HEARING BEFORE THE COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEES ON SELECT REVENUE MEASURES AND OVERSIGHT

United States House of Representatives

"Energy Tax Policy and Tax Reform"

Testimony of the Edison Electric Institute

Introduction

The Edison Electric Institute (EEI) is pleased to submit these comments for the record with respect to the joint hearing held by the Subcommittees on Oversight and Select Revenue Measures of the House Committee on Ways and Means.

EEI is the association of U.S. shareholder-owned electric utilities, international affiliates and industry associates worldwide. Our U.S. members serve 95% of the ultimate customers in the shareholder-owned segment of the industry and represent approximately 70% of the U.S. electric power industry.

The electric power industry is a $737 billion[1] industry that powers our economy and enhances our everyday lives. The electric power industry's 2010 revenues of $372 billion represent 3% of real GDP.[2] As of December 31, 2010, U.S. shareholder-owned electric utilities employed over 500,000 full-time employees.

EEI commends the Members of the Subcommittees for holding this hearing and examining the intersection of tax policy and energy policy. Income tax is a significant expense for shareholder-owned utilities, and how tax policy affects capital investment and the cost of capital is an important issue for electric utilities. The treatment of income taxes in the establishment of electricity rates is an issue that distinguishes utilities from other U.S businesses. Finally, energy tax incentives have proven effective in stimulating investment in various types of alternative, renewable, and energy-efficient projects. We look forward to working on these issues in detail with the Members and staff of the Subcommittee and the full Committee as tax reform legislation develops.

Utility ratemaking and income taxes

Generally, electric utilities engage in regulated and unregulated businesses. For this purpose, a regulated business is one where a governmental entity (such as the Federal Energy Regulatory Commission or a state or local public utility commission) regulates and establishes the rates that a utility may charge for the services it provides to its

[1] Edison Electric Institute, 2010 Financial Review, June 2011. Industry size as measured by net property, plant and equipment as of December 31, 2010.
[2] Edison Electric Institute, 2010 Financial Review, and U.S. Department of Commerce, Bureau of Economic Analysis.

customers. Generally, the transmission and distribution of electricity are regulated businesses, and the generation of electricity can be rate-regulated or unregulated depending on the state.

Electric utilities traditionally have been natural monopolies because they provide a standardized product and have immense start-up capital costs that create barriers to entry for competitors. Governments regulate electric utilities to ensure just and reasonable rates for consumers that allow utilities to attract capital and ensure reliable electric service. Under such regulation, a public utility commission generally determines the amount of revenues a utility needs to collect in order to provide adequate service (its "cost of service") and earn a reasonable return on its investments (its "rate base"). This amount of revenues, called the utility's "revenue requirement," is determined during a rate case investigation in which the commission estimates the utility's costs for a 12-month test year. The ratemaking process does not guarantee revenues or profits for utilities. Any number of factors—the demand for electricity, the price of fuel, weather, etc.—may affect actual financial results.

In setting electricity rates, public utility commissions generally attempt to set customer rates at a level that allows the utility to: (1) recover its operating expenses (the cost of service element), and (2) provide a fair rate of return to its investors (the rate of return element).

Elements of cost of service include operating expenses, such as employee compensation, fuel costs, depreciation on public utility property and income tax expense.

The rate of return element typically is computed by multiplying: (1) a rate of return (as determined by the public utility commission) times (2) the rate base. Rate base is usually comprised of the working capital of the utility, plus the original cost of utility plant and equipment, less accumulated regulatory depreciation, and less the deferred tax liability (as described below). This rate of return element is intended to provide sufficient revenue for a utility to pay interest to its bondholders and to provide a fair return to its shareholders.

The Internal Revenue Code provides certain specific rules for the determination of taxable income. The use of these rules means that a utility's income tax expense for financial accounting and ratemaking purposes generally will not be the same as the income tax liability as shown on its income tax return.[3] For example, the modified

[3] If a public utility commission uses the utility's Federal income tax liability as shown on the utility's tax return for income tax expense for ratemaking purposes, the commission is using a "flow-through" method of accounting for taxes. Section 168(f) of the Internal Revenue Code requires that a regulated public utility use a "normalization" method of accounting in order to qualify for MACRS. Under normalization, income tax expense for ratemaking purposes must be determined using the depreciation methods used for ratemaking purposes, and the difference between this income tax expense and actual income tax liability must be accounted for as a deferred tax liability. See Appendix A for

accelerated cost recovery system (MACRS) provides accelerated depreciation that allows the cost of property to be recovered more quickly for income tax purposes than for book and ratemaking purposes. The use of MACRS reduces a utility's income tax liability in the early years after depreciable property is placed in service relative to the liability that would have been determined if the slower regulatory depreciation method were used.[4] For ratemaking purposes, income tax expense is determined as if the utility used the slower regulatory depreciation method. The cumulative difference between income tax expense for ratemaking purpose (using the slower regulatory depreciation method) and the utility's actual income tax liability (using MACRS) is accounted for in a deferred tax liability. For ratemaking purposes, this liability is treated as an interest-free loan from the Federal government because it allows the deferral of Federal income tax payments relative to the payments that would be made if slower regulatory depreciation were used. As a result, the deferred tax liability reduces the utility's rate base for ratemaking purposes because the liability is considered to be a no-cost (i.e., interest-free) source of capital.

Federal tax reform and ratemaking

Shareholder-owned electric utilities currently have a significant Federal income tax burden. In 2010, electric utility companies had a total of $16.1 billion in income tax expense and an additional $15.6 billion expense for taxes other than income taxes. A January 2011 study of over 7,000 publicly traded firms by Professor Aswath Damodaran of New York University found that electric utilities had one of the highest effective tax rates among U.S. industry sectors.[5] Electric utility customers generally bear the burden of this expense because these tax expenses are included in the cost of service for determining rates.

As described above, income taxes play an important role in electric utility ratemaking. A utility's income tax expense is an element of its cost of service. A utility's deferred tax liability (i.e., the cumulative difference between the utility's income tax expense for ratemaking purposes and its Federal income tax liability) is treated as zero-cost capital and reduces the utility's rate base. Finally, Federal tax policies that affect the cost of capital (such as the deductibility of interest expense and rate of tax on dividends) will affect the rate of return that is applied to the utility's rate base.

Federal legislation that reduces the corporate income tax rate would reduce utilities' income tax expense, which would help mitigate upward cost pressures as utilities make major investments in cleaner generation facilities, environmental compliance, cyber security, grid modernization, and energy efficiency measures. Federal tax legislation that reduces or eliminates the benefits of timing differences, such as

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a description and comparison of the flow-through and normalization methods of accounting.

[4] Federal tax liability per the utility's tax return will be higher than regulatory tax expense in the later years of the property's regulatory life.

[5] New York Times, "A Large Tax Gap," January 28, 2011.

MACRS depreciation on public utility property, would reduce or eliminate deferred tax liabilities and put upward pressure on customers' electricity rates (because deferred tax liabilities reduce the rate base upon which a utility earns a rate of return).

Electric utilities finance their capital investments through a combination of debt and equity. As of December 31, 2010, the industry's aggregate capitalization structure was 57 percent debt and 43 percent equity.[6] As discussed in the section above, financing costs are taken into account through the rate of return element of the ratemaking process. Federal tax policies that affect financing costs (such as the rate of tax on dividends or the deductibility of interest expense) would affect utility rates and may make it more expensive to raise capital for investments.

Dividends paid by investor-owned utilities

The payment of dividends is an important and time-tested feature of electric utility stocks that helps attract needed capital to the industry. From 2003 through 2010, total electric utility industry-wide dividends increased 46%, from $12.3 billion to $18.0 billion annually. During this same period, the level of electric utility investment in infrastructure also increased significantly.

Lower dividend tax rates are good for investors, consumers, American businesses and the U.S. economy. They make dividend-paying companies—like electric companies—more attractive to investors. This helps to lower a utility's cost of equity capital (the raising of capital through issuing common stock) and maintain a stronger financial condition. A financially strong company is likely to receive more favorable terms when issuing debt, which is critical for electric companies at this time of elevated capital expenditures. By attracting new investment in their shares, electric companies are able to raise the capital they need to modernize and build new, cleaner generating capacity, invest in major transmission and distribution system upgrades, and make additional environmental and energy-efficiency improvements. These capital investment programs offer an important source of much-needed, high-quality job creation in many states.

Federal tax reform and capital investment

Electric utilities are capital intensive. As of December 31, 2010, the value of utility property, plant and equipment, net of accumulated depreciation, was $737 billion. Capital expenditures for U.S. shareholder-owned electric utilities are projected to remain at historically high levels of $80 billion to $85 billion per year for the next several years, or about twice as high as the $41.1 billion in 2004. These expenditures represent investments in both regulated and non-regulated energy businesses.

Federal tax legislation that provides incentives for capital investment lowers the cost of such investment and results in increased investment in needed infrastructure. The

[6] Edison Electric Institute, 2010 Financial Review.

significant increase in utility investment over the last decade as described in the prior paragraph coincides with the availability of the bonus depreciation provisions and the lower dividend tax rates since 2003. In the electric utility industry, these and other capital cost incentives have helped facilitate increased investment and mitigate related rate increases for a wide variety of diverse property, including cleaner generation facilities, alternative energy resources, and more efficient transmission and distribution systems (e.g., smart grids and smart meters).

Tax reform and transition

Tax reform will bring significant changes to a multitude of common business operations, transactions and investments. With the U.S. economy still feeling the effects of the recession, care must be taken to not negatively disrupt significant business decisions, particularly with respect to investments that have already been made, and to provide appropriate transition rules. This issue is of tremendous importance to the electric utility industry. Electric utilities have committed a substantial amount of invested capital to property already in service. In addition, because of the long lead times required for such projects, utilities have made significant plans and expenditures with respect to investments to be made in the near future based on an understanding of the current tax rules.

Congress has demonstrated sensitivity to transition issues in past tax reform efforts. For example, the Tax Reform Act of 1986 provided prospective application and extensive transition rules with respect to the repeal of the investment tax credit and the adoption of MACRS.[7] In addition, section 203(e) of the Act provided appropriate rules for the ratemaking treatment of the excess deferred taxes created by the reduction of the corporate tax rate. Appropriate transition rules should also apply to current tax reform efforts.

Energy tax incentives

The Internal Revenue Code contains a number of provisions that are intended to provide incentives and support for various energy-related investments, including the production tax credits for electricity produced from certain renewable resources and new nuclear facilities, investment tax credits for solar property, investment tax credits for the purchase of plug-in electric vehicles, and various deductions and credits for energy efficient property, among other important provisions.[8] These benefits generally are intended to address certain market failures that discourage these investments.[9]

A detailed examination of all these provisions is beyond the scope of this testimony. In general, however, these tax policies have spurred research, jobs, and

[7] See, *e.g.*, secs. 203 and 204 of the Tax Reform Act of 1986.
[8] See, Joint Committee on Taxation, *Tax Expenditures for Energy Production and Conservation* (JCX-25-09R) April 21, 2009.
[9] *Ibid.*, at 113.

investment, provided the United States with greater energy diversity, provided consumers with additional energy and transportation choices, and strengthened national security by lessening dependence on foreign energy sources. Many of these investments would not have occurred but for the tax incentives.[10]

Some commonly discussed versions of tax reform would lower tax rates and broaden the tax base by eliminating all or certain preferential tax deductions and credits. The Tax Reform Act of 1986 followed this theme. We urge Congress to consider a number of factors as it addresses the current energy tax incentives in the context of tax reform, including:

(1) Has the tax provision served its nontax purpose relative to its budgetary cost?
(2) If not, could the provision be improved?
(3) What are the implications to energy security and economic policy of eliminating or modifying the current energy tax provisions?
(4) If energy tax provisions are phased out, what transition rules are appropriate?

Tax reform and simplification

One of the goals for tax reform should be to simplify the tax code. Current administrative costs to comply with the Internal Revenue Code and the underlying regulations are high and are a dead weight to the economy. Any new tax reform proposals should be analyzed to determine the extent to which the proposals would add to this burden.

In addition, tax reform should include an attempt to eliminate or rationalize various current law provisions that contribute to tax complexity. The corporate alternative minimum tax is one oft-cited example of an unduly complex facet of the current tax system; one that forces a taxpayer to undergo excessive tax calculations and keep three sets of tax records (regular tax, alternative minimum tax and adjusted current earnings calculations). Another example relates to the treatment of corporate capital gains. Although the corporate tax rate is the same for both capital gains and ordinary income, present law does not allow a corporation to offset net capital losses with ordinary income. This rule complicates corporate business and tax planning, and should be reconsidered in tax reform. Finally, consideration should also be given to streamlining the myriad cost capitalization rules required under the tax code and regulations. For example, the IRS has recently been allowing additional safe harbor rules to simplify certain tax calculations. We strongly support these efforts and believe that Congress should consider codifying or directing the IRS to provide safe harbors when drafting regulations.

[10] See, *e.g.*, http://www.awea.org/issues/federal_policy/upload/PTC_April-2011.pdf, which demonstrates that wind energy project installations generally decline when the placed-in-service date for the production tax credit expires or is about to expire, and increase when Congress provides a long-term extension of the date.

Thank you for the opportunity to provide this testimony. If any of the Members of the Subcommittees or their staffs have any questions or comments, please contact:

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APPENDIX A

Methods of accounting for tax depreciation: flow-through vs. normalization

Flow-through accounting.--The determination of the amount of Federal income taxes reflected in cost of service and rate base depends on the treatment of depreciation of utility property. The use of an accelerated depreciation method for Federal income tax purposes results in an actual Federal income tax liability that differs from the Federal income tax liability that would have been incurred if the typically slower depreciation methods used for regulatory purposes had been used for tax purposes. In general, in the first few years after property has been placed in service, the Federal income tax liability will be lower than if the regulatory depreciation schedule had been used. The Federal income tax liability will be greater in later years when the tax depreciation allowances are less than the regulatory depreciation allowances.

Flow-through accounting treats the actual Federal income tax liability of the regulated utility as reported on its tax return as the utility's tax expense in determining appropriate utility rates. Under flow-through accounting, the tax benefits of accelerated depreciation are taken into account as they are claimed in determining utility rates. Thus, under flow-through accounting, utility rates are lower for those consumers who are charged for service in the earlier years of the useful life of the utility property (relative to those consumers who are charged for service in later years).

Normalization accounting.--In contrast, under normalization accounting, the utility's tax expense for ratemaking purposes is determined by using regulatory depreciation allowances. The normalization method for accelerated depreciation requires adjustments to actual Federal income tax liability to arrive at the regulatory tax expense and adjustments to rate base. The accumulation of the differences between regulatory tax expense and actual Federal tax liability creates a deferred tax liability that represents expected future Federal tax liabilities (see the example below). Normalization accounting is consistent with generally accepted accounting principles used to prepare financial accounting statements for non-regulated companies.

Utility rates are higher in the early years of the useful life of property under normalization accounting (relative to flow-through accounting) but are lower in the later years of the property (as the property becomes fully depreciated for tax purposes). Normalization accounting results in more consistent rates over time because income tax expense does not significantly vary under the method. Cumulative utility rates over the life of regulatory property are lower under normalization accounting because the deferred tax liability (which is not created under flow-through accounting) reduces rate base. Assuming consistent rates of return and discount rates, normalization accounting and flow-through accounting should produce the same results on a present value basis. The difference is which generation(s) of customers receive the benefits of accelerated depreciation. Under flow-through accounting, only customers in the early years of the property’s regulatory life realize these benefits. Under normalization accounting, the

benefits are spread to all customers who are paying for the costs of the property over the regulatory life of the property.

Example

Assume a calendar year regulated utility placed property costing $100 million in service in 2007. For regulatory (book) purposes, the property is depreciated over 10 years on a straight-line basis with a full year's allowance in the first year. For tax purposes, the property is 5-year property and is recovered using the straight-line method, with a full year's deduction allowed in 2007. Assume the rate of return as applied to the utility's rate base is 10%.

Assuming a tax rate of 35 percent for all years, the deferred tax liability (the tax rate times the cumulative difference between tax and book depreciation) would be computed as shown in Table 1 below.

Table 1.--Deferred tax liability assuming constant tax rates (millions of dollars)

	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013-16**	**2007-16**
Tax depreciation	20	20	20	20	20	0	0	100
Book depreciation	10	10	10	10	10	10	40	100
Timing Difference	10	10	10	10	10	(10)	(40)	----
Tax Rate	.35	.35	35	.35	.35	.35	.35	----
Annual adjustments to deferred tax liability			3.5	3.5	3.5	3.5	3.5	(3.5) (14.0)[1]
Deferred tax liability	3.5	7.0	10.5	14.0	17.5	14.0	----	----

[1] The deferred tax liability is reduced by $3.5 million a year for 2013 through 2016 so that no liability exists as of December 31, 2016.