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The New Tax Law and Choices for State Utility Commissions

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Introduction

- The major provision in the new tax law (NTL)reduces the corporate tax rate from 35% to 21% – a 40% drop
- The hope is that it would stimulate capital expenditures that would eventually increase productivity, wages and economic growth
- In unregulated industries, tax cuts will likely increase cash flow and earnings
- Pressure is mounting at the state level, from both consumer groups and commissions themselves, for returning tax savings to utility customers promptly
- One study estimates $1 billion of tax savings for the electric power industry in 2018, growing to $5 billion by 2020, translating into a 0.5% reduction in electricity prices

Lower Taxes Reduces a Utility's Cost of Service

- Federal taxes are an operating expense
- They are largely based on the tax gross-up factor (tax rate/1– tax rate) <u>times</u> the equity portion of the allowed return on rate base
- Accumulated deferred income taxes (ADIT) are deducted from rate base in most jurisdictions
- In the absence of a rate adjustment, lower taxes would increase a utility's return on equity (ROE)
- Lower tax rates creates excess deferred income taxes (EDIT), which almost everyone agreeing that utilities should eventually return to customers
- The NTL could affect some utility financial metrics negatively, like cash flow, credit ratings, and cost of capital

Ratemaking Treatment of Tax Reductions

- The fundamental question is what treatment would best reflect just and reasonable rates – namely, rates based on known and measurable costs, a utility's cost of service that includes its cost of equity but not a "windfall profit"
- Underlying regulatory objectives can include
  - Stimulation of utility capital investments
  - Largest benefits to customers in the shortest time practicable
  - No utility-earnings increase
  - Compensation to a utility with "deficient" earnings, which could defer future rate cases
  - Funding source for extraordinary and other unexpected expenses

Transmittal of Tax Reductions to Customers

- ***Primary issues***: How, how much and over what time frame should customers benefit from lower utility taxes?
- ***What commissions may want to ask***: What ratemaking treatment of tax savings would maximize the long-term well-being of customers?
- Immediate customer refunds would eliminate any utility incentive for additional capital expenditures
- Excess delay of refunds to customers unfairly deprives customers of benefits and may create windfall profits for utilities
- One option is to distribute tax savings to certain capital projects or to offset unexpected cost increases in certain accounts that could otherwise trigger a future rate case
- Another option is to create a regulatory liability that delays customers from receiving the benefits of tax savings until the next rate case
- Other issues
  - Single-issue ratemaking
  - Retroactive ratemaking

Regulatory Procedural Alternatives

- A new rider or tracker to adjust rates outside of a rate case
- Mini rate case
- Utility request to adjust rates reflecting lower tax rates
- Commission “show cause” order
- Technical conference
- New proposed rates in a pending rate case
- Settlement agreement
- Opening of a generic docket or individual dockets for each utility
- Temporary rate change pending final resolution
- Varied commission responses to the 1986 Tax Reform Act

Initiatives by Several States

- Commission required utilities to calculate the effects of the NTL on current and deferred taxes and how these savings should flow back to customers *(Michigan, Montana, New Jersey)*
- Rate adjustments in pending rate cases because of the NTL *(Arizona, Montana, New Mexico)*
- Commission staff proposed several questions for utilities; they include the appropriate way to change utility rates because of the NTL, and the initial year change in utilities' cost of service because of the NTL *(Missouri)*

Initiatives by Several States – *continued*

- Consumer advocates in a number of states proposed opening up new dockets to calculate the effect of the NTL and how customers can benefit from the tax savings
- Some state commissions have gone back to see how they handled the Tax Reform Act of 1986 *(New York, Oklahoma)*
- The Commission requested staff to begin evaluating how the NTL will affect utility rates; it will initiate a docket to evaluate mechanisms for transferring lower taxes to customers *(South Dakota)*
- The Commission ordered lower rates because of the reduction in the normalized level of federal income taxes and that EDIT be returned to customers "as soon as practicable" *(Massachusetts)*

Initiatives by Several States – *continued*

- The Commission ordered utilities, within 4 months or until their next rate case (whichever comes first), to calculate actual tax savings before distributing excess money to their customers ; retroactive from January 9 and with interest *(Oklahoma)*
- Statewide proceeding ordering utilities to (1)calculate the effect of the NTL on their cost of service and (2) create a "deferred regulatory liability" to track tax savings that will eventually benefit customers *(Colorado)*