National Association of Water Companies

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COMMENTS ON TAX REFORM FOR THE SENATE FINANCE COMMITTEE

Americans value clean, safe, and affordable drinking and wastewater services. Water is provided through a network of pipes over 700,000 miles long – more than four times the length of the National Highway system. These services are provided by America's water utilities—both public and private—which treat roughly 34 billion gallons of water every day.

The National Association of Water Companies (NAWC) is the voice of the private water service industry. By means of various business models, private water and wastewater professionals serve more than 73 million Americans. Nearly one in every four Americans receives service from a privately owned and regulated water or wastewater utility, or from a municipal utility operating under a public-private partnership. The vast majority of private water service providers are utilities which are overseen and regulated by state regulatory commissions (or PUCs) that determine the rates they charge their customers. Our members are located throughout the nation and range in size from large companies with hundreds of systems in multiple states to individual utilities serving a few hundred customers.

Tax Reform and Regulated Utilities

Regulated private water utility companies operate in a rate regulated environment in which the prices at which they deliver their services are set by PUCs. For this reason, the starting point for the private water sector in analyzing tax reform options is different than for non-regulated taxpayers.

By way of background, the prices charged by private water companies are based on the capital employed and expenses incurred in operating their businesses. PUCs set prices for services so that rates are affordable for customers and private water company shareholders can earn a fair return on their investment. If the costs of capital and taxes on private water companies increase, whether as a result of tax reform or otherwise, those increases are passed on to water customers.

Under state regulatory rules, private water companies are entitled to the opportunity to earn a fair rate of return on invested capital, and this is a key point that tax policymakers need to keep in mind. Because water companies are effectively "pass-through" entities with respect to taxes, the effects of tax reform eventually, and in some regulatory jurisdictions immediately (such as California and Hawaii), impact water customers dollar-for-dollar. While private water companies work hard to insure that the prices paid by their customers are in line with the prices that are paid by customers of municipally operated water services, tax reform may result in rate disparities that have little basis in terms of underlying cost of service and that are difficult for customers to understand.

Water touches everything and everyone; it is the unseen and unspoken engine of our economy. Drinking and wastewater infrastructure systems are critical to making everything function. If the cost of water goes up, the cost of living, of growing crops, of manufacturing and all else goes up. ***When evaluating tax reform, private water companies are concerned, above all else, on the impact the reform will have on the rates charged to their customers.***

A significant portion of the cost of service to customers is the cost of capital to support the enormous infrastructure necessary to deliver this service. The water and wastewater industry is highly capital intensive. On average the water and wastewater industry has invested approximately $3.50 of capital for every $1.00 of revenue[1]. Changes in tax law that have the potential to reduce the cost of service and push down rates would help provide access to capital by reducing pricing pressure on customers and making it possible for PUCs to establish rates that include an increased proportion for capital expenditures. Conversely, tax law changes that increase the cost of capital and the cost of service generally would have an opposite and detrimental effect.

In view of the country's massive need for investment in water infrastructure, water companies ask whether tax reform will increase or decrease their cost of capital and the rates borne by their customers. Water companies need access to affordable capital to meet the demand for infrastructure improvements. NAWC estimates that its six largest members, collectively, invest $2 billion per year in their systems – and those systems serve 6% of the U.S. population. Those companies, and all private water companies, have the central business mission of providing a secure and reliable water supply to their customers. Their ability to access capital to improve their systems is critically important.

[1] 2008 AUS Utility Reports.

Drinking and Wastewater Challenges

It is no secret that many parts of America's basic infrastructure are outdated, under stress and in need of major capital replacement or repair. Today, America's water infrastructure is more challenged than ever, requiring significant investment; tomorrow those challenges will be even greater.

The most recent assessment of the public's water system needs conducted by the Environmental Protection Agency[2] concluded that over the 20-year period from 2007 through 2026 the nation's drinking water infrastructure needs would be at least $334.8 billion.

In 2013, the American Society of Civil Engineers (ASCE) gave the U.S. water and wastewater infrastructure a grade of "D," as part of its infrastructure report card. According to the ASCE, if left unchecked, the nation's water infrastructure could cost businesses $147 billion and cost households $59 billion thru 2020. The ASCE also notes that under a worst-case scenario, if water infrastructure problems are not addressed, the U.S. could lose, through 2020, nearly 700,000 jobs, $541 billion in personal income, $416 billion in GDP and $6 billion in U.S. exports.[3]

A report from the Johnson Foundation, "Financing Sustainable Water Infrastructure,"[4] released in 2012, also found U.S. water systems in need of substantial investment. The report indicated that the investments required to meet increasing consumer demand and environmental standards are vast, but not insurmountable. It pointed out that meeting these investment needs would <u>require new financing models and pricing flexibility</u> to pay for new infrastructure and to support existing facilities.

Aging and deteriorating public water systems threaten economic vitality and public health. They are a severe challenge for the water industry—both public and private sectors—as is demonstrated by the staggering number of main breaks every day – 650 and rising – resulting in two trillion gallons of treated water lost at a cost of $2.6 billion annually. Communities nationwide are faced with massive fiscal challenges to replace critical water and wastewater infrastructure, many of which were originally intended to survive 50 to 75 years but have been in service for more than 100 years – well beyond their useful lives. Affordable and safe water is a critical resource and the time to ensure its reliable and continuous delivery to Americans is today.

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[2] The EPA performs a needs assessment for public water systems every four years. The last one was released in 2009 and a more recent report should be released later this year.
[3] The full report is available at http://www.asce.org/failuretoact.
[4] The Johnson Foundation, *Charting New Waters Convening Report: Financing Sustainable Water Infrastructure,* January 2012.

Corporate Income Tax Rate Reduction
Unique Regulatory Aspect and Revenue-Offset Concerns

NAWC supports the goal of reducing the current corporate tax rate of 35 percent. A reduced rate would directly reduce the cost of service of private water companies and enhance their ability to provide a secure, reliable water supply at affordable rates. However, NAWC has two concerns about a reduced corporate rate. First, as explained below, it is critically important that Congress accompany any such reduction with a provision specifying the effect of the rate reduction on the deferred tax liabilities that water companies hold on their balance sheets under utility regulatory accounting.

Second, in identifying tax increases needed to offset the revenue cost of rate reduction, NAWC's members are concerned that those tax increases could target capital-intensive companies, such as private water companies, and thereby offset the benefit of a reduction in the corporate tax rate. Whether a comprehensive bill would be, on balance, positive or negative for the industry, and its effect on the economy as a whole, would depend on the overall mix of such tax increases and reductions.

<u>Below we discuss the following issues in the sequence listed</u>:

I. Issues for regulated utilities concerning "excess deferred taxes,"

II. Issues of concern for all capital-intensive utilities, and

III. Issues **unique to the private water industry** that do not apply to other regulated utilities.

I. Treatment of "Excess Deferred Tax Liabilities"

If tax reform includes a reduction in the corporate rate, Congress must include in the legislation a provision that was included in the Tax Reform Act of 1986 relating to the effect of the rate reduction on deferred tax reserves of regulated utility companies. Such a provision is absolutely critical for private water companies. In the absence of such a provision, private water companies would likely view the overall effect of tax reform as sharply negative.

In the Internal Revenue Code of 1954, accelerated tax depreciation was formally sanctioned by Congress. Accelerated depreciation helps to stimulate capital formation, thus promoting "economic growth, increased production, and a higher standard of living."[5] However, for investor-

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[5] HR Rep No 1337. 83d Cong. 2d Session 24 (1954)

owned utilities regulated by state and local agencies, it was only with the subsequent Tax Reform Act of 1969 that the promise of capital formation was actually realized. The new rules provided that accelerated depreciation deductions for public utilities could not be claimed unless the utility used a "normalization method of accounting." Before that, regulators often required utilities to flow accelerated depreciation-related tax benefits to customers, depriving utilities of the needed cash flow to construct new facilities. Normalization is a concept in the tax code intended to dissuade regulators from requiring flow-through ratemaking. It requires a utility to use the same depreciation method in computing ratemaking tax expense as it uses in determining depreciation expense for cost of service. Thus, the benefits of accelerated depreciation are preserved, providing utilities with extra cash flow needed for plant investment.

Consistent with this normalization, the difference in tax and ratemaking depreciation must be adjusted to a liability account. This liability represents the amount of the utilities' tax expense recovered currently in rates, but not currently paid to the Treasury that the utility will actually pay in its future years' tax liabilities – a "deferred tax."

The deferred tax liabilities recorded by private water companies represent the pool of capital already invested by the companies in additional capital projects – precisely as intended by Congress in enacting accelerated depreciation and bonus depreciation. Given the country's pressing need for investment in water infrastructure, the tax deferral is a critically important tool for water companies. The rationale for tax policy that supports this investment has been repeatedly relied upon by Congress in extending and increasing rounds of bonus depreciation throughout the last decade when the economy has suffered some of its biggest setbacks.

If tax reform reduces the corporate rate, an immediate effect of the reduction will be to reduce the deferred tax liability of private water companies. That result would occur because the amount of income deferred through accelerated and bonus depreciation would be taxed in the future at the new reduced rate and not at the 35% rate that had been previously assumed to continue.

While non-regulated companies recognize an earnings benefit from a reduction of their deferred tax liabilities, the reduction remains a liability for regulated utilities because the future payment of the taxes must instead be returned to customers. The reduction in the deferred tax liabilities that remains a liability is known as an "excess deferred tax" liability. The Tax Reform Act of 1986 similarly reduced the corporate tax rate and, thereby, created excess deferred tax liabilities on the books of regulated utilities at that time. Congress included in the Act a provision (Section 203(e) of the Act) requiring utility regulatory commissions to return the amount of the excess liabilities back to the ratepayers over the average life of the associated assets (using the average rate assumption method or the South Georgia method). This resulted in making the timing of paying the excess deferred liability as if it had been returned as tax to the government as was originally intended. If there is corporate rate reduction in a new tax reform measure, Congress should again include both the average rate assumption method and the South Georgia method. A faster return of the excess deferred tax reserves would put private water companies in the position of having to identify new sources of capital to replace that amount. The deferred tax reserves are not sitting in cash waiting for the companies to tap; rather, companies have invested the reserves in new water infrastructure, as intended by Congress.

NAWC strongly urges Congress to include the requirement for the use of the average rate assumption method and/or the South Georgia method for returning excess deferred taxes. It is important to highlight that this is not an issue that affects the amount of federal income tax that will be paid by private water companies under tax reform. On the contrary, the requested relief described above would avoid a negative impact on tax revenues that could occur if the excess deferred tax reserves were returned to ratepayers more rapidly than under the average rate assumption method or the South Georgia method and, thereby, result in reductions in the taxable revenues of the companies.

The comprehensive tax reform measure introduced in 2014 by the chairman of the House Ways and Means Committee, Dave Camp, includes the requested relief described above. ("The Tax Reform Act of 2014," H.R. 1 (2014), hereinafter "Camp Proposal.") We strongly urge the Finance Committee to include the same provision in any tax reform measure considered in the committee.

II. Concerns Applicable to All Capital-Intensive Utilities

Interest Deductions

The arithmetic of tax reform is challenging. To significantly reduce the corporate rate will require Congress to make many difficult and possibly unpopular choices. We are aware that some tax writers are considering whether the deduction for interest could be cut back as a way of making the arithmetic work more easily. The possibility for such a cutback would create a major new risk in the tax reform debate from the perspective of NAWC companies.

For capital-intensive companies such as NAWC's private water companies, the cost of debt as a component of the cost of capital borne by its customers is significant. Any alteration of the deductibility of interest may offset the benefit of a rate reduction, result in an increase in rates to customers for their water service, and hamper investment in infrastructure. Interest has always been regarded as a deductible cost of doing business. Obviously, leveraged, capital intensive companies such as private water suppliers, that have had to take on debt to fund necessary investments, would be disproportionately affected by such restrictions.

The Camp Proposal of 2014 did not include restrictions on interest deductibility, but we are aware that some tax writers continue to explore whether such restrictions could be a suitable budget offset in a tax reform measure. We urge the Finance Committee to reject cutbacks in interest deductions.

<u>Accelerated Depreciation</u>

The timing of the recovery of plant and equipment costs through depreciation deductions has an effect on a utility's cost of capital. A robust allowance for depreciation is necessary to encourage capital investment in plant and equipment. NAWC members believe the existing depreciation rules for water companies' plants and equipment are appropriate. Nevertheless, we would point out that there are special depreciation rules for water that provide lesser depreciation benefits than afforded other industry segments. The Small Business Job Protection Act of 1996 created a new classification of depreciable property called "Water Utility Property." Prior to these amendments, water and sewer utilities could use the 150%-declining-balance method and a 20-year recovery period to calculate tax depreciation on this property. However, the Act mandated the use of the straight-line method and a recovery period of not less than 25 years.

If changes are made to the current cost recovery rules, NAWC requests that the new rules applicable to private water companies be developed based on considerations directly related to their pressing infrastructure needs. The faster that water companies can recover their costs of new plant and equipment, the sooner and the more money water companies can reinvest in additional new plants and equipment.

The Camp Proposal included a sharp cutback in depreciation for water utilities by specifying a recovery period of 50 years for water utility and water treatment property and other types of utility property. The proposal retains the required straight-line depreciation method. Only utility assets would be subject to 50-year depreciation under the Camp Proposal. Almost all other types of assets would be depreciable over 30 years or less (in most cases, much less). The shift to a 50-year depreciation period would substantially raise the cost of capital investment for water utilities. We urge the Finance Committee to reject such a disproportionate cutback in depreciation deductions for water utilities.

<u>Taxation of Dividends</u>

Private water utilities—many of which are investor-owned—issue dividend-paying stocks as the primary source of equity capital. Investors in water utility stocks expect and require regular dividends. The price of water utility stocks is closely tied to the dividends paid and the taxes imposed on those dividends. If the taxes on the dividends go up, the value of the stock will fall or the amount of dividends paid by the water utilities will have to increase. In either case, the cost to water companies of this very important source of equity capital will increase. NAWC has long supported low taxes on dividends both because they help reduce the cost of capital to private water companies, and the lower rates help ameliorate the current double taxation of corporate earnings.

As a result of the combined effects of the American Taxpayer Relief Act of 2012 (ATRA) and the investment income tax added by the Affordable Care Act, the top tax rate on dividends increased by more than 50%. ATRA also maintained parity of capital gains and dividend rates, a critical principle that ensures growth stocks and dividend-paying stocks operate on an even playing field under the tax laws. NAWC believes that continued parity between capital gains and dividend rates is vitally important. More importantly, NAWC believes no further increases are necessary and would be counter to the fundamental goals of tax reform.

The Camp Proposal preserved parity between the capital gains rate and the top tax rate on dividends. We urge the Finance Committee to take the same position in any tax reform measure.

Section 199

Congress enacted Section 199 in 2004 explicitly to encourage domestic production. The provision applied broadly to all forms of domestic production, including manufacturing, mining, agriculture, and utilities producing gas electricity and water. The intent of this policy still makes sense today.

The Section 199 deduction serves essentially as a rate reduction for companies that qualify. We recognize the possibility of curtailment of Section 199 in a major tax reform effort. A reduction of the corporate tax rate would offset the loss of the Section 199 deduction for NAWC companies. The Camp Proposal included repeal of Section 199.

III. Concerns Unique to the Water Industry

Private Activity Bond Reform

One of the most effective tools of the federal government in helping provide financing for long-term, capital-intensive infrastructure projects is the private activity bond (PAB). PABs are important tools water and wastewater systems need and use for public-purpose drinking water and wastewater projects. PABs make infrastructure repair and construction more affordable for municipalities and ultimately for users and customers, as they spur capital investment in public water projects throughout the country during a time when governmental budgets are tight. Investors prefer PABs because interest accrues tax-free. Tax reform should provide greater access to PABs by removing state volume caps for PABs used for community water projects.[6]

The Camp Proposal moved in the opposite direction by repealing the tax exemption for interest on newly-issued private activity bonds. The elimination of tax-exempt finance for water projects in which private companies are participants would have the inevitable effect of impeding access to capital by private water companies and thereby frustrating the ability of those companies to update infrastructure and provide the highest quality service to customers. We urge the Finance Committee to expand, not contract, the access to PABs used for water projects.

Contributions-in-Aid-of-Construction

To provide service to new customers or new locations, water utilities often must expand their systems by installing new pipes or other equipment. Typically land developers reimburse utilities for the actual cost of those expansions. The tax code treats the reimbursements (termed contributions in aid of construction, or CIAC) as nontaxable contributions to the capital of the utility rather than as taxable income. As a tradeoff, the tax code precludes the utility from including the system expansions in its rate base for rate-making purposes and also precludes the utility from taking any depreciation deductions with respect to the expansions. Absent this treatment, water utilities would require land developers to pay the utility a gross-up for additional taxes that the water utility would have to pay as a result of being required to include the CIAC in taxable income. Thus, the tax benefits of the current treatment of CIAC inures to the benefit of water customers (such a purchasers of new homes) and not to the water utilities.

This is another example of major tax reform potentially changing the balance of competition with municipal providers. We saw this after the Tax Reform Act of 1986 when CIAC became taxable. Municipal water utilities became more cost competitive than investor-owned utilities. Tax policy had the unintended consequence of encouraging development of areas served by municipal providers at the expense of investor-owned providers. The Small Business Job Protection Act of 1996 remedied this situation. Water customers ultimately bear the brunt of any tax increases on private water companies. Customers benefit from system growth through more efficient use of treatment and storage facilities. The treatment of CIAC as capital contributions is sound policy.

NAWC believes that the current tax law treatment of CIAC is appropriate and should not be changed. The rules governing CIAC, particularly the rule precluding depreciation deductions,

[6] Bi-partisan and bicameral Congressional support exists for removing water projects from state volume caps for PABs. Dozens of business and other groups support this proposal, including the Clean Water Council, the U.S. Chamber of Commerce, Operating Engineers and Laborers' Unions, and the U.S. Conference of Mayors.

ensure that no advantage is achieved by water utilities from the treatment of CIAC under current law.

As with private activity bonds, the Camp Proposal moved in the opposite direction by repealing the current treatment of contributions in aid of construction. Under H.R. 1 (2014), such contributions to a water utility would constitute taxable income. That provision would have the effect of tilting the playing field toward municipal utilities that would pay no tax on such contributions. We urge the Finance Committee to take the opportunity in tax reform to maintain parity in the treatment of private water companies and municipal water companies, not to create unnecessary disparities.

Closing Thoughts

NAWC members are good corporate citizens who provide essential services—safe, reliable and clean drinking and wastewater—every day at reasonable cost and excellent value. NAWC supports tax reform that increases U.S. competiveness and creates jobs here in the United States. This can be done through tax policies that encourage domestic investment by lowering the cost of capital, and the cost of service generally, to companies that invest in plant and equipment in the United States, particularly those companies investing in vital infrastructure needs. NAWC encourages Congress to design tax reforms that will consider the cost of water service throughout the nation, and promote increased investment in infrastructure.

NAWC members recognize that tax reform will involve difficult trade-offs. We support Chairman Camp's effort to reduce the corporate tax rate to 25 percent, and we applaud his inclusion of the normalization provision to address the issue of excess deferred taxes. However, the rate reduction would come at the cost of other provisions that will have the effect of a substantial hike in the cost of capital for water utilities. Specifically, the doubling of the depreciation period, along with the repeal of the current tax treatment of both private activity bonds and contributions in aid of construction will have that effect.

If the Finance Committee takes up tax reform, we strongly urge the committee to seek a means of offsetting the cost of tax reform other than hiking the cost of capital to the customers of investor-owned water companies. Private capital investment in domestic water infrastructure means not only economic growth, but reliable, safe water supplies.