NEW JERSEY UTILITIES ASSOCIATION

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Consolidated Tax Adjustments

Background Paper
New Jersey Utilities Association

Introduction

The New Jersey Board of Public Utilities (the Board or BPU) has instituted a generic proceeding to review whether consolidated tax adjustments (CTAs) are appropriate for setting utility rates. Existing Board policy concerning application of a CTA was first implemented in 1992.[1] Although the New Jersey Utilities Association opposes the use of a CTA in setting utility rates, this paper provides information on the application of a CTA in other jurisdictions across the United States. As demonstrated, the CTA is not utilized in the vast majority of jurisdictions and, in recent years, has been explicitly rejected in a number of jurisdictions in which it has been considered. In addition, this paper has been updated to reflect a recent change in one of the limited jurisdictions that has applied a comprehensive CTA, Texas. As explained below, effective September 1, 2013, application of the CTA in Texas is now statutorily precluded with respect to electric utilities. Additional information is also provided about the treatment of CTAs in Oregon and Virginia.

As a general rule, every corporation subject to the federal income tax must report their tax liability on a separate return. However, Section 1501 of the Internal Revenue Code permits an affiliated group of corporations to elect to report its tax liability on a single, consolidated return. Utilities are no different from other businesses in this respect. By filing a consolidated tax return, a utility's parent company may offset the income of some members of the consolidated group with the losses of other members. However, filing a consolidated tax return requires compliance with a complex set of regulations, and election to file such a return is somewhat permanent in nature (i.e., absent IRS consent to discontinue filing consolidated returns, the group must continue to file a consolidated return even if doing so turns out to be disadvantageous relative to filing separate returns).

CTA Defined

The CTA is a regulatory concept in which the federal income tax expense of a regulated utility that is set during a base rate case is reduced by a portion of the tax benefits generated by a non-regulated affiliate's tax losses. A CTA seizes a portion of the tax benefits generated by non-regulated affiliate companies and appropriates those benefits to the ratepayers of the regulated utility. There are also situations where the use of a consolidated tax return results in higher federal income taxes paid than if the filing had been done on a "stand-alone" basis.

[1] *In re the Petition of Rockland Electric Company for Approval of Changes in Electric Rates, Its Tariff for Electric Service, Its Depreciation Rates, and for Other Relief*, BPU Docket No. ER02100724 (Order dated April 20, 2004), *In re the Petition of Atlantic City Electric Company for Approval of Amendments to its Tariff to Provide for an Increase in Rates and Charges for Electric Service, Phase II*, Docket No. ER90091090J, (Order dated October 20, 1992).

However, NJUA is unaware of any regulatory commission symmetrically applying the CTA for ratemaking when the result is a higher tax expense, and therefore, higher rates, for the regulated utility.

Where else are CTAs utilized?

The Board's policy with regard to CTAs is not reflective of the vast majority of regulatory agencies in this country. Given that Texas passed legislation in June of 2013 to preclude CTAs for electric utilities[2], we are aware of only three remaining states where comprehensive CTAs[3] are applied on a systematic basis: New Jersey, Pennsylvania, and West Virginia[4].

Thus, 50 regulatory jurisdictions (including the Federal Energy Regulatory Commission (FERC), the District of Columbia, and the New Orleans City Council) do not subscribe to the imposition of comprehensive CTAs.

NJUA is aware of two states where a more limited adjustment for consolidated taxes, the "parent interest adjustment," is utilized – Indiana and Florida.[5] This methodology will be described in greater detail later in this paper.

Oregon previously imposed comprehensive CTAs systematically pursuant to a 2005 statute, but on May 24, 2011, the Oregon Legislature enacted legislation that repealed the 2005 statutory requirement.[6] Since the repeal, it is our understanding that CTAs have not been employed in Oregon. The 2005 statute implemented a "true-up" methodology between the amount of all income taxes collected through rates and actual income taxes paid by the utility or its parent company, for the state's four largest electric and natural gas utilities.[7] One of the original proponents of the law, the Citizens' Utility Board of Oregon, noted that ultimately the true-up process "was time-consuming, cumbersome, and resulted in some wacky outcomes…" They noted that "…if we look simply at the sum total of refunds and surcharges, the results [of the true-up] for customers were actually negative…"[8] This was an important factor in the repeal of the 2005 statutory requirement.

In 2005, the Virginia State Corporation Commission ("Virginia SCC") reported that it "has generally adopted a stand-alone policy for the determination of income taxes for ratemaking purposes…However, there have been

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[2] On June 14, 2013, Governor Perry signed SB1364/HB711, which effective September 1, 2013 will preclude application of a CTA for electric utilities. In addition, under Texas' "Gas Utility Regulatory Act," or "GURA", gas utilities are regulated by the Texas Railroad Commission (TRC), not the Texas Public Utility Commission. Under Section 104.055 of GURA, the TRC is precluded from imposing a CTA on the gas utilities under its jurisdiction. See Tex. Utilities Code Ann. Sec. 101.001 et seq. Finally, we are not aware of the application of a CTA for water utilities in Texas.

[3] A comprehensive CTA is one that considers the tax benefits produced by all members of the consolidated group rather than those produced by only selected members.

[4] *Barasch v. Pennsylvania Public Utility Commission*, 507 Pa. 561, 493 A.2d 653 (1985); *Monongahela Power*, Case No. 06-0960-E-42T (December 5, 2008).

[5] See Florida Commission rule 25-14.004; See Re Muncie Water Works Company, Cause No. 34571, Indiana Public Service Commission, 44 PUR 4th 331 (1981).

[6] ORS 727.210.

[7] Oregon Public Utility Commission Staff, *Oregon PUC Survey of Income Tax Treatment for Ratemaking* January/February 2005, pg. 2 (available at http://www.naruc.org/Publications/Section%208-Oregon-Income%20Tax%20Survey%202005.doc).

[8] Oregoncub.org/news/posts/2011-legislative-session and oregoncub.org/news/reports/cub-supports-utility-tax-law-reform

several cases where savings generated from the filing of consolidated returns have been recognized."[9] Yet, in 2007, Virginia law was modified to clarify that use of a CTA is precluded and stand-alone methodology has to be utilized in utility rate making.[10]

Recent CTA Activity

In addition to the explicit rejection of a CTA by the states of Texas and Virginia referenced above, the CTA has been rejected by regulatory entities in several jurisdictions. In the 30 months prior to the filing of Rebuttal Testimony in the Atlantic City Electric Company base rate case proceeding in May 2012 (BPU Docket No. ER11080469), at least four final orders were issued by state regulators specifically *rejecting* the use of CTAs. These include orders issued by the Public Service Commission of Maryland,[11] the District of Columbia Public Service Commission,[12] the Kentucky Public Service Commission (KPSC),[13] and the Nebraska Public Service Commission.[14] In addition, in May of 2012, the Washington Utilities & Transportation Commission expressly rejected a proposed CTA.[15] In Docket No. E-002/GR-05-1428 (Northern States Power), issued on September 1, 2006, the Minnesota Public Utilities Commission rejected the use of CTAs. The New Mexico Public Regulation Commission rejected the use of CTAs in Case #07-00077-UT (Public Service of New Mexico), issued on April 25, 2008. In fact, the last time a CTA was affirmatively adopted was in early 2007 by West Virginia.[16]

Three of the Commissions referenced above that have recently rejected the use of CTAs cite the rarity of its application in regulatory jurisdictions as a primary rationale for their rejection of CTAs. In a December 2009 order, the Public Service Commission of Maryland stated that, in order to adopt the CTA recommended within that proceeding by Commission staff, the Commission would have to "depart substantially from prior Commission decisions and join a v*ery small minority* of commissions."[17] In a later case, the Public Service Commission of the District of Columbia based its rationale for rejecting the CTA upon, among other factors,

[9] Oregon Public Utility Commission Staff, *Oregon PUC Survey of Income Tax Treatment for Ratemaking* January/February 2005, pg. 4 (available at http://www.naruc.org/Publications/Section%208-Oregon-Income%20Tax%20Survey%202005.doc).

[10] Specifically, subsection A. of Va. Code § 56-235.2 provides, in relevant part, that "[f]or ratemaking purposes, the Commission shall determine the federal and state income tax costs for investor-owned water, gas, or electric utility that is part of a publicly-traded, consolidated group as follows: (i) such utility's apportioned state income tax costs shall be calculated according to the applicable statutory rate, as if the utility had not filed a consolidated return with its affiliates, and (ii) such utility's federal income tax costs shall be calculated according to the applicable federal income tax rate and shall exclude any consolidated tax liability or benefit adjustments originating from any taxable income or loss of its affiliates."

[11] *Delmarva Power and Light Company,* Order No. 83085 (December 30, 2009).

[12] *Potomac Electric Power Company*, Formal Case No. 1076 (March 2, 2010).

[13] *Kentucky-American Water Company,* Case No. 2010-00036 (December 14, 2010). Note that in a 2005 order, the KPSC had imposed a CTA on Kentucky-American Water in Case No. 2004-00103. However, in two subsequent cases, Kentucky Utilities – Case No. 2009-00548, and Louisville Gas & Electric – Case No. 2009-00549, the KPSC affirmatively rejected CTAs and the KPSC rejected the imposition of a CTA on Kentucky-American Water in the more recent (2010) case cited above.

[14] *Source Gas Distribution*, Application No. NG-0060 (March 9, 2010).

[15] *Puget Sound Energy, Inc.*, Docket UE-111048/UG-111049 (May 7, 2012).

[16] *Rebuttal Testimony of James I. Warren, IMO Petition of Atlantic City Electric Company for Approval of Amendments to its Tariff to Provide for an Increase in Rates and Charges for Electric Service Pursuant to NJSA 48:2-21 and NJSA 48:2-21.1 and for Other Appropriate Relief* (May 23, 2012).

[17] *Delmarva Power and Light Company*, Order No. 83085 (pg. 10) (December 30, 2009) (emphasis added).

"well settled ratemaking practices, practices and reasoning of the FERC … [in addition to] the *overwhelming majority of other state commissions*."[18] In a December 2010 rate case where the KPSC denied utilization of a CTA, it was asserted that the KPSC's policy is to "consistently" reject proposals to apply a CTA and instead to treat utilities on a stand-alone basis. The KPSC's adoption of this policy is based on the KPSC's finding that use of a CTA "would result in the subsidization of ratepayers by non-regulated utility operations" and "[m]oreover" because "*many*" jurisdictions "disfavor" its application.[19]

Other regulators that have considered and rejected the CTA have pointed to its incompatibility with standard rate making practices, familiar principles of utility law, and ratepayer interests. In 2006, the Minnesota Public Utilities Commission (MPUC) rejected the CTA on multiple grounds and held that its rejection was consistent with cost- and benefit-allocation principles applied in previous orders in which it consistently rejected the CTA. Those principles, asserted the MPUC, were adopted, not only in recognition of utility burdens, but also to protect ratepayers from the risks associated with utility diversification into unregulated enterprises.[20] In 2008, in a New Mexico Public Regulation Commission (NMPRC) order rejecting a CTA, the NMPRC cited the treatise, <u>Accounting for Public Utilities</u>, by Robert L. Hahne and Gregory E. Aliff (a widely accepted and authoritative source on utility accounting), which explains that the stand-alone approach is "[t]he only approach that is consistent with *standard ratemaking principles.*"[21] The NMPRC determined that the stand-alone method is proper because it "serves the public interest by being consistent with and promoting the accounting and regulatory principles of cost causation, the benefits/burden equation, and prevention of cross subsidization."[22] Notably, NMPRC also cited the apparent "weight of state authority" in its determination to reject a CTA.[23] In its rejection of a CTA as part of a 2010 order, the Nebraska Public Service Commission found that, for any future rate cases, estimating the taxable income "the Company would report if it filed federal income taxes on its own … is the most reasonable way of determining the appropriate federal tax expense."[24]

More recently, in a May 2012 order rejecting a CTA, the Washington Utilities and Transportation Commission (WUTC), which has repeatedly rejected proposed consolidated tax adjustments, cited a prior order in which it held that utilization of a CTA would violate the "*familiar principle in utility law"* that financial benefits should only follow the burden of risks.[25] The WUTC referenced its adoption of ring-fencing provisions in its rejection of a CTA, noting the protection offered by the ring fence for utility customers: "…after having insulated PacifiCorp and its customers from the risks of leveraged financing at the parent, Staff and Public Counsel seek to secure for

[18] *Potomac Electric Power Company*, Formal Case No. 1076 (order on reconsideration, p. 16) (June 23, 2010) (emphasis added).
[19] *Kentucky-American Water Company*, Case No. 2010-00036 (December 14, 2010). The KPSC noted that a prior approval of the CTA in 2005 was an exception to its policy of consistently rejecting a CTA and that application in that case had involved "unique circumstances" concerning approvals and specific benefits associated with a merger. See *Id.* at 56 (emphasis added).
[20] *In the Matter of the Application of Northern States Power Company d/b/a Xcel Energy for Authority to Increase Rates for Electric Service in Minnesota*, Docket No. E-002/GR-05-1428 (pps. 25-26) (September 1, 2006).
[21] *Public Service of New Mexico*, Case No. 07-00077-UT (Recommended Decision of the Hearing Examiner, p. 129) (March 6, 2008) (Final Order issued April 25, 2008).
[22] *Id.* at 131.
[23] *Id.* at 128.
[24] *Source Gas Distribution*, Application No. NG-0060, at p. 15.
[25] *Puget Sound Energy,* Docket 111048/UG-111049, Order 08 at 69 (May 7, 2012) (emphasis added).

customers the cost and tax benefits of that financing … If the *risks and costs* of activities at the parent-level are borne *exclusively* by shareholders – *because customers are insulated from them by the ring fence* – then it is fair and appropriate for the shareholders, and not the customers, to receive the benefits that result from those activities."[26]

It is also worth noting that, after having employed CTAs for a number of years, in 1983, FERC switched to a "benefits follow burdens" (*i.e.*, a non-CTA) approach (Opinion No. 173).[27] Like the state jurisdictions referenced above, FERC rejected the CTA, abandoning its application for the stand-alone approach. In its opinion rejecting the CTA, *Re Columbia Gulf Transmission Co.,* 23 FERC 61,396, Opinion 173 (1983), FERC based its stand-alone approach primarily upon a "benefits follow burdens" analysis which was repeatedly referenced in that opinion.[28]

What CTA methodologies are used?

Of the three states that systematically impose comprehensive CTAs, only New Jersey utilizes a cumulative "time value"-based methodology (prior to its statutory prohibition of CTA, Texas had also utilized such a methodology for electric utilities). In each case, the theoretical tax benefit is the same: the cumulative amount of taxes saved by using tax losses in consolidation that would not have been able to be used absent consolidation. In New Jersey, the CTA is applied in such a way that the CTA rate "penalty" equals the portion of the theoretical tax benefit allocable to the utility multiplied by its weighted overall pre-tax cost of capital. Under the now prohibited Texas methodology, the "penalty" was equivalent to the portion of the theoretical tax benefit allocable to the utility multiplied by the utility's weighted long term debt rate.[29] Given that a utility's weighted overall pre-tax cost of capital is higher than its weighted long term debt rate, New Jersey's methodology results in a distinctly more punitive CTA than did Texas's methodology. In addition, Texas capped its "look back" at fifteen years based upon the fact that, under federal tax law, pre-1998 net operating losses can only be carried forward fifteen years.[30]

The remaining two states that systematically impose comprehensive CTAs, West Virginia and Pennsylvania,[31] utilize a "cost of service" methodology. During the rate making process, instead of computing the current portion of tax expense based on the tax liability the utility would owe as a stand-alone entity, regulators reduce that expense based on the tax losses produced by other members of the consolidated tax group. A rolling historical average over a number of years (such as 3 or 5) is utilized to derive the benefit by which tax expense for the test period is reduced. Unlike the New Jersey and Texas methodologies, the cost of service CTA is not cumulative so that it is only the tax results during the averaging period that impact rates.

As noted above, Indiana and Florida use a "parent interest adjustment". Under this methodology, if the parent company of a utility receives a tax benefit for deducting interest on debt and the parent and the utility file as

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[26] *Id. citing WUTC v. PacifiCorp*, Docket UE-050684, Order 04 ¶ 285 (April 17, 2006) (emphasis added).
[27] *Re Columbia Gulf Transmission Co.,* 23 FERC 61,396, Opinion 173 (1983).
[28] *See, e.g.,* 23 FERC at 61,851, 61, 861-62.
[29] *Central Light and Power* (Second Order on Rehearing) (pps. 107-08 and 111-13 and Conclusion of Law 38).
[30] *CPL v. Public Utility Com'n of Texas*, 36 S.W.3d 547, 555 (Tex. App. Austin-2000).
[31] See *Monongahela Power*, Case No. 06-0960-E-42T (pps. 7-8) (December 5, 2008); See generally *Barasch,* 507 Pa. 561, 493 A.2d 653.

part of a consolidated tax return group, then an allocable portion of the tax benefit of the parent's interest deduction is applied to reduce the utility's tax expense for ratemaking purposes.

History of the CTA in New Jersey

Since the inception of the CTA in New Jersey in 1952, the Board has applied several different methodologies for calculating a CTA, including, *inter alia*, the "imputed interest" methodology,[32] and the "chronic loss" approach,[33] both of which utilize a "cost of service" adjustment applicable to a utility's income statement. As noted in the introduction of this paper, existing Board policy in the calculation of a CTA, which is to utilize a "rate base" approach, was first implemented in 1992.

During the years 1986 through 1991, due to significant uncertainty with respect to the IRS's policy toward CTAs, the Board did not utilize a CTA in utility rate cases.

Summary

New Jersey is one of a very limited number of regulatory jurisdictions (3 of 53) that currently utilizes a comprehensive CTA. Of the few jurisdictions utilizing a comprehensive CTA, the Board's approach is one of the most onerous.

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[32] See *I/M/O The Revision of Rates Filed by New Jersey Water Company Increasing Rates For Water and Sewer Service*, BPU Docket No. 7412-915 (Decision and Order January 8, 1976) and *In re Monmouth Consolidated Water Co.*, P.U.R.4th 464, BPU Docket No. 776-481 (April 27, 1978).

[33] See *In re Lambertville Water Co.*, Docket Nos. 746-481, 754-244 (September 11, 1981).