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STATE OF MAINE  
ONE HUNDRED AND EIGHTH LEGISLATURE  
**COMMITTEE ON TAXATION**

December 29, 1977

TO: Legislative Council  
FROM: Representative Richard J. Carey  
SUBJECT: Public Utilities Commission's regulation of federal  
income tax expenses

The Committee, under House Paper 095 (see Appendix A) studied at considerable length the question of the Public Utilities Commission's regulation of federal income tax expenses. Many of the issues we considered will be heard by the Maine Supreme Judicial Court this February.

The majority of the Committee has voted to seek the approval of the Legislative Council for the following course of action: to suspend any further committee deliberations in this area until after the Maine Supreme Judicial Court hands down its decisions. The majority did not feel it proper to comment on these issues prior to the Court's decision.

A report of a minority of the committee is also attached.



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**COMMITTEE ON TAXATION**

The Report of the Minority  
of the Joint Committee on Taxation

PHANTOM TAXES ARE NOT JUSTIFIED:  
HOW CONSUMERS ARE CHARGED FOR TAXES  
THAT UTILITIES HAVE NOT PAID

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## SUMMARY

### The Report of the Minority of the Joint Committee on Taxation

#### Phantom Taxes Are Not Justified: How Consumers Are Charged For Taxes That Utilities Have Not Paid

#### 1. Introduction (pages 1-3 )

Phantom taxes are taxes which utilities have not paid yet which consumers are charged for. Consumers must pay \$2 for every \$1 of phantom taxes. The Minority of the Committee finds that:

- A. It is in the present and future benefit of consumers if the PUC is able to deny phantom taxes as actual costs of service; and
- B. Phantom taxes are in effect a regressive tax which places an unfair and unnecessary burden on Maine persons with poverty level incomes.

Complicating this issue is the fact that the Internal Revenue Code may preempt Maine's right to protect its consumers from unjust utility rates.

#### 2. How great are phantom taxes (pages 8-9 )

The nation's 150 largest electric utilities (including 2 two Maine utilities) in 1975 charged their customers \$1.5 billion for federal taxes which they had not paid. This was a \$.5 billion increase over the total 1974 phantom taxes.

#### 3. How utilities require Maine consumers to pay for phantom taxes (pages 10-11).

Since 1969 when utilities have requested from the PUC increased rates, utilities have sought to have phantom taxes included as an actual cost of service. These phantom taxes were primarily tax expenses which, because of federal income tax breaks, utilities did not actually pay. The major tax breaks involved were:

1. Accelerated depreciation
2. Investment tax credit
3. Right of parent and subsidiary corporations to consolidate income tax returns.

4. Current status of the Maine PUC's regulation of phantom taxes (pages 12-14)

In over 14 cases, the PUC has "flowed through" to consumers the benefits of phantom taxes. Each of these denials of phantom taxes as actual cost of services is on appeal to the Maine Supreme Judicial Court and should be decided by July, 1978. In the 1977 NET decree alone, the PUC denied phantom taxes and reduced consumer rates by over \$10 million.

5. Why phantom taxes impose an unfair and unnecessary burden on Maine consumers. (pages 15-23)

In general, the minority of the committee is convinced that allowing the PUC discretion to deny phantom taxes will result in consumer savings both in the present and future; further, the minority finds that phantom taxes are in effect a very regressive tax on Maine consumers.

Specifically, the minority of the committee feels phantom taxes represent poor social and economic policies for the following reasons:

- A. If a utility is expanding or even stable, phantom taxes are a permanent tax savings (page 15 ).
- B. If economic conditions change and phantom taxes become a necessity, utilities can apply to the PUC for a rate change (page 10 ).
- C. In the case of regulated utilities, the corporate income tax is, in effect, a very regressive excise tax on consumers. Further, phantom income taxes are an interest-free loan that customers - poor or wealthy - are forced to contribute (page 18 ).
- D. Regulated utilities, unlike free market industries, do not have to lower consumer prices due to federal and state tax breaks (page 20 ).
- E. Even if utilities should be able to force interest free capital contributions from consumers, phantom taxes are an inefficient means of raising such money. Because of utility's 55% tax rate, in order to keep \$1 of usable capital, a utility charges over \$2. (page 20 ).
- F. Phantom taxes, because they result in forced, interest free capital contributions from consumers, may provide utilities an incentive to construct unnecessary plant (page 21 ).

6. Minority of the Committee findings and recommendations (pages 24-26).

A. The PUC must have discretion to deny phantom taxes as an actual cost of service.

B. If the Maine Supreme Judicial Court decides that the Internal Revenue Code does in fact prevent the Maine PUC from "flowing through" to consumers the benefits of phantom tax breaks, the Maine Legislature should consider a constitutional challenge to the federal preemption of our state rights.

C. Finally, if the Maine Supreme Judicial Court rules that the current Maine income tax law automatically includes any Internal Revenue Code regulation the federal government sees fit to enact, then the Maine Legislature should immediately adopt legislation that will give the PUC discretion to deny phantom state taxes as an actual cost of service.



## INTRODUCTION

Setting rates on a straight-line depreciation expense basis and paying taxes based on accelerated depreciation results in ratepayers being forced to contribute interest-free capital to New England Telephone. New England Telephone has argued that flow-through would deprive the Company of internally generated cost-free capital and force the Company to resort to the capital markets. It is true that flow-through would terminate a source of cost-free funds to the Company, but this fact merely reinforces the reasonableness of flow-through. This Commission has the duty to set rates based upon a fair return on the reasonable value of property devoted to public use. It does not have the duty, and it may not have the power, to force contributions of capital from the ratepayers. Indeed, such forced contributions are contrary to our duty to insure that ratepayers pay for only real expenses.

Furthermore, it makes no economic sense to force capital contributions from the ratepayers under the guise of deferred taxes. The evidence clearly shows that in order to get \$1 worth of capital through deferred taxes, the customer must put up approximately \$2 of capital in order to provide the revenue to pay the tax to the IRS on income.

-from June 10, 1977 Public Utilities Commission Decree concerning, New England Telephone and Telegraph Company, Re: Proposed Increase in Rates

1. Landmark decree. Accelerated depreciation? Flow-through? Capital markets? Cost free funds? The terms are at first confusing, even bewildering, yet the above short paragraphs

represent a landmark position in a profound debate that has waged in Maine and in the United States for over a decade.

The Public Utilities Commission's June 10 decree prevented New England Telephone (NET) from charging its Maine customers for taxes it was not then paying. Denial of these taxes (termed "phantom" taxes by the PUC) as an actual cost of service resulted in a savings to Maine NET customers of more than \$10 million.

Nor are phantom taxes unique to Maine. Phantom tax charges are increasing each year in each state. In 1975 it was estimated that the nations 150 largest electric companies (including two in Maine) had collected \$2.2 billion from their customers for federal income taxes even though those utilities actually paid only \$.7 billion to the government.<sup>1/</sup>

3. Minority findings. The Minority of the Committee has studied the phantom tax issue at length. The PUC and Maine utilities alike have been very generous in providing us background materials and counsel. Utilities and regulators both agree that the denial of phantom taxes as actual expenses would produce an immediate benefit to the consumer. The central issue they disagree on is whether or not in the long run - - 10 or 20 years from now - utility rates will be lower or higher if phantom taxes are allowed. As to this debate the Minority makes four major findings:

A. the possibility that in the distant future denial of phantom taxes might increase rates is extremely speculative and unlikely;

B. **the** PUC would be derelict in its statutory duty to set "just and reasonable rates" if, upon such a speculative argument as distant, long range benefits, it automatically recognized phantom taxes as legitimate utility expenses; and

C. perhaps of greatest importance: even if phantom taxes could be proved to have long range benefits to the average consumer, they constitute a form of extremely regressive taxation;

D. finally, the PUC's professional staff and its statutory obligations to protect the rights of utilities and consumers alike, along with the utilities' right to appeal any PUC decision, insures that if the PUC does in fact have discretion to deny or accept a utility's claim of phantom taxes that the best interest of Maine consumers will be served.



II

DEFINING KEY PHRASES

1. Rate making process. "Rate making process" refers to the PUC's estimation of a utility's cost of providing service. This estimated cost then provides the base for the PUC's decision as to whether or not an utility's revenues should be increased. It should be emphasized that the PUC is required to set for each utility "just and reasonable rates". The case of In re Guilford Water Co. 118 ME. 367, 374-76 (1919) defined that standard: "Rates neither should be so low as to deprive the utility of means of appropriately discharging duty nor so high as to unduly burden the public". Further, the PUC's discretion is clearly defined in Maine statutes: "In determining just and reasonable rates, the Commission may consider whether the utility is operating as efficiently as possible and is utilizing sound management practices".<sup>5/</sup>

2. Phantom taxes. "Phantom taxes" refer to taxes that the consumer has been charged for but the utility is not at that time paying. While there are several different kinds of phantom taxes, the most prominent kind are:

A. Phantom deferred taxes. "Phantom deferred taxes" are taxes which are primarily associated with accelerated depreciation or the investment tax credit.<sup>6/</sup> Utilities argue

that because such taxes are eventually paid, they are legitimate expenses. The PUC counters this argument with a fact accepted by all parties: that total deferred taxes outstanding will never be reduced so long as the utility is stable or expanding and that therefore deferred taxes are a permanent tax savings. The utilities final claim is that the Internal Revenue Code prevents the PUC from denying deferred phantom taxes as a legitimate expense.

B. Phantom subsidiary taxes. "Phantom subsidiary taxes" refers to a parent company's refusal to reasonably allocate to the subsidiary utility (for example, NET is a subsidiary of AT&T) than the tax savings of a consolidated return.

3. Flow-through. "Flow-through" refers to the decision of the PUC to pass on to the consumer, by lowering a utility's allowed revenues, the tax savings represented by "phantom" taxes. "Flowing through" phantom tax savings to the consumer means the PUC has denied phantom taxes as an utility's actual cost of service.

4. Two for one. "Two for one" refers to the magnified cost of charging consumers for phantom deferred taxes. If phantom taxes are allowed to be computed as an utility's cost of service then the PUC must grant increased revenues equal to more than double the amount of the phantom taxes. Why does it take approximately \$2 of revenues to pay for \$1 of phantom deferred tax expense? Because phantom taxes affect net income, are not deductible for IRS purposes, and because utility revenues are taxed at a 55% rate (state and federal income taxes).

5. Normalized accounting. "Normalized accounting" refers to the procedure generally endorsed by the accounting profession whereby an industry can claim various deferred tax credits (e.g., accelerated depreciation, investment tax credits) when paying its federal and state taxes but for "book" purposes (rate making purposes) parcels these tax credits out over a number of years. As far as the PUC is concerned, "normalized" accounting means that an utilities actual tax bill is each year considerably lower than the tax expense they claim during rate hearings as an actual cost of service.

6. Depreciation. "Depreciation" is the cost of the progressive aging of a physical plant. Thus, depreciation must be figured in the rate making process.

7. Straight line depreciation. "Straight line depreciation" entails estimating the useful life of the plant and then equally apportioning the plant's original cost to each year.

8. Accelerated depreciation. "Accelerated depreciation" as approved by the Internal Revenue Code (IRC) allows an utility to "speed up" the straight line depreciation and deduct from its taxable income larger amounts earlier.

9. Investment tax credit. "Investment tax credit" is a federally funded mechanism to increase capital investment. A credit of up to 11.5% is allowed against the federal income tax for certain capital investment.

10. Consolidated income tax returns. "Consolidated income tax returns" refer to the practice of a parent corporation paying its federal taxes based on the consolidated profits, losses and expenses of itself and all its subsidiaries.

11. "Internal Revenue Code" the Internal Revenue Code (IRC) is the federal tax law that utilities claim prevents the PUC from denying phantom deferred taxes as an actual cost of service. It does this, utilities claim, in two sections.

A. IRC, §167(1), requires "normalized accounting for for tax benefits associated with accelerated depreciation; and

B. IRC §46(e)(1), requires "normalized" accounting for tax benefits associated with accelerated depreciation.

III

HOW GREAT ARE PHANTOM TAXES

1. Phantom taxes in Maine. While the exact amount of phantom taxes (deferred and subsidiary) claimed by Maine utilities is not known, an indication of their magnitude can be seen from the fact that in the 1977 NET case when the PUC denied just NET's claim for phantom deferred taxes, consumer rates were lowered by more than \$10 million. Further, since 1969 NET has charged consumers for over \$17 million phantom deferred taxes which they have not paid to any government. And testimony in the NET case estimated this amount would grow annually by 25%. In all, utilities are currently making 14 appeals to the Maine Supreme Judicial Court for denial of such phantom deferred taxes (see Appendix B).

2. Phantom taxes nationally. While the total amount of phantom taxes is not known, research has been done in the amount of phantom taxes charged by electric utility companies.

U.S. Senator Lee Metcalf in introducing his bill that would exempt electrical utilities from federal taxation rather than allow them to charge consumers for "phantom" taxes

entered into the congressional record the following estimates: <sup>7/</sup>

A. The nations 150 largest electric utilities (including 2 Maine utilities) in 1975 charged their customers \$1.5 billion for federal taxes which were not then paid. This figure is up over \$1/2 billion from 1974.

B. This ever increasing tax break is shown more dramatically when you consider that in 1955 the nation's electric utilities paid

more than \$1 billion in federal taxes. By 1975 this figure had dropped to \$800 million, even though revenues had increased more than five fold. Thus, in the past 20 years federal income taxes as a percent of utility revenues have decreased from 12.7% to 1.8%.

C. Of the 150 utilities surveyed:

(1) 134 charged their customers for more taxes than they actually paid;

(2) 43 paid no federal taxes at all; and

(3) 31 charged their customers for \$194 million in federal taxes even though they received refunds from the IRS totalling 82 million.

D. Thus, while the statutory corporate tax rate is 48% it was calculated that the electric utilities paid an average of only 8.2% of their taxable income to the federal government in 1975.

IV

HOW UTILITIES REQUIRE MAINE CONSUMERS TO PAY FOR PHANTOM TAX

1. Two major kinds of phantom taxes. In Maine, there are two major kinds of phantom taxes:

A. Phantom deferred taxes, which are divided into:

(1) phantom deferred taxes associated with the benefits accelerated depreciation;

(2) phantom deferred taxes associated with the benefits of the investment tax credit.

B. Phantom subsidiary taxes, associated with the tax benefits of consolidated income tax returns.

2. Phantom deferred taxes. Since 1969, the Maine PUC, like almost all state PUC's, has allowed utilities to in effect keep two sets of accounts, one for rate-making purposes and one for federal and state tax purposes. This common practice, called "normalized" accounting, allowed utilities to charge their customers for state and federal taxes that the Internal Revenue Code (IRC) allowed them to defer payment of. Further, §§167(1) and §46(e)(1) of the IRC discouraged the commission from setting lower rates and "flowing through" to the consumer these reduced costs arising from phantom deferred taxes. There are two major ways Maine utilities charge for phantom deferred taxes:

A. Accelerated depreciation. The utilities charge customers a state and federal tax expense according to the straight-line (normal) depreciation of their production property but pay taxes according to a more favorable accelerated depreciation schedule. The PUC argues that so long as the plant continues to expand, or even stays stable, charging customers for accelerated depreciation will result in the utilities re-

ceiving a permanent tax savings which will never be passed on to the consumers.

B. Investment tax credits. The utilities pass on to consumers their federal investment tax credits in a much slower manner than they themselves receive them and because utilities normally expand each year, the consumer always is paying for a tax burden greater than the utility ever actually experiences. Thus, again, deferred taxes result in a permanent tax savings.

3. Phantom subsidiary taxes. Many state utilities are subsidiaries owned by much larger corporations. Parent corporations, for tax purposes, will often pay their federal taxes based on the consolidated profits, losses and expenses of all their subsidiaries. This allows the parent company to take greater advantage of federal tax breaks. A parent corporation, in the process of consolidating its own and its subsidiaries' taxable income, may "charge" its subsidiaries an income tax expense computed as if the subsidiary were filing independently. However, by consolidating its subsidiaries' losses and gains, the parent's consolidated return can result in a greatly reduced federal tax bill. Meanwhile, the subsidiary then applies to the PUC for increased revenues, claiming the inflated phantom tax expense charged it by the parent as its actual federal tax burden.



CURRENT STATUS  
OF THE MAINE PUC'S REGULATION OF PHANTOM TAXES

1. Introduction. Each of the major PUC decrees disallowing phantom taxes (deferred and subsidiary) is currently being appealed to the Maine Supreme Judicial Court and will likely be decided by next July, 1978. The following is a short summary of the PUC's position on the various phantom taxes.

2. Phantom deferred taxes: accelerated depreciation. In the landmark June 10, 1977 NET decree the PUC denied as actual expenses phantom deferred taxes (federal and state) associated with accelerated depreciation. By "flowing through" to Maine consumers the benefits associated with accelerated depreciation, the PUC realized the following savings:

A. Federal income taxes. By prohibiting NET from charging to their operating expenses deferred federal income taxes for plant depreciation consumer rates were lowered by approximately \$8 million.

B. State income taxes. The PUC also prevented NET from charging to their operating expenses deferred state income taxes for plant depreciation. This resulted in an approximately \$1 1/2 million consumer savings.

Complicating the PUC's decision in these areas is the very real possibility that §167(1) of the Internal Revenue Code (IRC) mandates that a utility be denied the right to claim accelerated depreciation of the PUC's "flow-through" to the consumer its benefits. This is an issue the Maine Supreme Court will decide and one

the committee cannot resolve. However, if the court finds that federal tax law in effect forces the PUC to impose an unjust and unnecessary burden on Maine citizens, then this Minority will indeed consider recommending legislative action. Exactly what the Legislature might do in such a case is discussed more fully in Section VII of this report, the Minority's findings and recommendations.

3. Phantom deferred taxes: investment tax credit. The PUC has not yet challenged the right of utilities to charge customers for taxes they are forgiven due to the 11.5% federal investment tax credit. While the arguments for "flowing through" the benefits of this tax break are no less persuasive, the Internal Revenue Code, even more explicitly than in the case of accelerated depreciation benefits, threatens to deny utilities the right to claim at all the investment tax credit if its benefits are flowed through (see IRC § 46(e)(1)). Again, if the IRC does in fact preempt the PUC's discretion in setting rates, this Minority will consider recommending a legislative challenge to the federal law.

4. Phantom subsidiary taxes: consolidated income tax returns. If the parent corporation in consolidating its tax return overcharges a subsidiary as to its federal tax obligations, the PUC has refused in recent cases to allow the parent corporation's entire charge to be considered as an operating expense for ratemaking purposes. In the Mechanic Falls Water Company case,<sup>8/</sup> six Maine waterworks subsidiaries sought from the PUC an operating expense equal to 48% of their taxable income. Yet, I.U. International, the waterworks parent corporation filed a consolidated income tax return and paid federal taxes at a much lower rate. Specifically, I.U. "collected" from its subsidiaries \$25.6 million in taxes

(48% applied to the subsidiaries income) yet paid only \$4.6 million to the federal government. In other words, the subsidiaries were asking that their consumer rates reflect taxes that were not actually paid to the federal government. The PUC refused and this issue of subsidiary phantom taxes is also being appealed to the Maine Supreme Judicial Court.

VI

WHY PHANTOM TAXES  
IMPOSE AN UNFAIR AND UNNECESSARY BURDEN  
ON MAINE CONSUMERS

1. Introduction. The Minority of the Committee is convinced that if Maine utilities are allowed to continue to automatically claim as expenses phantom taxes - taxes for which the customer is charged but which the utilities do not pay - then the Maine consumer will be unfairly and unnecessarily burdened. While there are many reasons for reaching this conclusion, the two major ones are:

A. Denial of phantom taxes will certainly result in lower consumer rates in the short run and in all likelihood will also result in lower rates in the foreseeable future.

B. Even if phantom taxes are proven beneficial to the consumers of future decades, phantom taxes are in effect an extremely regressive tax on Maine's many poverty level families.

We will limit our discussion below to the two main types of phantom taxes: phantom deferred taxes and phantom subsidiary taxes.

2. Phantom deferred taxes: reasons against. Phantom deferred taxes are those which consumers are charged for yet which utilities, because of such Internal Revenue Code tax breaks as accelerated depreciation or the investment tax credit, do not actually pay. The reasons these phantom taxes are an unjust and unnecessary levy are:

A. Deferred taxes are indeed phantom taxes: they can be a permanent tax savings.

During the committee hearings, utilities were understandably disturbed by the PUC's use of the term "phantom" taxes. It denotes a clever ruse, an end-run around the regulatory process. This is not the case. Deferred taxes are perfectly legal and accepted means of encouraging capital expansion. But whether they should be considered an actual cost of service for utility rate making purposes is an entirely different issue. Both sides - utilities and regulators - will agree that phantom taxes while normally deferred are not actually paid. Maine Chief Justice Dufrense in his September 2, 1977 order (which cleared the way for NET's appeal of the PUC's June 10 decree) made this fact clear:

"The side effect of the normalization method [an accounting procedure that results in consumers being charged for taxes that utilities deferred and did not pay] is to give the utility use of additional working capital free of any charges for interest or dividends. Normalization during a period of growth or stability, e.g., when plant addition equals or exceeds plant retirement, does not merely defer taxes, but eliminates them so that the utility's stockholders rather than its customers are benefited by being provided through the ratepayers interest free capital.<sup>9/</sup>" (Emphasis added.)

The committee received graphic evidence that phantom taxes are in fact never paid when PUC Chairman Ralph H. Gelder described a "typical" utility and showed how its deferred tax account increased in size each year. (see Appendix D, Schedule C, Column F). Further, in the NET case, evidence showed that NET had accumulated a total of \$17 million in deferred state and federal taxes which it had charged consumers for but had not paid to the government. Finally, evidence was presented that estimated this amount could be expected to grow at a rate of 25% annually.

B. The immediate and future benefit to the consumer if phantom taxes are denied as legitimate costs is evident; the

argument that future events might result in lower consumer rates if phantom taxes are not denied is entirely too speculative. Besides, if conditions begin to change, utilities can apply for a rate change.

The utilities major argument for recognition of phantom taxes as a cost of service is that future events, such as increased cost of capital or Congressional repeal of accelerated depreciation might result in lower consumer rates. This is entirely too speculative. Chairman Gelder's "typical" utility exhibit (see Appendix D) shows clearly that under existing and immediately foreseeable conditions, the consumer would be significantly favored by "flowing through" the benefits of phantom taxes. Indeed, when one considers yearly inflation (this year's rate of capital-goods inflation is estimated at 8%) and the likelihood that tax laws will be revised to favor even greater capital investment,<sup>10/</sup> future events may only make worse the current injustice. Further, prior to 1969 when the Internal Revenue Code was amended, it was the PUC's policy to "flow through" the benefits of phantom taxes. When this decision was appealed, the Maine Supreme Judicial Court agreed that it was a "reasonable" policy:

"The Commission, apart from the matter of accelerated amortization, has allowed only the current income tax as a charge in rate making. It takes the position in substance that the creation of an income tax deferred reserve under the circumstances outlined would extend into the unforeseeable future charges to provide for expenses which might never arise, or to meet which, when and if the need should arise, the company could seek relief before the commission. There is nothing unreasonable in the conclusion reached." <sup>11/</sup>

Further, there is an even more compelling argument against the specter of unfavorable future events: rates can always be changed. The PUC is required to set utility rates that will

result in a fair rate of return (see section II of this report, sub-section 1, "Rate making process"). If future conditions indicate that the PUC should change its policy, the utility may apply for relief. Meanwhile, the present interest of the consumer is being protected. As the Maine Superior Judicial Court said in 1957 when it approved the PUC's denial of phantom taxes: "Rates do not stand forever, and corrections may be made from time to time."<sup>12/</sup> In its June 10, 1977 NET decree, the PUC again refused to set rates on speculation as to future events:

New England Telephone in its Brief has claimed that the deferral argument is still valid because Congress might repeal the availability of accelerated depreciation. We will not set rates on such speculation. The fact is that accelerated depreciation has been available since 1954 and continues to be available. If the tax laws change, then the Company can seek the appropriate relief from the Commission. New England Telephone has also argued that its growth in net plant might not continue. The evidence in this case is directly to the contrary, but, again, we can adjust rates according to any such development in a manner fair to customers and to the Company.

C. The PUC is required by law to view all tax expenses (including phantom taxes the utilities would argue) as a legitimate cost and pass it on directly to the consumer. For this reason the corporate income tax on regulated utilities amounts to an extremely unfair and regressive tax on consumers. Further, phantom deferred income taxes are an even greater injustice, for they force consumers - rich and poor - to make an interest free capital contribution to the utility.

Unlike free market industries, the entire income tax expense of regulated utilities is passed directly to consumers. The corporate income tax expense of an industry regulated by the free market is to a significant extent<sup>13/</sup> borne by the corporation's shareholders and not its customers. Thus, all utility income taxes, including phantom taxes, are in effect an extremely regressive<sup>14/</sup> tax on consumers. This committee is well aware

of the unfair burden of taxes based on the amount of utilities a person consumes. Last season we labored hard to exempt users of utilities from the very regressive sales tax. The fact that the poor paid a much greater percentage of their income for utilities than did the wealthy was all too evident. Consider the following national statistics:<sup>15/</sup>

<u>Family income</u> <u>before taxes</u>	<u>Percentage of income consumed by selected services</u>		
	<u>Fuel and</u> <u>Utilities</u>	<u>Health</u> <u>Care</u>	<u>Recreation</u>
\$ 1,612	13.8%	10.8%	12.9%
3,501	7.8	6.8	8.6
4,479	6.8	5.4	7.7
5,463	6.0	6.1	6.7
6,494	5.3	4.5	6.5
7,480	4.6	5.0	5.4
8,953	4.1	5.3	5.4
10,953	3.9	5.4	4.3
13,433	3.5	5.1	3.9
17,243	3.1	5.2	3.3
22,063	2.6	5.9	2.9
38,482	1.8	4.7	2.2

Certainly this suggests the most meaningful way to view phantom taxes: they are an extremely regressive burden placed squarely on the consumer. We have already seen that both regulators and utilities agree that phantom taxes result in the consumer being forced to contribute to the utility an interest free capital contribution.<sup>16/</sup> The grave injustice of such an arrangement is that the poor, who need the services of utilities as much as the wealthy do, cannot afford this contribution. There is not a little irony in the fact that in the free markets, shareholders bear the burden of taxes, but in regulated industries - where by law the public interest is deemed protected - the burden is shifted to the consumer, whether he be poor or rich. And what is even worse, consumers must pay \$2 for every \$1 of phantom taxes claimed by a utility.



D. Utilities, unlike free market industries, can avoid lowering consumer prices due to phantom taxes.

A business industry, operating in the competitive free market, would be forced to lower consumer prices somewhat due to the tax savings resulting from accelerated depreciation and the investment tax credit. A regulated utility, which operates without competition and which is assured reasonable revenues, does not have to lower prices due to phantom taxes. In the 1977 NET case the PUC directly addressed this issue:

We are not saying that Congress lacks the power to grant tax relief to utilities, nor are we saying that it could not, in some circumstances at least, prohibit flow through. We are saying that accelerated depreciation to a utility is a singularly unfocused subsidy that seeks to assist the building of plant that must in any case be built to satisfy the obligation to serve and on which we are required to allow an adequate return. Furthermore, only a utility is in a position to avoid competing some or all of these benefits back to the customers. Under circumstances of perfect competition, the entire subsidy would clearly be competed away, for a "cost" that doesn't exist at all could not be part of the marginal costs to which prices would be driven. Since we exist in large part as a surrogate for competition in the utility industry, it is our duty to seek the competitive result, which is clearly flow through. (Emphasis added.)<sup>17/</sup>

E. If forcing consumers to pay for phantom taxes makes no social sense, it has even less to recommend it in terms of economic policy. Using deferred phantom taxes to raise interest free capital is prohibitively expensive. Because utilities revenues are taxed by the federal and state governments, consumers must be charged \$2 for every \$1 of capital gained by the utility.

Because deferred phantom taxes, unlike the other expenses of a utility, are not considered a tax deductible expense, consumers must pay approximately \$2 for every \$1 of phantom tax expense. This "2 for 1" expansion is necessary because phantom taxes affect net income and the combined

federal state tax rate is over 50%. For example, in the 1977 NET case, NET claimed approximately \$3.5 million in federal deferred phantom taxes and therefore they requested that the PUC increase its revenues by approximately \$8 million. If consumers, and not investors, are going to be forced to supply interest free contributions for capital expansion, it should be done other than through the rate making process. For a further discussion of this "\$2 for \$1" expansion, see Appendix C..

F. Phantom deferred taxes, because they provide interest free capital contributions to utilities, may provide incentives to utilities to construct unnecessary utility plant.

The PUC's regulatory duty is to replace the competitive pressure for efficiency present in a free market enterprise.

Phantom taxes seem inconsistent with that duty:

Prudence is the watchword of both utility management and regulation. However, under existing tax laws, management's duty to be prudent may be inconsistent with its duty to the shareholders to maximize profits by utilizing all available tax credits or deductions. Also, the investment tax credit and accelerated depreciation provisions give utilities monetary incentives to promote growth. The desire for tax credits often undermines the responsibility of prudent utility management to determine whether growth is reasonable in light of foreseeable customer requirements. The present tax laws stimulate growth regardless of need within a particular service territory. No attempt is made to couple supply with demand.<sup>18/</sup>

6. Finally, two arguments in favor of phantom taxes - that the Internal Revenue Code endorses them and that normalized accounting is an approved accounting principle - must be recognized as not touching on whether or not phantom taxes are in the public interest.

(1) Internal Revenue Code (IRC). Sections 46(e)(1) and 167(1) of the IRC discourages utilities from "flowing through" to consumers the benefits of phantom taxes.

The Maine PUC claims the IRC is not an absolute bar<sup>19/</sup> to denying phantom taxes and the utilities have appealed

this issue to the Maine Supreme Court. But simply because the issue of phantom taxes is treated in the IRC does not resolve the issue of whether phantom taxes are necessary or just. Indeed, as we state in Section VIII of this study, if the utilities prevail on this issue and the PUC loses, we will consider recommending legislative action to challenge the IRC preemption of our state rights.

(2) Normalized accounting. Normalized accounting is the accounting procedure "required" for non-regulated industries by the accounting profession and the Securities and Exchange Commission when deferred taxes are used for tax purposes but not for "book" (ratemaking) purposes. The rationale behind this accounting procedure makes sense for free market enterprises but has little relation to the business climate of a regulated utility, in which the PUC must allow rates that provide fair returns. In any case, accounting procedures should not control policy discussions of the PUC.

3. Phantom subsidiary taxes: reasons against. In addition to phantom deferred taxes, the PUC has also denied phantom subsidiary taxes. The question of whether or not to allow phantom subsidiary taxes is much less controversial. As explained in Section IV, subsection 3, phantom subsidiary taxes are taxes charged a subsidiary of a parent company but not then paid to the government. PUC attorney Thomas R. Gibbon explained at a Committee hearing how this works:

General Waterworks is a holding company which owns many water companies in the State of Maine. General Waterworks is owned by a holding company called I.U. North America which has its offices in Philadelphia. I.U. North America, in turn, is owned by another holding company called I.U. International, also with headquarters in Philadelphia. Besides water companies, the I.U. system is a multi-national corporation dealing in such items as plantations in Brazil, Ryder Truck Lines and LNG Carriers. The Maine Public Utilities Commission found, and this has not been disputed, that the I.U. system collected \$25 million in federal income taxes from subsidiaries but paid to the federal government only \$4 million.

Given these undisputed facts, the Maine Commission has taken the not unreasonable position that only actual taxes paid to the state and federal government should be included as a legitimate ratemaking expense.

The Minority of the Committee strongly endorses the PUC's general stand on this issue.

The heatedly argued aspect of the PUC's decisions in this area is the accuracy of method used by the PUC to calculate a subsidiary's actual tax expense. This general procedure of estimating actual tax rates has been accepted by the Chief Justice of the Maine Supreme Judicial Court <sup>20/</sup> and the U.S. Supreme Court. <sup>21/</sup> However utilities are complaining that the PUC estimates are inaccurate. The committee takes no position on PUC accuracy. Again, we are confident the normal regulatory process, including the right to appeal, will result in a fair balancing of consumer and utility rights.

Finally, one further reason for endorsing the PUC's denial of phantom subsidiary taxes is their clear relation to the ill effects of phantom deferred taxes:

If a Maine utility filed independently and sustained a tax loss, that tax loss could reduce taxes paid to the federal government. Yet if a utility always is granted a 48% federal income tax rate for rate-making purposes, even after it has sustained a loss, the benefits of the tax loss are never passed on to the ratepayers. Furthermore, under the present tax laws, where certain expenses, like accelerated depreciation, are used for income tax purposes but not for rate-making purposes, the possibility of sustaining a tax loss, even when a utility is healthy, is substantial. <sup>22/</sup>

VIII

MINORITY OF THE COMMITTEE FINDINGS AND RECOMMENDATIONS

1. Phantom taxes are not just or necessary. The debate as to whether phantom taxes should be viewed as actual costs of service has been lengthy and complex. For years it has waged in Maine and other states; its debaters have been forced to crisscross the torturiously terrains of economics, tax policy and accounting principles. Yet, of all the arguments put forth in support of phantom taxes only one may have any real weight: that phantom taxes, may, in the future, result in lower rates for consumers.

We have concentrated our attention on this argument and found it, finally, not persuasive. We have listed our reasons extensively in Section VI; it is enough to say now that:

A. Phantom taxes are permanent tax savings. The available evidence indicates strongly that if a utility is expanding or even stable, "normalized" accounting (acceptance of phantom taxes as actual expenses) will not reduce consumer rates either now or in the foreseeable future. For the PUC to set rates on this speculation would be to desert its regulatory responsibilities.

B. Phantom taxes are a regressive tax on consumers. Even if at some distant point in the future approval of phantom taxes would result in lower consumer rates, such taxes should still be denied. Phantom taxes, which all agree force consumers to contribute interest free capital, are in effect an unjust and very regressive excise tax on consumers. Speculative lower rates in the future cannot justify forcing poverty level consumers to loan money, interest free, to utilities.

Investors, by nature persons affluent enough to be able to purchase securities, should not be allowed to profit at the direct expense of poverty level, cash poor, consumers.

2. Minority findings and recommendations. This Minority of the Committee, after due deliberation, makes the following findings and recommendations:

A. PUC must have discretion to deny phantom taxes. The PUC, in fulfilling its statutory duty, must be free to deny phantom taxes as a rate making expense if it deems it in the best interest of the consumer. We do not say the PUC must deny phantom taxes at every rate hearing. Indeed, a utility which is suffering a decrease in business, which is not expanding its capital plant or is even stable, might be able to convince the utility that approval of phantom taxes is a necessity. The utility would still have to counter the argument that phantom taxes are in effect a very regressive tax on consumers, but perhaps they would be successful. We argue that the PUC must have discretion to make such a determination.

B. Constitutional challenge may be necessary. If the Maine Supreme Court determines that the federal Internal Revenue Code preempts the PUC's right to use its discretion in rate cases as to whether approval of phantom taxes is in the best interest of Maine consumers, this committee should consider next fall the possibility of proposing legislation which will mandate that the PUC exercise such discretion. The purpose behind such a law would be to test in the federal courts whether the federal government can, in all instances, force a state PUC to set rates in a way to unjustly harm its consumers.

C. State phantom taxes must also be subject to regulation. Finally, several utilities have argued in their appeals to the Maine Supreme Judicial Court that Maine's corporate income tax law automatically incorporates utility accounting procedures found in the Internal Revenue Code. They contend that because the Internal Revenue Code might be read to require "normalized" accounting, that therefore the state income tax law does also. This is a significant issue. In the 1977 NET rate case alone, by denying phantom state income taxes the PUC saved consumers approximately \$1 1/2 million. This Minority will make no comment on this dispute involving the unstated intent of a past legislature. Suffice it to say

that if the Maine Supreme Judicial Court rules against the PUC, we will urge the Legislature to immediately adopt legislation which will give the PUC discretion to deny phantom <sup>25/</sup>state taxes.



IX

CONCLUSION

Since we exist in large part as a surrogate for competition in the utility industry, it is our duty to seek the competitive result, which is clearly flow through.

- PUC June 10, 1977 decree denying NET's request for approval of phantom taxes.

Regulated utilities are not free market industries. They need not compete against other utilities; their investments are reasonably assured of an attractive profit. To automatically provide them with the same tax favors needed in the competitive free market is poor tax policy and results in an unjustified, regressive burden on consumers.

The Minority of the Joint Committee on Taxation strongly endorses the Maine Public Utilities Commission efforts to approve phantom taxes as a rate making expense only when it is in the best interest of Maine consumers.

FOOTNOTES

- 1/ Environmental Action Foundation, National Consumer Information Center, Phantom Taxes In Your Electric Bill (1976).
- 2/ New England Telephone and Telegraph Co. v. Public Utilities Commission, KEN-77-28.
- 3/ The Committee first investigated phantom taxes at the direction of the Legislature under House Paper 095; see Appendix A.
- 4/ See Appendix B for a complete listing of cases in which Maine utilities are appealing the PUC's denial of phantom deferred taxes.
- 5/ 35 MRSA §51.
- 6/ Also included in the phase "deferred phantom taxes", would be such items as taxes associated with the cost of removal and salvage and vacation accruals. In the 1977 NET rate decree, the PUC denied such phantom taxes, reducing consumer rates by approximately \$1 million.
- 7/ United States Congressional Record, §13935, August 5, 1977.
- 8/ Mechanic Falls Water Company, Re: Increase in Rates, 7-16, F.C. 2120, et al (1975).
- 9/ New England Telephone and Telegraph Company v. Public Utilities Commission, 15, KEN-77-28 (September 2, 1977) See also FPC v. Memphis Light, Gas & Water Division 411 U.S. 458, 460 (1972).
- 10/ Indeed, with the federal corporate tax rate currently set at 48% and discussion prevalent that it will be reduced still further, the rationale of the PUC in the 1957 rate case, Re Central Maine Power Company, 17 P.U.C. 3d 452, 462-3 (Me. P.U.C. 1957), seems prophetic:

A great deal of evidence was presented on the question of whether accelerated depreciation results in a true tax 'savings' or only a tax 'deferral.' The detailed evidence of the expert witness, Mr. Van Scoyoc, was uncontradicted that in the case of a utility which is growing, the new tax method results in a permanent savings. And there can be no question but what this company is so expanding. Thus, the utility will receive from its consumers a larger sum than it may ever have to pay the government. And even if the consumers did get back over the life of the property what they pay today, a great deal of the plant of the company has a longevity of 50 to 100 years, and it is highly speculative to fix rates today on the possibilities of what may happen in such a distant future. It is, indeed, unrealistic to assume that taxes will remain at the present tax rate of 52 percent for so many years in the future.

11/ Central Maine Power Company v. Public Utilities Commission, 153 Me. 228, 248-249, 136 A.2d 726, 738-739 (1957).

12/ Id.

13/ The classical view is that in the short run shareholders bear the entire burden of a unregulated corporation's income tax expense. Recently, economists have begun to question this theory, believing instead that today's free markets are neither perfectly competitive nor perfectly monopolistic and that some of the corporate tax burden may be shifted forward to consumers. See Pechman, Obner, Who Bears the Tax Burden 31-34, The Brookings Institution (1974). U.S. Congressman Fortney H. Stark, Jr., in a letter to Robert Batinovich, President, California Public Utilities Commission (September 23, 1977). Congressman Stark explains in detail the transformation of the corporate income tax into a tax on utility consumers:

"To the extent that a corporate tax is justified at all, the burden of it should fall equally on all uses of capital. Given any sort of free market conditions - in the long run - such a tax is indeed borne by capital. This is so even if in the short run some companies are able to pass on the "cost" of the tax to customers in the form of higher prices.

This, however, is clearly not the situation in the case of regulated industries. In attempting to fulfill their mandate to provide consumers with utility services at low cost, while providing utility investors a fair return on their capital, state utility commissions are required by law to view tax expense as a legitimate cost and pass it on directly to customers. A company's rate of return may vary from the "authorized" rate for a variety of reasons; federal tax liability, however, is not one of those reasons."

14/ A tax is regressive if the percentage of a person's income used to pay the tax decreases as his income (ability to pay) increases; a tax is proportional if the percentage of income used to pay the tax stays the same at any income level; and a tax is progressive if the percentage of income increases as income increases.

15/ Provided to the 1976 Select Committee on State Tax Reform by the Advisory Commission on Intergovernmental Relations.

16/ This forced contribution of capital by consumers only reinforces the economic distortion caused by current regulatory law. The purpose of depreciation is to repay the original investor yet phantom taxes are paid for by the consumer not the stockholder.

17/ NET Re: Proposed Increase in Rates 48, 49, F.C. #2213 (June 10, 1977).

18/ Batinovich, "A Sensible Substitute for the Federal Income Tax on Utilities", Public Utilities Fortnightly 14 (July 21, 1977).

- 19/ The PUC has not taken a stand on IRC §167(e) (accelerated depreciation) but not §146(e)(1) (the investment tax credit).
- 20/ Continental Telephone Company of Maine v. Public Utilities Commission  
KEN-77-12 (January 21, 1977).
- 21/ Federal Power Commission v. United Gas Pipeline Co. 386 U.S.  
237, 243-244 (1967).
- 22/ The Mechanic Falls Water Co. Re: Proposed Increase in Rates  
11-12, F.C. #2120, et al. (January 26, 1976).
- 23/ As an example of such legislation:
- 36 M.R.S.A. § \_\_\_\_\_ is enacted to read:  
§ \_\_\_\_\_ Computation of public utility income taxes.

The corporation income tax established in this chapter does not incorporate United States Internal Revenue Code provisions relating to public utility accounting procedures for rate making purposes.



D. OF R.

STATE OF MAINE

HP 1817

APPENDIX A

In House

Whereas, the overall tax structure in Maine is regressive, which means the higher income person often pays a smaller percentage of his income than the low income person does; and

Whereas, the State has enacted many tax exemptions which provide relief to persons whether they need that relief or not; and

Whereas, the State has largely ignored tax rebate programs which can be tailored to go to those Maine citizens most deserving of assistance; now, therefore, be it

Ordered, the Senate concurring, that the Joint Standing Committee on Taxation study the methods and experience of the New Mexico tax rebate system which is designed to equalize the tax burden of low and high income persons; and be it further

Ordered, that the committee also investigate the basic question of whether Maine should pursue tax equity through rebates or through exemptions; and be it further

Ordered, that the committee shall complete this study no later than December 1, 1977 and submit to the Legislative Council within the same time period its findings and recommendations, including copies of any recommended legislation in final draft form; and be it further

Ordered, upon passage in concurrence, that a suitable copy of this order shall be forwarded to members of the committee.

1817

Cosponsors:

(Carcy)

Name:

*[Signature]*  
Town: Waterville

(Davies)

Name:

*[Signature]*  
Town: Orono

(Brenerman)

Name:

*[Signature]*  
Town: Portland

(Immonen)

Name:

*[Signature]*  
Town: W. Paris



APPENDIX B

PUBLIC UTILITY COMMISSION DECREES

CURRENTLY ON APPEAL TO THE MAINE SUPREME JUDICIAL COURT

In the following cases there is an issue where the Commission flowed through the benefits of accelerated depreciation for state income tax purposes.

Central Maine Power Company v. Public Utilities  
Commission, KEN-76-43.

Continental Telephone Company v. Public Utilities  
Commission, KEN-77-12.

In the following case there is an issue where the Commission flowed through the benefits of accelerated depreciation on pre-1970 property for federal income tax purposes.

Mechanic Falls Water Company v. Public Utilities  
Commission, KEN-76-13.

In the following cases there is an issue where the Commission flowed through the benefits of accelerated depreciation for state income tax purposes and on pre-1970 property for federal income tax purposes.

Caribou Water Works Corporation v. Public Utilities  
Commission, KEN-76-14.

Ellsworth Water Company v. Public Utilities  
Commission, KEN-76-15.

Washburn Water Company v. Public Utilities  
Commission, KEN-76-16.

Maine Water Company v. Public Utilities  
Commission, KEN-76-34.

Fort Kent Water Company v. Public Utilities  
Commission, KEN-77-21.

In the following cases there is an issue where the Commission flowed through the benefits of accelerated depreciation for state income tax purposes and on all property for federal income tax purposes. In all of these cases except the telephone Company case the flow through of federal income taxes relates to lack of evidence that the required election was made.

Mars Hill & Blaine Water Company v. Public  
Utilities Commission, KEN-77-13.

Waldoboro Water Company v. Public Utilities  
Commission, KEN-77-16.

Greenville Water Company v. Public Utilities  
Commission, KEN-77-17.



Northern Water Company v. Public Utilities  
Commission, KEN-77-24.

Eastport Water Company v. Public Utilities  
Commission, KEN-77-26.

New England Telephone and Telegraph Company v.  
Public Utilities Commission, KEN-77-28.

## APPENDIX C

### AN EXPLANATION OF THE "\$2 for \$1" PRINCIPLE AND THE EFFECT OF THE PUC DECISION TO "FLOW THROUGH" TO CUSTOMERS THE BENEFITS OF PHANTOM/DEFERRED TAXES

Introduction. In 1977, the PUC denied NET's request for \$8,000,000 of additional revenues for phantom/deferred taxes associated with the expense of plant and equipment depreciation. The actual tax expenses being claimed were only \$3.6 million but because of the "2 for 1" principle, the actual revenues being asked were \$8 million. The "2 for 1" principle is accepted by utilities and the PUC alike and its rationale is quite simple: because of the bite of federal and state taxes, it takes approximately \$2 of revenues to pay a utility for every \$1 of its costs.

How did NET arrive at a \$3.6 million tax expense (and \$8 million revenue request)? NET charged its customers as though it were depreciating its plant and equipment on a straight line basis and therefore would have a related tax expense of \$3.6 million. However, NET was in fact depreciating its plant and equipment on an accelerated basis and therefore did not then pay \$3.6 million in taxes.

With this background it is possible to see exactly how the \$2 for \$1 principle works. As an example, we will use NET's request for \$8 million in revenues, due to \$3.6 million tax expense associated with plant and equipment depreciation.

#### PUC's EXPLANATION OF "\$2 for \$1"

- A. Breakdown of \$8 million of requested additional revenues (2 for 1):
- (1) \$3.6 million in phantom/deferred taxes
  - (2) \$4.4 million of federal and state taxes levied additional net operating revenues required to pay \$3.6 million of deferred taxes.

Agreement on "2 for 1". To this point, the PUC and NET are in agreement as to the effect of "2 for 1". However, NET parts ways with the following PUC description of the effect on NET of "flowing through" the benefits of accelerated depreciation.

- B. Flow through of benefits of accelerated depreciation to customers (\$8 million dollar savings to consumers)

-2-

- (1) Assume that NET would have invested the \$3.6 million income in plant and equipment. This would then be a cost of business and must be added to the rate base.
- a. \$3.6 million x 8.7% (current rate of return granted NET) produces an additional income requirement for NET of \$314,280.
  - b. Apply "2 for 1" principal to the \$314,280 income need and the increased NET revenue requirement is \$698,791
  - c. Savings to rate payers attributable to flowing through benefits of accelerated depreciation amount to: \$7,301,209
    - i \$8,000,000
    - 698,791
    - \$7,301,209

NET disagrees. NET disagrees with this PUC analysis, claiming the \$3.6 million is not a false expense but one that they eventually will have to pay. This, of course, is the phantom tax issue. PUC claims the \$3.6 represents a permanent tax savings because NET, a constantly expanding utility, will always have in the foreseeable future greater tax credits than tax payments.

Schedule A

Typical Utility Company

<u>Item</u>	<u>Normalization Accounting - No Flow-Through of Deferred Taxes to Income</u>	<u>Flow-Through Accounting - Flow Through of Deferred Taxes to Income</u>
A. Revenues	\$5,000,000	\$5,000,000
B. Operating Expenses	3,800,000	3,800,000
C. Deferred Tax Expense from Accelerated Depreciation	200,000	--
D. Total Costs	4,000,000	3,800,000
E. Net After-Tax Income (A minus D)	<u>1,000,000</u>	<u>1,200,000</u>
F. Rate Base	\$10,000,000	\$10,200,000 <sup>(b)</sup>
G. Required Rate of Return	10%	10%
H. Required Return (F times G)	1,000,000	1,020,000
I. Return Excess (Deficiency) (H minus E)	0	+ 180,000
J. Revenue Excess (Deficiency) (I divided by 1 - 0.55) <sup>(a)</sup>	0	+ 400,000
K. Additional After-Tax Costs to Finance Loss of Deferred Taxes	0	15,600 <sup>(c)</sup>
L. Net Revenue Excess (Deficiency) (J minus K)	0	+ 384,400
M. Adjusted Required Revenue (A - M)	<u>\$5,000,000</u>	<u>\$4,615,600</u>

(a) The 55% tax rate consists of both state and federal taxes.

(b) Since the Maine PUC subtracts deferred taxes from the rate base, flow-through of deferred taxes would increase rate base by \$200,000.

(c) See Case I.

Schedule B

Capital Structure of  
Typical Utility Company

	<u>Capital Structure</u>		<u>Cost Rate</u>	<u>Return Requirement (Weighted Cost)</u>
	<u>Amount</u>	<u>%</u>		
Debt	5,000,000	50%	8%	4%
Common Equity	<u>5,000,000</u>	<u>50%</u>	12%	<u>6%</u>
	<u>10,000,000</u>	<u>100%</u>		<u>10%</u>

## Schedule C

Typical Utility Company

## Depreciation of Capital Investments

Assume \$1,000,000 construction and equipment outlays with 20-year average useful life in year 1 and a 10% increase in such outlays each year thereafter.

(A) Year	(B) Annual Construction Outlays	(C) Annual Amount of Straight-line Depreciation	(D) Annual Amount of Accelerated Depreciation (Sum of Digits)	(E) Excess of Accelerated over Straight- Line Depreciation	(F) Deferred Taxes (51.64% tax rate)
(thousands of dollars)					
1	1,000	50	95	45	23
2	1,100	105	195	90	47
3	1,210	165	300	135	70
4	1,331	232	411	179	93
5	1,464	305	529	224	115
6	1,611	386	653	267	138
7	1,771	474	785	311	160
8	1,949	572	926	354	183
9	2,144	679	1,075	396	204
10	2,358	797	1,235	438	226
11	2,594	927	1,406	479	248
12	2,853	1,069	1,590	521	269
13	3,138	1,226	1,787	561	290
14	3,452	1,399	1,999	600	310
15	3,797	1,589	2,227	638	330
16	4,177	1,798	2,474	676	349
17	4,595	2,027	2,740	713	368
18	5,054	2,280	3,029	749	387
19	5,560	2,558	3,341	783	404
20	6,116	2,864	3,680	816	421
21	6,728	3,150	4,048	898	464
22	7,400	3,465			
23	8,140	3,812			
24	8,954	4,193			
25	9,850	4,612			

Case I

Assume additional 200,000 must be raised in capital market to replace deferred taxes with capital structure remaining unchanged.

	<u>Return Requirement (weighted cost)</u>	<u>Weighted After-Tax Cost</u>	<u>After-Tax Return Per \$1,000</u>
Debt	4%	1.8% (55% tax rate)	\$18
Common Equity	<u>6%</u> 10%	<u>6.0%</u> 7.8%	<u>60</u> \$78

Additional Annual After-Tax Cost of Capital

$$\$78/1,000 \times 200 = \underline{\underline{\$15,600}}$$

\* \* \* \* \*

Case II

Assume additional \$200,000 that must be raised in capital markets results in a 10% increase in financing costs.

	<u>Current Weighted After- Tax Cost</u>		<u>10% Increase in Financing Costs</u>	<u>New Weighted After-Tax Cost</u>	<u>After Tax Return Per \$1,000</u>
Debt	1.8%	x	1.1	1.98%	\$19.80
Common Equity	<u>6.0%</u> 7.8%	x	1.1	<u>6.60%</u> 8.58%	<u>66.00</u> \$85.80

Additional Annual After-Tax Cost of Capital

$$\$85.80/1,000 \times 200 = \underline{\underline{\$17,160}}$$

## APPENDIX E

### RESOLVE, to Endorse the Need to Reform Taxation of Regulated Utilities

Whereas, it has been found that the lowest income families (\$1,612) must pay approximately 13.8% of their income for utilities while more affluent families (\$38,482) must pay only approximately 1.8% of their income on utilities; and

Whereas, it is clear that in the case of regulated utilities corporate income taxes are in effect a very regressive excise tax on consumers; and

Whereas, this regressive burden on consumers is only made worse by the fact that utilities currently seek to charge consumers for "phantom taxes" - taxes that they have not paid nor likely never will have to; and

Whereas, in 1975 America's 150 largest electric utilities (including 2 Maine utilities) charged customers for \$1.5 billion in phantom federal taxes which they did not actually pay; and

Whereas, in the past 20 years federal income taxes as a percent of electric utility revenues have decreased from 12.7% to only 1.8% and

Whereas, the Maine Public Utilities Commission has denied phantom taxes and thereby sought to save Maine consumers many millions of dollars from inflated utility bills; and

Whereas, it is increasingly evident that the current corporate income tax system, designed to levy a fair tax on free-market industries, has little justification when levied on PUC regulated public utilities, whose revenues are secure and who need not compete for customers; and

Whereas, United States Senator Lee Metcalf and U.S. Congressman Fortney Stark have introduced in Congress H.P. 8897, a bill which will completely exempt electric utilities from federal corporate income taxes and which will instead levy a proportional user tax directly on the consumer; and

Whereas, this approach to the taxation of utilities will:

1. Eliminate the regressive burden of federal corporate income taxes (especially, phantom tax expenses for which customers are charged but utilities do not pay);
2. Eliminate phantom tax incentives to construct unnecessary utility plants;
3. Provide a mechanism whereby conservation-minded consumers can be rewarded; and
4. Provide a mechanism to institute a national "lifeline" rate; now, therefore, be it



Resolved: that the State of Maine believes that a fundamental change is needed in the way regulated public utilities are taxed by the federal government; and be it further

Resolved: that the State of Maine endorse the general approach proposed in the United States Congress by Senator Metcalf and Congressman Stark; and be it further

Resolved: that the State of Maine recommends that the Metcalf-Stark approach should be expanded so that it includes regulated public utilities other than just electric utilities and that the proposed direct consumer user tax be so designed that the burden it levies on consumers is non-regressive and encourages conservation.