

BEFORE THE TENNESSEE PUBLIC UTILITY COMMISSION

NASHVILLE, TENNESSEE

October 1, 2018

IN RE:

**TENNESSEE PUBLIC UTILITY COMMISSION
INVESTIGATION OF IMPACTS OF FEDERAL TAX
REFORM ON THE PUBLIC UTILITY REVENUE
REQUIREMENTS**

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**DOCKET NO.
18-00001**

ORDER APPROVING STAFF REPORT AND RECOMMENDATIONS

This matter came before Chair Robin L. Morrison, Vice Chair Kenneth C. Hill, Commissioner Herbert H. Hilliard, Commissioner John Hie, and Commissioner David Jones of the Tennessee Public Utility Commission (“TPUC” or “Commission”) during a regularly scheduled Commission Conference held on July 23, 2018, for consideration of the *First Report and Recommendation Regarding Tax Impacts of the 2017 Tax Cuts and Jobs Act* (“Staff Report”) submitted by TPUC Staff.

BACKGROUND

As a result of passage of the 2017 Tax Cuts and Jobs Acts, Pub. L. No. 115-97 (“2017 Tax Act”), the primary business tax rate was reduced from thirty-five percent (35%) to twenty-one percent (21%) which has an immediate impact on income tax expenses that are currently recovered in utility service rates. In addition, future tax liability will be impacted for utilities that have deferred income taxes due to the difference in the tax rate included in the ratemaking calculations and the actual tax rate.

The Commission, during its January 16, 2018 Commission Conference, found that because the 2017 Tax Act will result in increased earnings for utilities, it is necessary to review, investigate, and make appropriate reductions or other adjustments to rates in order to prevent

utilities from receiving windfall profits.¹ Further, the Commission found that because the tax benefits are immediate and in order to best preserve the Commission's options concerning the tax benefits, utilities should use deferral accounting to capture the benefits of tax reform. The Commission voted unanimously to require the following actions from the five largest utilities – Tennessee American Water, Kingsport Power, Atmos Energy, Piedmont Natural Gas, and Chattanooga Gas:

1. Track and accumulate monthly in a deferred account the portion of its revenue representing the difference between the cost of service approved by the Commission in its most recent rate case and the cost of service that would have resulted had the provision for federal income taxes been based on 21% rather than 35%; and
2. Calculate the excess deferred tax reserve caused by the reduction in the corporate federal income tax rate and recognize as a deferred liability the estimated reduction of the utilities' revenue requirement resulting from the 2017 Tax Act; and
3. Calculate and defer any other tax effects resulting from the 2017 Tax Act on revenue requirement that are not included in the preceding calculations.²

The Commissioners also voted unanimously that these calculations, including all amounts deferred, shall be submitted to the Commission no later than March 31, 2018, along with proposals to reduce rates or make other ratemaking adjustments to account for the tax benefits resulting from the 2017 Tax Act. In addition, the Commissioners voted to create a separate docket for each individual utility's filing. The Commissioners directed the Commission Staff to work with and assist the remaining water, wastewater, and natural gas utilities³ under the Commission's jurisdiction in calculating the tax impacts on their earnings resulting from the 2017 Tax Act and for the Staff to report the results to the Commission.⁴

¹ *Order Opening an Investigation and Requiring Deferred Accounting Treatment*, pp. 1-4, (February 6, 2018).

² *Id.* at pp. 4-5.

³ Local and long distance telecommunication providers that have elected to operate under market regulation pursuant to state law are exempt from the Commission's regulation of retail rates.

⁴ *Order Opening an Investigation and Requiring Deferred Accounting Treatment*, p. 6 (February 6, 2018).

On July 16, 2018, Commission Staff filed its *First Report and Recommendation Regarding Tax Impacts of the 2017 Tax Cuts and Jobs Act* (“*Staff Report*”).⁵ In the *Staff Report*, Commission Staff examined:

(1) the financial impact on utilities related to the calculation for any excess deferred income taxes resulting from the 21% corporate tax rate; (2) the financial impact on utilities related to the calculation of any excess deferred income taxes resulting from the 21% corporate tax rate; and (3) the tax impact of the new requirement for water and wastewater utilities to pay corporate taxes on contributions in aid of construction.⁶

Based upon this examination, the *Staff Report* contains recommendations concerning the application, impact and actions to be taken by utilities identified in the *Staff Report*.⁷

JULY 23, 2018 COMMISSION CONFERENCE

During the regularly scheduled Commission Conference on July 23, 2018, the Commission considered the *Staff Report*. Thereafter, the Commission voted unanimously to approve the *Staff Report* including all recommendations contained therein. The Commission ordered the utilities identified in the *Staff Report*⁸ file, as soon as possible, the recommended Proposed Tariff for Contributions in Aid of Construction that is attached to the *Staff Report*. Further, given the fact that the 2017 Tax Cuts and Jobs Act became effective January 1, 2018, the Commission voted unanimously to waive the 30-day notice requirement found in Commission Rule 1220-04-01-.04 concerning tariffs submitted that are consistent with the Proposed Tariff attached to the *Staff Report*. In addition, the Commission voted unanimously to require the utilities identified in the *Staff Report* to submit proposals and/or comments regarding the appropriate regulatory accounting treatment of Contributions in Aid of Construction no later than August 31, 2018.

⁵ Notice of Filing By the Utilities Division of the Tennessee Public Utility Commission (July 16, 2018).

⁶ *Id.* at p. 3 of Report.

⁷ *Id.* at pp. 3-6 of Report.

⁸ Counce Natural Gas; General Gas Pipeline; Aqua Utilities Company, Inc.; Integrated Resources Management, Inc.; Tennessee Wastewater Systems, Inc.; Newport Resort Water System; ESG Pipeline; Aqua Green Utility, Inc.; Berry's Chapel Utility, Inc.; Shiloh Falls, Inc.; Condo Villas of Gatlinburg Assoc., Inc.; and, Tennessee Water Service, Inc.

IT IS THEREFORE ORDERED THAT:

1. The *First Report and Recommendation Regarding Tax Impacts of the 2017 Tax Cuts and Jobs Act*, including all recommendations contained therein, is approved.

2. Counce Natural Gas, General Gas Pipeline, Aqua Utilities Company, Inc., Integrated Resources Management, Inc., Tennessee Wastewater Systems, Inc., Newport Resort Water System, ESG Pipeline, Aqua Green Utility, Inc., Berry's Chapel Utility, Inc., Shiloh Falls, Inc., Condo Villas of Gatlinburg Assoc., Inc., and Tennessee Water Service, Inc., are ordered to file the recommended Proposed Tariff for Contributions in Aid of Construction that is attached to the *Staff Report* as soon as possible.

3. The 30-day notice requirement found in Commission Rule 1220-04-01-.04 is waived with regard to tariffs submitted consistent with the Proposed Tariff attached to the *Staff Report*.

4. Counce Natural Gas, General Gas Pipeline, Aqua Utilities Company, Inc., Integrated Resources Management, Inc., Tennessee Wastewater Systems, Inc., Newport Resort Water System, ESG Pipeline, Aqua Green Utility, Inc., Berry's Chapel Utility, Inc., Shiloh Falls, Inc., Condo Villas of Gatlinburg Assoc., Inc., and Tennessee Water Service, Inc., are ordered to submit proposals and/or comments regarding the appropriate regulatory accounting treatment of Contributions in Aid of Construction no later than August 31, 2018.

Chair Robin L. Morrison, Vice Chair Kenneth C. Hill, Commissioner Herbert H. Hilliard, Commissioner John Hie, Commissioner David Jones concur.

ATTEST:



Earl R. Taylor, Executive Director

EXHIBIT 1

BEFORE THE TENNESSEE PUBLIC UTILITY COMMISSION
NASHVILLE, TENNESSEE

July 16, 2018

IN RE:

TENNESSEE PUBLIC UTILITY COMMISSION)	
INVESTIGATION OF IMPACTS OF FEDERAL)	DOCKET NO. 18-00001
TAX REFORM ON PUBLIC UTILITY REVENUE)	
REQUIREMENTS)	

NOTICE OF FILING BY THE UTILITIES DIVISION OF THE
TENNESSEE PUBLIC UTILITY COMMISSION

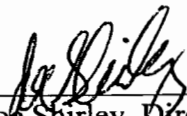
The Utilities Division of the Tennessee Public Utility Commission hereby gives notice of its filing in this docket of Staff's *First Report and Recommendation Regarding Tax Impacts of the 2017 Tax Cuts and Jobs Act* as required by the Commission's *Order Opening an Investigation and Requiring Deferred Accounting Treatment* entered on February 6, 2018.

The Utilities Division hereby files its report with the Tennessee Public Utility Commission for deposit as a public record and approval of the report and the recommendations contained therein.

Respectfully submitted,



David Foster, Director of the
Utilities Division
Tennessee Public Utility Commission



Joe Shirley, Director of Utility
Audit and Compliance
Tennessee Public Utility Commission

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**FIRST REPORT AND RECOMMENDATION REGARDING
TAX IMPACTS OF THE 2017 TAX CUTS AND JOBS ACT**

DOCKET NO. 18-00001

PREPARED BY

**TENNESSEE PUBLIC UTILITY COMMISSION
UTILITIES DIVISION**

JULY 16, 2018

**FIRST REPORT AND RECOMMENDATION REGARDING
TAX IMPACTS OF THE 2017 TAX CUTS AND JOBS ACT**

DOCKET 18-00001

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Commission’s February 6, 2018, *Order Opening an Investigation
and Requiring Deferred Accounting Treatment*

Recommended Tariff Regarding Taxation of CIAC

I. IMPACTS OF THE 2017 TAX CUTS AND JOB ACT ON UTILITIES

On December 22, 2017, the President signed into law the 2017 Tax Cuts and Jobs Act (“2017 Tax Act”) enacting tax reductions for corporations. The primary business tax reduction lowers the corporate tax rate from 35% to 21%. This tax cut reduces income tax expenses that are currently recovered in service rates of incorporated utilities. The lower tax liability for utilities is not reflected in existing rates because they were set based upon the 35% tax rate.

The lower tax rates will also impact the future tax liability for utilities that have deferred income taxes because the tax deferrals were included in ratemaking calculations at 35% but will now be paid at 21% due to passage of the 2017 Tax Act. Deferred tax liabilities are major components included in establishing rates for corporate investor-owned utilities. The primary situation that creates deferred tax liability for utilities is that public utility commissions, including Tennessee, require depreciation methods to recognize expenses ratably over the entire life of the asset placed into service. The Internal Revenue Service (“IRS”), however, allows businesses, including utilities, to recover investment at a faster rate by utilizing accelerated depreciation methods.¹ Accelerated depreciation lowers utilities income for federal tax purposes in the earlier years after an asset is placed in service, thereby reducing income taxes owed in those years. These tax savings are then recorded as deferred income taxes and returned to taxpayers in future years to avoid utility windfall profits. This deferral in income taxes is generally referred to as a timing difference. There may also be other timing differences related to certain expenses that also create tax deferrals. These other timing differences generally have a smaller impact on utility rates than those related to utility assets.

In sum, the reduction in federal income tax rates creates excess deferred income taxes owed to utility customers. Additionally, the earnings of larger corporate utilities under the Commission’s jurisdiction will generally increase due to the lowering of the corporate tax rate from 35% to 21%. Absent a mechanism to return these profits to consumers, service rates would remain at a level unreflective of lower costs, thereby potentially resulting in unreasonable rates.

Another impact of the 2017 Tax Act affecting water and wastewater utilities is due to the requirement to now recognize contributions in aid of construction (“CIAC”) as revenues for federal income tax purposes. CIAC may consist of donated utility plant or money donated to a utility for constructing facilities. Prior to the 2017 legislation, water and wastewater utilities could receive such CIAC without incurring a federal income tax liability due to an IRS provision enacted in the early 1990s that excluded these utilities from tax liability on CIAC. The 2017 Tax Act, however, removed this exclusion for water and wastewater companies; therefore, beginning January 1, 2018, water and wastewater utilities became subject to paying the 21% corporate tax rate on CIAC.

¹ State Commissions generally do not allow accelerated depreciation methods, but favor depreciation methods that recover expenses over the life of the asset. This allows for rates to remain more constant rather than having utility rate volatility that would otherwise be caused by accelerated depreciation methods.

II. SUMMARY OF COMMISSION'S FEBRUARY 6, 2018 ORDER OPENING AN INVESTIGATION AND REQUIRING DEFERRED ACCOUNTING

At the January 9, 2018 Commission Conference, the Commissioners recognized the significant impacts of the 2017 Tax Act and considered appropriate actions for the five largest utilities under the Commission's jurisdiction: Atmos Energy Corporation, Chattanooga Gas Company, Kingsport Power Company, Piedmont Natural Gas Company and Tennessee American Water Company.

The Commission concluded that since utility rates are based upon a 35% statutory tax rate, the new 21% tax rate will reduce utilities' federal income tax expense currently recovered in utility service rates. Second, the Commission found the lower tax rate also creates excess deferred tax reserves due to the fact that taxes were deferred at a higher rate. This reduced tax liability also affects revenue requirements of utilities. The Commission further found that it is necessary to make appropriate rate reductions or other ratemaking adjustments in order to prevent utilities from receiving windfall profits.²

Moreover, to preserve the Commission's options relative to these tax benefits, which are immediate, utilities were ordered to use deferred accounting methods to capture the benefits of tax reform. Specifically, these five utilities must:

1. Track and accumulate monthly in a deferred account the portion of its revenue representing the difference between the cost of service approved by the Commission in its most recent rate case and the cost of service that would have resulted had the provision for federal income taxes been based on 21% rather than 35%;
2. Calculate the excess deferred tax reserve caused by the reduction in the corporate federal income tax rate and recognize as a deferred liability the estimated reduction of the utilities' revenue requirement resulting from the 2017 Tax Act; and
3. Calculate and defer any other tax effects resulting from the 2017 Tax Act on revenue requirement that are not included in the preceding calculations.³

The Commission also required these calculations, including all amounts deferred, to be submitted to the Commission no later than March 31, 2018, along with proposals to reduce rates or implement other ratemaking adjustments to account for the tax benefits resulting from the 2017 Tax Act.⁴

² *In re: Tennessee Public Utility Commission Investigation of Impacts of Federal Tax Reform on the Public Utility Revenue Requirements*, Docket No. 18-00001, *Order Opening an Investigation and Requiring Deferred Accounting Treatment*, pp. 3-4 (Feb. 6, 2018).

³ *Id.*, pp. 4-5.

⁴ *Id.*, p. 5.

For the remaining water, wastewater and natural gas utilities under the Commission's jurisdiction, Staff was directed to work with and assist the utilities in calculating the tax impacts on their earnings resulting from the 2017 Tax Act, and to report the results to the Commission.⁵

III. SCOPE OF INVESTIGATION

Staff was tasked with determining the tax impacts of the 2017 Tax Act on utilities other than Atmos Energy Corporation, Chattanooga Gas Company, Kingsport Power Company, Piedmont Natural Gas Company and Tennessee American Water Company. To accomplish the goals of the investigation, Staff examined the following: (1) the financial impact on utilities' earnings resulting from enactment of the 21% corporate tax rate; (2) the financial impact on utilities related to the calculation of any excess deferred income taxes resulting from the 21% corporate tax rate; and (3) the tax impact of the new requirement for water and wastewater utilities to pay corporate taxes on contributions in aid of construction.

IV. INVESTIGATIVE CONCLUSIONS AND RECOMMENDED ACTIONS FOR SMALLER UTILITIES RESULTING FROM THE 2017 TAX ACT

As identified herein, the five major corporate utilities operating under the Commission's jurisdiction were ordered to make separate filings detailing the impacts of the tax law changes on their earnings. This report will provide Staff's investigative results regarding the impacts of the 2017 Tax Act on the remaining incorporated utilities under the Commission's jurisdiction:

- | | |
|--------------------------------------|---|
| - Counce Natural Gas | - ESG Pipeline |
| - General Gas Pipeline | - Aqua Green Utility, Inc. |
| - Aqua Utilities Company, Inc. | - Berry's Chapel Utility, Inc. |
| - Integrated Resources Mgmt, Inc. | - Shiloh Falls, Inc. |
| - Tennessee Wastewater Systems, Inc. | - Condo Villas of Gatlinburg Assoc., Inc. |
| - Newport Resort Water System | - Tennessee Water Service, Inc. |

A. Limited Liability Companies (LLCs)

There are numerous other, smaller utilities under the Commission's jurisdiction that operate as limited liability companies ("LLCs"). While one of the primary benefits of establishing a business as an LLC is to limit the personal liability of its owners, an LLC generally does not fall under the IRS corporate tax code unless such an election is made, but rather operates as a partnership or sole proprietorship. As a partnership or sole proprietor, each owner pays income taxes on their respective individual tax returns. Accordingly, federal income tax expense is excluded from recovery in rates of such utilities organized as LLCs. Consequently, LLCs operating as partnerships or sole proprietorships are not impacted by the change in corporate tax rates.

⁵ *Id.*

B. Income Tax Expense

The most common corporate phraseology with respect to the 2017 Tax Act is that the corporate tax rate was reduced from 35% to 21%; this 35% marginal rate, however, was only applicable to corporations with higher levels of earnings. Smaller corporations with lower levels of taxable income, especially below \$100,000, paid lower taxes due to a graduated system of tax rates as follows:

Taxable income of \$0 to \$50,000	15%
Taxable income of \$50,000 to \$75,000	25%
Taxable income of \$75,000 to \$100,000	34%

Beginning January 1, 2018, however, the graduated system of tax rates was eliminated, and every corporation will now pay the 21% federal income tax rate on taxable earnings. As one can see from the chart, it is possible for smaller corporations to pay higher taxes under the 2017 Tax Act. For example, a company with taxable income of \$40,000 under the 2017 tax rates would owe \$6,000 in taxes ($\$40,000 \times 15\%$). All conditions being equal, the same corporation will owe \$8,400 ($\$40,000 \times 21\%$) in federal income taxes under the 2017 Tax Act.

In order to ascertain the impact of the revised federal income tax rates on the aforementioned incorporated utilities, Staff reviewed the latest annual reports for each utility.⁶ Only two utilities, Aqua Green Utility, Inc. and Integrated Resources Management, Inc., reported positive net earnings on their latest annual report. Accordingly, based upon the reported earnings of the remaining utilities, there does not appear to be a significant impact on their service rates; therefore, no further action is recommended.

Both Aqua Green Utility and Integrated Resources Management reported net income of less than \$7,500 each.⁷ Under the new 21% corporate rate (assuming all things held equal), the utilities would each owe no more than \$450 in additional federal income taxes ($\$7,500 \times 6\%$ [difference between new 21% corporate tax rate and previous 15% tax rate]). Staff considers this potential increased tax liability as a *De Minimis* amount for these two companies, especially given the fact that the companies' time and effort to implement higher rates, including filing, tariff and notification requirements, would quickly erode and quite likely exceed any funds received from increased rates. Staff, therefore, recommends no action be taken regarding these utilities' *De Minimis* income tax expense impacts.

C. Accumulated Deferred Income Taxes

As discussed above, the lower tax rates will impact the future tax liability for utilities that have deferred income taxes because the tax deferrals were included in ratemaking calculations at 35% but will now be paid at 21% due to passage of the 2017 Tax Act. In order to ascertain the impact

⁶ Newport Resort Water System reported net income of \$3,247 on its 2013 annual report, the latest on file with the Commission. Staff, therefore, does not have any recent financial information to ascertain the tax impacts, if any, of the 2017 Tax Act on Newport Resort Water System.

⁷ See Aqua Green Utility, Inc.'s 2017 Annual Report; Integrated Resources Management, Inc.'s 2016 Annual Report (the company requested and received an extension to file its 2017 annual report and it has not been received to date).

of the revised federal income tax rates on the utilities' accumulated deferred income taxes, Staff reviewed the latest annual reports for each utility, along with recent rate cases.

None of the utilities subject to Staff's investigation reported any accumulated deferred income taxes on their annual reports. Furthermore, these utilities are primarily regulated on a margin basis, which means the utility receives rate recovery of all prudent expenses, including interest and taxes, plus a margin return on those expenses as shareholders' profit. The primary reason these small utilities are regulated on a margin basis is due to the fact that the smaller companies generally have plant that was contributed or is substantially depreciated. Accordingly, since there is no impact on these utilities' earnings related to accumulated deferred income taxes, Staff concludes that no further action necessary.

D. Contribution in Aid of Construction

The federal income tax provisions relating to contributions in aid of construction ("CIAC") have changed over the past thirty years, with different types of utilities sometimes receiving different tax treatment for CIAC. Under the 1986 Tax Reform Act, all utilities were required to pay federal income taxes on CIAC. The Tennessee Public Service Commission, the predecessor agency to this Commission, required all utilities to file tariffs mandating payments from donors in order to defray the utilities' tax expenses associated with CIAC.

In the early 1990s, however, the IRS tax code was amended to exclude water and wastewater companies from the requirement to pay federal income taxes on CIAC. Staff's understanding of the change was to benefit water and wastewater utilities because they often rely on third parties to build and donate facilities or to provide necessary funding to construct facilities. Accordingly, the water and wastewater utilities ceased collecting the upfront taxes from the contributor.

As stated herein, however, the 2017 Tax Act removed this tax exclusion for water and wastewater companies; therefore, beginning January 1, 2018, water and wastewater utilities became subject to the 21% corporate tax rate on all CIAC.⁸

E. Recommended Action to Account for CIAC

The utility is ultimately responsible for paying federal income taxes on contributed plant or money contributed for plant construction. Without change in regulatory practice, utilities will owe federal income taxes for which, in turn, the utility could seek recovery through increased customer rates. However, utility payment of taxes and subsequent recovery from ratepayers is not feasible. First, the earnings reported by these utilities suggest there would be insufficient funds to pay the required federal income taxes on CIAC. Second, if these additional income taxes were collected from ratepayers, the monthly rate for wastewater service could reach an unreasonable level.

For example, assume a wastewater utility receives donated plant at a cost of \$600,000, which is not unreasonable given the cost of systems that have been previously donated. The tax liability

⁸ The incorporated local distribution gas and pipeline companies listed in this report are unaffected by this tax law change because these companies never received an IRS exclusion from paying income taxes on CIAC.

of the CIAC would be \$126,000 in additional taxes (\$600,000 * 21% corporate tax rate). Based upon Staff's review of the utilities' reported financial data, they could not meet such liability from earnings or existing reserves. Further, given the small customer base of these utilities, funding the additional tax from consumers could result in substantial rate increases, potentially taking individual customer rates to an unreasonable level. Staff is of the opinion that requiring the utility or the ratepayers to pay increased taxes on CIAC is not in the public interest.

Rather, Staff recommends that the established regulatory policy of requiring contributors of plant or money to pay the associated federal income taxes to the utility be extended to these utilities. This regulatory practice will thereby remove the tax burden from the utility and its customers. This practice has not only been adopted by this Commission but also by others nationwide. With regard to extending this policy, Staff has been in contact with several wastewater companies that routinely receive contributed plant and funding to build facilities. Three of these companies, Tennessee Wastewater Services, Aqua Green Utility, and Integrated Resources Management, have all filed tariffs incorporating language suggested by Staff to require contributors of plant and money to pay the associated federal income tax at the time the plant or money is donated. In this manner, the utility and customers are shielded against large tax bills and potentially high wastewater rates. Staff recommends that the remaining incorporated water and wastewater utilities be required to follow this policy and file the recommended tariff attached hereto.

One remaining issue concerns the regulatory accounting for the tax payment received by the utility for the tax liability created by CIAC. Of particular concern is the initial recording and subsequent amortization, if any, of the tax payment related to CIAC. Staff has briefly discussed with some companies proposed journal entries and regulatory treatment of CIAC, including the associated tax payment, but recommends that utilities subject to this report provide comments no later than August 31, 2018, regarding the regulatory accounting for CIAC in light of the 2017 Tax Act. Upon receipt of these comments, Staff will provide its recommended accounting policy to the Commission for consideration.

BEFORE THE TENNESSEE PUBLIC UTILITY COMMISSION

NASHVILLE, TENNESSEE

February 6, 2018

IN RE:

**TENNESSEE PUBLIC UTILITY COMMISSION
INVESTIGATION OF IMPACTS OF FEDERAL TAX
REFORM ON THE PUBLIC UTILITY REVENUE
REQUIREMENTS**

**DOCKET NO.
18-00001**

**ORDER OPENING AN INVESTIGATION AND REQUIRING DEFERRED ACCOUNTING
TREATMENT**

This matter came before Chairman David F. Jones, Vice Chairman Robin Morrison, Commissioner Herbert H. Hilliard, Commissioner Kenneth C. Hill and Commissioner Keith Jordan of the Tennessee Public Utility Commission ("TPUC" or "Commission"), at a regularly scheduled Commission Conference held on January 16, 2018.

During the Conference, the Commissioners voted unanimously to require Atmos Energy Corporation ("Atmos Energy"), Chattanooga Gas Company ("Chattanooga Gas"), Kingsport Power Company d/b/a AEP Appalachian Power ("Kingsport Power"), Piedmont Natural Gas Company ("Piedmont Natural Gas"), and Tennessee American Water Company ("Tennessee American Water"), to immediately apply deferred accounting treatment, specifically described herein, with respect to the impact of the lowering of the federal corporate income tax rate and to require the named public utilities to provide to the Commission no later than March 31, 2018, the amounts deferred and a proposal to reduce rates or otherwise make adjustments to account for the tax benefits resulting from the 2017 Tax Cuts and Jobs Act, Pub. L. No. 115-97 ("2017 Tax Act").

BACKGROUND

Generally, the statutory rate for federal income tax expense is included as a component of the revenue requirement when utility rates are set by the Commission. On December 22, 2017, new federal tax reductions, including those for businesses, were signed into law. The primary business tax reduction impacting utilities and utility rates was the lowering of the corporate tax rate from 35% to 21%, which will significantly reduce income tax expenses that are currently recovered in utility service rates. The lower tax rates will also impact the future tax liability for utilities that have deferred income taxes because the tax deferrals were included in ratemaking calculations at 35% when in fact the rate is now 21%; this lower tax liability is not reflected in existing rates because future recovery in previous proceedings was based upon a 35% tax rate.

Income taxes and deferred tax liabilities are major components included in establishing rates for all corporate investor-owned utilities. Many public utility commissions, including Tennessee, require depreciation methods to recognize depreciation benefits over the life of the asset placed into service.¹ The Internal Revenue Service (“IRS”), however, allows businesses, including utilities, to recover investment at a faster rate by utilizing accelerated depreciation methods. Accelerated depreciation lowers a utility’s income for federal tax purposes in the early years when an asset is placed in service thereby reducing income taxes owed in those early years. These tax savings are then recorded as deferred income taxes and returned to ratepayers in future years to avoid utility windfall profits.

Absent an adjustment, utilities’ service rates would be unreflective of a significantly lower cost. This Commission and other state commissions have in the past allowed for deferring expenses and/or revenues until such time as a final decision can be made as to (1) the proper amounts to be

¹ See *In Re: Petition of Tennessee American Water Company to Change and Increase Certain Rates and Charges to Permit It To Earn A Fair And Reasonable Rate of Return*, Docket No. 08-00039, Order, p. 32 (January 13, 2009).

recovered by the utility or returned to ratepayers and (2) the method by which amounts are recovered by utilities or returned to ratepayers.²

The five largest public utilities under the Commission's jurisdiction, Tennessee American Water, Kingsport Power, Atmos Energy, Piedmont Natural Gas and Chattanooga Gas charge rates that were set by the Commission using the now superseded statutory rate of 35% while utilizing accelerated depreciation for income tax purposes. However, most of the smaller utilities under the Commission's jurisdiction, either do not utilize accelerated depreciation methods or the amounts are not significant. A large number of the smaller utilities do not currently pay the 35% tax rate, but rather pay lower tax rates due to lower earnings being taxed on the graduated business tax scale or because they do not generate significant positive net income. Several of the smaller utilities are established as Limited Liability Companies ("LLCs"), wherein income taxes are not included in the calculation of utility rates because the LLC members are personally responsible for paying income taxes on utility operations. Finally, telecommunication providers that have opted for market regulation are not subject to the Commission's rate-setting jurisdiction.³

FINDINGS AND CONCLUSIONS

The tax benefits of the 2017 Tax Act have an immediate impact. Since the earnings of larger utilities under the Commission's jurisdiction are significantly impacted by the 2017 Tax Act due to the lowering of the corporate tax rate from 35% to 21%, Commission review and action is necessary in order to investigate to prevent utilities from receiving windfall profits. This review should take place in an efficient manner as possible.

² *In re: Application to Lower Rates and Charges for Any Refund Due to Customers of Centerpoint Energy Resources Corporation, Oklahoma Corporation Commission*, No. PUD 201700568, *Order*, (January 9, 2018); *Kentucky Industrial Utility Customers v. Kentucky Utilities Company, et al.* Kentucky Public Service Commission, Case No. 2017-00477, *Order* (December 27, 2017); *In Re: Tax Reform Act of 1986*, Mass. Dept. of Public Utilities, *Order*, D.P.U. 87-21-A, (June 1, 1987); *Pennsylvania Public Utility Commission v. ALLTEL Pennsylvania, Inc.* M-860105, *Order Prescribing Temporary Rate Reductions in Response to the Tax Reform Act of 1986*, (June 10, 1987).

³ Tenn. Code Ann. § 65-5-109(m).

The 2017 Tax Act, which became effective January 1, 2018, significantly impacts earnings of investor-owned utilities in two significant areas. First, the corporate federal income tax rate is being reduced from 35% to 21%. As utility rates are based upon the 35% statutory tax rate, the new 21% tax rate will significantly reduce utilities' federal income tax expense currently recovered in utility service rates. Second, the lower tax rate also creates excess deferred tax reserves due to the fact that taxes were deferred at a higher rate. This reduced tax liability also affects revenue requirements of utilities.

Since the 2017 Tax Act will result in increased earnings for utilities, the Commissioners found that it is necessary to investigate and make appropriate rate reductions or other ratemaking adjustments in order to avoid utilities from receiving windfall profits.⁴ Furthermore, since the tax benefits are immediate and to preserve the Commission's options relative to this tax benefit, the Commissioners determined that utilities should use deferral accounting to capture the benefits of tax reform. Specifically, the Commissioners voted unanimously that the five largest utilities under the Commission's jurisdiction – Tennessee American Water, Kingsport Power, Atmos Energy, Piedmont Natural Gas and Chattanooga Gas must:

1. Track and accumulate monthly in a deferred account the portion of its revenue representing the difference between the cost of service approved by the Commission in its most recent rate case and the cost of service that would have resulted had the provision for federal income taxes been based on 21% rather than 35%; and
2. Calculate the excess deferred tax reserve caused by the reduction in the corporate federal income tax rate and recognize as a deferred liability the estimated reduction of the utilities' revenue requirement resulting from the 2017 Tax Act; and

⁴ Local and long distance telecommunication providers that have elected to operate under market regulation pursuant to state law are exempt from the Commission's regulation of retail rates.

3. Calculate and defer any other tax effects resulting from the 2017 Tax Act on revenue requirement that are not included in the preceding calculations.

Further, the Commissioners voted unanimously that these calculations, including all amounts deferred, shall be submitted to the Commission no later than March 31, 2018, along with proposals to reduce rates or make other ratemaking adjustments to account for the tax benefits resulting from the 2017 Tax Act. In addition, the Commissioners voted unanimously to create a separate docket for each individual utility's filing. The Commissioners directed the Commission Staff to work with and assist the remaining water, wastewater and natural gas utilities under the Commission's jurisdiction in calculating the tax impacts on their earnings resulting from the 2017 Tax Act and for the Staff to report the results to the Commission.

IT IS THEREFORE ORDERED THAT:

1. Atmos Energy Corporation, Chattanooga Gas Company, Kingsport Power Company d/b/a AEP Appalachian Power, Piedmont Natural Gas Company, and Tennessee American Water Company shall:

- a. Track and accumulate monthly in a deferred account the portion of its revenue representing the difference between the cost of service approved by the Tennessee Public Utility Commission in its most recent rate case and the cost of service that would have resulted had the provision for federal income taxes been based on 21% rather than 35%; and
- b. Calculate the excess deferred tax reserve caused by the reduction in the corporate federal income tax rate and recognize as a deferred liability the estimated reduction of the utilities' revenue requirement resulting from the 2017 Tax Cuts and Jobs Act; and

c. Calculate and defer any other tax effects resulting from the 2017 Tax Cuts and Jobs Act on revenue requirement that are not included in the preceding calculations.

2. The calculations made by Atmos Energy Corporation, Chattanooga Gas Company, Kingsport Power Company d/b/a AEP Appalachian Power, Piedmont Natural Gas Company, and Tennessee American Water Company in relation to the tax deferred accounting treatment ordered herein shall be submitted no later than March 31, 2018, including proposals to reduce rates or make other ratemaking adjustments to account for the tax benefits resulting from the 2017 Tax Cuts and Jobs Act.

3. The Docket Manager of the Tennessee Public Utility Commission is directed to open separate, individual dockets for Atmos Energy Corporation, Chattanooga Gas Company, Kingsport Power Company d/b/a AEP Appalachian Power, Piedmont Natural Gas Company, and Tennessee American Water Company for the filing of the aforementioned calculations, adjustments and proposals.

4. The Staff of the Tennessee Public Utility Commission shall work with the remaining water, wastewater and natural gas utilities under the jurisdiction of the Tennessee Public Utility Commission to calculate the tax impacts on earnings resulting from the 2017 Tax Cuts and Jobs Act, and Staff shall report the results to the Commission.

Chairman David F. Jones, Vice Chairman Robin L. Morrison, Commissioner Herbert H. Hilliard, Commissioner Kenneth C. Hill, and Commissioner Keith Jordan concur.

ATTEST:



Earl R. Taylor, Executive Director

PROPOSED TARIFF

Contributions In Aid of Construction The contract with the developer/customer shall contain a notice of these charges and time table of payment.

For all cash and property contributions provided to the utility a gross-up factor shall be applied in order to recover the corporate federal income taxes associated with those contributions. The Utility will be paid this amount directly before the sewage system is allowed to start operation. The formula used to gross up contributed cash and property is as follows:

$$\text{Tax Impact} = \text{TR} / (1 - \text{TR}) * (\text{C} + \text{P})$$

TR = Marginal tax rate of federal corporate income tax.

C = Dollar amount of charges (cash) paid to the utility as a contribution.

P = Dollar amount of property (plant, land...) conveyed to the utility to be recorded at the original construction cost of the property conveyed to the utility, or a reasonable estimate of the original construction cost if such cost is not reasonably ascertainable.

Example 1:

Developer donates \$500,000 cash to utility to build a specified facility.

Using a 21% federal corporate tax rate, developer owes the utility federal income taxes of:

$$.21 / (1 - .21) * \$500,000, \text{ or } .2658 * \$500,000 = \$132,900$$

In total, developer owes utility \$632,900 (\$500,000 cash + \$132,900 in federal corporate income taxes).

Example 2:

Developer donates \$500,000 in plant and land to utility as a contribution.

Using a 21% federal corporate tax rate, developed owes the utility federal income taxes of:

$$.21 / (1 - .21) * \$500,000, \text{ or } .2658 * \$500,000 = \$132,900$$

For the contributed property, developer owes the utility \$132,900 in corporate federal income taxes for the \$500,000 in property contributed.

Annual Reporting Requirements for Contributions In Aid of Construction

Utility shall file calculations with its Annual Report detailing: (1) the individual amounts of cash and property contributions received for the twelve months ending December 31 ("reporting year"); (2) the location and description of contributed plant; (3) the location and property deed of donated land; (4) amount of cash contributed for each project; (5) the calculation of the utility's tax liability using the tariffed formula for the reporting year, separated by amounts related to property and cash; and (6) the amount of federal corporate income taxes actually collected on contributions in aid of construction for the reporting year.

CERTIFICATE OF SERVICE

I hereby certify that on this 16th day of July 2018, a true and exact copy of the foregoing has been either delivered by electronic mail or by U.S. Mail, postage pre-paid, to the following persons:

Chair Robin L. Morrison
Tennessee Public Utility Commission
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Nashville, TN 37243

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Consumer Advocate and Protection Division
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