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Tax Reform Isn't One-Size-Fits-All For Energy Industry

By **Keith Goldberg**

Law360, New York (September 7, 2017, 5:59 PM EDT) -- President Donald Trump's choice of a North Dakota refinery for a speech on tax reform Wednesday hinted that tax relief for the energy sector might be in the cards.

But different segments of the industry have differing wants and needs. Even if Congress manages to craft tax reform legislation, which is far from a sure thing, the few, overly broad goals sketched out so far by Trump and Republican congressional leaders could hurt one corner of the energy sector as much as it helps another, experts say.

“It is very hard to generalize and say all energy is going to look at tax reform the same way,” said Stoel Rives LLP partner Greg Jenner, a former head of the U.S. Department of the Treasury's Office of Tax Policy who also worked on the last major tax reform bill passed by Congress, in 1986. “It's a big mix and not easy to cull out one factor that means more than anything else.”

Here, energy tax experts outline what issues will be on the minds of the oil and gas, power, and renewables sectors as Congress and the Trump administration try to tackle tax reform.

Oil and Gas Sector

The tax reform priorities of oil and gas companies will depend on the part of the sector in which they operate, experts say.

Supermajors and other large, multinational oil and gas producers will likely welcome Trump's call to reduce the corporate tax rate from its current level of 35 percent to 15 percent. Given their global reach, those companies would also be interested in an adoption of a territorial tax system in which they're taxed little on their non-U.S. earnings, as well as an ability to repatriate profits stashed abroad.

“Given that commodity prices are very low, using that money where it's safer and cheaper to drill would be beneficial for these big international companies,” said James Chenoweth, a partner in Gibson Dunn & Crutcher LLP's tax and energy and infrastructure practices. “Those will be big-dollar items.”

But those issues matter less the further one gets from oil and gas wells, experts say. Most midstream companies — pipeline operators and other infrastructure companies — are organized as master limited partnerships, which are pass-through entities that aren't subject to corporate-level taxation.

What those companies will be focused on is whether any tax reform would allow full expensing of capital investments, in which companies can depreciate the entire value of their investment at once instead of over time, experts say.

“For people in the downstream and midstream sector, that would be very beneficial because expansion is very capital-intensive,” Chenoweth said. “In the upstream sector, not as much, because most of the cost of expansion in the upstream sector is leasehold and actual drilling costs.”

Utility and Power Sector

While utilities and independent power producers and transmission companies wouldn't mind a somewhat lower corporate tax rate, a drastic cut might not be as welcome, experts say. Like the midstream oil and gas industry, the power sector is an infrastructure-heavy business that counts on its ability to depreciate the value of its projects to ease its tax burden.

“If you're capital-intensive, the lower the tax rate, the less value your depreciation is,” Jenner said. “To the extent you're adding new equipment, your cost is going to be the same, but your tax benefit is going to be lower, because of lower rates.”

The power industry will also be wary of any potential tradeoffs to a lower corporate tax, especially ones that reduce the ability to deduct interest, experts say. For an industry that finances much of its development, lower interest deductions would translate to higher capital costs.

Utilities can recover those costs through regulated rates, but merchant power companies don't have that option.

“The power industry finances so many of these power plants, so the power industry and private equity guys coming with money they've borrowed, they're really wondering about the interest expense limitations,” Orrick Herrington & Sutcliffe LLP tax partner Barbara de Marigny said. “There's a big question mark there.”

Renewables Sector

Given the Trump administration's focus on fossil fuels, preserving the tax credits they currently have will be the immediate tax reform priority for the renewables industry, experts say.

For the wind industry, that means protecting the phaseout of the production tax credit, which expires in 2020. For the solar industry, it's the reduction of the investment tax credit that starts in 2019 and reaches its lowest level in 2022.

However, any potential reduction on corporate tax rates will be squarely on the radar of renewable companies, given their reliance on tax equity investors as a project financing source.

Ironically, the renewable producers benefit from higher corporate tax rates, because their tax equity investors will pay more, Jenner said. “They are beginning to see the amount that tax equity investors will invest decrease because of the prediction of lower tax rates.”

Mayer Brown LLP tax partner David Burton, who leads the firm's New York renewable energy group, said the wind industry, through its use of the PTC, will be especially sensitive to any corporate tax rate cuts.

“Solar deal models are less impacted by a reduction in tax rates — there's more pre-tax income that gets a benefit from a reduced tax rate than in a wind deal,” Burton said. “They still don't want the corporate tax rate to be too low, because they still need taxpayers willing to be tax equity investors."

Like utilities and conventional power producers, renewable companies could also be affected by any changes to their ability to deduct interest or how they can depreciate their assets. Full expensing of capital investments as opposed to gradual depreciation is essentially a timing issue — the ability to fully depreciate an asset isn't affected — but a change in timing could impact the financing of a project, experts say.

“If you're a utility and you have to expense your capex, that's going to probably wipe out your tax appetite and the ability to then build a solar or wind project and take the tax credit yourself,” Burton said. “In the tax equity market, there's an adverse impact on the partnership capital account modeling from tax expensing."

--Editing by Philip Shea and Edrienne Su.