

# MOODY'S

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### SECTOR COMMENT

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## Regulated Utilities - US

# Tax reform is credit negative for sector, but impact varies by company

The wide-ranging tax legislation passed by the US Congress on December 20, 2017 cut the statutory corporate tax rate to 21% from 35%. The legislation was broadly credit positive for corporate cash flows but for regulated investor-owned utilities, which include electric, gas and water utilities, the effect was the opposite.

- » **The legislation is credit negative for investor-owned utilities.** A lower tax rate will reduce the difference between the amount that utilities collect from rate payers to cover taxes and their payments to tax authorities, reducing cash flow.
- » **Tax reform is neutral for earnings but negative for cash flow.** Utilities collect revenue based on book tax but cash tax is much lower. A lower tax rate lowers revenue, while loss of bonus depreciation increases cash tax.
- » **Cash flow to debt ratio could decline by 150-250 basis points.** We estimate that regulated utilities could experience a decline in the ratio of cash flow from operations pre-working capital to debt (CFO pre-WC/debt) of 150 bps to 250 bps, assuming no corrective action is taken.
- » **Utilities with weaker than expected financials are most affected.** The potential for lower cash flows hurts the credit profile of numerous regulated utilities that already have weakening financial projections. Major holding companies affected include American Electric Power Company (AEP, Baa1 stable), Consolidated Edison, Inc. (ConEd A3 negative), Dominion Energy (Dominion, Baa2 negative), Duke Energy Corporation (Duke, Baa1 negative), Entergy Corporation (Entergy, Baa2 negative) and The Southern Company (Southern, Baa2 negative).
- » **Most utilities are still well positioned within their credit profiles.** The vast majority of utilities and their holding companies are well positioned within their credit profiles thanks to supportive regulatory relationships and a capital structure balanced between both debt and equity.

## Tax reform negatively affects utility cash flows

For the investor-owned utilities sector, the 2017 tax reform legislation will have an overall negative credit impact on regulated operating companies and their holding companies. Moody's calculates that the recent changes in tax laws will dilute a utility's ratio of cash flow before changes in working capital to debt by approximately 150-250 basis points on average, depending to some degree on the size of the company's capital expenditure program.

Although the regulated utility sector is carved out in terms of the treatment of interest deductibility and expensing of capital expenditures, from an earnings perspective the effect on regulated entities is neutral because savings on the lower tax expense are passed on to their customers, as required by regulation. However, from a cash flow perspective, the legislation is credit negative.

Investor-owned utilities' rates, revenue and profits are heavily regulated. The rate regulators allow utilities to charge customers based on a cost-plus model, with tax expense being one of the pass-through items. In practice, regulated utilities collect revenues from customers based on book tax expense but typically pay much less tax in cash. Under the new tax regime, utilities will collect less revenue associated with tax expenses and pay out more cash tax, squeezing its cash flows.

With the lower tax rate and the loss of bonus depreciation treatment, utility cash flows will be negatively affected by three tax dynamics:

1. A fall in the tax rate means that regulated entities will collect less revenue from customers for the purpose of tax expense compensation. Going to a tax rate of 21% from 35% represents about a 40% fall in revenue collection related to tax expense. Although this revenue is ultimately paid out as an expense, under the new law utilities will lose the timing benefit, thereby reducing cash that may have been carried over many years.
2. The loss of bonus depreciation treatment means that most utilities will start paying cash tax in 2019 or 2020, earlier than under the current tax law. The loss of bonus depreciation treatment means that utilities can claim less in depreciation expenses and will therefore have higher taxable income. We still expect utilities to pay little or no cash tax in 2018 because most have significant accumulated net operating losses driven by past claims of bonus depreciation.
3. Lowering the tax rate also means that utilities will have over-collected for tax expense in the past because they charged for future tax expense, assuming a 35% tax rate. As utilities refund the excess collection to customers, it will reduce cash flows, likely spread out over the remaining life of the assets associated with the depreciation.

## Significant credit deterioration for many utilities

Since the tax reform was passed at the end of last year, numerous utilities will experience a weakening in their credit profiles because of declining financial metrics (see Exhibit 1). Major holding companies affected include AEP, ConEd, Dominion, Duke, Entergy and Southern.

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Exhibit 1

**Utilities with weakened, or weakening, financial profiles due to tax reform**

Company	Senior Unsecured Rating	CFO pre-WC / Debt 3-yr Avg as of 3Q17	CFO Pre-WC / Debt 2018-2019 <sup>[1]</sup>	Downgrade Guidance
<b>Holding Companies</b>				
Consolidated Edison, Inc.	A3 / Negative	21.2%	15-18%	18%
American Electric Power Company, Inc.	Baa1 / Stable	20.8%	15-17%	15%
Duke Energy Corporation	Baa1 / Negative	14.7%	13-15%	15%
Dominion Energy, Inc.	Baa2 / Negative	12.9%	12-15%	15%
Entergy Corporation	Baa2 / Negative	18.0%	13-15%	15%
Southern Company (The)	Baa2 / Negative	13.8%	13-15%	15%
<b>Vertically Integrated</b>				
Alabama Power Company	A1 / Negative	25.7%	20-22%	22%
Public Service Company of Oklahoma	A3 / Negative	18.2%	15-18%	19%
Avista Corp.	Baa1 / Negative	20.6%	15-17%	17%
Southwestern Public Service Company	Baa1 / Negative	22.2%	16-18%	18%
<b>Local Distribution Companies</b>				
New Jersey Natural Gas Company	Aa2 / Negative <sup>[2]</sup>	25.3%	17-20%	20%
Brooklyn Union Gas Company, The	A2 / Negative	12.2%	14-17%	17%
KeySpan Gas East Corporation	A2 / Negative	15.8%	15-18%	17%
Piedmont Natural Gas Company, Inc.	A2 / Negative	20.9%	14-17%	17%
ONE Gas, Inc	A2 / Negative	22.0%	16-19%	20%
South Jersey Gas Company	A2 / Negative	18.1%	15-17%	20%
Wisconsin Gas LLC	A2 / Negative	25.5%	16-19%	19%
Questar Gas Company	A2 / Negative	22.2%	17-20%	20%
Northwest Natural Gas Company	A3 / Negative	18.3%	14-17%	16%
<b>Transmission &amp; Distribution</b>				
Consolidated Edison Company of New York, Inc.	A2 / Negative	21.7%	19-21%	20%
Orange and Rockland Utilities, Inc.	A3 / Negative	19.8%	15-17%	17%
<b>Water</b>				
American Water Works Company, Inc. <sup>[3]</sup>	A3 / Negative	17.2%	14-16%	15%

[1] 2018-2019 Moody's estimates are pro forma for tax reform and do not incorporate current rate plan collection at 35%.

[2] Senior Secured Rating.

[3] The Regulated Water Utilities Methodology uses FFO to net debt as a key cash flow metric.

Source: Moody's Investors Service

Tax reform mainly affects companies that already had limited cushion in their credit profile. The tax reform usually resulted in a further 150-250 bps drop in CFO pre-WC/debt.

Moody's expects that most utilities will attempt to manage any negative financial implications of tax reform through regulatory channels. Corporate financial policies could also change. The actions taken by utilities will be incorporated into our credit analysis on a prospective basis. It is conceivable that some companies will sufficiently defend their credit profiles.

In practice, we believe that most companies will actively manage their cash flow to debt ratios by issuing more equity or obtaining relief by working through regulatory channels. For example, to offset a decline in cash flow, utilities could propose to regulators additional investments that benefit customers or accelerate recovery of regulatory assets. Some of the corporate measures could have

a more immediate boost to projected metrics than certain regulatory provisions, which may take time to approve and implement. They could also propose to increase the equity layer in rates or the level of the authorized return on equity. In these cases, a cooperative regulatory relationship matters most for a given utility.

The majority of US regulated utilities and utility holding companies continue to maintain stable credit profiles despite weakening financials. Some of the larger holding companies in this category include PPL Corp. (Baa2 stable), Fortis Inc. (Baa3 stable) and Xcel Energy, Inc. (A3 stable) and Alliant Energy Corporation (Baa1 stable). We did not take action on NiSource, Inc. (Baa2 stable), despite the fact that they are weakly positioned even before the tax reform, because we believe that the management will address their financial ratios sufficiently in a timely manner to strengthen their credit profile.

Several companies were already on negative outlook or on review for downgrade before the effects of tax reform occurred, including Emera Inc. (Baa3 negative), Georgia Power Company (A3 negative), NorthWestern Corporation (Baa1 negative), OGE Energy Corp (A3 negative), SCANA Corporation (SCANA, Baa3 RUR-down), Sempra Energy (Baa1 negative), WEC Energy Group, Inc. (A3 negative), and WGL Holdings, Inc. (A3 negative).

### Company-specific comments

All companies below have had their outlooks revised to negative due to the recent tax reform, except AEP, whose outlook was revised to stable from positive.

#### American Electric Power

AEP will continue to produce CFO pre-WC to debt in the mid-teens range, incorporating the effects of tax reform.

AEP could strengthen its credit profile if there are credit supportive regulatory actions at the state level to mitigate the impact of tax reform, or if there is a change in AEP's corporate finance policies such that cash-flow credit metrics could be sustained near their recent levels, in the high-teens range.

AEP could weaken its credit profile if a more contentious regulatory environment were to develop in any of its key jurisdictions; if ongoing capital investments cannot be recovered on a timely basis; or if recent tax reform or other developments cause a sustained deterioration in financial metrics—if, for example, the ratio of CFO pre-WC to debt were to remain below 15%.

#### American Water Works Company, Inc.

American Water Work Company, Inc.'s (American Water, A3 negative) cash flow to debt metrics were already expected to decline due to debt-funded growth and dividends over the next five years. Now, in the absence of any corrective action, the incremental deterioration in metrics due to tax reform could affect its credit quality.

American Water's debt is expected to increase due to its \$8.0-\$8.6 billion 5-year capital program, dividend growth approaching 10% and no additional equity issuance through 2022. Following the company's 11 December guidance call, we project funds from operations (FFO) to net debt ratios will decline from current levels. Using LTM 3Q17 as a base, we project that FFO to net debt will fall from 17% to 16% over the next couple of years. Losing an estimated \$150 million of cash flow to deferred taxes, as a result of tax reform, will further pressure FFO to net debt to around 15%, a level that we have highlighted as potentially affecting the company's credit profile.

American Water's credit profile could be maintained if its FFO to net debt and RCF to net debt were to stabilize around 16% and 11%, respectively, and without an increase in parent debt levels (currently at around 23% of consolidated debt).

#### Avista Corp.

Avista Corp. (Avista, Baa1 negative) has over the last few years maintained steady credit metrics with CFO pre-WC to debt consistently in the 18-20% range. However, deferred income taxes have constituted a significant portion of Avista's operating cash flow, about a third in 2016. Further, Avista has experienced delays with its Washington rate case, presenting uncertainty around the utility's regulatory relationships and future financial profile.

The negative outlook reflects the expected reduced contribution of deferred taxes to operating cash flow and regulatory uncertainty related to the Washington rate case. We expect weaker credit metrics going forward, with CFO pre-WC to debt falling to or below the

17%, which would represent a significant credit deterioration in the absence of actions to mitigate tax reform impacts and without adequate regulatory relief in Washington.

In addition, Avista's credit profile would be negatively affected by any indication that it would be required to support Hydro One Ltd.'s (not rated) acquisition debt. The credit profile could be stabilized if Avista receives sufficient regulatory relief and if state-level regulatory and corporate financial actions are taken to offset the negative tax reform impact such that CFO pre-WC to debt remains consistently at or above 18%.

### **Brooklyn Union Gas Company**

Brooklyn Union Gas Company (KEDNY, A2 negative) has been weakly positioned against our guidance for several years, with CFO pre-WC to debt of 13.7% in the year to March 2017 and 7.9% in the year to March 2016, compared with guidance in the mid to high teens.

Since deferred taxes represented 18% of KEDNY's CFO pre-WC in the year to March 2017, we expect that the lower corporate tax rate will translate into a lower revenue requirement, making it more difficult for the company to maintain its current credit profile in absent of significant mitigating actions or relief offered by the New York Public Service Commission (NYPSC). The credit profile could be maintained if the National Grid Plc (Baa1 stable) chose to reduce leverage at KEDNY or if the NYPSC allowed the company to offset the customer benefit of the lower tax rate with some other allowances.

### **Consolidated Edison, Inc.**

Consolidated Edison Company of New York's (CECONY, A2 negative) is Consolidated Edison's principle subsidiary and contributed about 90% of consolidated cash flows. Deferred taxes have represented nearly 20% of CECONY CFO over the past three years; therefore the tax rate reduction to 21% will reduce this deferred tax benefit and CECONY's cash flow generation over the next several years. While the utility is expected to maintain relatively stable financial metrics, such as CFO to debt at around 20%, in the remaining two years of its current rate plan, we expect tax reform will have negative cash flow implications over the longer term, all else being equal.

When normalizing CECONY's cash flow for the new tax law, we see the potential for the company to generate CFO pre-WC to debt in the high-teens range on an ongoing basis. This reflects a 21% tax rate, reduced revenue requirement, low cash tax payments and normalized refunds of excess deferred tax liabilities to customers.

We see uncertainty over the amount and pace of any "unprotected" deferred tax liability refunds that CECONY may be required to pay, over the nature and timing of customer benefits and over the potential to offset cash flow leakage with some other cash-generative measure. The NYPSC is investigating methods of approaching the tax reform and we expect increasing clarity in the coming months.

### **Dominion Energy, Inc.**

Dominion's (Baa2 negative) CFO pre-WC to debt ratios have been weak for its rating since 2012, for which we had expected an upward trend to begin in 2018. However, the impact of tax reform will offset the improvement we expected, as the utility base of the company will have less deferred tax benefit to boost cash flow. We see a risk that CFO pre-WC to debt will remain around 14% until that time.

The acquisition of SCANA would keep Dominion's metrics lower for longer, since they will have sizeable customer credits. SCANA has its own cash leakage from tax reform, and incremental debt is to be issued in the SCANA family.

### **Duke Energy Corporation**

Duke's consolidated cash flow credit metrics are currently weakly positioned and likely to be incrementally pressured by tax reform. We currently expect the company's CFO pre-WC to debt ratio will remain below 15% through 2019 without assuming any action to counter the effects of the tax reform.

The company's credit profile could be strengthened if Duke achieves credit supportive outcomes in its current rate proceedings and if it is able to mitigate the cash-flow impact of tax reform through regulatory treatment or financial policies such that it can sustain a ratio of CFO pre-WC to debt above 15%, for example. In the longer term, a ratio of CFO pre-WC to debt closer to 20% could result in a material improvement in the credit profile.

Duke's credit profile could weaken if there were a deterioration in the regulatory relationship at one or more of its key utility subsidiaries; if recent tax reform or other developments cause the ratio of CFO pre-working capital to debt to remain below 15% for an extended period; or if parent company debt levels rise above 35% of total Moody's adjusted consolidated debt for an extended period.

### **Entergy Corporation**

Entergy's (Baa2 negative) CFO pre-WC to debt through LTM was 15%, which is on the low end of the financial range expected for its credit profile. We consistently normalize Entergy's cash flow for variability in tax payments and deferred tax contributions to CFO. However, recent federal tax reform has brought incremental risks to the company's financial profile.

The primary risk relates to the revaluation of deferred tax liabilities and ensuing customer refunds for the excess amounts collected. At 30 September 2017, Entergy had roughly \$7.5 billion of deferred tax liabilities on its balance sheet, which we estimate will fall to around \$4.5 billion under a 21% tax rate. The \$3.0 billion of excess deferred taxes will likely be refunded to customer. However, the timing and source of financing of this refund is uncertain. This carries the risk of reducing cash flow beyond our typical sensitivities and increasing the funding needs of the consolidated entity.

### **Keyspan Gas East Corporation**

Deferred taxes have been a strong contributor to Keyspan Gas East Corporation's (KEDLI, A2 negative) CFO pre-WC to debt ratio, accounting for 22% of CFO pre-WC in 2017. The lowering of the corporate tax rate and the attendant decline in cash-flow will result in credit deterioration for KEDLI in the absence of any mitigating action by the company or additional allowances offered by the NYPSC.

The company's credit profile could be maintained if the National Grid group chose to reduce leverage at KEDLI or if the NYPSC chose to offset the customer benefit of the lower tax rate with some other allowances.

### **New Jersey Natural Gas Company**

New Jersey Natural Gas's (NJNG, Aa2 secured rating, negative) metrics are projected to weaken because of the expected funding of its capital plans primarily with debt, compounded by the estimated cash flow impact of tax reform. The lower projected cash flows combined with increasing absolute debt levels will result in CFO pre-WC/debt to range in the 18% to 19% range over the next two years.

NJNG's credit profile could weaken if there is a significant deterioration in NJNG's business profile, in its regulatory environment or an increase in regulatory lag. The profile could also be negatively affected if NJNG reports CFO pre-WC to debt below 20% for an extended period of time. NJNG's credit profile could be strengthened by demonstrated consistency in the company's current regulatory framework or if there are mitigating regulatory actions or corporate fiscal policies such that its CFO pre-WC to debt ratio is maintained above 20%.

### **Northwest Natural Gas Company**

Northwest Natural Gas Company's (A3 negative) current financial profile is strong, with CFO pre-WC to debt around 19% through 30 September 2017. However, the combination of tax reform impacts to deferred tax cash flow and rate relief needed through a general rate case could reduce this metric to below 16% over the next two years.

The company has a rate case filing currently outstanding with the Oregon Public Utility Commission and could receive the necessary rate relief to maintain cash flow to debt ratios in the high-teen's range, which would support its current credit profile.

### **ONE Gas, Inc.**

We expect the ONE Gas, Inc.'s (A2 negative) already weak cash flow to debt ratios will further deteriorate with the reduction in the corporate tax rate and the loss of bonus depreciation. We anticipate that its CFO pre-W/C to debt will be in the 17%-18% range without any offsetting action.

The credit profile could improve if regulatory actions are taken at the state level to mitigate the cash flow impact of tax reform and if the company makes changes to its corporate financial policies such that financial metrics improve, including a CFO pre-WC to debt ratio consistently at or above 22%.

ONE Gas' credit profile could weaken if CFO pre-WC to debt is sustained below 20%; if there is a significant decline in the support provided by the utility's regulators; or if the company pursues an aggressive dividend payout policy as it executes its elevated capital program.

### **Piedmont Natural Gas Company**

We expect that tax reform legislation will pressure Piedmont Natural Gas Company's (Piedmont, A2 negative) financial metrics, which in the absence of mitigation measures could adversely affect Piedmont's ability to maintain CFO pre-WC to debt ratio above 17%.

Piedmont's credit profile could be stabilized if the company is able to mitigate the cash flow impacts of tax reform through regulatory treatment or financial policies. For example, if the company is able to sustain a ratio of CFO pre-WC near 20%. In the longer term, a ratio of CFO pre-WC to debt above 23% could also boost credit quality.

Piedmont's credit profile could weaken if there were to be a significant deterioration in the company's regulatory environments, or if recent tax reform or other developments cause the ratio of CFO pre-WC to debt ratio to remain below 17% for an extended period.

### **Public Service Company of Oklahoma**

Public Service Company of Oklahoma's (PSO, A3 negative) historically strong financial metrics have been negatively impacted by a combination of lower load growth, elevated capital expenditures for environmental compliance and increased regulatory lag. We expect that tax reform will add downward pressure on the utility's cash flow credit metrics. We anticipate the company's CFO pre-WC to debt ratio will remain below 19%, which is weak for PSO's current credit quality.

PSO's credit profile would stabilize if there were to be an increase in cash flow or a reduction in leverage, or if the company is able to mitigate the cash flow impact of tax reform such that we could expect key financial credit metrics to strengthen with, for example, a ratio of CFO pre-WC to debt remaining in the low 20% range. In the longer term, a ratio of CFO pre-WC to debt sustained above 25% could boost the profile.

PSO's credit profile could weaken if the regulatory environment took a more adversarial tone; if there were a significant increase in capital or operating expenditures that were not able to be recovered on a timely basis; or if key financial credit metrics exhibited a sustained deterioration over a period of time—for example, a ratio of CFO pre-WC to debt remaining below 19%.

### **Questar Gas Company**

Questar Gas Company's (Questar Gas, A2 negative) financial profile is expected to decline amid a rate freeze through 2020. While the company will continue to recover costs through decoupling and infrastructure riders, we see cash flow to debt metrics declining from 22% through LTM 3Q17 to the high-teens range because of increasing debt and a lack of general rate increases. We expect that cash leakage from tax reform impacts will be implemented at the end of this rate freeze, which will reduce cash that Questar Gas collects from customers and will keep the company's cash flow to debt metrics lower for longer.

### **South Jersey Gas Company**

South Jersey Gas Company's (South Jersey Gas, A2 negative) debt coverage metrics have weakened over the last few years in part due to a significant increase in environmental remediation costs. The negative outlook is based on our expectation that South Jersey Gas' already weak credit metrics will be sustained in the mid-to-high teens as a result of the negative cash flow impact of tax reform.

South Jersey Gas' credit profile can be maintained with further improvements in regulatory transparency and if state-level regulatory or corporate financial policy actions are taken to alleviate the negative impacts of tax reform such that CFO pre-WC to debt is maintained at or above 22% on a consistent basis.

The credit profile would be negatively affected if CFO pre-WC to debt remains below 20% on a sustained basis; if there is pressure to support debt incurred by the parent to acquire Elizabethtown Gas and Elkton Gas; if South Jersey Gas' regulatory jurisdiction becomes less credit supportive; or if the company and its affiliates fail to maintain adequate liquidity across the utility family.

### **The Southern Company**

Tax reform will pressure Southern's financial metrics. Absent mitigation measures, it will hinder Southern's ability to maintain CFO pre-working capital to debt at or above 15%.

Southern's credit profile would be strengthened if there are credit supportive regulatory actions at the state level to mitigate the impact of tax reform, or if parent level debt is reduced or cash flow coverage metrics improve materially, including CFO pre-WC to debt in the high teens to 20%.

Southern's credit profile is heavily dependent on the credit quality of the Alabama Power Company (A1 negative), Georgia Power Company (A3 negative) and Southern Company Gas/Southern Company Gas Capital (Baa1 stable) subsidiaries. It could also suffer if there are additional delays or cost increases at the Vogtle nuclear project, or if recent tax reform legislation or other developments cause consolidated coverage metrics to show a sustained decline, including CFO pre-WC to debt below 15%.

### **Southwestern Public Service Company**

Southwestern Public Service Company (SPS, Baa1 negative) faces lower financial metrics because of tax reform as well as a deteriorating regulatory environment in New Mexico. The company's CFO pre-WC to debt ratio has been 20% or above in the past few years, but we estimate that CFO pre-WC to debt will fall below 18% without any corrective action. SPS' parent company Xcel Energy has indicated that it plans to work directly with regulators of their operating utilities to offset the cash-flow impact of tax reform, including the potential for a higher equity layer, a higher authorized return on equity and accelerated recovery of regulatory assets. SPS' credit profile would strengthen if the company succeeds in bolstering its CFO pre-WC to debt ratio to above 20% on completion of its material capital program.

### **Wisconsin Gas LLC**

Wisconsin Gas LLC's (A2 negative) CFO pre-WC to debt metric has averaged around 25% in the past three years, but tax reform could cause it to decline to 16% to 19%. We believe that Wisconsin Gas has a reasonable chance of receiving regulatory support because Wisconsin Public Service Commission approved the company filing a plan for accelerated recovery of regulatory assets for Wisconsin Electric Power Company (A2 stable), Wisconsin Gas' sister company, to offset the effect of tax reform.

## Moody's related publications

- » [Corporate tax cut is credit positive, while effects of other provisions vary by sector \(21 December 2017\)](#)
- » [Trump Tax Blueprint Would Raise US Debt, But Be Credit Positive for Many Sectors \(9 May 2017\)](#)
- » [Tax Reform Likely to Increase Credit Risk, Impact Dependent on Regulatory Response \(15 March 2017\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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