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PUBLIC UTILITIES AND THE ALLOCATION OF CONSOLIDATED RETURN TAX BENEFITS

When a public utility is a member of an affiliated group of companies, the traditional regulatory practice for ratemaking purposes has been to keep the utility's revenues and expenses separate from those of other group members. This means, among other things, that the utility's tax expense allowance for ratemaking purposes should be computed as though the utility were an independent company filing a separate tax return. It has long been regarded as sound regulatory policy not to commingle the income and expenses of public utilities with those of nonregulated affiliates lest utility customers end up subsidizing or being subsidized by non-utility operations.

Some public utility commissions would now like to make an exception to this rule with respect to the tax benefits that may result from filing consolidated tax returns. A group of affiliated companies may sometimes reduce its total federal tax liability by filing a consolidated corporate income tax return because, if one group member has losses, a consolidated filing permits the member's losses to be netted against the income of the rest of the group. If the affiliates filed separate returns, restrictions in the tax code might bar much of the loss from being recognized for tax purposes. Of relevance here, suppose an affiliated group contains, among its members, a regulated utility with profits and a nonregulated company suffering losses. Some public utility commissions have suggested allocating to the utility a portion of the tax benefits achieved when the group files a consolidated return on which it nets out the losses of the nonregulated company.

Such an allocation would reduce the utility's federal tax expense for ratemaking purposes and permit public utility commissions to trim utility rates. An alternative regulatory approach is to apply the allocated tax benefits against the utility's rate base. Because the utility's net return is computed as a percentage of its rate base, a smaller rate base would decrease the amount that the utility must be permitted to collect from its customers.

The federal government's involvement in this controversy comes via an indirect route. Taxes play a significant role in public utility rate setting. Beginning in 1969, Congress added to the tax code rules known as normalization requirements, that stipulate how federal tax depreciation allowances are to be handled in public utility ratemaking calculations. The federal government was

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concerned that public utility commissions might order the tax benefits of accelerated depreciation to be passed through to utility customers so quickly that utility operators would receive none of the investment incentives the government hoped to provide by allowing accelerated depreciation of capital assets instead of straight-line depreciation.[1] The normalization rules are intended to prevent that.[2] Although the normalization requirements apply specifically to depreciation allowances, it was generally thought that they placed standards on other parts of the ratemaking process, as well. Perhaps the reasoning was that if utility commissions were constrained only in how they treated federal tax depreciation for ratemaking purposes, they might try to reach the same ends by making other adjustments in their ratemaking calculations so as to have the same effects.

For many years, both utility firms and utility regulators believed that the normalization requirements effectively barred consolidated return tax benefits from being allocated to utilities. A recent state court decision, however, challenged that interpretation. In response, the Internal Revenue Service began studying the matter, and last November, it issued a proposed regulation. The IRS took the position that the normalization requirements prohibit one method of allocating consolidated tax benefits to public utilities but permit another. That satisfied no one and, more to the point, even the IRS soon concluded that its proposal was bereft of legal backing. The problem is that the normalization requirements apply specifically to depreciation; it is unclear how far the rules can be extended to other aspects of the ratemaking process on the ground that the depreciation requirements could otherwise be circumvented.

The IRS withdrew the proposed regulation in early 1991 and asked Congress for guidance. As a result, this issue is now before Congress. The first step was a hearing before the House Ways And Means Committee's Select Revenue Measures Subcommittee in September 1991.

Congressional legislation is desirable, not only to end the confusion but also to avoid inefficiencies and inequities that would occur if regulators assigned consolidated return tax benefits to public utilities. Congress should indicate that federal taxes are to be computed for ratemaking

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[1] It is often thought — incorrectly — that an income tax which permits accelerated depreciation of capital assets subsidizes investment. In reality, accelerated depreciation does not subsidize investment; it merely reduces the bias against investment resulting from the requirement in the law for writing off capital outlays over an extended period of time. To avoid a tax bias against investment, the income tax code should permit investors to claim deductions for the full amount of capital expenditures when they are made. For an explanation of why immediate write off (or its present-value equivalent) is needed to avert a tax bias against investment, see Norman B. Ture and Carlos E. Bonilla, "ACRS, ITC, and Tax Neutrality," *IRET Economic Report* No. 25, January 1985.

[2] The federal tax code does not directly force public utility commissions to obey the normalization rules. However, if utility commission ratemaking procedures do not conform to the requirements, utilities cannot use accelerated depreciation in determining their federal tax liabilities. In the context of how rapidly the benefits of accelerated depreciation should be passed through to ratepayers, it would be pointless for utility commissions to violate the normalization requirements because, if they did, all the benefits to utilities and their customers of accelerated depreciation would evaporate. In general, utility commissions are unlikely to breach the normalization requirements because the loss of accelerated depreciation would be very costly for utilities and, due to the nature of the regulatory process, those costs would soon be passed on to utility customers.

purposes as though public utilities filed separate returns pertaining only to their regulated activities. This should be done not by trying to link the issue to the proper treatment of federal tax depreciation allowances, but as good public policy in its own right.

The allocation of consolidated return tax benefits to public utilities would have many unfortunate consequences. Of direct bearing on the federal tax code, it would impair the current ability of consolidated returns to soften a tax bias against risk taking. It would also interfere with the efficient organization of business activities by creating a regulatory prejudice against consolidated groups with utility subsidiaries. Utility investors would be hurt by lower than expected returns. It might seem that utility customers would gain, but that ignores the dynamic feedback effects arising from the negative investment incentives. Moreover, even if utility users did gain, redistributing income by regulatory fiat from utility producers to utility consumers is not necessarily just.

Some Fundamentals Of Utility Rate Making

State public utility commissions often set the rates that utility operators are allowed to charge for their services. The utility services most likely to be subject to state price controls are electricity, gas, water, and telephone. Rate determination presumably aims to protect consumers from excessive prices while assuring utility producers that their revenues will be sufficient to cover operating expenses and to afford a reasonable after-tax rate of return.

In order to be fair simultaneously to the producers and users of utility services, public utility commissions are supposed to allow utility providers to charge enough to earn a reasonable rate of return after covering their expenses. Besides being equitable, this is a sensible policy because, if their returns were set too low, utility producers could not attract the funds they need to maintain a proper level of services.

To illustrate some basics of rate making, consider a highly simplified example. Suppose a utility has just invested $1,000,000 in a piece of equipment that provides a steady stream of utility services during its life, that will last exactly 40 years, and that has yearly operating costs of $10,000. Also assume the utility commission has determined that a 10 percent after-tax rate of return is reasonable. Finally, assume temporarily that there are no taxes. Looking only at this one investment, how much should the regulatory commission permit the utility to charge?

The utility commission should approve rates that are sufficient to cover three factors. First, it should allow the agreed upon return on the investment. In the first year, the investment adds $1,000,000 to the rate base; a 10 percent return is $100,000. Second, the commission should allow $10,000 to cover operating expenses. Third, recognizing that capital assets eventually wear out or become economically obsolete, the commission should allow for capital recovery. Utility commissions use straight-line depreciation for this latter purpose. If the utility commission assumes the equipment in the example has a 40 year useful life, the yearly capital recovery allowance would be $25,000. According to these numbers, the utility company must be able to charge rates that provide revenues of $135,000 in the first year if it is to meet the expenses associated with the

investment and earn a 10 percent rate of return ($135,000 gross receipts - $10,000 operating expenses - $25,000 capital recovery = $100,000 net return).

In the second year, the rate base of the equipment would be $975,000 because $25,000 of the original investment has been recovered. Thus the charges in the second year can fall to $132,500 ($132,500 receipts - $10,000 operating expenses - $25,000 capital recovery = $97,500 net return on rate base). This process is repeated for succeeding years.

In reality, of course, federal, state, and local governments assess heavy taxes that are a major expense of doing business. Utility commissions must include allowances for tax expenses in ratemaking calculations or utility producers could not earn adequate rates of return.

In the previous example, suppose that just one tax is introduced. Let it be a highly simplified federal corporate income tax that has a 34 percent marginal rate, allows immediate deduction of operating expenses, and requires 40 year, straight-line depreciation of capital assets. Whereas the utility commission previously needed to approve rates that would provide revenues of $135,000 in the first year if the utility was to earn a 10 percent return on its investment, utility rates must now be set so as to yield $186,500. The extra $51,500 would all be needed to pay the tax ($186,500 gross receipts - $10,000 operating expenses - $25,000 capital recovery - $51,500 tax = $100,000 net return).

In the second year, the utility's rate base would be $975,000 after subtracting the prior capital recovery. The utility would need to collect $182,700 in the second year, instead of the previous example's $132,500, to obtain a 10 percent return on its investment ($182,700 receipts - $10,000 operating expenses - $25,000 capital recovery - $50,200 tax = $97,500 net return on rate base). Similar ratemaking calculations apply in ensuing years.

Consolidated Tax Returns

If certain conditions are met, a group of corporations is considered to be affiliated. Two of the main requirements are that the corporations must be domestic and that they must be linked to a parent corporation through stock ownership. (At least 80 percent of the stock of every affiliate must be owned by the parent or by another affiliate linked through stock ownership to the parent.) An affiliated group of corporations may elect to have the parent corporation file a single tax return instead of each filing a separate return.

Consolidated returns are noted for their complexity, but treating the group as one taxpaying entity may have advantages. For example, suppose one member has operating losses, capital losses, or excess tax credits (most likely foreign tax credits these days). On a separate return, these may be carried back or carried forward, but the company cannot use them to reduce taxes for the current year. On a consolidated return, however, the net operating losses (NOLs) of one subsidiary can be netted against the profits of another; the capital losses of one group member can be netted against the capital gains of another; and one member's excess tax credits may perhaps become usable when

the tax code's various limitations on credits are recomputed for the consolidated group. The issue at hand primarily involves consolidated tax benefits associated with NOLs.

For instance, suppose that one affiliate has NOLs of $10 million while another has profits of $30 million. On a consolidated return, the parent corporation computes the net income of the group by subtracting the loss from the profit, leaving it with net income of $20 million. The recognition of the loss reduces the total tax liability of the consolidated group by $3.4 million (at the 34 percent corporate tax rate). This is algebraically (though not legally) equivalent to claiming a $3.4 million refund on the losing subsidiary's $10 million loss and paying a $10.2 million tax bill on the other subsidiary's $30 million profit.

In contrast, suppose that each member corporation files a separate tax return. Because the corporate income tax is nonrefundable, the company with the losses cannot show a negative tax liability in the current year and claim a refund check from the government. To be sure, the losses may be carried back to offset income from prior years or carried forward to offset income from future years, but these options have drawbacks. Losses can generally be netted against income in the prior 3 years and used to claim reimbursement against taxes paid in those years, but this is only useful if the company had income and paid taxes during that period. Losses can generally be carried forward 15 years, but this is only valuable if there is expected to be future income and even then the delay reduces the present value of the tax benefits.

It should be emphasized that the filing of a consolidated return can be said to afford benefits only because of limitations in the tax code on the use of losses and credits to reduce taxes. If the income tax were refundable in the example, total tax liabilities would be exactly the same whether the parent company filed a consolidated return or its subsidiaries filed separate returns. The consolidated return cuts taxes in the example only because it relaxes the limitations so that more of the losing subsidiary's losses can be recognized for tax purposes. When the losses are recognized, they naturally result in a lower tax bill.

It should also be observed that the tax benefits from filing a consolidated return are probably less than $3.4 million in the example. If the losing company had filed a separate return, carrybacks might have allowed it to claim some reimbursement against prior tax payments and carryforwards might let current losses reduce its future taxes. The IRS acknowledged in its since withdrawn regulation that carrybacks and carryforwards would have to be tracked over the years in order to calculate accurately the tax reduction brought about by filing a consolidated return.

Consolidated Returns Combat A Tax Bias

In addition to being helpful to the affiliated groups that use them, consolidated returns lessen a bias against risky investments that is created by the corporate income tax's nonrefundability. This bias causes many risky but rewarding investments to be cast aside in favor of safer but less promising ones. The bias also decreases the total amount of investment that people undertake.

Because these distortions lead to a stodgier, slower-growth economy, consolidated returns benefit everyone when they ease the anti-risk bias.

To explain the bias, suppose that a $50 million investment has equal odds of producing a net, before-tax return of $25 million or losing $10 million. The expected net, before-tax return is $7.5 million (0.5 x $25 million + 0.5 x -$10 million). The expected return on the $50 million investment is 15 percent. This looks like a productive investment, the sort of free-market risk taking that produces a dynamic and vigorous economy. If the corporate income tax were refundable, the tax would reduce the expected net, after-tax return by one-third to a still respectable $4.95 million (a 9.9 percent return). (The government would take 34% of the gain if the project succeeded, but refund 34% of the loss if the project failed. Because of this symmetry, there are even odds of an after-tax gain of $16.5 million or an after-tax loss of $6.6 million.) In contrast, if losses are not refundable (and if the losses cannot be offset against other income), the expected value of the project plunges 57% from its pre-tax value to $3.25 million (a 6.5 percent return). (There are even odds of a $16.5 million after-tax gain or a $10 million loss.) Because of this drastic fall in the investment's expected return, it is much less likely, despite its value, to be undertaken.

Investors will be tempted to stick with less worthwhile, play-it-safe investments. Compare the first investment with a safe but inferior $50 million project that is almost certain to yield $5 million before tax and $3.3 million after-tax. On a before-tax basis, this investment's expected value is only two-thirds as high as the first project's. If the income tax is refundable, it continues to look only two-thirds as attractive. But if the income tax is nonrefundable and if losses cannot be offset in some other manner, the much less worthwhile project will suddenly appear more rewarding than the first and divert funds away from it.

Nonrefundability also acts to lower the total quantity of investment. One reason investment tends to fall is that, with the tax penalty on risk, fewer projects appear sufficiently rewarding to investors on an after-tax basis. Moreover, the after-tax income available for investment would be less, because with lower after-tax returns on their investments due to nonrefundability, the pool of internally generated funds would be smaller. Public utilities, to an even greater degree than many other businesses, rely on these funds to finance their capital outlays. Particularly in times like the present, when lending institutions are constrained by regulations to pursue restrictive loan policies, curtailing internal funds for utilities would significantly limit expansion of their plant and service capacity.

Fortunately, consolidated returns ameliorate this bias, as do the offsets provided by carrybacks and carryforwards. Suppose, for instance, that one member of a group undertakes the risky, high-yield investment described in the example. If other group members are reasonably sure to have income of at least $10 million and if the group files a consolidated return, the loss, should it occur, could be recognized for tax purposes immediately. Because gains and losses are treated symmetrically for tax purposes under these circumstances, the anti-risk bias disappears. In effect, consolidation is equivalent to refundability if income exceeds losses for the group.

The IRS Proposal

For most of the 1980s, the IRS's position was that to comply with the normalization requirements, a utility's tax expense had to be calculated for all ratemaking purposes as though the utility filed a separate return. However, a Pennsylvania state court challenged this interpretation in a 1988 decision, and the IRS reconsidered the issue. In November 1990, the IRS gave notice of a proposed new regulation.[3]

In trying to extend the normalization rules, which center on the timing of depreciation allowances, to consolidated return tax benefits, the IRS decided that it would violate the normalization requirements to allocate these benefits to utilities for the purpose of reducing the tax expense allowance but it would be acceptable to allocate the benefits to utilities for the purpose of reducing the rate base.

According to the proposal "a utility must compute its ratemaking tax expense as if it filed a separate [tax] return...[I]t is inconsistent with normalization for ratemaking tax expense to be reduced on account of the losses of another corporation with which the utility files a consolidated return." In other words, if a public utility's tax bill would have been, say, $10.2 million if it had filed a separate tax return, a public utility commission must permit it a $10.2 million tax expense allowance in its ratemaking calculations; the commission could not reduce the tax expense allowance to below $10.2 million by citing consolidated return tax benefits without running afoul of the normalization requirements.

The proposal went on to say, however, that it would "permit the exclusion from a utility's rate base (or, alternatively, the treatment as no-cost capital) of an amount not in excess of the utility's share of the consolidated tax benefits." In other words, a public utility commission could allocate some of the tax benefits from a consolidated filing to a utility subsidiary and use it to reduce the rate base on which the utility is allowed to earn a return.[4] For instance, if a utility's share of the tax saving on a consolidated return is, say, $2 million according to the allocation formula and if the utility is allowed a 10 percent rate of return, a utility commission could reduce its rate base by up

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[3] The proposed regulation was published in the *Federal Register* of November 27, 1990 and reprinted in *Daily Tax Report*, November 21, 1990.

[4] The IRS attempted to defend its position by drawing an analogy to a rate base adjustment that is permitted under the normalization requirements for the timing difference between straight-line and accelerated depreciation. Without evaluating here whether or not the rate base adjustment for depreciation timing is appropriate, it should be realized that the two cases are fundamentally different. A utility's depreciation allowances arise as a result of its own operations; they involve only the utility and no other businesses. The source of consolidated tax savings is exactly opposite to this. They originate in losses occurring in non-utility businesses; the losses have nothing whatsoever to do with utility operations. Thus, the supposedly analogous cases are not analogous at all.

to $2 million and lower its after-expense return by up to $200,000 yearly.[5] (The utility commission could not, however, reduce the utility's current tax expense allowance by $2 million.)

In present value terms both methods of adjustment would reduce utility returns by the same amount. (At a 10 percent discount rate, $200,000 less in every year has the same present value as $2 million less this year.) Thus, notwithstanding the legal contortions, it is mostly a distinction without a difference in economic terms to proscribe one method but approve the other. The one economic difference is that a reduction in the rate base might be slightly less painful because it would not cause as large a drop in cash flow in the early years. Hence, a utility's ability to finance further investments with internally generated funds would not be diminished as much in the early years under a rate base adjustment.

Another consequence of the IRS proposal, though it should hardly be called a distortion, is that overall federal tax revenues would probably drop slightly. If a utility must charge lower rates because its rate base is reduced, its revenues will be less. This implies that the utility's federal tax liability will also decline. The reduction in overall tax receipts will mainly apply to the share of utility services bought by households. With business purchases, lower utility charges will decrease utilities' taxable incomes but they will also reduce the tax deductible expenses of business customers.

At a public hearing in February 1991, the IRS proposal elicited strong criticism from all sides. Utility representatives charged that the rules conflicted with Congressional intent, previous regulations, and normal practices, while state utility commission representatives complained that the proposals encroached on their authority. The comments convinced the IRS that it could not defend its position. The IRS withdrew the proposed regulation shortly thereafter, saying it would not issue further regulations until it received Congressional guidance.

Biases Resulting From The Allocation Of Consolidated Return Tax Benefits To Public Utilities

The argument on behalf of attributing some of the tax benefits to the utility is, presumably, that they reflect the benefits obtained by the utility from participation in a consolidated group of companies, and these benefits should be passed on to the consumers of the utility's services.

But the argument against allocating tax benefits to the utility is stronger. The losses that give rise to the tax benefits occur in nonregulated companies having nothing to do with utility operations. Although one subsidiary's loss can only be used to reduce taxes on a consolidated return if another subsidiary has income, it is purely incidental if the subsidiary with income happens to be a utility.

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[5] The regulation adopts a complex procedure for apportioning the tax savings. "[A] utility's share of consolidated tax savings is based on a method for allocating the tax liability among members of a consolidated group for purposes of calculating earnings and profits that is provided in sections 1.1502-23(d)(2)(i) and 1.1552-1(a)(2) of the consolidated return regulations."

Attributing some of the tax benefits to the utility would commingle the results of regulated and nonregulated operations. This would contradict a basic principle of utility rate making. Moreover, the commingling would be done in a lopsided manner. The utility would be credited with a share of the tax benefits if a non-utility operation suffered losses, but it would not be allowed to show as a recoverable expense any of the losses on which the lower taxes were based; nor would the utility be charged with a share of the tax expense if the non-utility operation made money.

This inconsistent treatment would poison one of the main benefits that producers may now derive from filing consolidated corporate tax returns, impairing the current ability of consolidated returns to mitigate tax biases against risk taking and investment. As has been explained, the government creates an anti-saving tax bias if it taxes producers when they have gains but denies them refunds when they have losses. Because of restrictions on the deductibility of losses, the government does not give refunds directly, but it does permit several types of offsets that can have a similar effect. Consolidated returns are an important means of accomplishing this when some members of consolidated groups incur losses while others post gains.

The allocation of consolidated return tax benefits to public utilities that happen to belong to the groups would throw a monkey wrench into this process. Although consolidated groups could still obtain tax relief when non-utility members suffered losses, much of the relief would be taken away from the companies and diverted into the hands of utility customers if utility commissions ordered rate reductions.

An example was presented earlier in which a non-utility company was considering an attractive but risky investment that might earn $25 million or lose $10 million. It was shown that if the company had to pay the full tax in the event of a gain but could obtain no refund in the event of a loss, there would be a disproportionate fall in the after-tax expected value of the investment. On the other hand, a consolidated return could provide a tax reduction equivalent to a refund, thereby avoiding the tax bias. But, suppose, as an extreme case, that all of the tax benefits (assumed to be $3.4 million, if possible carrybacks and carryforwards are ignored) are passed to the customers of the utility affiliate by subtracting $3.4 million from the tax expense allowance or rate base used in ratemaking calculations. The effect would be to undo the tax relief provided by the consolidated filing. That is, the consolidated company would be no better off if it had to pass the $3.4 million tax saving to the customers of its utility subsidiary than if it never received the tax saving from the government in the first place. Hence, the penalty for risk taking would return with full force.

More likely, of course, only some of the tax benefits from consolidated return filing would be attributed to the utility. To the extent that any such attribution were made, the utility's profitability would be impaired. The reduction in the rates the utility may charge resulting from the attribution to it of some of the tax benefits from consolidation reduces the utility's earnings without any comparable reduction in its operating or capital costs. This, too, would reduce the value of the tax relief associated with the non-utility company's loss, hence impair the usefulness of the consolidated return filing in offsetting risk.

Another way of viewing the problem is that allocating consolidated tax benefits to public utilities discourages risk taking because of the asymmetry of the allocation. Risk taking would not be penalized by a balanced allocation in which utility customers paid some of the non-utility's tax bill if its investments succeeded and received part of the relief if its projects failed. Needless to say, this balanced allocation is never proposed. And, indeed, it is undesirable because it would make the bills of utility customers depend on the success or failure of ventures having nothing to do with the provision of utility services. The allocation schemes being proposed have this flaw, as well. They would give utility customers a bonus if non-utility business operations suffered losses.

Thus, an unhealthy consequence of allocating consolidated return tax benefits to utilities is that some promising but risky non-utility investments would be passed over. Consolidated groups with utilities among their subsidiaries would look for safer, less adventurous investments. In addition, because fewer investments would be attractive on an after-expense basis, the total quantity of investment would tend to fall.

Another predictable distortion is that consolidated groups would have an artificial incentive not to have public utilities as subsidiaries. In the earlier example, the group could keep the $3.4 million tax reduction if it had no utility subsidiary and if the remaining subsidiaries generated sufficient income against which to offset the $10 million loss. But suppose the group contains a utility and suppose a regulatory commission allocates half the tax saving to it. In effect, the cost to the group of having the public utility as a member would be $1.7 million. This would strongly discriminate against consolidated groups that happen to have public utilities as members. As a matter of public policy, it is not clear that it is either efficient or fair to handicap consolidated groups with utility subsidiaries relative to other consolidated groups.

Keeping public utilities out of consolidated groups would be easiest if the utilities are not already members. Groups with public utilities might investigate spinning them off, but that is apt to be complicated and expensive.

The reason this distortion is inefficient is that it would interfere with the productive organization of business activities. In some cases it may simply be convenient for one reason or another to have utilities and non-utilities belonging to the same group. In other cases the expertise acquired in running one business may be carried over into the more efficient operation of another business.

In addition, business organizations often enter diverse fields in order better to control their risks. The idea is the simple but sound one of not putting all your eggs in the same basket. For instance, a consolidated group might balance a highly cyclical nonregulated subsidiary against a relatively noncyclical public utility subsidiary. Thus, risk taking will be discouraged on two fronts if consolidated return tax benefits are allocated to utilities. As mentioned previously, consolidated groups with utility subsidiaries will shy away from risk because of the regulatory penalty. Beyond that, business organizations that decide not to own utility subsidiaries because of the regulatory deterrent will often lose some of their ability to manage risk through diversification and, therefore, will shun risky but promising ventures they would otherwise be capable of undertaking.

Although people who invest in and work for utilities would lose if some of the consolidated return tax benefits were allocated to the utilities, wouldn't utility customers, both businesses and households, win? If people ignored incentives, that would be true enough. But, in reality, people pay very close attention to incentives. In their role as savers and investors, people would be reluctant to invest in utilities as a result of what they perceived to be a threatening regulatory stance.

Because of those perverse investment effects, trying to save money for utility customers by allocating consolidated return tax benefits to them is likely to backfire. Many potential investors would take an allocation rule as a signal that the investment climate has just become chillier. With the overturning of one established rule, they would wonder what other unpleasant surprises might be in store for them. For example, they might fear that this would be the first step in a general weakening of the normalization requirements. Investors would probably not be willing to pay as much when utilities tried to raise money by issuing stock. Perhaps they would demand higher interest rates before buying utility debt. As a result, the cost of funds would be higher and that would tend to drive utility rates back up.

If public utility commissions stubbornly refused to permit rate increases, utilities could not obtain as much financing as before. Utility financing would also tend to fall because utilities would be generating less internally due to the lower rate schedules resulting from reduced tax expense allowances or lower rate bases. (As explained earlier, this problem would be somewhat less severe in the early years if utility commissions reduced rate bases instead of cutting tax expense allowances.) Businesses often prefer internal to outside financing. With less financing, utilities would have to scale back their capital and operating expenditures. That would cause some deterioration in their provision of services. For instance, they might reduce their planned capital expenditures, compromising their ability to meet future demand. As another example, they might cut back on maintenance, increasing the number of service breakdowns.

To be sure, it would probably take time for rates to increase again and for service to deteriorate. Thus current consumers would obtain most of the advantages from temporarily lower rates while future consumers would face most of the problems. The intergenerational transfer among consumers raises the equity question of whether it is fair to benefit current consumers at the expense of future ones.

Moreover, fairness should not be judged solely in terms of utility users. Isn't unfair to producers to mix together in ratemaking calculations regulated and nonregulated operations in an uneven manner that can only reduce investment returns?

Conclusion

Regardless of the legalities, allocating consolidated return tax benefits to utilities would be inefficient and of questionable fairness. With regard to efficiency, the ability of consolidated returns to reduce the tax bias against risk would be undercut if consolidated return tax benefits were allocated to utilities. As a result, some risky but promising non-utility ventures would be rejected.

Utility investments would tend to be discouraged also because the allocation would probably increase the perceived riskiness of the regulatory climate. In addition, the allocation would tend to distort the organization of business activity by creating an incentive to exclude public utilities from affiliated groups.

The fairness of the allocation is also suspect. When a non-utility member of a consolidated group also containing a utility suffers losses, why should much of the tax relief effectively be diverted into the hands of utility customers who were not associated with the losing company and bore none of its risks?

There is much to be said, in the abstract, for minimizing interference by the federal government in the work of state public utility regulators. In this case, however, there is a need to insure that in their ratemaking activity, public utility commissions do not frustrate the results sought by the consolidated return provisions in the federal income tax. Congress should legislate guidance for the Internal Revenue Service and for utility firms and public utility commissions to insure that the tax benefits that may be obtained by filing consolidated returns are not used to reduce either a utility's tax expense or its capital base for ratemaking purposes. Moreover, the legislation should not seek merely to codify an extension of the normalization rules to the consolidated return situation, but should establish that the soundness of these results rests on more general and fundamental principles of public utility regulation.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.