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Report to the Honorable Byron L. Dorgan, House of Representatives

December 1987

PUBLIC UTILITIES

Information on the Cash Position of the Electric Utility Industry

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GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

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December 30, 1987

The Honorable Byron L. Dorgan
House of Representatives

Dear Mr. Dorgan:

In your letter of July 13, 1987, you asked that we examine the financial position of the public utility industries (electric, natural gas, and telephone). In particular, you expressed interest in the apparent improvement in the industries' level of available cash and whether this improved cash position would facilitate the ability of utilities to "return" to utility ratepayers excess deferred taxes resulting from the Tax Reform Act of 1986 in a time period shorter than that provided for in the act.[1] In subsequent meetings with your office, we agreed to develop historical trend information on the utility industries' cash availability and offer any comments or observations on these trends as well as the potential impacts on the industry of returning excess deferred taxes in a shorter time period (referred to as flow-through). Your office indicated that our work should initially focus on the electric utility industry.

This report provides the results of our analysis of cash availability in the electric utility industry for the 1976-85 period and offers some preliminary views on the flow-through of excess deferred taxes. Our analysis of cash availability in the natural gas and telephone industries is continuing and will be reported to you separately.

In summary, our work showed that the electric utility industry's level of cash availability in the aggregate had improved from the late 1970s through 1985. We found that the industry's current and quick ratios[2] had improved, the industry's cash availability after major obligations have been met had increased, and the percentage of total cash provided from internal operations had increased relative to cash obtained through

[1]One provision of the Tax Reform Act of 1986 was to reduce the corporate tax rate. One effect of this change was to create an excess amount of taxes that had been collected from utility ratepayers but had been deferred for future payment to the Treasury. Under the act, the excess, referred to as excess deferred taxes, is to be returned to utility ratepayers through a normalization approach. The time period for accomplishing the return is associated with the remaining life of utility assets, which, in the case of coal and nuclear power plants, can be up to 30 years.

[2]The current ratio and quick ratio have been traditional measures of a company's ability to meet its short-term obligations. The current ratio represents a company's current assets divided by current liabilities. The quick ratio represents a company's liquid assets (cash, current receivables, short-term investments, etc.) divided by its current liabilities.

long-term borrowings and stock sales. Our overall review of changes in the industry's use of cash showed that, on a relative basis, cash devoted to construction had decreased while cash used to retire long-term debt and pay dividends had increased.

With respect to the financial impact on electric utilities of the flow-through approach to excess deferred taxes, individual utility financial situations would have to be considered. The flow-through approach would shorten the allowable time period utilities would have for "returning" the excess deferred taxes to ratepayers, thus increasing the financial impact on utilities in the near-term. We did not assess the relative merits of accomplishing the return under alternative time periods. Our limited examination of financial data for selected individual utilities with significant amounts of excess deferred taxes showed that their financial situations varied widely. This variability suggests the importance of examining an individual utility's financial situation when considering the flow-through option.

Cash Availability in the Electric Utility Industry

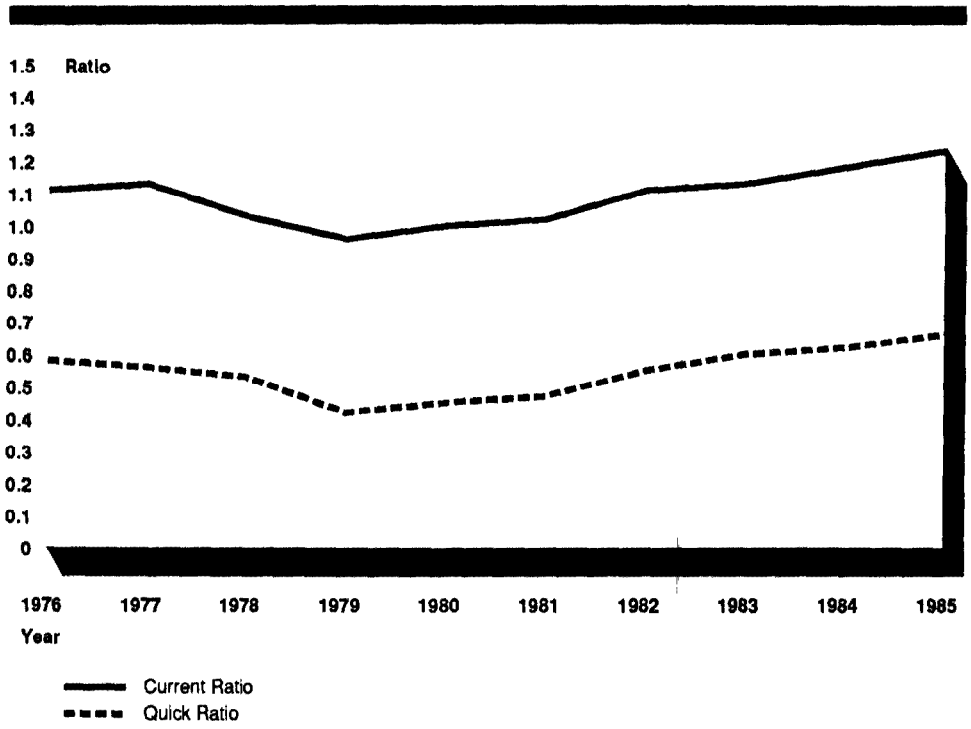
To measure trends in the electric utility industry's cash availability, we examined aggregate industry year-end financial data for the period 1976-85.[3] More specifically, we computed (1) the industry's current and quick ratio for each of these years, (2) the industry's cash flow, and (3) the percentage of total cash provided from internal operations relative to cash obtained from primary external sources, i.e., long-term borrowings and stock sales. We computed the current and quick ratios because these measures have often been used to examine changes in financial position. We examined cash flow because this measure of change in financial position had been recently supported by the Financial Accounting Standards Board. We examined the relative levels of internal and external sources of cash because the electric utility industry had experienced a major period of construction activity requiring significant amounts of externally raised cash.

The electric utility industry's current and quick ratios for the period 1976-85 are shown in figure 1. As figure 1 shows, in 1976 the industry's current ratio was 1.11; it declined to 0.96 in 1979 and then gradually increased to 1.23 in 1985. Similarly, the quick ratio was 0.58 in 1976; it declined to 0.42 in 1979 and gradually increased to 0.66 in 1985. These

[3]Financial data for electric utilities are compiled and aggregated annually by the Energy Information Administration (EIA). Aggregated data for 1985 were the most recent data readily available. Figures 1 through 4 were prepared by GAO on the basis of the EIA data.

overall trends indicate that since 1979, the industry's ability to meet its short term obligations had improved.

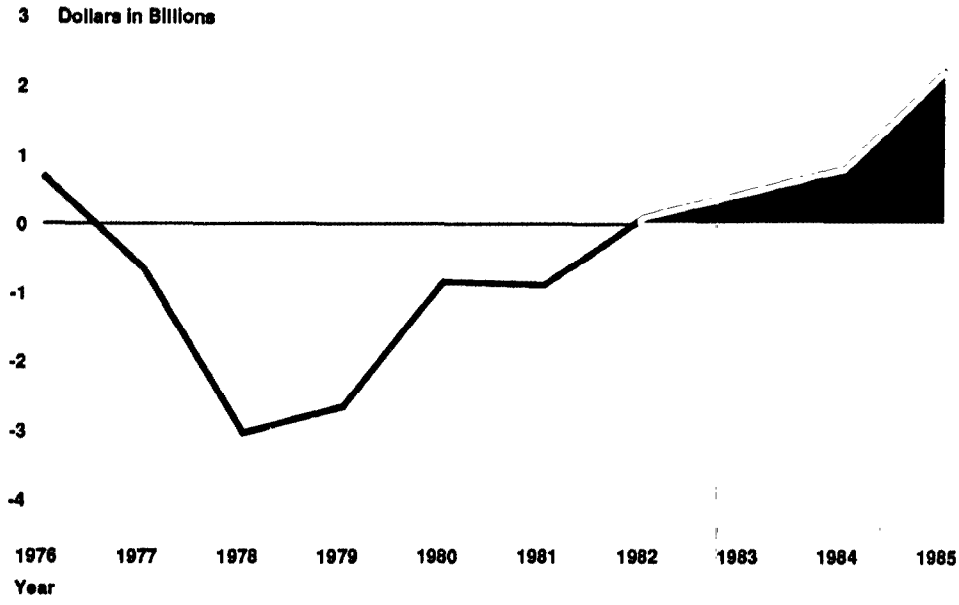
Figure 1: Current and Quick Ratios for the Electric Utility Industry, 1976-85



The electric utility industry's cash flow (major sources of cash less cash payments for major uses[4]) is shown in figure 2. In 1976 the industry had a positive cash flow of about $695 million; in 1978 the industry had a negative cash flow of about $3.0 billion; but by 1985 the industry's cash flow had improved to a positive level of $2.2 billion.

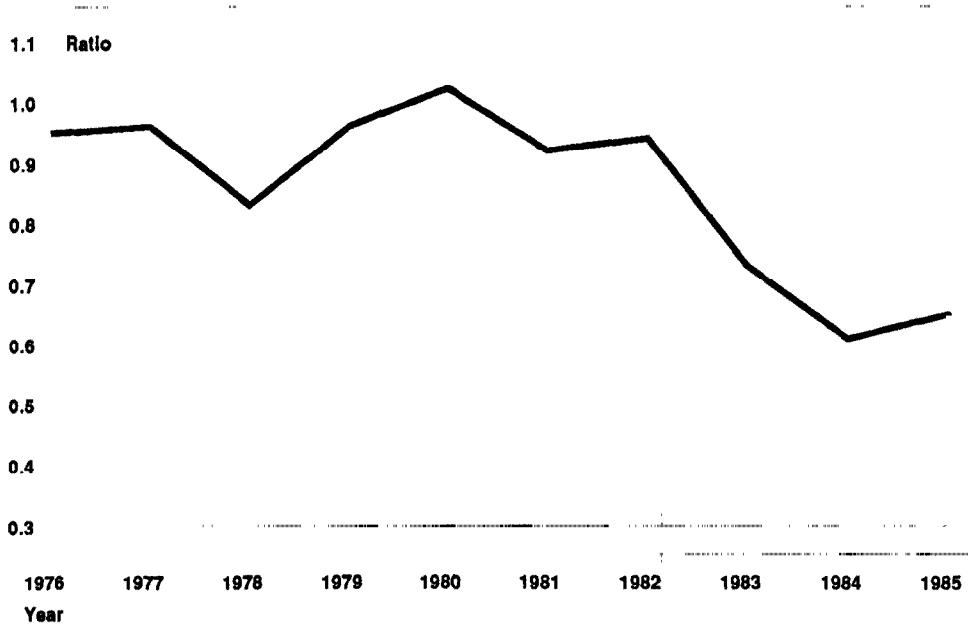
[4]Major sources of cash include cash from operations, long-term borrowings, and stock sales. Major uses of cash include construction, retirement of long-term debt, and dividends.

Figure 2: Cash Flow of the Electric Utility Industry, 1976-85



The trends in the electric utility industry's net cash from operations relative to cash obtained through borrowings and stock sales is shown in figure 3. In 1976 the ratio of external sources of cash to internal sources was 0.95 and by 1980 this ratio had increased to about 1.02, the highest point during the 10-year period. However, by 1985 this ratio had fallen to a level of 0.65, indicating that the amount of cash from internal sources contributed a greater share of the industry's total cash available.

Figure 3: External to Internal Cash for the Electric Utility Industry, 1976-85



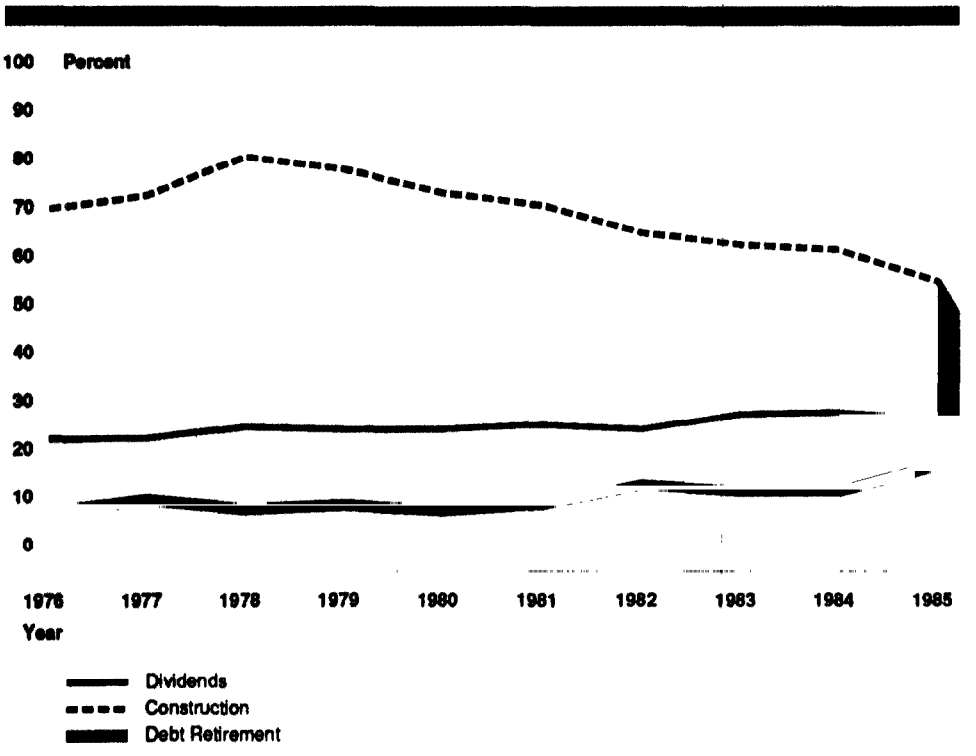
Taken together, the above results indicate that between 1976 and 1985 the electric utility industry's cash situation generally declined through the late 1970s. However, in more recent years the cash situation has improved as the industry overall appeared better able to meet its short-term obligations, had experienced an increasing level of positive cash flow, and was realizing a greater share of its total cash available from internal operations.

Use of Cash in the Electric Utility Industry

To supplement our examination of cash availability, we also examined selected financial data that would indicate whether and how the electric utility industry's use of available cash from major sources had changed during the 1976-85 time period. We made this examination because the 1976-early 1980s time period was characterized by significant construction of higher-cost generation facilities, whereas in more recent years the level of plant construction activity had appeared to level off. Specific data we examined included expenditures for construction, long-term debt retirement, and dividends. According to the industry aggregate source-and-use-of-funds statements, these three uses of cash represented between 96 percent and 110 percent of total cash from major sources during the period.

Figure 4 shows trends in the electric utility industry's use of cash as a percent of major cash sources between 1976 and 1985.

Figure 4: Uses of Cash by the Electric Utility Industry, 1976-85



As shown in figure 4, in 1976 cash used by the industry for construction represented over 69 percent of total available cash from major sources. This percentage increased to about 80 percent in 1978 and then gradually decreased to a level of about 54 percent by 1985.

With respect to the retirement of long-term debt, in 1976 over 6 percent of cash was used to retire such debt. Between 1976 and 1981, this percentage varied between 6.4 percent and 8.8 percent. In 1982 this percentage increased to about 12 percent, then dropped to about 10.6 percent for the years 1983 and 1984, and increased to over 16 percent in 1985.

In paying dividends in 1976 and 1977, the industry used over 21.5 percent of its cash from major sources. Between 1978 and 1982, this percentage varied between 23.4 percent and 24.4 percent, and for the years 1983 through 1985 it varied between 25.7 percent and about 27 percent.

The above trends in the electric utility industry's major uses of cash show that the percent of cash used for construction has significantly decreased in recent years, the percent of cash used to retire long-term debt has more than doubled since 1981, and the total of the three major uses of cash, as a percent of total major sources of cash, is less in 1985 than in any year of the 1976-85 period.

Flow-Through of Excess Deferred Taxes

As a result of the Tax Reform Act of 1986, cash collected by electric utilities in prior years to meet future tax obligations (deferred taxes) became excess because of the 1986 act's change in the corporate income tax rate. In the aggregate, the amount of excess deferred taxes for the electric utility industry, according to the National Association of Regulatory Utility Commissioners, was about $10 billion as of the end of 1986. Under the act, these excess deferred taxes are to be "returned" to ratepayers.

In general, both the normalization approach (the approach, in effect, required under the tax act) and a flow-through approach (an alternative) could accomplish the return of the excess by reducing the annual amount of sales revenue collected from ratepayers below that amount that otherwise would be collected on the basis of utility costs. The basic difference in the two approaches is the length of the time period over which the excess is returned: the normalization approach generally providing up to a 30-year period and the flow-through approach providing a shorter period, such as 10 years, 5 years, 3 years, or 1 year. While both approaches result in utilities' financing a portion of their annual operations (equal to the "return" amount) with cash from sources other than sales revenues, the flow-through approach creates a larger annual supplemental cash requirement since the return of the excess deferred taxes occurs over a shorter time period.

When viewing electric utility industry financial data in the aggregate, it would appear that some utilities may be in a financial position to return excess deferred taxes in less than 30 years, depending upon the length of the flow-through period, without significant adverse financial impacts. For example, in 1985, as discussed above, the industry had an aggregate positive cash flow of about $2.2 billion (the highest level

experienced in the 10-year period 1976-1985). This suggests that the industry, overall, had a level of cash that could potentially be used to offset reduced sales revenues resulting from a flow-through of excess deferred taxes.

We also performed a limited review of 1985 and 1986[5] financial data for selected individual utilities to compute their respective cash flow positions. Financial data we reviewed were from the eight utilities that had an excess deferred tax amount of $250 million or greater. Our review was performed to compare, for each utility, the dollar value of its cash flow position with its respective amount of excess deferred taxes. The results are shown in table 1.

Table 1: Selected Financial Data for Eight Electric Utilities

Dollars in millions

Company	Amount of excess deferred taxes	Cash flow position, 1985	Cash flow position, 1986
A	$310.1	$15.9	$(69.2)
B	530.7	(128.1)	(96.2)
C	303.3	(568.4)	(563.3)
D	379.7	47.6	121.6
E	429.1	254.6	(538.1)
F	367.8	341.0	(212.1)
G	275.9	95.4	14.4
H	255.9	2.0	191.9

Source: Prepared by GAO on the basis of information compiled by the National Association of Regulatory Utility Commissioners, the Energy Information Administration, and the Federal Energy Regulatory Commission.

As table 1 shows, the cash situations of individual utilities, based on the measure we applied, varied widely relative to one another as well as from 1985 to 1986. When viewed in the context of each company's amount of excess deferred taxes, a question arises as to whether some of these particular utilities were in a financial position to accomplish a flow-through of excess deferred taxes without significant financial impacts, particularly if the flow-through period was relatively short.

In assessing the flow-through option, the length of the flow-through period examined is critical for determining financial impacts. For example, the industry's 1985 $2.2 billion cash flow would not appear to support a 1-year flow-through of excess deferred taxes (amounting to about

[5]Financial data for 1986 for individual utilities was obtained from the Federal Energy Regulatory Commission Form 1.

$10 billion) without significantly affecting the industry's financial situation. As the flow-through period lengthens, however, one could expect a decreasing impact on the industry's situation.

Observations

On the basis of our examination of aggregate financial information from the electric utility industry, it appears that the cash position of the industry had improved through 1985. The extent that the industry's improving cash position is continuing, however, is uncertain. Future utility decisions, particularly with regard to the construction of new power facilities, could result in a reduction in the cash available to utilities.

With respect to the aggregate cash position of the industry and the issue of normalization vs. flow-through of excess deferred taxes, while the industry's aggregate 1985 cash position appeared to suggest that flow-through of excess deferred taxes may be a viable option for some utilities, our limited examination of utilities with large excess deferred tax amounts showed that the cash position of individual utilities varies widely. Thus, consideration of the flow-through option should be based on individual utility financial positions as well as the time period in which the flow-through would take place.

Our work was based on an examination of financial data reported by electric utilities to the Federal Energy Regulatory Commission between the years 1976 and 1985 and compiled by the Energy Information Administration. Our review was performed in accordance with generally accepted government auditing standards except that we did not verify the accuracy of the data reviewed. Our work was conducted between August and November 1987.

We plan no further distribution of this report but will make copies available to interested parties on request.

Major contributors to this report are listed in appendix I.

Sincerely yours,

Keith O. Fultz

Keith O. Fultz
Associate Director

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