



Insight

Implications for Regulated Utilities under the House Blueprint for Tax Reform

GORDON GRAY | MARCH 22, 2017

One of the most compelling reasons for pursuing fundamental tax reform is the need to reduce the U.S.'s outsized corporate tax rate. Among the most attractive elements of the House Blueprint for Tax Reform is therefore its low rate of 20 percent. For regulated utilities, and unlike competitive firms, this central component may appear irrelevant as any rate reduction will be passed along to ratepayers. Despite this appearance, rate reduction does give rise to important tax considerations for regulated utilities, as well as other elements of the Blueprint, particularly with respect to expensing of investment and the denial of interest expense. This brief evaluates those tax considerations for regulated utilities.

Regulated utilities are allowed by their local regulator to earn a rate of return on their rate base, which reflects the utilities' investment in property, plant, and equipment. In determining this rate base, utilities subtract from the value of their PP&E the value of deferred tax liabilities that arise from the difference in how utilities report income for rate-setting purposes and for tax purposes. For rate-setting purposes, utilities use straight-line depreciation of investments, while the current tax code allows for accelerated depreciation. This creates a difference in the value of tax expenses calculated for regulatory and rate-setting purposes and actual tax payments. For a new investment, tax expense for rate-setting purposes would exceed tax payments early in the investment due to investment incentives in the tax code, but would fall below tax payments later in the life of the investment. The calculated tax expense and tax payments are equal in nominal terms over the life of the investment. During the period when the calculated tax expense exceeds the actual tax payments, regulated utilities accumulate deferred tax liabilities on their books, which are subtracted from their net PP&E to determine the rate base on which these utilities may earn a regulated return.

A reduction in the corporate tax rate would affect the value and disposition of these liabilities. A reduction in the corporate rate would diminish actual future tax liabilities. Accordingly, a portion of a utility's existing deferred tax liabilities would exceed the value of future tax payments under the new lower rate. For regulated entities, these excess tax liabilities would be returned to ratepayers through lower rates. This process can be rapid, which is known the "flow through" approach, or it can be "normalized," whereby the excess is returned to ratepayers over the life of the investment. The relative merits of these approaches is beyond the scope this analysis, but it is worth noting that the following the 1986 reduction in corporate tax rates, Congress allowed for excess tax liabilities to be returned to ratepayers through normalization.

Beyond the immediate effects on a utility's deferred tax liabilities, a reduction in corporate tax rates, all else

being equal, reduce deferred tax liabilities going forward. To the extent that these liabilities against the rate base on which utilities may earn a regulated rate of return, a reduction in the corporate rate should increase regulated utilities' earnings. There are, however, countervailing elements of the House Blueprint that would suppress earnings or contribute to rate increases.

The House Blueprint would move the U.S. tax code to a destination-based cash flow tax, whereby investment is expensed in the first year. For regulated utilities, this would substantially increase deferred tax liabilities relative to current law. Even including the lower 20 percent rate, the House Blueprint would *increase* the value of a deferred tax liability for new investment for regulated utilities.^[1] This increase would slow rate base growth, and diminish earnings.

For budgetary and economic reasons, specifically to ensure neutrality between debt and equity-financed investment, the House Blueprint would deny the deductibility of interest. For regulated utilities, which are capital intensive and have an average capital structure that is 50/50 split between debt and equity, this would materially affect the cost of capital.^[2] As a recoverable expense, this would be passed on to ratepayers. However, given the long asset lives of utility investment, the effects of this new costs would be gradual. Moreover, one estimate of the net effects of the House Blueprint would be to improve, on average, the utility sectors' cash flow, which would have a salutary effect on the incremental increase in cost from debt-finance.^[3] However, separate analysis from Moody's finds that regulated-entities would be adversely effected by the House Blueprint.^[4]

This brief evaluated how the Blueprint would affect regulated utilities overall. In general, the implications are mixed, but relative to other sectors, regulated utilities likely stand to benefit less than the private sector in general. Some utilities would likely benefit while others would not, depending on circumstances that prevail across the industry and those unique to the individual utility. Separate from this specific analysis is consideration of how these entities, their shareholders, and ratepayers would benefit from stronger overall economic growth that the House Blueprint would help generate.

[1] <http://www.ssrlc.com/publication/how-will-the-trump-and-gop-tax-plans-impact-rate-base-growth-the-opportunity-and-risk-facing-utility-investors/>

[2] <https://www.finance.senate.gov/imo/media/doc/EEI1.pdf>

[3] <http://www.ssrlc.com/publication/how-will-the-trump-and-gop-tax-plans-impact-rate-base-growth-the-opportunity-and-risk-facing-utility-investors/>

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https://www.moodys.com/research/Moodys-Potential-US-tax-policy-reform-could-be-credit-negative-PR_363590?WT.mc_id=AM~WWFob29fRmluYW5jZV9TQl9SYXRpbmcgTmV3c19BbGxfRW5n~2017031