COUNTERFLOW
BY STEVE HUNTOON

Brother, Can You Spare 70 Billion Dimes?

By Steve Huntoon


Huntoon

I'm sorry to disappoint folks by kicking off the new year without another column on the Trump-Perry carbon tax (aka the DOE NOPR).

This column is about another tax matter: that very beautiful tax legislation that became the law of the land on Dec. 22. OK, maybe not very beautiful, or even beautiful, or even not that attractive. But whatever.

The centerpiece of the tax legislation is a reduction in the corporate tax rate from 35% to 21%. The raison d'etre is making the U.S. corporate tax rate more competitive with the rest of the world.

Public utilities are direct beneficiaries of this reduction, even though they are one industry that can't move outside the U.S. You can't get your utility service from China (at least not yet). Utility customers ought to be the indirect beneficiaries, but as I discuss here, it ain't clear how that's going to happen and when.

I know we all hate death and taxes, but please bear with me.

How Income Taxes Work in Rate Regulation

Traditional rate regulation allows utilities a return on their invested capital (aka rate base[1]) based on a composite of their shareholder equity (stock) and their debt (bonds). The equity portion is determined net of income taxes, so utilities are given an income tax allowance to cover income taxes.

So let's take an example of a utility with a rate base of $10 billion that is financed 50% by debt and 50% by equity. Let's say the equity portion of $5 billion is being allowed an annual return of 10%, or $500 million. That 10% is a rough average of allowed returns on equity (ROE).

By the way, this 10% allowed level of ROE is wildly excessive for reasons I've explained before,[2] but no one seems particularly concerned about that. The excessive ROE is not only unfair to consumers in and of itself, but it has spurred a spending frenzy by utilities to increase rate base notwithstanding little to no growth in demand.[3] Utilities do not need any more encouragement to "invest" consumers' money in gold-plating.

Anyway, getting back to the point of this column (and I do have one), to get to a "net of tax" return of 10%, that percentage is "grossed up" for taxes, which can be calculated by dividing by 1 minus the tax rate, or 65%.[4] So for $5 billion of equity, the utility is awarded $769 million that consumers actually pay.

You can confirm this admittedly convoluted approach by multiplying $769 million by 35% (the tax rate) to get an income tax allowance of $269 million and then subtracting that $269 million from $769 million to get the $500 million "net of tax" allowed return.

Cut in Tax Rate Amounts to $7+ Billion Owed to Electric Consumers. Per Year.

So what's the difference as a result of the tax rate reduction from 35% to 21%? We get the tax "gross up" by dividing by 1 minus the new tax rate, or 79%. So for $5 billion of equity, and $500 million of "net of tax" return, the utility would receive $633 million.

To recap, the overall return on $5 billion at an income tax rate of 35% is $769 million. The overall return on $5 billion at an income tax rate of 21% is $633 million. See the difference? The former is 21.5% more than the latter.

This means that if a utility's overall equity return was just and reasonable on New Year's Eve, on New Year's Day it was 21.5% more than just and reasonable.

What does that amount to? There is roughly $41 billion in relevant electric utility earnings.[5] So on New Year's Day, electric utility rates became excessive by $7 billion ($41 billion, minus $41 billion divided by 1.215). That's 70 billion dimes.

And the tax cut creates another benefit for utilities: excess accumulated deferred income taxes. I will spare you an explanation of this. But believe me, it is another huge pile of money that consumers ought to start getting back as of … yesterday.

Who is Getting Electricity Consumers Their $7+ Billion?

What are our nation's regulators doing about this?

So far it seems to be a trickle instead of a wave.[6] And it's not as if the utilities even think they're entitled to windfalls. The Edison Electric Institute issued a press release headlined: "Passage of Tax Reform Bill a Win for Electricity Consumers."[7] S&P Global simply assumes that regulators will require pass through to consumers.[8]

We need more action from our nation's regulators to, as Captain Picard might say, make it so.

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[1] Although rate base has a number of complicating factors, in most regulatory jurisdictions, it is basically the booked cost of utility capital investment less the accumulated depreciation for that investment.

[2] http://www.energy-counsel.com/docs/Nice-Work-If-You-Can-Get-It-Fortnightly-August-2016.pdf.

[3] LED lighting is killing electric demand, as I've written about, http://www.energy-counsel.com/docs/LED-Kills-the-Edison-Star-2017-01-24%20RTO-Insider-Individual-Column.pdf, as have others more recently, https://energyathaas.wordpress.com/2017/05/08/evidence-of-a-decline-in-electricity-use-by-u-s-households/.

[4] I'm ignoring state income taxes for simplicity. There is negligible effect on the point being made.

[5] EEI reports members' energy operating income of $73 billion for 2016 here, http://www.eei.org/resourcesandmedia/industrydataanalysis/industryfinancialanalysis/QtrlyFinancialUpdates/Documents/QFU_Income_Statement/2016_Y_Income_Statement.xlsx. Subtracting $22 billion of interest expense yields $51 billion of normalized equity return. I reduced that $51 billion by a guesstimate of 20% to reflect merchant generation owned by EEI utilities (principally in PJM), utility formula rates that track prevailing tax rates, and tax adjustment provisions in individual utility tariffs (such as per a rate case settlement). That leaves $41 billion upon which to apply the income tax reduction effect.

[6] One exception is Kansas, where on Dec. 14, the Kansas Corporation Commission staff requested rate investigations with interim accounting measures, http://estar.kcc.ks.gov/estar/ViewFile.aspx/S20171214155815.pdf?Id=660e208e-b7b9-4263-9168-688f4dc50759, and a Kansas industrial consumers group filed a complaint against all investor-owned electric and gas utilities, http://estar.kcc.ks.gov/estar/ViewFile.aspx?Id=6d5a5f12-f228-483a-b416-1f7b488f0bbf. And Montana regulators voted last week to require its utilities to immediately defer the tax benefit and to submit proposals for passing it through to consumers. Michigan and South Dakota are among other states reportedly opening dockets on this issue.

[7] http://eei.org/resourcesandmedia/newsroom/Pages/Press%20Releases/EEI%20Passage%20of%20Tax%20Reform%20Bill%20a%20Win%20for%20Electricity%20Customers.aspx.

[8] "On the regulated side of the fence, utilities will almost certainly be required to pass along savings from new tax guidelines through state regulatory proceedings." https://marketintelligence.spglobal.com/documents/our-thinking/research-reports/Corporate-Tax-Reform-and-Utilities.PDF.