The Honorable Kevin Brady
United States House of Representatives
301 Canon House Office Building
Washington, DC 20515

The Honorable Mike Thompson
United States House of Representatives
231 Canon House Office Building
Washington, DC 20515

Via Electronic Service: tax.reform@mail.house.gov

Re: Comments of the American Gas Association to the Energy Tax Reform Working Group

Dear Representatives Brady and Thompson,

The American Gas Association is pleased to provide comments to the Ways and Means Committee Energy Tax Reform Working Group. Through these comments, AGA respectfully requests that Congress consider tax reform initiatives that preserve and encourage our member natural gas delivery companies' ability to invest in safe, reliable natural gas systems. AGA supports the goals of comprehensive corporate tax reform to promote economic growth, fairly allocate tax responsibility, simplify the U.S. tax code, and reduce corporate tax rates. Natural gas is already proving to be a key driver of the economic recovery that is also the ultimate goal of comprehensive tax reform. A tax environment favorable to investment in natural gas and the infrastructure that carries it to American homes and businesses, will continue to benefit our economic recovery while serving our nation's growing energy needs. Our comments below explain how changes to existing tax policy could impact gas utilities' ability to assure the integrity and safety of gas utilities' pipeline infrastructure and maintain stable customer rates.

I. Statement of Interests

AGA represents more than 200 local energy companies that collectively make more than $7 billion in investments annually to deliver clean natural gas throughout the United States. Of the 71 million residential, commercial and industrial natural gas customers in the U.S., 92 percent — more than 65 million— receive their gas from AGA members. AGA's membership delivers the fuel that American homes and businesses will continue to rely on as the cornerstone of a bright energy future. Our comments are focused on ways to keep the delivery of gas affordable so America can realize that future.

II. Background: Tax Cost Impacts on Regulated Utilities and their Customers

Regulated, shareholder-owned natural gas utilities are capital-intensive businesses because they invest in large projects to maintain and enhance long-lived pipeline assets that support a reliable, expanding, nationwide natural gas delivery infrastructure. The industry has an ever-growing need for capital investment for this purpose, and satisfies this need with debt and equity financing in about equal portions. The industry's need for additional capital has never been greater than today, as companies are actively revitalizing their infrastructure, adding needed capacity, and undertaking significant investments to comply with pipeline safety and environmental regulatory mandates. AGA's member natural gas delivery companies' efforts in this regard benefit American energy consumers by enhancing the reliability, quality and affordability of natural gas service, and also contribute to job creation and economic growth in the communities they serve.

State regulatory authorities play a major role in overseeing the rates charged to natural gas customers and what services must be provided by gas utilities. Gas utilities are charged with an "obligation to serve" that distinguishes them from other businesses, because they must have the resources and ability to provide gas to all of their customers, even on the coldest day of the year. This obligation closely informs gas utilities' current and future capital outlays, and they are permitted by their state regulatory authorities to pass their capital costs, including tax costs, to their customers.[1] The state regulatory entity will consider these costs along with other operating expenditures, to determine how much the utility can charge for its delivery services as well as the amount of profit the utility is permitted to earn, known as the rate of return.[2] Gas utilities do not, however, earn a return from the sale of natural gas itself, passing the costs of purchased gas dollar-for-dollar to customers.[3]

Cost recovery is therefore a regulatory mechanism which allows gas utilities to cover a portion of the financial outlays made for infrastructure. Along with the ability to earn a return on the delivery service provided, these rate-making considerations have important consequences for gas utilities' future access to the capital required to maintain safe and reliable service. Gas utilities rely on cost recovery and on a reasonable rate of return to reinvest profits into their businesses, return a dividend to shareholders, and thereby

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[1] *See, e.g.* American Gas Association, "How Natural Gas Utility Rates are Set," available on the AGA website.

[2] It is important to note that the regulatory authority does not guarantee a utility a rate of return, or profit; the rate-making process simply gives a utility an opportunity to make a return. If, due to inflation or some other cause, the utility fails to achieve its authorized rate of return, the utility can go back to the state commission to request a new rate, but it may not recover what it failed to earn previously.

[3] This gas cost is typically passed through in purchased gas adjustment clauses in gas utility tariffs, and may be modified routinely and at least annually so that gas utilities can flow through these costs in customer rates.

incentivize additional investment, maintain a favorable credit rating, and ultimately raise more capital to benefit the quality of service to current and future customers.

AGA also urges Congress to consider the long-term impact of revenue-raising proposals on American energy consumers, particularly small businesses and low-income customers. Tax costs passed on in natural gas rates will have a disproportionate impact on these customers, who spend a greater share of their income on affordable natural gas to run their facilities and heat their homes. Therefore, not only would tax cost increases crowd out gas utility investments in natural gas infrastructure, they would have a regressive impact on the commercial and residential customer base served by AGA's member companies.[4]

For these reasons, the regulated gas utility business model uniquely relies on access to affordable capital sources to meet the twin goals of investing in reliable service and achieving customer rate stability. These considerations make it incumbent on gas utilities to identify and take advantage of tax and financial policies that create opportunities to raise affordable capital. AGA submits that significant changes to current tax policies could be highly disruptive to the industry and their customers in the short and medium term, but could be managed in the long-term, provided that permanent constraints are not placed on gas utilities' access to affordable debt and equity financing.

III. Tax Policy Priorities for Natural Gas Utilities

AGA respectfully requests that potential impacts on gas utilities and their customers be carefully evaluated, as Congress considers tax expenditures, deductions and tax-deferral mechanisms as potential "trade-offs" for a lower corporate tax rate. Our comments below focus on four major areas where any modifications to existing tax policy should be tailored to preserve gas utilities' access to affordable capital required to invest in the long-lived pipeline assets which deliver safe and reliable natural gas to American energy consumers. We also requests that Congress ensure that tax and financial reform proposals incorporate policies and transition rules that anticipate and mitigate unintended consequences for natural gas utilities and their customers.

Parity between Dividends and Investment Income Taxes Drives Economic Growth.

Maintaining parity in the tax treatment of dividend and capital gains is important to ensure that natural gas utilities can continue to raise capital from investors and contribute to economic growth and job creation. For example, parity in dividends and capital gains taxation prevents current and future gas utility investors from migrating away from lower risk, dividend-paying stocks toward higher risk capital gains opportunities. AGA commends Congress' action to make permanent a 20% rate for

[4] *See* American Gas Association, "Low Income Home Energy Assistance Program," for a discussion of how natural gas utility programs funded by customers and shareholders help low-income customers with their gas bills, available on the AGA website.

dividends, and encourages lawmakers to maintain lower rates on investment income and maintain parity for tax rates on dividends and capital gains.

Gas Utilities Rely on the Corporate Interest Deduction to Access Affordable Capital.

Natural gas utilities drive economic growth through investments in large capital projects. In general, they typically raise about 50% of the capital required for these projects from corporate debt. If gas utilities cannot deduct interest payments made on corporate debt, their borrowing costs and overall cost of capital would increase dramatically. For AGA members, the loss of the interest deduction, without a concurrent reduction in the corporate tax rate, could increase effective tax rates to between 42% and 50%.

These impacts can vary further depending on upward pressure on interest rates and the recoverability of capital costs from ratepayers over time. Gas utilities rely on federal deductions for interest costs to help minimize increases in customer rates, particularly for critical infrastructure and other capital-intensive projects. Further, while gas utilities' rate-regulated revenue streams include the costs of servicing their debt obligations over time, their cost recovery is limited in any given year by state regulators to maintain stable customer rates. For these reasons, the dramatic increase in tax costs created by a loss of interest deductibility would place serious economic constraints on gas utilities' ability to both invest in reliable service and achieve customer rate stability. Short and long-term impacts would include (i) an immediate capital shortfall, (ii) flow-through of tax increases or related higher costs to customers, (iii) increase in the overall cost of capital, and (iv) financial constraints on utilities' ability to meet their infrastructure investment goals. AGA urges Congress to preserve gas utilities' ability to deduct interest expenses on corporate debt obligations.

Tax Policies that Protect Deferred Taxes Incentivize Gas Utility Investments.

AGA supports a reduction in the corporate tax rate as part of a comprehensive tax reform effort to stimulate the U.S. economy. So that natural gas utilities can continue their contribution to promoting economic growth, AGA requests that Congress protect natural gas utilities' ability to rely on tax code provisions that encourage capital investment in a safe, reliable natural gas delivery infrastructure.

Normalization is an accounting methodology in the tax code that ensures the inter-period allocation of the income tax benefits associated with tax provisions designed to incentivize capital investments, like accelerated depreciation. As gas utilities are uniquely capital-intensive businesses subject to state regulatory oversight, they rely on normalization principles to receive the intended benefits of deferred taxes created through such tax provisions. For example, to take advantage of tax benefits from accelerated depreciation, a gas utility "normalizes" the tax benefit by setting up a "tax-deferred" reserve account that is funded with the difference between the tax benefit created by accelerated depreciation and the "book" or rate-making expense used to determine the utility's cost of service. This reserve account is drawn down in later years, as the benefits of accelerated depreciation reverse and the utility pays back the deferred tax amount to the government. Normalization therefore does not permit state regulators to use the higher expense for rate-making purposes, allowing utilities to retain the current cash flow benefits of accelerated depreciation as a source of capital in the short and medium-term. Importantly, customers also receive this benefit because the utility's deferred tax balance is treated as capital available to the utility at no cost to customers and reduces the overall capital costs passed to customers over time. For these reasons, AGA strongly supports the continued normalization of deferred tax benefits.

Normalization accounting should also be made available to gas utilities to protect any "excess" deferred taxes created by a reduction in the corporate rate. Gas utilities compute and accumulate deferred tax balances at the current 35 percent rate, planning to pay future taxes at that rate. A drop in the corporate rate would create a surplus that is not protected under current normalization rules, and that surplus (or "excess") would need to be flowed back (refunded) to customers. Should Congress reduce the corporate tax rate, AGA requests a transition rule also be enacted to allow gas utilities to return excess deferred taxes to customers over the remaining regulatory life of the assets which gave rise to the deferred taxes.

Congress previously recognized the need for a transition rule to protect such a surplus in the 1986 Tax Reform Act. If a similar requirement is not enacted as a part of corporate tax reform, state-level regulators could require gas utilities to immediately flow through (refund) all excess deferred taxes to customers. This would lead to acute pressure on gas utilities' cash positions and force utilities to seek costly financing from capital markets to meet investment targets that were originally made in reliance on tax deferral planning. An immediate flow-through of excess deferred taxes would also bestow a disproportionate windfall on current customers at the expense of future customers, and crowd out capital investment opportunities that would benefit all customers in the short and long-run.

Tax Policy Changes Impacting Depreciation Should Protect Deferred Taxes.

As explained above, accelerated depreciation allows natural gas utilities to depreciate their long-lived pipeline assets more rapidly than they take the same costs into account for ratemaking purposes. Under principles of normalization, the benefits created by accelerated depreciation have a significant role in reducing the cost of capital paid for by customers over a period of years and provide an affordable source of capital for current investments.

Natural gas utility capital cost recovery periods are among the longest in any industry. Recently, the depreciation life of gas distribution property was increased to 20 years from 15 years. If Congress were to further move natural gas utilities' pipeline assets to a longer depreciation schedule, immediate capital shortfalls would result because utilities would lose an important source of affordable capital, and their customers would lose the accompanying benefits in the short and medium term.

In the longer-term, AGA members note that customer impacts created by a move to an alternative depreciation schedule and accompanying reduction in the corporate rate can be managed as long as: (i) the corporate tax rate falls to between 20% and 22%, (ii) gas utilities are able to maintain their past normalized deferred tax account balances, and (iii) Congress protects gas utilities' ability to normalize the return of surplus, or "excess" deferred taxes to customers.

IV. Conclusion: Favorable Tax Policy for Natural Gas Will Drive Economic Growth

Natural gas is proving to be a backbone of the American economic recovery, a vital contributor to our national emissions reduction goals, and the foundation fuel for an energy-independent America. Tax reform initiatives should allow AGA members continued access to affordable capital that is required to sustain and enhance the infrastructure that delivers this vital resource throughout the United States. Tax policies should mitigate unintended consequences on gas utilities and their customers because tax costs associated with revenue-raising proposals will ultimately impact natural gas prices paid by American energy consumers.

AGA appreciates the opportunity to submit comments on these issues. If you have any further questions about these items, please contact us at the contact information noted below.

Sincerely,

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