EXPERT ANALYSIS: Tax Law Challenges for the Regulated Power Sector
April 27, 2018

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Last year marked a significant milestone for the U.S. power sector and regulated utility companies. In Dec. 2017, President Trump signed the monumental $1.5 trillion tax overhaul bill, which included several provisions relevant to regulated power companies. Like other corporations, regulated power companies will now enjoy a lower tax rate of 21 percent under the new law going forward, down from the previous 35 percent tax rate.

This lower tax thrilled companies in almost every sector due to a lower tax rate naturally benefiting companies with increased earnings and cash flow, leading to an increase in investor confidence and resulting in higher stock prices. This is a windfall for financially distressed and higher leveraged entities seeking additional sources of cash flow to fund already high debt service requirements. The challenge for utility companies, though, is that these same benefits may not directly translate to their business. Here is why:

Utilities and regulated power companies hoping the tax law would bring financial relief are unlikely to see it, and the reason boils down to the fact that unlike other sectors, these companies require their taxes to be absorbed in the calculation of their cost-of-service for their consumer customers. The resulting impact is that while companies in many sectors directly benefit from tax breaks while charging consumers the same price for their product or service, effectively helping boost the bottom line, regulated power companies do not have the same benefit inuring in their favor. This is because any form of tax break is ultimately passed down to consumers in the form of price cuts.

The argument for this is that since many of these power companies already have a dominant or monopolistic position in their markets, any monetary savings they realize should be passed on to the consumers that rely on them. Utility companies and their investors will frequently argue the need to invest cash flow savings in core infrastructure investment or capital upgrades, benefiting consumers in the long-term. Yet projects do not always gain approval, bringing into question whether all targeted savings ultimately get passed on. Therefore, while on paper it may have seemed like these regulated power companies would fully enjoy the benefits of a lower tax rate, the reality is far less clear.

Power companies and U.S. utilities are only now beginning to realize the full effect of the tax law and how it impacts their bottom line, but the new federal law is not the only key recent development being monitored. Rather than relying solely on the federal statutes, certain states are taking their own steps to ensure that consumers receive the full benefit of the tax law over regulated power companies, further underscoring how difficult it is for the new corporate tax rate to benefit these entities. In Kansas, for example, the Kansas Corporation Commission requested an investigation into the savings power companies will receive from the tax cuts and how those might be passed on to customers. As part of that investigation, the Kansas Corporation Commission has issued an order to state utilities requiring them to track all their savings from the tax cuts and to maintain those funds in a separate interest-bearing account with regulatory oversight. Similarly, Massachusetts

Attorney General Maura Healey recently asked the state's Department of Public Utilities to reverse a rate hike for utility company Eversource Energy, stating that the company's lower tax rate under the new law should disqualify any further rate hikes. Additionally, in late March of this year, Healey's office called for the end of the competitive electricity supply market for individual residential customers in Massachusetts, citing the results of a two-year study which found customers who switched to a competitive electric supplier paid over $170 million more when compared to customers who stayed with their regulated utility company.

At the federal level, the Federal Energy Regulatory Commission issued a notice of inquiry in March seeking comments regarding the effects of the new tax law on rates for local utilities and interstate natural gas pipelines. FERC signaled that one of its priorities with these comments is to gain clarity around how the commission should begin to address accumulated deferred income taxes and bonus depreciation, a tax incentive which encourages capital investment. In that same announcement, FERC also issued two Federal Power Act show-cause orders involving 48 companies whose transmission tariffs still referenced the previous tax rate of 35 percent. These orders compel the companies to propose revisions to their service rates or establish a requirement to argue why they are not required to, once again signaling that the agency is focused on directing any potential tax savings to consumers. This is great news for consumers, but it can create a headache for utilities who may be struggling financially. Some of these utilities may be able to convince the agency to allow the use of part of their tax savings to fund infrastructure upgrades or to offset future rate increases, but these cases are anticipated to be rare. Others, depending on the situation, could challenge FERC's findings about the extent of tax savings actually realized. Thus far, FERC has not issued further guidance for electric power companies, but it has changed its policies to no longer allow interstate natural gas and oil pipelines that operate as a master limited partnership to recover income tax allowances in cost of service rates.

While the tax law does not directly benefit regulated power companies the same way as other corporations, a silver lining appears to remain. The new tax law limits the amount of interest a corporation can deduct to lower its tax bill but utilities are exempt from this limit. For most companies, this limit is set at 30 percent of earnings before interest, taxes, deductions and amortization, or EBITDA, which may create challenges for high leveraged entities. Power companies and utilities, however, receive a 100 percent exemption in the bill for this element. Supporters argue this exemption is necessary since the utility business is such a capital-intensive industry, and limiting the amount of interest that companies are permitted to deduct could impact necessary capital investments in the space. At the present time, this exemption appears to be the biggest windfall regulated power companies can hope to receive from the tax law in its current form.

It is clear the new tax law presents a unique challenge for regulated power companies and utilities. Handicapped by not receiving the same benefit from the corporate tax rate as other industries yet hopeful that favorable treatment on the interest deduction exemption will help mitigate. States are continuing to take their own steps to protect consumers at the behest of power companies and utilities, and the possibility of FERC issuing further guidance or enacting additional regulations is something that will continue to loom over these companies throughout the year. No doubt interesting developments and advocacy to follow.

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