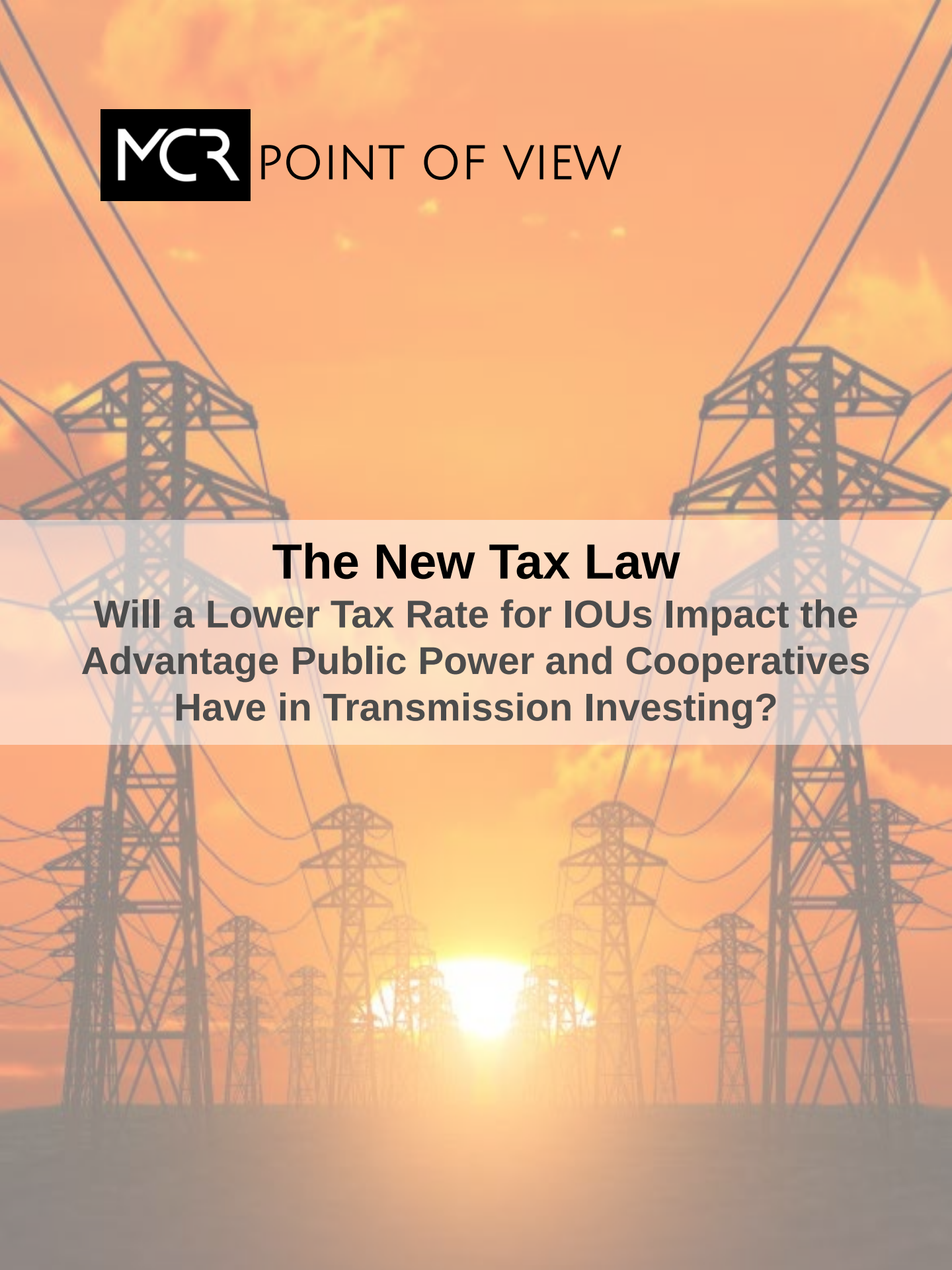

MCR POINT OF VIEW

The New Tax Law

Will a Lower Tax Rate for IOUs Impact the Advantage Public Power and Cooperatives Have in Transmission Investing?

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Before the new tax law, public power and cooperatives had a significant revenue requirement advantage when investing in transmission. For example, the annual transmission revenue requirement ("ATRR") of the typical investor owned utility ("IOU") or Transco was 35-70% higher than a joint action agency ("JAA") or generation and transmission ("G&T") cooperative. There are three primary reasons for the stark difference:

1. IOUs and Transcos have a combined federal and state income tax rate, typically in the range of 37-41% while public power and cooperatives do not pay any income tax.
2. The equity ratio of IOUs and Transcos are in the 45% to 60% range, whereas G&Ts and JAAs are typically in the 15%-40% range.
3. The cost of debt for IOUs and Transcos can be higher than the cost of debt for G&Ts and JAAs, because in most cases, public power and cooperatives have access to tax-exempt or low-interest government financing.

In a typical case, before the federal income tax rate change,[1] we can compare a G&T (or a JAA) that has an equity ratio of 25% and a cost of debt of 4.5% with a nearby IOU in a joint pricing zone. The IOU has an equity ratio of 55%, pays a 39.5% combined income tax rate[2] and has a

[1] This paper does not address the one-time rate impacts related to the reversal of deferred taxes due the reduction in the tax rate. These one-time impacts do not affect the calculations in this paper as customer rates are generally based on book accounting rather than tax accounting impacts.

[2] 35% federal rate and 6.95% state rate with state taxes being deductible on the federal return.

5% cost of debt.[3] Each party is considering whether to invest in a $10M transmission project.[4] In this example, the IOU's first year revenue requirement (i.e., annual cost) is about $1.60M and the G&T's is $1.04M – a difference in the first year of $556,000 or 53%.[5] Assuming the project is needed, the difference in revenue requirement is a huge motivation for public power and cooperatives to invest as much in the transmission project as it is can in order to better control rate increases applicable to all customers in the pricing zone.

With the new tax law, which lowers the statutory "book" rate from 35% to 21%,[6] the IOU's ATRR decreases by $163,000. Thus the difference in the annual revenue requirement in the example shrinks from 53% to 38%, or from about $556,000 to $393,000 (a 29% reduction).[7] While this is a sizable reduction in the spread, a 38% difference is still a substantial revenue requirement advantage for the G&T. Note that the ATRR difference between the IOU and G&T declines as the equity ratio for the G&T increases (see Exhibits 1 and 2 for the dollar difference and the percentage difference, respectively).

In the case of many municipal utilities, however, the impact of the new tax law can be more consequential, because the equity ratio for a municipal can be much higher. Assume a municipal has an equity ratio of 80% with a 3.5% cost of debt. Before the tax rate reduction, a typical IOU's annual

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[3] Assumes total ROE (including 50 basis point RTO membership adder) of 10.15%, which is representative of recent ROE settlements in SPP (e.g., 9.60% base plus adder) and the recent administrative law judge ("ALJ") decision in MISO (9.7% base). Also assumes incremental O&M, A&G and non-income taxes as a percentage of the gross plant investment are comparable (2%) and each party has the same depreciation rate (2.5%). Assumes the project is routine without a hypothetical capital structure available for the G&T. Assumes the cost of capital is not materially affected by the investment.

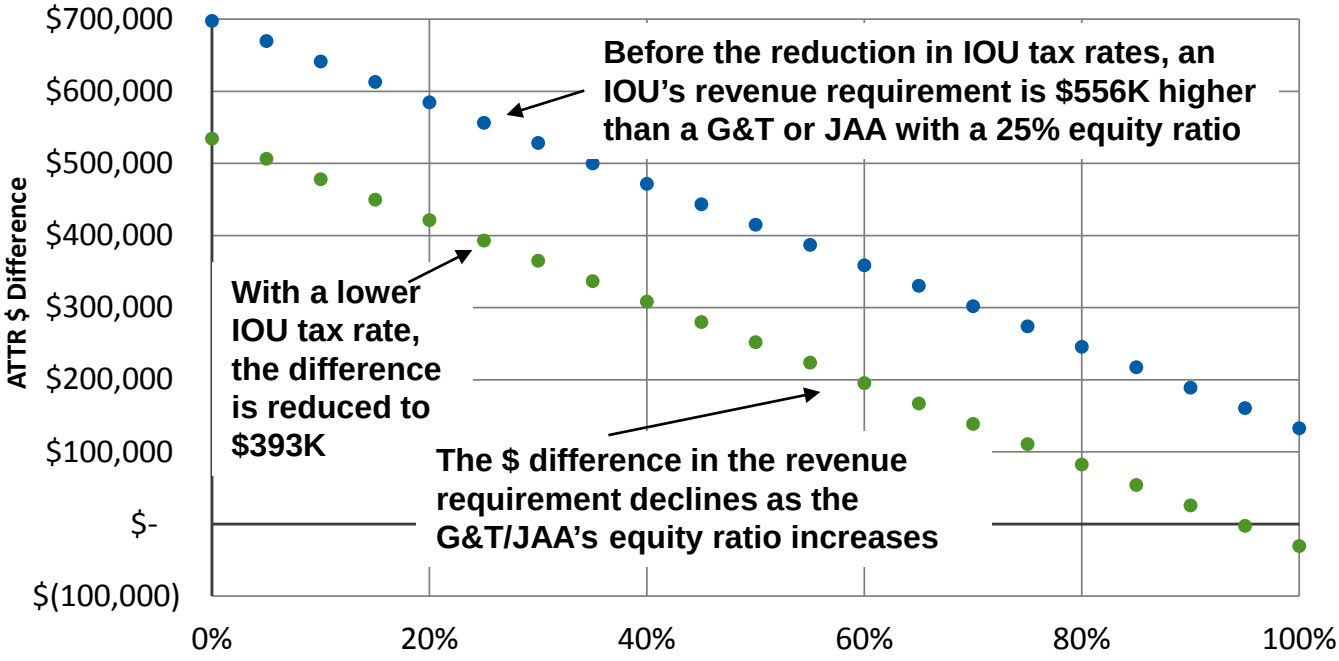
[4] The project is assumed to be a routine reliability project (not cost-shared).

[5] Revenue requirement figures reflects each party investing the full amount in the project. To the extent the ROE for both the IOU and G&T is higher or lower, the dollar difference in revenue requirements will change slightly but the percentage difference does not change.

[6] The combined federal and state income tax rate is lowered from 39.5% to 26.5%, assuming a 6.95% state tax rate.

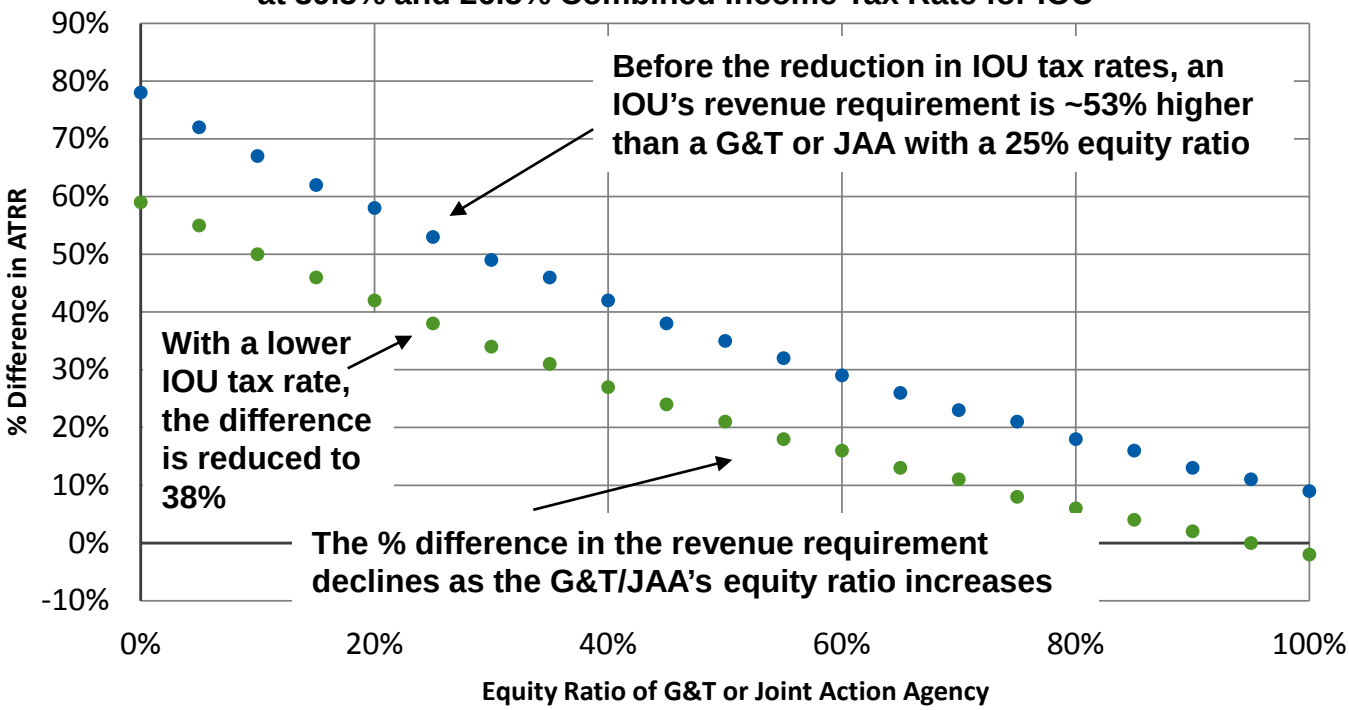
[7] Assumes all other factors remain the same. As the investment depreciates, the dollar difference declines slightly each year but the percentage difference remains the same.

Exhibit 1
$ Revenue Requirement Difference* Between IOU and G&T/JAA as Equity Ratio Changes for $10M Transmission Investment
at 39.5% and 26.5% Combined Income Tax Rate for IOU



* ATRR difference in first year

Exhibit 2
% Revenue Requirement Difference Between IOU and G&T/JAA as Equity Ratio Changes for $10M Transmission Investment
at 39.5% and 26.5% Combined Income Tax Rate for IOU



revenue requirement was about 20% higher than this municipal in our example.[8] After the drop in the IOU's income tax rate, the IOU's $163,000 reduction in its revenue requirement reduces the spread to only 8%. Assuming a $10M transmission investment, the difference in the annual revenue requirement in the first year from this project shrinks by 61%, from about $266,000 to about $103,000. In general, the higher the municipal's equity ratio, the smaller the cost advantage it has over IOUs and Transcos.[9]

So, will a shrinking revenue requirement advantage from lower IOU tax rates dampen new transmission investment by public power and G&Ts? No, it should not. Although the tax rate reduction will narrow the revenue requirement advantage in transmission investing for G&Ts, JAAs and municipals, in the vast majority of cases, there is still a significant rate advantage to customers when public power and cooperatives invest. Therefore, the tax rate reduction for IOUs alone will not substantively raise the "market share" of new transmission for IOUs/Transcos relative to public power and G&Ts.[10] Even if a public power entity has a relatively high equity ratio, the economic reality is that transmission investing for public power and cooperatives is still very attractive, as they will continue to receive high rates of return relative to their low actual cost of debt capital. Public power and cooperatives gain a very attractive "margin" on transmission investment that they can use to offset rising industry transmission rates. The bottom line is that the tax law change should not affect the fundamental transmission investment strategy of G&Ts and public power. MCR

[8] Again, assumes the same ROE of 10.15%, the same incremental O&M and non-income taxes as a percentage of the gross plant investment (2%), and the same depreciation rate (2.5%)

[9] To the extent the ROE is lower for both the IOU and the municipal, the dollar difference in revenue requirements will change slightly but the percentage difference does not change.

[10] A possible exception is when an IOU or Transco is partnering with public power or cooperatives with the sole purpose of lowering the revenue requirement in a competitive bid.

ABOUT THE MCR TRANSMISSION STRATEGY PRACTICE

MCR provides strategy support to G&T and T&D cooperatives, joint action agencies and municipals in various RTOs/ISOs with a focus on finding value for our clients. Our services:

Formula Rate and Cost Analysis

- **Development of Annual Transmission Revenue Requirements (ATRR) for New Transmission Owners (TOs).** MCR develops cost data to support full RTO revenue recovery, which involves, for example, developing MISO's Attachment O, and Attachment H in SPP and PJM.
- **Formula Rate Review for Existing TOs.** MCR reviews costs for formula rate filings to optimize revenue, properly record costs and withstand stakeholder scrutiny.
- **Challenge to Incumbent/IOU Formula Rate Costs.** MCR reviews neighboring utility transmission costs to ensure adherence to protocols and formula rates.
- **Staff Education Workshops.** MCR conducts workshops to educate client staff on the development and optimization of transmission formula rates.

FERC Filings

- **Section 205 Rate Filing Support.** MCR provides expert testimony for ATRR filings, including new transmission formula rates or changes to an existing formula rate.
- **Cost of Capital Expert Testimony.** MCR provides expert testimony and analytics to support proposed cost of capital requests of public power and cooperatives.
- **Transmission Incentive Rate Filings.** MCR provides expert testimony and supporting analytics for incentive rate applications, including CWIP, hypothetical capital structure, abandoned plant and regulatory asset.
- **Intervention and Mediation Support.** MCR provides analytical and intervention support during intervention, settlement, mediation and hearing.
- **Reactive Power Revenue Filings.** MCR provides testimony and analysis to support recovery of reactive power costs.

Strategic Analysis

- **Development of Transmission Business Plan.** MCR works with clients to define issues, goals, strategies and project opportunities, providing analytic support.
- **Economic Evaluation of Transmission Investment.** MCR determines economics, risks of new investment, or sale/purchase of existing assets.
- **Evaluation of RTO Membership.** MCR conducts economic and risk analysis to determine the cost-benefit of becoming a TO.
- **Analysis and Development of Negotiating Strategies.** MCR provides analytical support to clients in negotiations with IOUs.

Learn more at www.mcr-group.com

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