

STATEMENT OF WILLIAM A. PASCOE  
BEFORE THE  
SENATE FINANCE COMMITTEE

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The Role of Tax Incentives in Addressing Rural Energy Needs and Energy  
Conservation

Introduction

I am Bill Pascoe, Vice President of Energy Supply for The Montana Power Company. Montana Power serves more than 280,000 electric customers and more than 140,000 natural gas customers in one the largest utility service territories in the United States, covering most of the western two-thirds of the state of Montana. To serve these customers MPC owns and maintains more than 22,000 miles of electric transmission and distribution lines and more than 6,000 miles of natural gas pipelines. In many ways, MPC is typical of utilities serving rural areas throughout the Great Plains and Rocky Mountain States.

Until last March I served as MPC's Vice President of Transmission Services. In that capacity, I was actively involved in efforts to form a regional transmission organization (RTO) for the Pacific Northwest. Prior to taking on my new responsibilities at MPC, I served as the Chairman of RTO West, a non-profit corporation formed by Northwest utilities to foster the formation of an RTO for the region. I currently serve as the Vice Chair of the Western Systems Coordinating Council (WSCC), the industry organization charged with maintaining the reliability of the bulk power grid in the Western U.S. and Canada.

Incentives for RTOs and Transmission Investments

Based on my experience in regional transmission matters, I believe certain tax reforms are necessary to insure that the regional transmission organizations (RTOs) sought by FERC are successfully formed and that necessary new investments are made in transmission systems throughout the United States. The appropriate tax measures are included in the Electricity Tax Agreement reached by the Edison Electric Institute (EEI), the American Public Power Association (APPA) and the Large Public Power Council (LPPC). This agreement, representing a consensus between investor-owned utilities and public power utilities, is included as Sections 957, 958, 959 and 962 of S. 389, the "National Energy Security Act of 2001", introduced earlier this year by Senators Murkowski, Breaux and Lott. Most of these provisions were included in H.R. 4, "Securing America's Future Energy Act of 2001" which was passed by the House in July.

S. 389 includes necessary reforms to private use restrictions allowing public power utilities to participate in RTOs without risking their tax-exempt status. Although these provisions of the bill focus on municipal utilities, MPC and EEI support equivalent provisions included in H.R. 4 that would encourage rural electric cooperatives to participate in RTOs. Because RTOs will work most effectively if they are inclusive and cover large, contiguous geographic areas, it is essential that public power utilities,

including municipals and cooperatives, choose to participate. Without the private use reforms included in The Act, this participation is unlikely to occur.

Although RTOs will improve the efficiency and reliability of transmission grids, some RTOs, including RTO West, will not be structured to raise capital for new investments in the grid. Capital for these improvements must come from the members of the RTO who will own the transmission facilities controlled by the RTO. I believe that the restructuring of the electricity industry has significantly diminished the enthusiasm of these utilities for making new investments in transmission.

In the past, vertically integrated utilities willingly invested in transmission lines as part of an overall strategy to provide low cost power for their customers. These transmission lines connected new sources of remote generation to the utilities' load centers, allowed the utilities to arrange for emergency assistance with neighboring systems, and provided opportunities for wholesale power purchases and sales. In short, these transmission investments were attractive because they provided strategic opportunities for the utilities' generation and bulk power marketing activities.

However, with the passage of the 1992 Energy Policy Act and FERC Order 888, utilities were required to offer open access to transmission lines and the strategic power supply advantages of transmission ownership were eliminated. Open access has provided a more competitive wholesale generation market with significant benefits for consumers, but it has fundamentally changed the incentives for new transmission investments. Transmission investments now must stand on their own, and must provide sufficient returns to attract capital.

As the electricity industry restructures, most utilities have chosen to focus on the generation or distribution segments of the business and transmission investments have diminished accordingly. The result is an increasingly congested and less reliable grid. This is in stark contrast to the natural gas industry where companies compete vigorously to construct new pipeline capacity connecting producing regions to consuming areas. So why the different levels of enthusiasm for transmission investment? I think the reason is obvious. In the electric industry most transmission lines are owned by vertically integrated utilities more interested in the generation and distribution segments. In the natural gas industry, most transmission lines are owned by interstate pipeline companies seeking profitable opportunities to invest in the transmission business.

There has been significant discussion about the formation of independent electric transmission companies (Transcos) that would be similar to the interstate pipeline companies. Transcos would focus on the electric transmission business and actively seek opportunities to invest in the grid. However, there are significant adverse tax consequences for vertically integrated utilities that want to transfer their transmission assets to Transcos.

S. 389 eliminates tax impediments to Transcos in two key areas. First, if a utility sells its transmission system to a Transco, the taxes on the sale may be deferred as long as the proceeds are reinvested in other energy assets. This is similar to the way in which the gain on the sale of a house is deferred as long as the proceeds of the sale are reinvested in another house. Second, if a utility forms a separate transmission company and "spins" this company to its shareholders, this new transmission company can be consolidated with similar transmission companies without the risk of adverse tax consequences for the "spinning" utility. In each case, the tax

impediments would be removed only if the resulting Transco is part of a FERC-approved RTO.

In order to foster the development of stand-alone transmission companies that will actively pursue opportunities to invest in transmission infrastructure, these reforms must be adopted.

#### Contributions in Aid of Construction (CIACs)

The bill also removes the current tax penalties levied on customers that provide construction funds to utilities for new transmission and distribution facilities. Referred to as Contributions In Aid of Construction (CIACs), these capital advances are treated as operating revenues by the Internal Revenue Service and taxed as ordinary income rather than being treated as an offset to the cost basis of the constructed property. Utilities are left with little choice but to add a significant carrying charge, in MPC's case 33%, to these advance payments to cover the cost of the taxes. What the IRS collects as a tax from utilities in effect becomes a direct tax on consumers. I can tell you from personal experience that the CIAC tax adder is a significant source of frustration for utility customers, especially in rural areas where a customer may already be faced with significant costs to attach to the nearest utility lines.

#### Incentives for Renewable Energy

MPC also supports tax incentives for renewables energy sources and for energy efficiency. In this area, my comments will focus on production credits for wind power.

Although Montana has great potential for wind power, little development has occurred to date. However, as wind turbine technology has improved and manufacturing costs have declined, wind power has reached the point where it is cost-competitive with traditional forms of generation, assuming the current production tax credits are renewed.

MPC has announced its intention to purchase 150 MW of power from wind turbines, heralding the beginning of commercial scale wind power development in Montana. We have received a number of excellent proposals and are in the process of selecting the projects that will be offered contracts. These projects meet our cost criteria assuming current tax incentives remain in place. However, if the production credits are not renewed, MPC will not be able to proceed with these projects.

Government incentives have brought wind power to the verge of commercial deployment in Montana and neighboring states. Now is not the time to change course.

#### Summary

Thank you for the opportunity to appear before the Committee to offer MPC's views on these important matters. Properly structured tax legislation, as described above, can help to address critical energy infrastructure needs in rural areas.