HOUSE
RESEARCH
ORGANIZATION bill analysis 4/12/95

HB 176
Stiles

SUBJECT: Use of taxes in calculating gas utility rates

COMMITTEE: Energy Resources — favorable, without amendment

VOTE: 9 ayes — Holzheauser, West, Dutton, Hawley, Hirschi, Jackson, Ramsay, Smithee, Torres

0 nays

WITNESSES: For — William E. Avera, Energas, Entex, Southern Union and Lone Star Gas; Paul Plunket, Entex; Pam McClellan, Southern Union Gas Company; Joe N. McClendon, Lone Star Gas Company; Patrick Nugent, Texas Natural Gas Pipeline Association

Against — Jay Doegey, City of Arlington; Ellen Blumenthal; Janee Briesemeister, Consumer's Union; Tim Curtis, Texas Citizen Action; Tom Smith, Public Citizen

On — Walter Washington, Office of Public Utility Counsel

BACKGROUND: Under authorization of the Gas Utility Regulatory Act (GURA), the Texas Railroad Commission regulates investor owned and gas utilities operating outside municipal city limits and hears appeals from rate decisions by municipalities. GURA does not apply to municipally owned gas utilities.

The rates a gas utility is permitted to charge consumers are determined by the utility's net income, which is the difference between the revenues the utility receives from its customers and the utility's expenses. The higher the gas utility's expenses, the higher its rates will be allowed to rise to offset those expenses. A gas utility's costs include its tax burden and operating expenses.

Current law recognizes two sources of income tax credits and deductions for gas utilities: disallowed expenses and consolidated tax savings. Disallowed in calculating utility rates are expenses for fees paid to lobbyists, charitable contributions, excessive executive salaries and other expenses that the Texas Railroad Commission (TRC) determines are not prudently or actually incurred by a utility. Disallowed expenses are absorbed by the shareholders of the utility and are not passed on as higher rates to the utility's customers.

GURA allows a gas utility that is an affiliate of a larger corporate entity to file a consolidated income tax return with the corporation's other affiliates if this results in tax savings for the utility. Any tax savings received by the larger corporate entity from the tax deductions of all of its affiliated subsidiaries is considered in the calculation of federal income tax expense for ratemaking purposes.

DIGEST:

HB 176 would redefine the way rates are determined for gas utilities that are affiliated with companies that are under the same parent corporation and file consolidated tax returns with those affiliates. If a utility files a consolidated tax return with other affiliates, the utility's rates would be determined using only the revenues and expenses that make up the net income of the utility operation. The expenses of an affiliate of the utility, including any tax deductions of the affiliate, would not be considered as part of the utility's net income for the calculation of the utility's rates.

Affiliate expenses could be used as a component of an utility's net income for transactions within the parent corporation if the regulator finds it reasonable to include them as a component and if an affiliate sells something to a utility at a price not higher than the prices it charges to other affiliates or to entities not affiliated to the corporation.

Tax deductions that a utility gets for its disallowed expenses — those expenses not allowed to be used in the calculation of utility rates —would not be used in the calculation of utility rates.

HB 176 would apply to rate proceedings for which the statement of intent to change rates is filed on or after the date HB 176 became law. Appeals of rate decisions to the Texas Railroad Commission would only be affected if the statement of intent for the original rate hearing was filed on or after the bill's effective date. The bill would take immediate effect if approved by two-thirds of the membership of each house.

SUPPORTERS SAY:

HB 176 would eliminate an unfair method of calculating gas utility rates by establishing a tested method of regulating utilities that is fair both to consumers and to a utility's corporate shareholders. The methods of calculation provided for in HB 176 have already been adopted by regulatory bodies in 46 other states and by the Federal Energy Regulatory Commission.

HB 176 provides for a "stand alone" method of rate calculation, in which a utility's income and operating expenses are calculated "standing alone" and separate from any income, expenses or tax deductions incurred by its affiliates. This means that when a regulator is to determine utility rates for a corporate-owned utility that files a consolidated tax return with its corporate affiliates, the regulator will look only at the amount of federal income taxes the utility pays. The regulator will not determine whether the utility's tax burden is lowered due to the tax deductions of the affiliates, even if the parent corporation's overall tax burden will be lowered because the corporation gets to take advantage of its affiliates' tax deductions.

Such practices are fair and justified because shareholders paid the cost and assumed the risks associated with the affiliate's tax deductions. This practice matches the risks that the shareholders take with their tax benefits, rather than arbitrarily extracting those tax benefits from shareholders and giving them to ratepayers who have not assumed the risks or paid the expenses and associated taxes that gave rise to the income tax deduction.

Since disallowed expenses are not included in calculating the gas utility's rates, then the associated tax deductions are the only benefits the shareholders receive and therefore should not be included in calculating the gas utility's rates. A utility's deductions for its disallowed expenses are therefore not included in the utility's tax burden out of fairness to the shareholders who bear the cost of the disallowed expenses.

The underlying principle behind HB 187 is that in setting utility rates, if there is an income tax deduction, the benefit of the tax deduction should be allocated to the party that funds the cost producing the deduction. Utility rates are intended only to cover the costs of utility operations.

HB 176 would only affect gas utilities regulated by the Texas Railroad Commission and has nothing to with electric and telephone companies regulated under the Public Utility Regulatory Act (PURA).

HB 173 is needed to restore tax incentives to gas utilities to make charitable contributions. Under current law, the true cost of charitable contributions can be nearly doubled because these expenses are not allowed to offset a utility's income, yet any resulting tax savings will be included as income for ratemaking purposes. Contributions should only be paid for by the company once.

HB 176 would encourage utilities to invest in alternative natural gas markets and other ventures. When an investment tax credit or utility's affiliate's investment losses results in tax savings, those savings may be factored into the utility's rate base, even though the utility's received no savings from its own operations. In effect, the ratepayers benefit from savings instead of the company shareholders. Using a "stand alone" method of rate calculation would allow gas companies to diversify and invest profits in alternative fuel consumption areas that may lose money initially. Diversification allows gas utilities to sell more gas on a year-round basis instead of primarily during the winter.

HB 176 proposes the correct course for Texas. It is fair, it does not send a punitive message to the gas company shareholders, and it would ensure that ratepayers continue to enjoy the tax benefits associated with all expenses included in the rates.

OPPONENTS SAY:

HB 176 would change the law on the treatment of gas utility's federal income tax expenses in a manner that causes ratepayers to pay more than what they owe in gas rates. The bill is contrary to the underlying ratemaking principle in Texas law: that ratepayers pay only actual and reasonable expenses. By requiring ratepayers to pay for a hypothetical or "phantom" tax expense — that is, an expense that fails to take into account the utility's tax deductions — HB 176 actually would increase profits to shareholders in excess of the profit granted by regulators.

Two types of tax deductions are at issue: (1) tax deductions associated with disallowed expenses and (2) tax deductions that provide consolidated tax savings. Current law provides that ratepayers pay none of the disallowed expense. Thus, when the commission disallows an expense, the utility bears all the responsibility for paying the disallowed cost. Under HB 176, the utility would be able to collect its tax deductions for the disallowed costs from the ratepayer, which amounts to 35 percent of the disallowed expense. Therefore, the utility would bear only 65 percent of the responsibility for the disallowed cost.

With regard to consolidated tax savings, GURA and the courts require that ratepayers receive the "fair share" of the consolidated tax savings that the utility receives by filing a consolidated tax return. It is not true that the utility "stands alone" from the affiliate companies. The utility provides the cash flow and profits that the parent company uses to start-up and fund affiliate companies. Some of the affiliates lose money. The parent is able to sustain those losses because the utility provides revenue and profits to offset those losses. HB 176 would make it easier for holding companies to use utilities to cross-subsidize affiliate companies.

If this bill passes, electric and telephone utilities would likely demand the same treatment as gas utilities, potentially costing residential users and small businesses hundreds of millions of dollars in additional charges. GURA and PURA (Public Utilities Regulation Act) currently contain the same language regarding the treatment of consolidated tax savings and the treatment of disallowed expenses. Consequently, the electric and telephone utilities will argue that the change in GURA should be extended to PURA as well.

The amount of corporate charitable contributions would not be affected by rejection of HB 176. Experience shows that utilities continue to make charitable contributions even when the regulator disallows that expense from the rates charged to the customer. The bill would neither preserve the current level of contributions nor prevent a drop in contributions.

HB 176 would give gas utilities an unfair amount of leverage in negotiating with cities over utility rates. Most municipal rate cases are never appealed to the railroad commission for review because the gas utility and the municipality settle the cases. The settlements are based on the assumption that the utility recovers the actual tax expense, not an amount greater than its actual expense. The gas utilities will use HB 176 as a negotiating tool to demand rates that are higher than are otherwise the case. This will make it more difficult for municipalities and gas utilities to settle rate cases, which in turn, will lead to more appeals of gas rate cases to the commission. Although the Legislature's intent may be that this bill would be used only for ratemaking procedures, an unintended by-product would be that it could be used in negotiations with cities as well, potentially affecting gas utility rates throughout Texas.

NOTES: The companion bill, SB 239 by Armbrister, is pending in the Senate State Affairs Committee.

SB 421 by Carriker, containing the same provisions as HB 176, passed both houses during the 73rd Legislature in 1993, but was vetoed by Gov. Ann Richards. The governor said in her veto message that SB 421 might increase the cost of gas to consumers. She urged that gas utilities be included in an interim study examining electric and telephone utility issues.