Testimony of Charles V. Fullem

Director, Rates and Regulatory Affairs (PA)
FirstEnergy Service Company

Pennsylvania House Consumer Affairs Committee
Hearing on Consolidated Federal Income Taxes
HB 1436

Sept. 29, 2015
Harrisburg, Pennsylvania

Before the House Consumer Affairs Committee
Pennsylvania House of Representatives
September 29, 2015

Testimony of Charles V. Fullem
Director, Rates and Regulatory Affairs (PA)
FirstEnergy Service Company

Introduction

Good morning, Chairman Godshall, Chairman Daley and members of the Committee. I am Chuck Fullem, Director of Rates and Regulatory Affairs in Pennsylvania for FirstEnergy Service Company, which is a direct subsidiary of FirstEnergy Corp. The Pennsylvania Rate Department of FirstEnergy Service Company provides regulatory support for each of FirstEnergy's wholly owned Pennsylvania operating companies: Metropolitan Edison Company ("Met-Ed"), Pennsylvania Electric Company ("Penelec"), Pennsylvania Power Company ("Penn Power") and West Penn Power Company ("West Penn"), (each individually a "Company") and collectively, the "Companies"). Today, I am here to inform this committee why consolidated tax adjustments ("CTAs") are not appropriate for setting utility rates. Thank you for providing this opportunity to address industry concerns regarding CTAs made in Pennsylvania and to offer our Companies' perspective on HB 1436.

CTA Defined

Section 1501 of the Internal Revenue Code ("IRC") permits an affiliated group of corporations to elect to report their tax liability on a single, consolidated return, so that losses incurred by an affiliate can offset income earned by other affiliates. Electric distribution utilities are permitted to join with other members of their consolidated group in filing a consolidated return.

To be clear, the CTA doesn't change the amount of taxes paid to the Federal Government or to the Commonwealth of Pennsylvania by our Companies. The practical effect of the CTA is a purely regulatory construct by which the federal income tax expense of a regulated utility that is established in a base rate case is reduced by a portion of the tax benefits generated by the utility's non-regulated affiliate's tax losses. In essence, a CTA appropriates the tax benefits generated by

a non-regulated affiliate and hands them over to the customers of the regulated utility in the form of lower rates.

CTA in Other Jurisdictions

Pennsylvania is one of only a small minority of states that apply a comprehensive CTA on a systematic basis in setting utility rates. Over the past several decades, there has been a clear trend away from application of the CTA in utility ratemaking proceedings. The Federal Energy Regulatory Commission (FERC) began moving away from application of the CTA in the 1970s and 1980s. 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." In 2013, the Texas legislature amended the Texas Utilities Code to prohibit the use of a consolidated tax adjustment for electric utilities. Finally, on October 22, 2014, the New Jersey Board of Public Utilities ("BPU") entered an Order modifying its CTA policy, greatly reducing the subsidy to utility customers.

The Companies' Most Recent Base Rate Cases

In August of 2014, the Companies filed base rate cases with Pennsylvania Public Utility Commission ("PUC") in which CTA was an issue in setting the Companies' rates. Specifically, the Office of Consumer Advocate ("OCA") and the Investigation and Enforcement Division ("I&E") supported a CTA consistent with past precedent. While the Companies last base rate cases were settled, the value of the CTA proposed by the OCA was equal to an average of $1.45 per residential customer per month across the Companies.

Legislators Should Eliminate CTA

In light of electric industry restructuring after the passage of the Competition Act, some former regulated activities have become unregulated functions, specifically generation. At FirstEnergy, about 73 percent of the consolidated tax losses are created by unregulated generation-related activities that the Legislature specifically took out from under the regulatory umbrella. Under this new paradigm, it is no longer appropriate to pass unregulated income tax benefits, through the consolidation process, from unregulated generation operations to utility customers as a reduction in the utility's current federal income taxes, included in its cost of service for setting utility rates.

When FERC rejected the use of CTAs in 1983, and adopted the "stand-alone" approach, its decision was based on the concept that benefits should follow burdens. That concept dictates that financial benefits should only follow those who bear the corresponding risks. Thus, in this case, the benefits of tax deductions produced by unregulated generation losses should not be given over to customers of the regulated distribution utility, who do not shoulder any burden associated with supporting the unregulated generation business.

Pennsylvania's Competition Act, which deregulated generation, supports that approach by, among other things, creating a wall of separation between the generation and distribution functions and prohibiting cross-subsidization. The "stand-alone" method of calculating federal income tax is consistent with the premise of the Competition Act by promoting accounting and regulatory principles that track cost causation, striking the appropriate balance of benefits and burdens and preventing cross-subsidization.

Not only is the "stand-alone" approach more sound conceptually, it also has the advantage of encouraging investment. Currently, because of the CTA, an Electric Distribution Company ("EDC") that has unregulated affiliates has lower retail rates and generates less cash for investment than a stand-alone EDC. This results in companies such as Met-Ed, Penelec, Penn Power and West Penn Power having less cash to support their long-term infrastructure improvement plans than they would as independent companies.

Legislation is the Only Fix

The PUC has had its hands tied in addressing the consolidated federal income tax adjustment by Pennsylvania case law which mandates the imposition of CTAs. Specifically, in Pennsylvania there is a 30-year-old decision, *Barasch v. Pennsylvania Public Utility Comm'n*, 493 A.2d 653 (Pa. 1985), in which the Supreme Court of Pennsylvania overturned the PUC's rejection of imposing a CTA, and ruled that a CTA must be applied and removed the PUC of any regulatory discretion on the matter. This case precedent occurred before deregulation. Therefore, the General Assembly needs to enact legislation in order to eliminate CTA.

House Bill 1436

The Company supports HB 1436. HB 1436 eliminates the CTA by specifying that the calculation of allowable federal income tax expense for ratemaking be established based on the expense and revenue incurred by each individual EDC.

As always, the Companies remain committed to working with this Committee and the General Assembly on this important issue.

Now, I would be glad to take any questions you might have.