

**BEFORE THE PENNSYLVANIA
HOUSE CONSUMER AFFAIRS COMMITTEE**

Testimony Of

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**Regarding
House Bill 1436**

**Harrisburg, Pennsylvania
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**Chairman Godshall, Chairman Daley
And Members of the House Consumer Affairs Committee**

My name is Tanya McCloskey. I am the Acting Consumer Advocate for the Office of Consumer Advocate and have worked at the Office of Consumer Advocate since 1987. Thank you for 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 consolidated tax savings adjustment has been recognized by the Commission and the Pennsylvania Courts for decades as part of establishing just and reasonable rates under Section 1301 of the Public Utility Code with the landmark Pennsylvania Supreme Court decision in 1985 in Barasch v. Pennsylvania Public Utility Commission, 507 Pa. 561, 493 A.2d 653 (1985). The consolidated tax savings adjustment reflects what has been called by the Courts “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 under Section 1301 of the Public Utility Code that the rates of a 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 allowance for proper operating expenses, taxes, depreciation, and other legitimate items. While the Commission has discretion in considering what expenses incurred may be charged to ratepayers, the Commission cannot include hypothetical expenses that are not actually incurred by the utility. Without the application of the consolidated tax savings adjustment, ratepayers would be asked to pay hypothetical tax expense to the utility in their rates.

The consolidated tax savings adjustment applies when a utility that is part of a holding company structure participates in the filing of a consolidated tax return with its parent company, sister companies and affiliates. The consolidated group uses the tax losses of some of the affiliates to lower the overall actual tax liability of the parent company and thereby, the tax liability of each company that contributes to paying the parent company taxes. Through the consolidated tax filing, the utility pays a lower tax than if it was not part of the holding company and filed a tax return on a stand-alone basis.

To eliminate the consolidated tax savings adjustment as is proposed in HB 1436 would allow a utility to collect from ratepayers hypothetical taxes that it *never* pays to the federal or state government. This additional expense included in rates would be a direct transfer from ratepayers to shareholders' profit. And the impact on ratepayers will be substantial. If HB 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 seven utilities. This is \$28.6 million in additional profit every year to shareholders above each Company's authorized rate of return since these dollars are never paid to the state or federal government as a tax. The Table below shows the amount of the consolidated tax savings adjustment to the tax expense in each Company's public filing, by the Company's own calculation:

Table I		
Consolidated Tax Savings Adjustment		
Utility	Rate Case Year	Consolidated Tax Savings Amount (per Company)
Penn Power	2014	\$ 3,862,782 *
Met-Ed	2014	15,090,566
Penelec	2014	3,862,782
PECO	2015	1,339,000
Aqua Pennsylvania	2011	539,292
Pennsylvania-American Water	2013	2,817,000
United Water	2015	1,152,992
		<u>28,664,414</u>

*During the course of the proceeding, the Company updated this number to \$4,963,245.

As noted in the Table, this is the tax expense savings that results from the filing of a consolidated tax return. I must add that the amount of the rate increase needed to collect this expense is much higher as there will be additional taxes on the revenues required for this additional expense. This is what is known as the “gross up” factor in ratemaking. When “grossed up” for ratemaking purposes using the Company’s factor in each case, my Office has calculated that the actual increase in annual rates for just these seven utilities is approximately \$51.7 million.¹

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.² 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

¹ With the correction made to the Penn Power tax expense during the course of the case, the annual tax expense increase would be \$29,764,877 with a rate increase impact of approximately \$53.7 million.

² An Appendix that includes a list of these appellate cases dating back to 1956 is attached to this testimony.

have perhaps said it best. For example, in 1956, in rejecting a challenge to the consolidated tax savings adjustment, the Superior Court of Pennsylvania stated:

The use of a consolidated tax return, the same as the use of the holding system of investment, is of mutual benefit to the Columbia Gas System, Inc., and its subsidiaries. Advantages which result from this system should benefit the consuming public as well as the utility and the parent company.

City of Pittsburgh, 182 Pa. Super. 551, 583, 128 A.2d 372, 387 (1956).

In considering the issue in 1980, the Pennsylvania Commonwealth Court reasoned:

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 rate payer by way of subsidiary-claimed non-existent tax expense.

Western Pennsylvania Water v. Pennsylvania Public Utility Commission, 54 Pa. Commw. 187, 191, 422 A.2d 906, 909 (1980).

The Pennsylvania Supreme Court put the issue firmly to rest in 1985 when it unanimously held as follows:

All tax savings arising out of participation in a consolidated return must be recognized in rate-making, otherwise we would be condoning the inclusion of fictitious expenses in the rates charged to ratepayers.

Barasch v. Pennsylvania Public Utility Commission, 507 Pa. 561, 568, 493 A.2d 653, 656 (1985).

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. These arguments fail to recognize the many benefits that accrue to the corporation through the holding company structure and the fact that approval of such structures for utilities 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 is that it

allows the parent to use the losses of some affiliates that otherwise may have been unusable or significantly delayed for purposes of reducing tax liabilities. Public utilities, because of the authorized rate of return and regulation, most often generate positive income so that the losses of other affiliates can be timely used by the parent company.

The Pennsylvania Supreme Court also aptly described the serious flaw in this argument as follows:

If a utility, because of its combining with a group, is able to obtain a desirable long term lease of property containing a very favorable rental which, through the passing years, becomes considerably less than market value, we would not sanction the inclusion of the market rental value in place of the actual rent in the rate-making process. If a utility joins with non-utility companies in a buying group, and because of the increased purchasing power wielded by the group, it is able to purchase material, equipment, supplies, etc. at discount prices – lower than that which it would be required to pay if it made the purchases as a separate entity, we would not condone the inclusion of the higher costs in the rate-making process. It is a violation of basic rate-making principles to charge ratepayers for theoretical expenses which in practice the utility bears no liability. This is true no matter the category of expense.

Barasch v. Pennsylvania Public Utility Commission, 507 Pa. 561, 569-570, 493 A.2d 653, 657

(1985). Simply put, if we allow our utilities to become part of multi-state holding companies but then treat them solely as stand-alone companies 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. This argument too fails to overcome the fundamental necessity of the consolidated tax savings adjustment. In the first instance, tax dollars collected from ratepayers are not intended to fund investment and indeed, these hypothetical tax dollars are not required to be invested in the utility at all. This hypothetical tax expense is paid to

the parent company, and the parent company can retain it as profit or invest the dollars in other affiliates if it so chooses. Additionally, the General Assembly has already provided for further investment in 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 the 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. Circumstances in other states, including such things as merger standards, ratemaking standards, the number of utilities and the number of utilities that are part of holding companies, can be very different. I do, however, find it interesting that while our utilities would like to adopt other states' consolidated tax policies, they are not asking for the lower return on equity (profit) that is 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 urge the Committee to table House Bill 1436 as it will negatively impact Pennsylvania ratepayers by requiring them to pay tens of millions in higher rates every year in order to fund hypothetical tax expenses that a utility never incurs and never pays. I look forward to answering any questions that you may have.

APPENDIX

Pennsylvania Consolidated Tax Savings Adjustment Case Law

Barasch v. Pa. Public Utility Comm'n, 507 Pa. 561, 493 A.2d 653 (1985)

Barasch v. Pa. Public Utility Comm'n, 120 Pa. Commw. 292, 548 A.2d 1310 (1988)

Bell Tel. Co. v. Pa. Public Utility Comm'n, 17 Pa. Commw. 333, 331 A.2d 572 (1975)

Bell Tel. Co. v. Pa. Public Utility Comm'n, 47 Pa. Commw. 614, 408 A.2d 917 (1979)

Continental Tel. Co. v. Pa. Public Utility Comm'n, 120 Pa. Commw. 25, 548 A.2d 344 (1988)

Met-Ed Indus. Users Group v. Pa. Public Utility Comm'n, 2008 Pa. Commw. LEXIS 534, 960 A.2d 189 (2008)

Pittsburgh v. Pa. Public Utility Comm'n, 182 Pa. Super. 551, 128 A.2d 372 (1956)

Riverton Consol. Water Co. v. Pa. Public Utility Comm'n, 186 Pa. Super. 1, 140 A.2d 114 (1958)

Western Pa. Water Co. v. Pa. Public Utility Comm'n, 54 Pa. Commw. 187, 422 A.2d 906 (1980)