

SENATE FINANCE COMMITTEE'S TAX REFORM WORKING GROUPS

COMMENTS OF THE EDISON ELECTRIC INSTITUTE ON TAX REFORM ISSUES

April 15, 2015

The Edison Electric Institute (EEI) is the association of U.S. investor-owned electric utilities, international affiliates and industry associates worldwide. Our industry directly employs more than 500,000 workers and EEI's investor-owned electric utility members serve nearly 70 percent of America's industries, businesses and consumers.

The electric power sector is a \$910-billion industry and is the most capital-intensive industry in the United States. It is projected to spend approximately \$90 billion a year, on average, for major transmission, distribution and smart grid upgrades; cybersecurity measures; new, cleaner generating capacity; and environmental and energy-efficiency improvements. The electric power industry represents approximately 2 percent of our nation's real gross domestic product.

Investor-owned electric utilities support the goals of corporate tax reform that will promote economic growth, fairly allocate the tax burden, simplify the tax code and reduce corporate tax rates. While tax provisions affect each utility differently, we want to comment on three tax provisions that are critically important to all investor-owned electric utilities. These provisions relate to the cost of capital incurred by electric utilities and therefore impact the industry's ability to invest in upgrades to the electric system infrastructure.

Federal Income Tax Deduction for Interest Expense

The investor-owned electric power industry has a capital structure comprised of about half equity and half debt. The capital needed by electric utilities is used to invest in very long-life assets—the power plants, facilities, and equipment needed to provide affordable, safe and reliable electric service. Lower capital costs translate into lower electricity costs for consumers.

Past proposals from the White House, as well as a number of think tanks, have suggested the repeal of the deductibility of interest for corporations should be considered as part of tax reform. However, as an industry, we are deeply concerned that any significant change in the deductibility of interest costs would harm investor-owned electric utilities and their customers because it would not only increase the cost of capital for the industry, it would also increase customer rates.

Importantly, the lower corporate tax rate being suggested by proponents of tax reform would not offset the negative impact of a significant change in deductibility of interest costs for electric utilities. In fact, eliminating the interest deduction and decreasing the corporate tax rate to 25 percent would actually increase the amount of corporate taxes paid by utilities—a change that ultimately would be reflected in consumers' electric bills.

The rates that customers who are served by a traditionally regulated utility pay for electricity reflect their utility's costs of providing such service, including its after-tax cost of capital. Utilities work hard to achieve the lowest cost of capital and benefit from the federal income tax deduction for interest costs to help minimize increases in customer rates—especially during this time of major capital expansion.

If they are unable to deduct interest costs for critical infrastructure projects, rate-regulated utilities would pass any tax increases and related higher costs on to their customers. As an added cost for electricity, this tax increase would have negative economic implications, including a disproportionate impact on lower-income individuals, who spend a higher percentage of their income on electricity, and small businesses; a drag on the global competitiveness of energy-intensive industries in the United States, such as manufacturing; and a contributor to inflation.

In addition, these higher costs would adversely impact utilities' infrastructure expansion and enhancement projects. Because utilities are major contributors to the tax base and to job creation in the communities they serve, the elimination or deferral of infrastructure projects would hurt these communities.

Proponents for limiting interest deductibility argue that a limit is expected to reduce leverage and thereby enhance economic security; however, this is not the case for utilities. State public utility commissions (PUCs) and the securities markets impose discipline on electric utilities that significantly limits their ability to over leverage their capital structures. The debt of regulated utilities is more secure than the debt of other industries because regulated utilities have a more secure revenue flow. This is why regulated utilities can have both higher debt-to-total-capital ratios and a lower cost of capital than many other industries.

The Need to Maintain Tax Normalization and Address Excess Deferred Taxes

The electric utility industry supports reducing the U.S. corporate tax rate as part of fundamental tax reform in an effort to stimulate the economy, create jobs, promote economic growth and make U.S. corporations more competitive on a global basis. However, reducing federal tax rates as part of tax reform will create unique transition issues for regulated investor-owned electric utilities that we urge Congress to address in any tax reform legislation. One such transition issue is the treatment of excess deferred taxes under the normalization method of accounting.

A deferred tax liability represents the amount of taxes that a company has recorded as an expense in its financial records, that it will pay to the government in future years due to a timing difference between the company's financial accounting methods, which are based on regulatory rules, and its tax accounting methods, which are based on the Internal Revenue Code. These differences occur due to investment incentives within the tax code such as accelerated depreciation.

Deferred taxes are accumulated at the current tax rate. If a reduction in the corporate tax rate occurs, a company's deferred taxes are reduced because the company will be paying taxes in the future at a lower tax rate, thus creating "excess deferred taxes." Companies in most industries remove the excess deferred taxes from their balance sheets and recognize the reduction as an

increase to profit in their income statements. However, because the rates investor-owned utilities charge their customers are regulated by state PUCs and reflect the after-tax cost of their businesses, investor-owned electric utilities are required to refund any excess deferred taxes to their customers. The transition issue for regulated utilities is the amount of time over which these excess deferred taxes are refunded to customers.

“Normalization,” a concept that has been in the tax code since the late 1960s, is the method by which utility companies have historically returned the tax incentives, including excess deferred taxes, to their customers. Normalization requires state utility regulators to treat tax benefits to customers in the same way the recovery of the cost of the associated utility property is treated, which is essential to stabilizing utility rates. Normalization ensures that tax benefits are spread to all customers who benefit from utilities’ long-life assets and not just current customers.

Tax normalization should be retained in any fundamental overhaul of the tax code. It should be used, as it has in prior rate reduction legislation, to provide a fair and equitable process to account for excess deferred taxes resulting from a rate reduction, and also continued as a requirement for any investment incentives that are retained or added in the tax reform process. We support inclusion of a normalization transition rule similar to that provided by the Tax Reform Act of 1986. For more information on these issues, including more in-depth examples, please see Appendix A for normalization rules and Appendix B for excess deferred taxes.

Dividend Tax Rates

EEI commends Congress for maintaining low tax rates on dividends that are at parity with the tax rates on capital gains as part of the American Taxpayer Relief Act of 2012 (ATRA). If Congress had not acted, the top tax rate on dividends would have skyrocketed from 15 percent to 39.6 percent, while the top tax rate on capital gains would have increased from 15 percent to 20 percent. Instead, ATRA set the top tax rate for both dividends and capital gains at 20 percent for couples earning more than \$450,000 (\$400,000 for singles), while maintaining the lower rates for taxpayers below those income thresholds. We also commend Congress for making these rates permanent in the Internal Revenue Code instead of providing another temporary extension.

Unfortunately, there are still efforts to raise the tax rate on dividend income, most recently in President Obama’s fiscal year 2016 budget proposal. In the proposal, the President recommends raising the top dividend tax rate from 20 percent to 24.2 percent. After factoring in the 3.8 percent Affordable Care Act investment surtax, the effective top dividend tax rate would actually be 28 percent. Raising taxes on investment is out of step with the global economy, especially considering that the United States already has the second highest integrated dividend tax rate among OECD and BRIC countries.¹ U.S. tax rates should be made more competitive, not less.

EEI’s member companies believe very strongly that federal tax policy should not distort investment decisions, and taxing dividends at higher rates than capital gains would create a tax policy that favors growth stocks over dividend-paying investments. Higher dividend tax rates also would harm all Americans who invest directly in dividend-paying stocks or who invest

¹ Corporate Dividend and Capital Gains Taxation: A comparison of the United States to other developed nations (Ernst & Young, 2015).

indirectly in mutual funds. Higher rates would also have a negative effect on the value of dividend-paying stocks, which would adversely impact those who have an interest in employer or union pension plans, 401(k) plans, individual retirement accounts, and/or life insurance policies.

As Congress considers tax reform, it is important to note that dividends are currently subject to double taxation—first at the corporate level when the company pays taxes on these earnings and again at the individual level when shareholders receive the dividends. Increasing the tax rate on dividends would increase the overall cost of capital for utilities, their shareholders and their customers.

Appendix A: Normalization Rules

Investor-owned electric utilities are highly regulated businesses. A state PUC sets the rates that a regulated electric utility may charge its customers for electricity service. The PUC allows the utility to recover its “cost of service” and also gives the utility an opportunity to earn a reasonable rate of return on its invested capital (i.e., its “rate base”). Among the items included in cost of service are fuel costs, operations and maintenance costs, depreciation expense, and income tax expense.

The “book” or regulatory treatment of a utility asset may differ from the tax treatment of the asset under the Internal Revenue Code. Utilities account for depreciation of their assets through both regulatory depreciation and tax depreciation. Regulatory depreciation generally spreads the cost of utility property ratably over its useful life so that the cost is borne equally by both current and future customers who will benefit from the property.

Current tax law allows a company to accelerate depreciation allowances. When a company accelerates the depreciation of an asset for tax purposes, it records more tax depreciation in the first few years of an asset’s life, and less depreciation in the later years, relative to book or regulatory depreciation. While this approach results in a timing difference, cumulative tax and book depreciation generally are equal over the course of an asset’s life.

One issue federal and state regulators face in establishing utility rates is whether income tax expense should be based on regulatory depreciation or tax depreciation.

The use of regulatory depreciation to determine income tax expense in setting rates is known as the normalization method of accounting. The use of tax depreciation to determine income tax expense in setting rates is known as the flow-through method.

- **Normalization Accounting:** When setting rates, normalization spreads the tax benefits associated with utility assets over the same time period that the costs of those assets are recovered from customers. Normalization seeks to treat current and future utility customers equitably by allowing all customers to enjoy the tax benefits of depreciation. Normalization has the effect of stabilizing and reducing cumulative customer rates over time.

Normalization accounts for the difference in timing of tax benefits reflected on the utility's tax return and in customers' rates by creating a liability representing the utilities future tax obligation. This liability represents capital the utility has to invest that has no cost and thus reduces the amount of capital on which customers provide the utility rate of return.

The Internal Revenue Code requires the use of normalization as a condition of a utility claiming accelerated depreciation and certain tax credits. If the tax benefits are not normalized in the ratemaking process, the utility loses the right to the benefits.

- **Flow-Through Accounting:** Under flow-through accounting, PUCs reduce customer rates — to account for tax benefits — during the same time period that the utility realizes these tax benefits on its tax returns. This regulatory accounting method has the effect of “flowing through” the current year's tax benefits concurrently to current customers.

With flow-through accounting, utility rates would be lower in the early years of the life of the property that produced tax benefits and higher in the later years. Cumulative rates will be higher over the life of an asset under flow-through accounting relative to normalization accounting. Flow-through accounting would eliminate or reduce a utility's incentive to invest in qualified property, such as new generating facilities or new transmission or distribution upgrades because the incentive created by the government is immediately provided to the customers and will not be available to the regulated utility for incremental capital investment.

Congress first promulgated normalization rules for accelerated depreciation in 1969. Congress imposed rules restricting the ability of PUCs to flow through tax benefits to customers because the purpose of accelerated depreciation is to stimulate capital investment and not to subsidize consumers' utility rates. Depending upon the accounting of these benefits, some or all of the incentive for the utility to invest is eliminated, thus negating Congress' fundamental intent for economic stimulation.

Deferred tax accounting (upon which normalization is based) is required under Generally Accepted Accounting Principles (GAAP) for all non-regulated companies. The Federal Energy Regulatory Commission (FERC) has required normalization for all timing differences for electric utilities since 1982. However, some PUCs have adopted normalization only for items mandated by the Internal Revenue Code, such as accelerated depreciation, while other PUCs have adopted normalization similar to the FERC method.

EEI believes tax normalization must be maintained to the extent that accelerated depreciation or other investment incentives are included in the tax code but also needed as a transition for excess deferred taxes. Normalization is a key element in setting and stabilizing utility rates because it requires regulators to reflect tax benefits in the same manner as the recovery of the cost of the associated utility property. Normalization also has proven effective in maintaining incentives for electric utilities to invest in capital equipment.

Appendix B: Excess Deferred Tax Transition Issues

Electric utilities support a fair and equitable distribution of excess deferred taxes across their customer base. To meet this goal, EEI believes any tax reform legislation should include a provision to require state PUCs to refund excess deferred taxes to customers, related to asset depreciation, over the remaining lives of the assets being depreciated.

A deferred tax liability is the amount of taxes currently saved by a company that will be paid in the future due to a temporary timing difference between the “book” treatment of an asset on a company’s financial records and the tax treatment based on Internal Revenue Code rules.

The most common example of a deferred tax liability occurs when a company claims accelerated tax depreciation for an asset. (For an electric utility, an asset could be a power plant or large power transformer, for example.) Accelerated depreciation means that a company will record more tax depreciation expense in the first years of an asset’s life and less tax depreciation expense in the later years, relative to book or regulatory depreciation. While this approach results in a timing difference, cumulative tax and book depreciation generally are equal over the course of an asset’s life.

Following is a basic example of how deferred taxes work:

- Assume the tax depreciation of an asset is \$20.00 in the year the asset is placed in service.
- If the book depreciation of the asset is \$10.00 that year, there is a \$10.00 temporary difference between the tax depreciation and the book depreciation.
- The \$10.00 temporary difference creates a current tax savings of \$3.50 (\$10.00 taxed at the current 35 percent federal income tax rate) and a future (deferred) tax liability in the same amount. This future liability is recorded in a reserve on the balance sheet and generally is titled “Accumulated Deferred Income Taxes.”

Excess deferred taxes arise as the result of a reduction in the corporate tax rate. If the federal corporate tax rate is reduced from 35 percent to 25 percent, for example, the amount of deferred taxes that would be needed to pay the future obligation to the federal government would decrease by approximately 28 percent (10 percent divided by 35 percent).

Using the accelerated depreciation example, the \$3.50 of deferred taxes would be reduced to \$2.50 (\$10.00 of future income taxed at the 25 percent tax rate). For a company with an accumulated deferred income tax liability, the tax rate reduction is equivalent to the federal government reducing a portion of future tax liabilities. This reduction is known as the excess deferred taxes which, in this the example, would be \$1.00 (\$3.50 minus \$2.50).

When a tax rate reduction creates excess deferred taxes, all companies must account for the excess. Companies in most industries generally would recognize the excess deferred taxes as income for financial statement purposes. However, because investor-owned electric utilities are heavily regulated by state PUCs, utilities must refund the excess deferred taxes to ratepayers, requiring the recording of a regulatory liability.

The transitional issue facing electric utilities is the timing of the payments to customers. Generally, if the excess deferred taxes are returned to customers immediately, the utility's cash flow is sharply reduced, which could create liquidity issues for the utility. In addition, an immediate payment disproportionately benefits current customers — who receive the entire refund — and unfairly penalizes future customers, who pay for the cost of long-lived utility assets over their remaining useful lives and who may not receive any of the refund.

When Congress last reduced corporate tax rates in the Tax Reform Act of 1986, lawmakers resolved this issue by enacting a provision that would require state PUCs to refund the excess deferred taxes related to depreciation over the remaining lives of the assets (in essence, “tax normalization”). We urge Congress to include a similar provision in any tax reform legislation that reduces the federal income tax rate. This would allow all customers who pay for the cost of utility assets over their useful lives to share in the return of the excess deferred taxes.