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Tax Reform

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Significant Tax Law Changes

- Reduction in Corporate Tax Rate to 21%
  - As of 1/1/2018 the federal statutory corporate tax rate drops from 35% to 21%
- Interest Limitation Carve out for Regulated Utilities
  - Interest deduction will continue without limitation for regulated utilities
  - Interest deduction is important because electric utilities are a capital intensive industry
- Elimination of Bonus Depreciation as a Result of Interest Carve out
  - Bonus depreciation was an accelerated tax deduction for certain property including transmission assets
  - Accelerated bonus deduction allowed an immediate tax deduction of up to 50% of the cost of an asset
  - Property “acquired” prior to 9/28/2017 is subject to the bonus depreciation phase out rules under prior law

Primary Impacts Regulated Utilities

- Lower Effective Tax Rate
  - Tax rate decrease results in less taxes being collected from customers as part of cost of service
    - 21% corporate tax rate means less taxes need to be paid to the IRS
- Lower Deferred Tax Balance
  - No bonus depreciation and a lower corporate tax rate result in a smaller deferred tax balance used in ratemaking.
    - Smaller deferred tax balance = smaller offset to rate base = higher earnings
- Excess Deferred Taxes
  - Deferred taxes were recorded at a higher tax rate than they'll be paid back to the IRS, therefore utilities have collected too much from customers
    - A tax deduction was taken at a 35% rate and reversal of deduction will be at 21%
    - This permanent tax savings is refunded to customers over the regulatory life of the assets via reductions in future taxes collected, which lowers costs for customers

Understanding Deferred Taxes

- What are deferred taxes?
  - Simply put they are taxes that are owed to the IRS or the states that may be deferred or paid in a future year
    - The result of differences between what is recorded for GAAP accounting and ratemaking versus what is recorded for the tax returns
    - Primary example of a deferred tax item is accelerated tax depreciation vs. book depreciation

- Why are deferred taxes important for a regulated utility?
  - Depreciation is a part of the ratemaking calculation
    - Taxes collected in rates are based on book depreciation
    - Effect is that taxes collected from customers are not paid until sometime in the future (Deferred Taxes)
    - Utility is allowed tax benefit of accelerated depreciation but may not earn on "interest free loan" of deferred taxes
      - Results in rate base offset created for "interest free loan" since they do not need to be financed by debt or equity – reduces need for capital with cash received upfront in rates

Deferred Tax Example Prior Law

Assume:

- $100 Asset
- GAAP Depreciation = 10 Year Straight Line
- Tax Depreciation = 50% Bonus
- Tax Rate = 35%
- Revenue Per Year = $150

		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
GAAP	Revenue	150	150	150	150	150	150	150	150	150	150	1,500
	Book Depreciation	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(100)
	Net Book Income	140	140	140	140	140	140	140	140	140	140	1,400
	Taxes at 35% Rate	**49**	**49**	**49**	**49**	**49**	**49**	**49**	**49**	**49**	**49**	**490**
TAX	Revenue	150	150	150	150	150	150	150	150	150	150	1,500
	Tax Depreciation	(50)	(15)	(15)	(13)	(7)	-	-	-	-	-	(100)
	Net Taxable Income	100	135	135	137	143	150	150	150	150	150	1,400
	Taxes at 35% Rate	**35**	**47**	**47**	**48**	**50**	**53**	**53**	**53**	**53**	**53**	**490**
	Cumulative Deferred Tax Liability	**(14)**	**(16)**	**(18)**	**(19)**	**(18)**	**(14)**	**(11)**	**(7)**	**(4)**	**(0)**	**-**

As illustrated above the deferred taxes are simply a difference in timing of when taxes are paid. In this case each year's deferred tax liability is represented by the difference between book depreciation and tax depreciation multiplied by the tax rate.

Deferred Tax Example New Law

Assume the same example as on previous page except there is no bonus depreciation and the tax rate is only 21%

		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
GAAP	Revenue	150	150	150	150	150	150	150	150	150	150	1,500
	Book Depreciation	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(100)
	Net Book Income	140	140	140	140	140	140	140	140	140	140	1,400
	Taxes at 21% Rate	**29**	**29**	**29**	**29**	**29**	**29**	**29**	**29**	**29**	**29**	**294**
TAX	Revenue	150	150	150	150	150	150	150	150	150	150	1,500
	Tax Depreciation	(20)	(20)	(20)	(20)	(20)	-	-	-	-	-	(100)
	Net Taxable Income	130	130	130	130	130	150	150	150	150	150	1,400
	Taxes at 21% Rate	**27**	**27**	**27**	**27**	**27**	**32**	**32**	**32**	**32**	**32**	**294**
	Cumulative Deferred Tax Liability	**(2)**	**(4)**	**(6)**	**(8)**	**(11)**	**(8)**	**(6)**	**(4)**	**(2)**	**0**	**-**

The lower tax rate creates a smaller deferred tax balance. In addition, the lack of bonus depreciation creates a smaller difference between book depreciation and tax depreciation and contributes to a smaller deferred tax liability as well.

Understanding Ratemaking

- Earning on Rate Base
  - Regulated utility's book income after taxes is primarily based on weighted rate of return percentage applied to rate base.
    - Rate base is net book value of assets less the deferred tax liability balance
    - Lower deferred tax balance equals higher rate base which means higher earnings
- Taxes on Earnings
  - Earnings on rate base are subject to taxes
    - Regulated utility is allowed to collect those taxes, plus gross up, from customers
    - Lower taxes equal lower pretax earnings which equals lower ultimate cost to customers

Ratemaking Example

Assume the following for Example 1 under prior law:	Assume the following for Example 2 Under Prior Law:
$10,000 of Assets Placed in Service Prior to 2018	$10,000 of Assets Placed in Service Prior to 2018
$1,000 Assets Placed in Service 2018	$1,000 Assets Placed in Service 2018
GAAP Depreciation = 40 Year Straightline	GAAP Depreciation = 40 Year Straightline
Tax Depreciation = 50% Bonus	Tax Depreciation = No Bonus
Tax Rate = 35%	Tax Rate = 21%
Return on Rate Base = 10%	Return on Rate Base = 10%
All equity	All equity

Example 1 Prior Tax Law

	2018
Gross Plant	11,000
Accumulated Book Depreciation	(525)
Net Plant	10,475
Deferred Tax Liability	**(1,960)**
Rate Base	8,515
Rate of Return	10%
Net Income	**851.50**
Tax Rate	35%
Taxes	298.03
Tax on Tax Effect	1.54
Total Taxes Collected	**458.50**
Net Income Before Taxes	**1,310.00**
Taxes	**458.50**
Net Income After Taxes	**851.50**

Book Depreciation	275
Tax Depreciation	(875)
Deferred Tax Difference	(600)
Tax Rate	35%
Current Deferred Tax Liability	(210)
Beginning Year DTL Balance	(1,750)
Ending DTL Balance	(1,960)

Example 2 New Tax Law

	2018
Gross Plant	11,000
Accumulated Book Depreciation	(525)
Net Plant	10,475
Deferred Tax Liability	**(1,776)**
Rate Base	8,699
Rate of Return	10%
Net Income	**869.88**
Tax Rate	21%
Taxes	182.67
Tax on Tax Effect	1.27
Total Taxes Collected	**231.23**
Net Income Before Taxes	**1,101.11**
Taxes	**231.23**
Net Income After Taxes	**869.88**

Book Depreciation	275
Tax Depreciation	(400)
Deferred Tax Difference	(125)
Tax Rate	21%
Current Deferred Tax Liability	(26)
Beginning Year DTL Balance	(1,750)
Ending DTL Balance	(1,776)

Summary

- Higher Earnings for Regulated Utilities
  - Higher rate base as the deferred tax balance offset is less
- Lower Cost for Customers
  - Less taxes collected from customers