

State of Florida



Public Service Commission

CAPITAL CIRCLE OFFICE CENTER • 2540 SHUMARD OAK BOULEVARD
TALLAHASSEE, FLORIDA 32399-0850

-M-E-M-O-R-A-N-D-U-M-

DATE: January 25, 2018

TO: Office of Commission Clerk (Stauffer)

FROM: Division of Accounting and Finance (Cicchetti, Fletcher) *MC BG ALM*
Division of Economics (Daniel, Draper) *PO GS*
Office of the General Counsel (Brownless) *JSC*

RE: Docket No. 20180013-PU – Petition to establish a generic docket to investigate and adjust rates for 2018 tax savings, by Office of Public Counsel.

AGENDA: 02/06/18 – Regular Agenda – Interested Persons May Participate

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Administrative

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: None

Case Background

On January 9, 2018, the Office of Public Counsel (OPC) filed a Petition to Establish Generic Docket to Investigate and Adjust Rates for 2018 Tax Savings. Subsequent to this filing, OPC filed a letter on January 11, 2018, requesting that the Commission act on its petition at the earliest possible Agenda Conference. On January 22, 2018, Florida Power & Light Company (FPL) filed its response to OPC's petition. The Commission has jurisdiction over this subject matter pursuant to Sections 366.06, 366.07, and 367.081, Florida Statutes (F.S.).

Discussion of Issues

Issue 1: What should the effective date be for adjustments associated with the Tax Cuts and Jobs Act of 2017?

Recommendation: Unless the utilities agree to a January 1, 2018 effective date, the effective date for adjustments associated with the Tax Cuts and Jobs Act of 2017 should be February 6, 2018, for utilities that do not have settlement agreements addressing this issue. For utilities that have settlement agreements addressing this issue, the terms of each settlement agreement should control. (Cicchetti, Fletcher, Brownless)

Staff Analysis:

Tax Cuts and Jobs Act of 2017

The Tax Cuts and Jobs Act of 2017¹ (Act) was signed into law by President Trump on December 22, 2017, and applies to the taxable year beginning after December 31, 2017. The Act affects many sections of the Internal Revenue Code that will impact the federal tax liability of regulated utilities. Four areas are of particular importance: 1) the tax rate reduction for corporations from 35 to 21 percent; 2) limitations on the amount of interest expense corporations can deduct to lower their tax bill; 3) flow back of excess deferred taxes caused by the reduction in the corporate tax rate, and 4) treating Contributions in Aid of Construction (CIAC) as taxable income for water and wastewater utilities.

Corporate Rate Change

The Act lowered the tax rate for corporations from 35 percent to 21 percent. Regulated utilities, like other corporate entities, will realize a reduction of 14 percentage points from the previous rate. For unregulated corporations, a lower tax rate means more cash flow and higher earnings. For most regulated utilities, the tax cut benefit will accrete to customers. For electric, natural gas, and certain water and wastewater utilities,² taxes are part of the utilities' cost-of-service calculation. Therefore, a lower tax rate may translate into lower utility rates for customers.

Deductibility of Interest Expense

The new law puts limits on the amount of interest expense corporations can deduct to lower their tax bill. The limit is set at 30 percent of EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) and then drops to a more restrictive measure of 30 percent of EBIT (leaving out the depreciation and amortization). Regulated utilities, however, have a 100 percent exemption. Although regulated utilities maintained their 100 percent exemption, they lost bonus depreciation (which allows quicker recovery of capital investments for tax purposes) and utilities cannot write-off capital investments to expense in the year the investment is made as unregulated companies can do under the new law. That puts utilities back on the modified accelerated cost recovery system (MACRS) which is beneficial, but not as beneficial as bonus depreciation or immediate write-off.

¹ HR-1, Pub. L. No. 115-97, December 22, 2017, 131 Stat 2054.

² Rule 25-30.433(7), Florida Administrative Code (F.A.C.), states: "Income tax expense shall not be allowed for subchapter S corporations, partnerships or sole proprietorships."

Deferred Taxes

Generally, deferred taxes arise for regulated utilities due to the book-tax timing difference associated with utilities being allowed to book higher depreciation expense (accelerated depreciation) for tax purposes as compared to the straight-line depreciation required by regulation. Regulators require straight-line depreciation to allocate the recovery of investments in equal annual amounts over the life of the investments. Deferred taxes can also arise from various other book-tax timing differences.

Because taxes have been paid by the customer before the company pays them to the government, deferred taxes are recorded on the company's balance sheet as a regulatory liability. Deferred taxes are a cost-free source of capital to the utility, and for regulatory purposes, can be included in the capital structure as zero cost capital or used to reduce rate base. Both treatments have exactly the same effect on the revenue requirement. In Florida, deferred taxes are included as a cost-free source of capital in the capital structure. Deferred taxes reverse over time as the annual straight-line depreciation expense exceeds the annual accelerated depreciation expense in the later years of an asset's useful life. This treatment is required by the Internal Revenue Service (IRS) and is known as normalization accounting (i.e. spreading the benefit over time as opposed to flowing it immediately through to customers).

The deferred taxes currently on utilities' balance sheets were calculated at a 35 percent rate. However, the new lower 21 percent rate means the deferred taxes eventually will be paid to the government at a lower rate. This is a benefit (lower cost) for customers. The new law and normalization accounting require that the deferred tax difference between the 35 percent and 21 percent be booked as a regulatory liability and flowed back (returned) to customers over the regulatory remaining life of the asset. For Florida utilities, the annual flow back of the excess deferred taxes will be a benefit to customers that will be somewhat offset by the gradual reduction of zero cost capital in the capital structure which will somewhat increase the overall cost of capital.

Contributions in Aid of Construction

The previous law included a carve-out for water and wastewater utilities that excluded CIAC from gross income, (i.e. non-taxable). The new law removed that carve-out, thereby making CIAC taxable for water and wastewater utilities. Consequently, water and wastewater utilities will need to petition the Commission to gross-up CIAC for taxes thereby increasing the cost to customers of utilities that receive and record CIAC.

OPC's Petition

In its Petition, OPC has made several requests. First, that the Commission take jurisdiction over any revenue requirement reduction caused by the Act for all regulated utilities: electric, natural gas, water, and wastewater. Second, that the Commission place revenues subject to refund covering at least the amount of the Net Operating Income (NOI) impact of lowering the corporate rate from 35 to 21 percent. OPC estimates that this amount is presumptively at least 13 percent of overall NOI for each utility. OPC would accept a corporate undertaking for the NOI impact or written acknowledgement of Commission jurisdiction. Third, with regard to the creation of excess accumulated deferred income taxes, OPC requests that the Commission identify the balances for each utility and order the benefits to be captured and returned to

customers pursuant to applicable law. Fourth, for excess deferred income taxes not related to depreciation, OPC requests that the Commission identify excess amounts for each utility and require that those be flowed back to customers to the greatest degree possible. Fifth, OPC acknowledges that four electric utilities³ have settlement agreements which address the issue of a change in federal tax rates. For those utilities, OPC states that the terms of the individual settlement agreements should be followed for implementation of revenue requirement impacts through filing limited proceedings within the time limits set forth in each of the agreements.

FPL's Response

In its response, FPL takes the position that while the Commission should attach jurisdiction over the resulting federal tax savings on February 6, 2018, no generic proceeding is required at this time. FPL argues that its Settlement Agreement⁴ allows it to amortize its \$1.25 billion of depreciation and dismantlement reserve surplus as it sees fit to maintain its earnings within its authorized rate of return range of 9.6 percent to 11.6 percent. At this time FPL has been able to offset most of its Hurricane Irma expenses by amortizing the full amount of the depreciation and dismantlement reserve surplus. FPL intends to use tax savings that are the result of the Act to partially replenish the reserve surplus through amortization of debits as allowed by the Settlement Agreement. Finally, FPL states that this process can be fully tracked through the depreciation and dismantlement reserve report attached to the December surveillance report required by the Settlement Agreement to be filed each year.

Discussion

Jurisdiction

The Commission has the authority to regulate and supervise each electric and gas public utility with respect to its rates and service as well as to set fair, just, and reasonable rates for those utilities. Sections 366.04(1) and 366.06(1), F.S. The Commission also has exclusive jurisdiction over each non-exempt water and wastewater utility with respect to its authority, service and rates. Section 367.011(1), F.S. The Legislature has recognized that regulation of public utilities is in the public interest and is an exercise of the police power of the state to protect the public health, safety and welfare. As such the Commission's authority shall be liberally construed to accomplish this purpose. Sections 366.01 and 367.011, F.S. While the Commission has broad ratemaking authority, it does not have the ability to impose retroactive rate modifications. City of Miami v. Florida Public Service Commission, 208 So. 2d 249, 259 (Fla. 1968); Southern Bell Telephone and Telegraph Company v. Florida Public Service Commission, 453 So. 2d 780, 784 (Fla. 1984).

Due to the potential significant revenue requirement impacts that the Act may have on all electric and natural gas utilities, as well as certain water and wastewater utilities, staff recommends that the Commission assert jurisdiction over this subject matter effective either on the date of the vote, February 6, 2018, or the date contained in the regulated utilities' settlement agreements. The practical effect of asserting jurisdiction is to put utilities on notice that all revenue

³ Gulf Power Company (Gulf); Duke Energy Florida, LLC (DEF); Tampa Electric Company (TECO); and Florida Public Utilities Company (FPUC).

⁴ Order No. PSC-16-0560-AS-EI, issued on December 15, 2016, in Docket No. 160021-EI, In re: Petition for rate increase by Florida Power & Light Company.

requirement adjustments ultimately imposed by the Commission due to the Act's provisions will be calculated as of February 6, 2018, the date of the Commission vote, or the date contained in each electric utilities' settlement agreements. Attachment A lists the regulated utilities by industry and gives the effective date for each.

Revenues Subject to Refund

At the outset, it is important to note that the impact of the Act on each regulated industry, as well as each individual utility, will be vastly different as each industry, as well as each utility, has a unique set of financial characteristics affected by the Act. The most obvious of these is whether the utility is currently earning within its authorized rate of return. If a utility is currently earning below its authorized rate of return range, as is the case for many water and wastewater utilities, a reduction in corporate tax rate may produce no reduction in revenue requirements. The second important consideration is the fact that the Act is complex with many moving parts some of which will increase revenue requirements and some of which will reduce revenue requirements. Further, the IRS has not yet published directives interpreting and implementing the Act and will not be able to do so for some time. The Act is less than 30 days old. While good corporate management requires that each regulated utility immediately begin to analyze the impact of the Act on its finances, that task takes time, particularly when one considers that Florida's electric utilities are part of larger conglomerates as are many natural gas, and water and wastewater companies.

For these reasons, staff does not recommend that the Commission require each utility without a settlement agreement to set an amount subject to refund based on a 13 percent reduction in overall NOI. There simply is no basis for using that amount, or any other amount, at this time. The date for each regulated utility to provide the Commission with its calculation of the impacts of the Act should be made with input from all utilities affected as part of developing an overall schedule for processing the issues in this docket. Likewise, staff agrees with OPC that each regulated utility must calculate the excess accumulated deferred income taxes and excess deferred income taxes not related to depreciation which result from the Act. The date that these calculations must be provided to the Commission should also be the subject of discussions with all affected utilities as part of developing an overall schedule for processing the issues in this docket. Discussions with stakeholders on the most efficient procedure(s) to process the impacts of the Act should be instituted as soon as practical.

Conclusion

Staff recommends that unless the utilities agree to a January 1, 2018 effective date, the effective date for adjustments associated with the Tax Cuts and Jobs Act of 2017 should be February 6, 2018, for utilities that do not have settlement agreements addressing this issue. For utilities that have settlement agreements addressing this issue, the terms of each settlement agreement should control.

Issue 2: Should this docket be closed?

Recommendation: No, this docket should remain open pending resolution of all issues raised. (Brownless)

Staff Analysis: This docket has just been filed and should remain open to develop the process by which all issues raised by the Act are addressed and resolved by the Commission.

Attachment A	
Company	Effective Date
<u>Electric</u>	
1 Florida Power & Light Company	Feb. 6, 2018
2 Duke Energy Florida, LLC	Jan. 1, 2018
3 Tampa Electric Company	Jan. 1, 2018
4 Gulf Power Company	Feb. 6, 2018
5 Florida Public Utilities Company	Jan. 1, 2018
<u>Gas</u>	
1 Florida City Gas	Feb. 6, 2018
2 Florida Division of Chesapeake Utilities	Feb. 6, 2018
3 Florida Public Utilities Company	Feb. 6, 2018
4 Florida Public Utilities Company - Fort Meade Division	Feb. 6, 2018
5 Florida Public Utilities Company - Indiantown Division	Feb. 6, 2018
6 Peoples Gas System	Feb. 6, 2018
7 Sebring Gas System, Inc.	Feb. 6, 2018
8 St. Joe Natural Gas Company, Inc.	Feb. 6, 2018
<u>Water and Wastewater</u>⁵	
1 East Central Florida Services, Inc.	Feb. 6, 2018
2 Forest Utilities, Inc.	Feb. 6, 2018
3 Gold Coast Utility Corporation	Jan. 1, 2018
4 Indiantown Company, Inc.	Jan. 1, 2018
5 Marion Utilities, Inc.	Jan. 1, 2018
6 NHC Utilities, Inc.	Feb. 6, 2018
7 Ni Florida, LLC	Jan. 1, 2018
8 North Beach Utilities, Inc.	Feb. 6, 2018
9 Peoples Water Service Company of Florida, Inc.	Jan. 1, 2018
10 Pine Island Cove Homeowners Association, Inc.	Feb. 6, 2018
11 Placid Lakes Utilities, Inc.	Feb. 6, 2018
12 Pluris Wedgefield, Inc.	Jan. 1, 2018
13 St. James Island Utility Company	Jan. 1, 2018
14 Utilities, Inc. of Florida	Feb. 6, 2018
15 Wildwood Water Company	Feb. 6, 2018

⁵ Rule 25-30.433(7), F.A.C. states: “Income tax expense shall not be allowed for subchapter S corporations, partnerships or sole proprietorships.”