**BEFORE**

**THE PUBLIC UTILITIES COMMISSION OF OHIO**

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| In the Matter of the Commission's Investigation of the Financial Impact of the Tax Cuts and Jobs Act of 2017 on Regulated Ohio Utility Companies | :<br>:<br>:<br>:<br>: | Case No. 18-47-AU-COI |

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# MERIT BRIEF
# SUBMITTED ON BEHALF OF THE
# PUBLIC UTILITIES COMMISSION OF OHIO

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DATE: August 13, 2018

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## INTRODUCTION

Due to a reduction in the federal corporate income tax rate from 35 percent to 21 percent, the Commission opened this docket to determine the appropriate method to pass benefits resulting from this change to ratepayers.[1] A utility company's payment of corporate income taxes makes up part of the rates that customers pay. The Commission, in a January 10th 2018 Order, invited comments to address the components of utility rates that the Commission will need to reconcile with the Tax Cuts and Jobs Act of 2017 (TCJA); and the process and mechanics for how the Commission should do so. In addition, the Commission, pursuant to its authority under R.C. 4905.13, ordered that, in the interim, effective January 1, 2018, the utility companies were to record on their books

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[1] Order at 1 (Jan. 10, 2018).

and records the estimated reduction in federal income tax resulting from the TCJA as a deferred liability.

Ohio Power Company, Duke Energy Ohio, Inc., The Dayton Power and Light Company, The Cleveland Electric Illuminating Company, and The Toledo Edison Company (collectively, the EDUs) filed a joint application for rehearing of the Commission's January 10, 2018 Order. Ohio Partners for Affordable Energy, Industrial Energy Users-Ohio, the Ohio Consumers' Counsel, and The Kroger Company filed Memoranda Contra the EDUs' application for rehearing. The Commission's Second Entry on Rehearing granted in part and denied in part the issues raised on rehearing and the Commission reiterated that it intended that all tax impacts resulting from the TCJA be returned to customers and that a deferred liability for each utility should remain in place until the return had been accomplished.[2] Furthermore, the Commission called for a hearing on the narrow question of whether the utilities should be required to establish a deferred tax liability.[3]

Seven parties, including Staff, filed testimony and a hearing was held on July 10, 2018. Staff timely files its brief and asks the Commission to adopt its recommendations.

[2] Second Entry on Rehearing at 6 (April 25, 2018).

[3] *Id*. at 12.

## DISCUSSION

The Commission asked what components of utility rates need to be reconciled in light of the TCJA and the process and mechanics of how the Commission can implement the tax reduction in customers' rate payment.[4] Ohio utility companies obtain customers' funds through base rates and additional riders. The Commission's ratemaking formula allows operating expenses, including current federal income taxes (FIT), to be recovered on a dollar for dollar basis in revenue requirements in all cost-based rates of investor-owned electric, gas and water utilities. Income tax expense is calculated in the ratemaking process by "grossing-up" for income taxes the equity component of the utility's rate of return historically at a rate of 35 percent. With the FIT reduction to 21 percent, the utilities' income tax expense is reduced. The tax benefits from current FIT expenses reduction from January 1, 2018, should be returned to customers.

Most Ohio utilities have numerous riders in effect at this time. There are riders that will be affected by the TCJA and one of those riders is a distribution investment rider.. These distribution investment riders (and all other riders that contain a tax component) should now incorporate the 21 percent FIT rate and customers should receive the associated benefits of the FIT reduction dating back to January 1, 2018.

The Ohio Cable Telecommunications Association's (OCTA) raised an issue that would be affected by the changes in the FIT. The OCTA is concerned about the effect that the FIT change has on pole attachment rates. OCTA's witness Ms. Kravtin testified

[4] Order at 2 (Jan. 10, 2018).

that pole attachment rates for third-party pole attachers are set under a unique rate setting process pursuant to Ohio Administrative Code Rule 4901:1-3-04(D).[5] Ms. Kravtin points out that the reduction in the federal corporate income tax rate from 35% to 21% under the TCJA lowers both the current and deferred income tax expense obligation of the utility, the latter creating excess accumulated deferred income taxes (ADIT).[6] Ms. Kravtin points out that both elements enter into the pole rate formula calculation through the specified FERC Accounts.[7] Ms. Kravtin states that the pole attachment rate formula takes ADIT into account in the calculation by reducing net investment dollars used in the formula and argues that since ADIT applies as a reduction to gross investment, any TCJA-related reduction in the ADIT will result in a corresponding increase in the Net Bare Pole component of the formula.[8] Given that utility assets are long lived, Ms. Kravtin contends that it would be inappropriate from an economic and public policy perspective to remove the excess ADIT for purposes of the pole rate formula in one-time lump sum adjustment.[9] Ms. Kravtin argues that excess ADIT related to the TCJA should not be removed in a lump sum but should apply an appropriately small percent reduction reflecting a relatively long amortization period commensurate to the long-lived nature of pole and other distribution assets.[10]

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[5] Kravtin Test. at 6.

[6] *Id*. at 12.

[7] *Id*.

[8] *Id*. at 13.

[9] Id. at 14.

[10] Id. at 15.

The transfer of excess ADIT out of the pole attachment formula-designated FERC accounts used to offset gross pole investment costs could adversely affect pole attachment rates. In order to better understand the consequences of this change, a review or investigation into future pole attachment rates must be done in order to determine if any unamortized excess ADIT transferred from the ADIT as a result of the TCJA should, in addition to current ADIT and depreciation reserves, be used as a reduction to total gross plant and gross pole investment in the pole attachment formula.

The more complicated implication for the Commission is deriving how to flow the TCJA reduction back to customers in base rates. Base rates are calculated in part on ADIT. The Commission has a duty to consider taxes assessed, even if the taxes are outside of the test year. *East Ohio Gas Co., v. Pub. Util. Comm.*, 133 Ohio St. 212 (1938). ADIT is the difference between the amount of tax recovered in rates and the amount of tax actually paid by the company to the government.[11] Since ADIT has currently been accumulated at a 35% tax rate, now, with the enactment of the TCJA, taxes will be paid at a 21% rate, thus the amount currently deferred will exceed the actual amount owed. This is referred to as excess ADIT. This excess amount represents money owed to customers. Ohio utility companies have been ordered to track this excess beginning January 1, 2018. Staff recommends that the utilities quantify the total tax savings and the utility companies recommend a method to return these savings to customers.

[11] Ohio Energy Group Comments at 4 (Feb. 15, 2018).

When evaluating whether a deferral is the appropriate accounting methodology, the Commission reviews the following five factors: whether the utility's current rates or revenues are sufficient to cover the costs associated with the requested deferral; whether the costs are material; whether the reason for requesting the deferral is outside the utility's control; whether the expenses are atypical and infrequent; and whether the financial integrity of the utility will be significantly and adversely affected if the deferral is not granted.[12] Staff recommends that the Commission consider the same five factors that are used in evaluating a deferral associated with a regulatory asset when evaluating the implications of the TCJA as a regulatory liability.[13]

Staff witness Borer's testimony addressed these criteria as applied to a deferred liability. When considering the first factor, "[a]re the utility's current rates or revenues insufficient to cover the costs associated with the deferral,"[14] Borer answered that the utilities meet this criterion because rates have been developed based upon a 35% FIT rate, therefore, current rates are sufficient to cover the deferral associated with the reduction of the FIT rate to 21%.[15] In answering the next question – Are the expense reductions material? – Witness Borer stated that he found the tax expense reduction to be a material change.[16] Mr. Borer reasoned that since the current and deferred income taxes

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12 *In the Matter of the Application of Duke Energy Ohio, Inc. for Approval to Change Accounting Methods*, Case No. 17-2118-GA-AAM, Order at 8 (April 18, 2018)

13 Borer Test. at 4 (June 29, 2018).

14 Borer Test. at 5 (June 29, 2018).

15 *Id.* at 5.

16 *Id.* at 6.

are directly affected by the FIT rate, the expense reductions are material because changing the FIT rate from 35% to 21% represents a reduction of 40% and there is also an approximate reduction of 18% to the Gross Revenue Conversion Factor. Additionally there will be the separate issue of ADIT and this alone may be in excess of tens or hundreds of millions of dollars, which Staff deems to be material. The next factor to consider is whether the deferral is outside the utilities' control. Mr. Borer noted that the decision to reduce the federal income taxes was an act of Congress, signed by the President of the United States and clearly outside the control of the utility companies.[17]

The fourth factor asks whether the expense reductions are atypical and infrequent. Witness Borer commented that minor changes in the tax code may be frequent but the last major change to the tax code occurred in 1986.[18] Therefore, Mr. Borer deems the corporate tax reduction form 35% to 21% to be atypical and infrequent.[19] And in analyzing the last criteria of whether the financial integrity of the company will be significantly and adversely affected if the deferral is required, Mr. Borer testified that cash inflows will remain the same as they would have had the TCJA not been enacted and outflows to the federal government have decreased, which means that the utilities are experiencing an increase in net income. So in effect, when the utilities defer the difference between a 35% and 21% FIT, it effectively lowers the revenues that hit the income statement by an amount equal to the reduced tax obligation. This results in the

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[17] *Id*. at 6.

[18] *Id*. at 6.

[19] *Id*. at 6.

companies having the same financial effect as when the companies collected money from its customers for the 35% FIT rate and its tax obligations were at 35%.[20] The financial integrity of the companies will not be adversely affected by the deferral.

At the hearing, Duke's witness Mr. Wathen testified that the Commission's January Entry did not address whether or not the utilities' revenues generated at currently effective rates are sufficient or insufficient to cover the costs of utility service, insinuating that the first factor mentioned above would not be met – whether the utility's current rates to revenue are sufficient to cover the costs associated with the requested deferral.[21] However, on cross examination, Mr. Wathen testified that Duke's current return is 8.2%.[22] Earning a return of 8.2% is clearly sufficient to cover the costs of the utility service and furthermore, as explained by Staff Witness Borer the cash inflows remain the same and the outflow to the federal government has decreased[23], so company earnings should not be affected when utilizing a deferral for the tax savings. When addressing the factor regarding whether or not the reasons for the deferral are outside the control of the utility, Duke witness Mr. Wathen turned the question around as if to blame the Commission on the enactment of the TCJA when he stated, " "the enactment of the TCJA was outside the control of either the Commission or the Company. However, in this case, the Commission is the entity requiring utilities to record accounting deferrals, and the

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20 *Id*. at 7.

21 Wathen Test. at 10.

22 Tr. I at 78.

23 Borer Test. at 7 (June 29, 2018).

reasons for the Commission to request deferral accounting are NOT outside of its control."[24] The factor to consider is whether the reason for the deferral is outside the control of the utility company and Mr. Wathen's answer is yes. He agreed upon cross examination that "Congress acted first and the President signed the bill".[25] Maybe Duke is suggesting, as Mr. Wathen testified, that the Commission should not require that Duke take into account the reduction in the tax rate. But ignoring the tax cut is not an option and in order for customers to realize the benefits of the TCJA, the utilities must first account for the tax overpayments by its customers and eventually return the overpayment.

## CONCLUSION

The reduction in corporate taxes directly affects the utility rates that customers pay. Though no gas or water companies intervened in this proceeding, all utility companies must pass tax savings back to their customers. The companies have an obligation to track and defer the money collected from their customers for the difference between the 35% FIT and the now-effective 21% FIT. According to R.C. 4905.13, the Commission can order utility companies to establish a deferral. The Commission's five-factor criteria for establishing a deferral is met because the utility's revenues are sufficient to cover the costs associated with the deferral; the expense reduction created by the TCJA is material and could amount to hundreds of millions of dollars; the TCJA

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[24] Wathen Test. at 11.

[25] Tr. I at 78.

enactment was outside of the companies' control; the expense reduction is atypical as the last major tax change occurred in 1986 (32 years ago); and the financial integrity of the utility will not be significantly or adversely affected by the deferral since the utility is collecting at the 35% rate, but will now pay a 21% FIT rate.

Respectfully submitted,

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## CERTIFICATE OF SERVICE

This is to certify that the foregoing **Merit Brief** has been served upon all of the parties of record in Case No. 18-0047-AU-COI by electronic and/or U.S. mail, postage pre-paid mail this 13th day of August, 2018.

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**Case No(s). 18-0047-AU-COI**

Summary: Brief electronically filed by Ms. Tonnetta  Scott on behalf of PUC