Prepared Testimony of

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before the

Pennsylvania House of Representatives
Consumer Affairs Committee

House Bill 1436

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Chairman Godshall, Chairman Daley, and Members of the Committee:

While I am unable to attend this hearing, I appreciate the opportunity to present testimony on House Bill 1436. As described in the following, the Public Utility Commission (Commission or PUC) maintains a neutral position on this legislation. We further offer for your consideration suggestions which the PUC believes can benefit utility ratepayers and the public at large.

Background – Consolidated Tax Adjustment

Pennsylvania is currently one of a small number of states that requires a consolidated tax adjustment to a public utility's tax expenses when setting rates. When consolidated tax returns are used, each subsidiary of a parent corporation calculates its separate income, deductions, tax liability and tax credits on a standalone basis. However, the subsidiary does not then file a separate federal income tax return or pay the calculated tax to the Internal Revenue Service. Rather, the subsidiary submits its calculations (and, typically, the amount of its standalone tax liability, if any) to the parent corporation. As is permitted by the Internal Revenue Code[1], the parent corporation then offsets taxable income generated by some subsidiaries with tax losses and credits generated by other subsidiaries to arrive at a net amount representing the taxable income of the consolidated group.

Prior to the 1980s, public utilities, when filing for rate increases before the Commission, were able to claim federal income tax expenses equal to the full amount of their "stand alone" tax liabilities. This was even allowed when the regulated public utility participated in a consolidated tax return filing of its parent holding company, which may have numerous subsidiaries, including both regulated public utilities and unregulated companies, which may possibly result in an aggregate tax liability significantly less than the sum of the members' tax liabilities as individually computed.

[1] 26 U.S.C. §§ 1501-1505

In *Barasch v. Pennsylvania Public Utility Commission*[2], the Pennsylvania Supreme Court considered the question of what treatment to afford the tax savings of utilities resulting from participation in a consolidated tax return. The Supreme Court affirmed the prior decision of the Commonwealth Court, which had reversed and remanded the Commission's decision to not take into account the adjustment to tax expense proposed by the Office of Consumer Advocate to reflect the utility's proportionate share of the savings that result from the utility participating in the consolidated tax return of its parent company[3]. The court in *Barasch* stated that:

> "[A]lthough the Commission is vested with broad discretion in determining what expenses incurred by a utility may be charged to the ratepayers, the Commission has no authority to permit, in the rate-making process, the inclusion of hypothetical expenses not actually incurred. When it does so, as it did in this case, it is an error of law subject to reversal on appeal."

It was also noted that Pennsylvania appellate courts, for many years, had refused to permit utilities to include in consumer rates tax expenses that, because of participation in a consolidated return, they did not actually pay to the government.[4]

Furthermore, the Supreme Court noted that the arguments advanced by the Commission and the utility failed to recognize the basic ratemaking maxim that only expenses that are actually paid or payable by the utility may be included for the purpose of ratemaking. The Court determined that all tax savings arising out of participation in a consolidated return must be recognized in ratemaking; otherwise it would condone the inclusion of fictitious expenses in the rates charged to the ratepayers.[5]

The basic premise of the Supreme Court's determination was the "actual taxes paid" doctrine. As a result, the Supreme Court held that the

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[2] 507 Pa. 561, 493 A.2d 653 (1985)
[3] *Cohen v. Pennsylvania Public Utility Commission*, 78 Pa. Cmwlth. Ct. 545, 468 A.2d 1143 (1983)
[4] *Cohen*, 78 Pa. Commonwealth Ct. at 559, 468 A.2d at 1150
[5] *Barasch/UGI*, 507 Pa. at 568, 493 A.2d at 656

ratepayers are entitled to the benefits of reduced tax expenses accruing to the utility by its participation in a consolidated tax return.[6]

It should be noted that these adjustments can potentially result in an increase in tax liability for utilities. This may be the case when a utility's affiliates have experienced strong earnings over the course of many years.

Presently, the Commission is aware of three states that have not abolished the use of consolidated tax adjustments; New Jersey, West Virginia and Pennsylvania.

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The proposed bill introduces legislation that requires a public utility's federal income tax expense to be calculated on a "stand-alone" basis – separate from the gains or losses of any affiliates – when establishing base rates for the regulated public utility, even when the public utility participates in the consolidated tax filing of its parent company and has benefitted tax-wise from those same gains or losses of an unregulated affiliate on a consolidated basis.

The elimination of the consolidated tax adjustment and implementing the "standalone" tax approach for ratemaking purposes would be a departure from the "actual taxes paid" doctrine established by the Pennsylvania courts and followed for many years. The net result will be to eliminate this potential downward adjustment to consumer rates for utilities that participate in a consolidated tax return.

[6] *Id.* at 570, 493 A.2d at 657

PUC Suggestions

If the legislature desires to depart from the "actual taxes paid" approach to ratemaking, it should do so in a manner that ensures that funds from any incremental increase in consumer rates due to elimination of the consolidated tax adjustment are used for the benefit of the consumers who paid those rates. In other words, the incremental increase in rates that accrues to the public utility as a result of computing its current or deferred income tax expense using the "stand alone" tax approach should not be passed to the parent company, shareholders or affiliated companies; rather, those incremental amounts should be used for infrastructure improvement and repair in Pennsylvania.

In this fashion, the additional amounts paid in rates by the utility's consumers, due to elimination of the consolidated tax adjustment, would be spent in a manner that directly benefits service to those consumers and the Commonwealth.

An alternate approach would be to require that any tax savings realized by a utility using the "stand alone" method for calculating tax expenses in determining rates are shared between ratepayers or infrastructure investments in Pennsylvania and the utility's shareholders, parent company or affiliated companies according to a ratio predetermined in the legislation.

In sum, the Commission maintains a neutral stance on this piece of legislation. With that said, if the intent of the legislation is to encourage investment in utility infrastructure, it would be advantageous to ensure that those improvements have a beneficial impact in Pennsylvania.

The Commission appreciates your interest in this matter and stands ready as a resource to help the Committee address any questions that may arise from this testimony or during the pendency of deliberation of HB 1436.