the New Jersey Board of Public Utilities ("BPU") entered an Order modifying its CTA policy and greatly reducing the subsidy to utility customers.[viii]

In summary, to encourage investment in Pennsylvania and align the Commonwealth with the policy followed in a strong majority of other states and the federal government, the General Assembly should enact House Bill 1436 which requires a "standalone" approach and eliminates the CTA in rate proceedings.

Thank you for the opportunity to testify and I would be happy to answer questions.

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[i] States and other jurisdictions that have adopted the standalone approach and rejected the CTA are Arizona, Arkansas, California, Colorado, Hawaii, Idaho, Kentucky, Maryland, Minnesota, Nebraska, Nevada, New Mexico, New York, North Carolina, Virginia, Washington, Wyoming, the District of Columbia, and the Federal Energy Regulatory Commission.

[ii] States that apply the CTA, in full or limited form, are Florida, Indiana, New Jersey, Oregon, Pennsylvania, and West Virginia. For the states not named here or in note i, no law or definitive decision could be found.

[iii] *See e.g., Pittsburgh v. Pennsylvania Public Utility Commission*, 128 A.2d 372 (Pa. Super. 1956), *Barasch v. Pennsylvania Public Utility Commission*, 548 A.2d 1310 (Pa. Cmwlth. 1988).

[iv] *See City of Charlottesville v. Federal Energy Regulatory Commission*, 774 F.2d 1205 (D.C. Cir. 1985).

[v] *Id.*

[vi] 2007 Va. Acts 537 (enacted Mar. 19, 2007, amending Va. Code Ann. § 56-235.2.A)

[vii] 2013 Tex. Gen. Laws 787 (effective Sept. 1, 2013, amending Tex. Util. Code Ann. § 36.060)

[viii] In the Matter of the Board's Review of the Applicability of a Consolidated Tax Adjustment, Docket No. EO12121072 (Order entered October 22, 2014) (Among other things, the Order determined that a utility's revenue requirement could be adjusted by only 25% as a result of applying the CTA, instead of 100% as under the earlier policy.)