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Tax Reform and the Regulated Distribution Utility: A Regulatory Summary

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While the Tax Cuts and Jobs Act ("TCJA") enacted December 22, 2017, has been a boon for the broader corporate sector, for the regulated distribution utility which recovers the cost of corporate taxes in its allowed revenue requirement, it is a cash-flow and credit negative. Utility credit profiles have suffered from the lower operating cash flows associated with the corporate tax rate reduction from 35% to 21%, but also from the past over-collection of future income taxes which now must be returned to customers. Other features of the law eliminate bonus depreciation for utilities, which has historically allowed utilities to defer substantial accumulated tax balances. Alternately, it has also allowed utilities to retain full deductibility of corporate interest expense which under the law is limited for the broader corporate sector. Regulated utilities' revenue requirements are now exposed to substantial potential reductions, which will reduce cash flows and strain credit metrics, and in many cases, credit ratings. Though the TCJA will ultimately benefit ratepayers and will create valuable headroom for utilities, without active credit profile management regulated utilities could incur negative cash flow and credit outcomes.

Overview of Tax Implications

Because taxable utilities are capital intensive companies with substantial depreciable assets, they have historically incurred large deferred tax liabilities for timing differences arising from accelerated depreciation allowed by the tax code and book depreciation expense. The utility receives revenue recovery in its authorized revenue requirement at a rate equivalent to the statutory tax rate applied to income. However, a significant portion of the statutory tax liability may be deferred and actual taxes the utility pays are often significantly less. The deferred tax liability captures the cumulative differences between book and tax deductions and is unwound over the life of the assets that generated the timing difference. Because the revenue requirement provides an earnings stream to compensate for taxes on a book basis, the amount of tax that is deferred in a liability provides additional funds to the taxable company in the early years of an asset that will later be required to meet future tax expenses ratably over the remaining life of the asset. As a result, regulated utilities have historically benefitted by carrying large accumulated deferred income tax liabilities ("ADIT"), which contribute to operating cash flows and are typically carried as no-cost capital. Moody's estimates that roughly 13% of the sector's funds from operations have historically been comprised of these deferred tax benefits.

With the new tax law, not only are regulated utilities bringing in less cash due the effect of the lower tax rate in its cost of service (i.e., recovering tax expense at a rate of 21% rather than 35%), they also have significant deferred tax balances, representing over-collected future taxes based on the higher rate, which must be dealt with. Lower tax rates will also slow the recognition of future tax benefits, such as NOLs and tax credits. The rate with which overstated deferred liabilities are refunded to customers will have significant credit implications for utilities. Regulatory Research Associates, an offering of S&P Global Market Intelligence, estimates that $91.4 billion of excess deferred income taxes ("EDIT", approximately 43% of 2017's deferred tax liability balance) will be returned to ratepayers nationwide. This averages roughly $1.7 billion of EDIT per regulated investor-owned utility.

Normalization Rules require that EDIT that arises from differences between federal tax and book depreciation or tax credits is "protected." This is also known as the "average rate assumption" method and requires that EDIT is used to reduce revenue requirements no quicker than would occur from the reversal of book/tax differences in accordance with the original amortization schedule. Any reduction in revenue requirements quicker than this method would be a normalization violation. All other federal timing differences which result in a deferred tax liability, are not protected by the IRS normalization rules, and the rate at which these excess balances are returned to ratepayers are at the discretion of the regulator.

Credit Impacts and Tools for Mitigation

According to the credit rating agencies, companies on the cusp of a downgrade, depending on their tax position, may find themselves downgraded as a result of the change in tax law. On June 18, 2018, Moody's downgraded the outlook on the regulated utility sector to "negative," citing lower cash flows and higher debt levels as federal tax reform and increased capital spending continued to weigh on the sector. This follows a January 2018 downgrade by Moody's of the ratings outlook on 25 U.S. utilities, which cited weaker cash flows due to tax reform. Moody's estimates that the tax law changes have reduced the average utility's ratio of cash flow (before changes in working capital) to debt by approximately 150 to 250 basis points. Under Moody's rating methodology, a low-risk utility generally requires this ratio to be in excess of 19% for an A rating, and in excess of 11% for a Baa rating. Holding companies are equally at risk for downgrades due to reduced operating cash flows from utility subsidiaries coupled with their typically more-highly-leveraged holding company balance sheets.

It is expected that utilities will manage the financial implications of tax reform through regulatory channels. To the extent that the utility credit profile cannot absorb the rate of refund to ratepayers, it will need to replace what is essentially no-cost capital with what will likely be some combination of debt and equity, or find other creative approaches to pass on tax savings to customers. This will certainly be a negotiated outcome between the utilities and their regulators that preserves the credit quality of the utility.

In practice, we have observed that the general response among utilities and regulators has been to transfer the EDIT from the deferred tax liability balance to a regulatory liability account. The protected portion of the EDIT is amortized in accordance with IRS normalization rules (the remaining useful life of the asset.) The unprotected portion has typically been amortized over an abbreviated period of five to ten years. However, there are some interesting and creative regulatory responses that are notable.

Recent Notable Regulatory Actions

In November 2017, the Duke Energy Florida, LLC settlement provided that 40% of the revenue requirement impact (up to $50 million pre-tax) would be retained to accelerate depreciation of legacy coal assets. It was reasoned that this would provide regulators the option to leverage funds available for refund to customers by accelerating retirement of aging coal assets and early replacement with cleaner, cheaper energy sources. This has mitigated a portion of the revenue requirement impact while passing the majority of tax savings (60%) to customers. Utilities with rate freezes and stay out provisions are well positioned to enable targeted investment rather than decrease rates for the duration of stay out period.

Recently, PSE&G cited strain on credit ratios due to tax reform to support its request for an increased equity ratio to 54%, as well as earmarking a portion of the reduction in tax expenses for storm cost recovery before the New Jersey Board of Public Utilities.

Several utilities (Yankee Gas, CT and Ameren, IL) have pointed to the need for a robust authorized ROE to help manage the impacts of tax reform.

The New York Public Service Commission staff has proposed that all net benefits associated with the new tax law be returned to customers through pending rate cases or a sur credit effective October 1. However, the proposal provided for flexibility should the utility demonstrate that the pass back to customers is not in customers' long-term interest.

The Oklahoma Corporation Commission ("OCC") recently approved rates for OG&E that provided a refund for tax savings to customers. Separate from the base rate reduction, the OCC approved a one-time refund related to federal tax reform.

Emera Maine has argued that it should not be required to return tax savings to customers for the interim period between when the law took effect and when new rates are set (June 30), since it is "relying on the tax savings to provide needed financial support for ongoing operations in 2018, including the additional distribution costs the company is incurring to improve services in response to the Commission feedback in the last rate case." However, in the event that tax savings were to result in Emera Maine exceeding its allowed distribution ROE, the Company has proposed that the excess would be refunded to customers. Later, Emera proposed to utilize tax savings to offset storm costs and recommended that the PUC accumulate ongoing tax savings in a regulatory liability account such that those amounts could be used to offset costs of an October 2017 storm, and that tax savings for the first quarter of 2018 be handled in the same manner. In its final Order, the Commission required the Company to transfer all tax savings to a regulatory liability account to be deferred and considered in a future proceeding.

A recent Maryland rate case order for Potomac Electric Power ("PEPCO") resolves tax reform issues by reflecting reduced tax rates in the approved revenue requirement, by providing amortization of protected property-related excess deferred income tax, or EDIT, using the average rate assumption method, and by establishing amortization practices for unprotected property-related EDIT liabilities (20 years), and for unprotected, non-property related EDIT liabilities (7 years). PEPCO is also providing rate credits to return year-to-date over collections of taxes to customers.

In a recent rate proceeding, Green Mountain Power in Vermont has proposed to return "protected EDIT" in accordance with the Reverse South Georgia Method ("RSGM"), which uses an aggregated method for amortization of deferred tax liabilities, by taking total depreciable plant divided by the average remaining life of composite plant. This methodology has been accepted by the IRS when the company's records lack the necessary granularity to apply the average rate assumption. The company has proposed a one-time bill credit to return 100% of EDIT from unprotected plant to customers. The Department of Public Service has recommended that the Company's proposal be accepted by the Commission.

Conclusion

Utilities have inadvertently been caught in the crosshairs of a federal tax policy that is significantly changing the regulated cost of service revenue stream and may influence future utility investment decisions. The new tax law has reduced utility cash flows due to lower tax rates, lower and fewer tax benefits, and the need to refund EDIT to customers. Utilities will need to calculate and weigh the impacts of tax reform and work with regulators to effectively manage this nascent risk. Loss of bonus depreciation will increase current tax payments but will promote more robust growth in rate base (since bonus depreciation leads to greater deferred tax liabilities, which are ultimately deducted from rate base). Depending on the utility's tax position, a well thought out, tailored and balanced mitigation plan should be developed with regulators.

Examples of mitigation tools that utilities and regulators have at their disposal may include: obtaining additional equity or debt to replace no cost capital, accelerating depreciation on legacy assets to mitigate cash flow impact, retaining and deferring savings to absorb future rate increases, allocating a portion of tax savings to capital investment initiatives, deferring CapEx plans, or allowing more equity in their capital structures, requesting higher ROEs, or both. Though the tax law presents near-term challenges for regulated utilities, creative solutions can be developed to achieve simultaneous positive outcomes for customers, regulators and utility shareholders leading to lower rates, stimulated investment, and the maintenance of a strong utility credit profile.

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