Analyzing Tax Reform & Impact On Regulated Utilities

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The Impact On A Regulated Utility: Some Good Stuff & Some Bad Stuff

1. Lowering the Corporate Tax Rate from 35% Currently to 20%

- House Proposal: 20% FIT rate effective in 2018
- Senate Proposal: 20% FIT rate effective in 2019

a) Under the regulated construct utilities should have no earnings benefit

- Income tax expense is a pass-through
- All things equal should result in lower customer bills from reduction in tax collections

❖ Over the long run customers benefit from a reduction in tax rate, but…How will the lower tax expense actually be flowed through in rates?

  ❖ Base or single issue rate cases?

    ❖ How will companies with rate case stay outs be treated?

  ❖ Automatic adjustments through existing rider mechanisms?

  ❖ Other means?

  ❖ Will there be regulatory lag?

b) Lowering revenues for tax results in lower cash flow

- Collecting lower taxes should be EPS neutral, once rates reflect the new tax rate at the utility opco level we think it negatively impacts corporate level cash flow.
- The average regulated utility collects an income tax allowance reflecting its expected annual tax payments. The parent, who files a consolidated tax return, is expected to pay little or no cash taxes due to the impact of bonus depreciation, NOLs and/or other favorable tax positions until at least 2019. So they have a cash flow issue. This will increase financing needs and—all things being equal—is dilutive to EPS.

Source: Evercore ISI Research

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c) Lower tax rates creates long term benefits for customers & companies

- A reduction in the FIT rate from 35% to 20% will generate a significant decline in the customer bill compared to the current bill creating "headroom" for utilities to earn on higher rate base due to elimination of bonus depreciation / lower deferred taxes (see below) & potentially higher cap-x to finance grid-modernization, EV grid infrastructure, other future capital needs while still driving lower bills if they can find "shovel ready" projects that are good for customers

d) Reduction in existing Deferred Tax Liability probably will be amortized to customers over time under the Normalization principle

- A reduction in FIT rate would also result in a lowering of the existing deferred income tax liability, hence theoretically increasing rate base significantly in a one time step up.
- However we think it is likely that regulators (you) will set up a regulatory liability or contra-asset to neutralize the majority of that impact so ratepayers receive a return on the tax payments they paid at the old FIT rate.

e) Utility Rate Base will however, still increases vs. prior expectations.

- Lowering the FIT rate lowers the reduction in rate base that comes from the deferred tax calculation resulting in a higher rate base growth profile per each dollar invested prospectively
- Also (more on next page) most companies assumed 40%/30% bonus depreciation in their financial outlook for '18 and '19, as that is the current phase-out period. If it goes to zero in '18/'19 they will have higher rate base / higher earnings power than they anticipated, and can access the revenue needed from a portion of the tax cut benefit.

Source: Evercore ISI Research

The Impact On A Regulated Utility: Some Good Stuff & Some Bad Stuff

2. 100% Expensing of Cap-x—Utilities Get A Pass

- House Proposal: 100% expensing for 5 yrs - Regulated Utilities exempt
- Senate Proposal: 100% expensing for 5 yrs, phase down over next 4 yrs – Regulated Utilities exempt

a) Would be accretive to rate base/earnings under House/Senate proposal

- As we explained on the prior page, under the current tax code bonus depreciation provision phases down to 50%/40%/30% in years ’17/’18/’19 respectively. Both House/Senate proposal exempt utilities from bonus depreciation which would be accretive to rate base/earnings power.

3. Limitation on Interest deduction—Utilities Get A Pass

- House Proposal: 30% EBITDA limitation on interest deduction - Public Utilities exempt
- Senate Proposal: 30% EBIT limitation on interest deduction – Public Utilities exempt

a) Our initial assessment is no impact for most utilities

- It is pretty clear that utility operating companies get a pass, and continue to deduct interest expense.
- Most utility holding companies that we cover would pass the EBIT/EBITDA tests which the House/Senate are proposing if we assume it is calculated at the filer or taxpayer level (that is not 100% clear but we think that is the case).

b) One nuance, utility holding company leverage will have a lower tax shield

- Not good but not your problem (see slide 6)

Source: Evercore ISI Research

The Impact On A Regulated Utility: Some Good Stuff & Some Bad Stuff

4. <u>Renewable tax credits</u>

- House Proposal: eliminates inflation adjustment for Production tax credits(PTC's) and imposes stricter standard on safe harbor provision
- Senate Proposal: No change to PTC's, however includes BEAT adjustment & retaining AMT at 20%

a) Utilities should see no earnings/cash flow impact as tax credits are pass through in rates.

- But this is a bad deal for customers. They will have to pay more to get renewable energy, whether it is through rate basing or PPAs, because…

b) House/Senate proposals increase renewable generation cost of capital

- If you rate base an asset there is a lower tax benefit that goes to the customer as an offset to rates. Both proposals effectively reduce the value of PTC's and discourage Tax Equity Investors from Investing in renewable projects which could lead to higher cost of capital passed through to utility customers.
  - House bill lowers PTC credit by removing the inflation adjustment brining the value of the credit down to 1.5c/KWH from 2.3c/KWH presently.
  - Base Erosion Anti-Abuse Tax (BEAT) provision would subject tax credits given to companies with operations overseas to a tax rate.
  - With the Senate proposal of retaining the Alternative Minimum Tax (AMT) at 20% most corporations would now likely be paying the AMT and thus only able to utilize the PTC for four years.
  - <u>It is not clear that all of these provision will make it through, there is stiff opposition.</u>

Source: Evercore ISI Research

Analyzing The Impact On Utility Holding Companies

1. Limitation on Interest deduction

- House Proposal: 30% EBITDA limitation on interest deduction - Public Utilities exempt
- Senate Proposal: 30% EBIT limitation on interest deduction – Public Utilities exempt

a) Our initial assessment is no impact as we said previously

- Edison Electric Institute (EEI) is working with both the Senate Finance Committee and the House Ways & Means Committee on a clarification to the exemption to include utility holding companies not just operating companies.
- Even if they don't get it we think most if not all will be below the hurdle if we assume they are measured at the filer level, but there is some uncertainty.

2. Lowering Corporate Tax Rate from 35% Currently to 20% Still Hurts

- House Proposal: 20% FIT effective in 2018
- Senate Proposal: 20% FIT effective in 2019

a) Parent/Corporate interest drag on EPS will be higher

- A lower tax rate results in larger parent/other losses because with a lower tax rate those costs (parent interest expense and overheads) have a lower tax shield

b) Lower Cash flow from utility subsidiaries could impact corporate credit metrics

- Lower consolidated cash flow due to loss of tax cash flow from utility subsidiaries could have an impact on FFO/Debt and impact credit quality

Source: Evercore ISI Research

Analyzing The Impact On A Non Regulated/Merchant Subsidiary

1. Lowering Corporate Tax Rate from 35% Currently to 20%

- House Proposal: 20% FIT effective in 2018
- Senate Proposal: 20% FIT effective in 2019

a) It should be earnings/cash flow accretive for non-regulated business subsidiaries (obviously!)

  - Companies like Exelon Corporation, PSE&G, NextEra Energy, Avangrid, Centerpoint Energy, OG&E, Dominion and Hawaiian Electric have profitable non-regulated subsidiaries which should benefit from a lower tax rate.

2. 100% Expensing of Cap-x

- House Proposal: 100% expensing for 5 yrs - Regulated Utilities exempt
- Senate Proposal: 100% expensing for 5 yrs, phase down over next 4 yrs – Regulated Utilities exempt

a) This should be cash flow positive for non regulated/merchant companies

  - Ability to deduct 100% cap-x for tax purposes results in lower cash tax payments and is a net positive for non-regulated/merchant subsidiaries.
  - This indirectly supports utility investment at their regulated subsidiaries.

Source: Evercore ISI Research

Analyzing The Impact On A Non Regulated/Merchant Subsidiary

3. Limitation on Interest deduction

- House Proposal: 30% EBITDA limitation on interest deduction - Public Utilities exempt
- Senate Proposal: 30% EBIT limitation on interest deduction – Public Utilities exempt

a) No impact as we stated previously

- Most non-regulated businesses and holding companies that we cover appear to pass the EBIT/EBITDA tests which the House/Senate propose at the filer or taxpayer level but there is uncertainty.

4. Renewable tax credits

- House Proposal: eliminates inflation adjustment for Production tax credits(PTC's) and imposes stricter standard on safe harbor provision
- Senate Proposal: No change to PTC's, however includes BEAT adjustment & retaining AMT at 20%

a) This could result in meaningful headwinds for non-regulated/merchant renewable power producers

- Lowering the PTC rate is margin dilutive
- Both BEAT provision and AMT @20% could result in higher financing costs on renewable projects
- NextEra Energy and Avangrid are the two largest wind developers in the U.S.
- It is not clear these provisions will survive as there is stiff opposition.

Source: Evercore ISI Research

TIMESTAMP

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In Line – the total forecasted return is expected to be in line with the expected total return of the analyst's universe
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Buy - Return 10% to 20%
Neutral - Return 0% to 10%
Cautious - Return -10% to 0%
Sell - Return < -10%

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Coverage Universe

Ratings	Count	Pct.
Buy	352	52%
Hold	240	36%
Sell	52	8%
Coverage Suspended	21	3%
Rating Suspended	8	1%

Investment Banking Services / Past 12 Months

Rating	Count	Pct.
Buy	64	18%
Hold	14	6%
Sell	2	4%
Coverage Suspended	8	38%
Rating Suspended	1	12%

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