Approved:_____

Date 2/3/98

MINUTES OF THE HOUSE COMMITTEE ON UTILITIES.

The meeting was called to order by Chairperson Don Myers at 9:00 a.m. on January 20, 1998 in Room 514-S of the Capitol.

All members were present except: Rep. Mayans
Rep. Samuelson

Committee staff present: Lynne Holt, Legislative Research Department
Mary Ann Torrence, Revisor of Statutes
Mary Shaw, Committee Secretary

Conferees appearing before the committee:

Others attending: See attached list

Chairman Don Myers mentioned to the Committee that on Thursday Walker Hendrix of the Citizens' Utility Ratepayer Board (CURB) will give an overview of pending litigation regarding the telecommunications act.

The Chairman asked if there were any bill introductions. There being none, the Chairman introduced Lynne Holt, Staff, of the Legislative Research Department, who continued a review and discussion of the Retail Wheeling Task Force bill draft and policy. Staff distributed a flow chart on How Securitization Works which was from a presentation that was given to the Retail Wheeling Task Force by Ken Rose (Attachment #1) and information on Tax Implications of Electric Industry Restructuring (Attachment #2). Topics discussed were: Securitization and the Universal Service Fund. Under the review of Securitization, the Chairman discussed with Staff and a determination was made that Staff will draft a letter to the Attorney General regarding whether allowing for securitization would violate state constitution prohibiting against state involvements in internal improvements.

Questions and discussion followed.

The meeting was adjourned at 10:00 a.m.

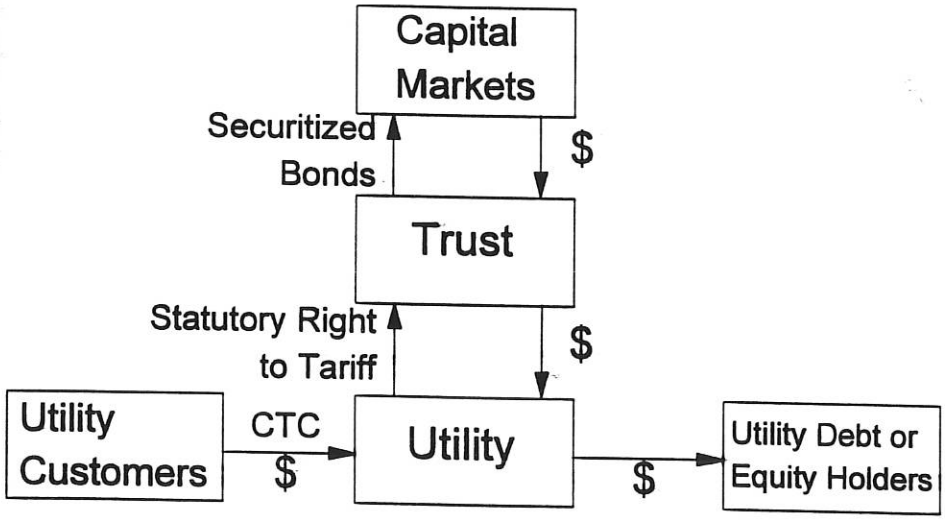
The next meeting is scheduled for January 21, 1998.

HOUSE UTILITIES COMMITTEE GUEST LIST

DATE: January 20, 1998

NAME	REPRESENTING
Carrie Ann Brown	KS Gov't Consult.
Blythe Ridenour	Dan Johnson
DAVID BYBEE	KDOCH.
Larry Holloway	KCC
Tim Martin	Western Resources
Wayne Kitchen	Western Resources
Leslie Kaufman	KS Farm Bureau
Jim Ludwig	Western Resources
Tom Bruno	Allen & Assoc
J.C. Long	UtiliCorp United
Dan Gaches	McGill & Assoc.
Patrick Hurley	KCPL
Kim Gulley	League of KS Municipalities
TOM DAY	KCC
Ron Hein	Hein & Weir, Chtd

How Securitization Works



Source: Salomon Brothers, Inc. (January 1997)

How Securitization Works *(continued)*

- Key steps:
  1) legislation creates a "nonbypassable" customer charge with a transferable guaranteed right to collect for the utility
  2) the state utility commission determines and authorizes the amount to securitize
  3) the utility sells the right to collect the customer charge through a trust in the capital market
  4) the utility receives the proceeds

House Utilities
01-20-98
Attachment 1

Tax Implications of Electric Industry Restructuring

A Series by the NCSL Partnership on State and Local Taxation of the Electric Industry

Franchise Fees in the Changing U.S. Electric Industry

As with the telecommunications, natural gas and airline industries, the electric utility industry is in the midst of a fundamental transformation. Indeed, one no longer can accurately characterize it as solely the utility industry. Wholesale competition is robust today, with dozens of sellers of electricity as a result of the Public Utility Regulatory Policies Act of 1978, the Energy Policy Act of 1992 and the actions of the Federal Energy Regulatory Commission in orders 888 and 889. As shown in figure 1, retail customers in at least a dozen states will be able to choose their electricity providers as the result of legislation or comprehensive regulatory packages enacted in those states. It is not only utilities that now are selling electricity. Electric companies that operated in the retail electricity sales business as state-regulated monopolies for more than 50 years will face competition not only from each other, but also from other companies that previously sold no retail electricity.

The effect of electric industry restructuring on state and local taxes should be part of these policy debates because electric industry restructuring may cause a shift in expected revenues and thereby affect state and local budget planning. In a restructured electric market, policymakers may need to revise the state's tax system to more fully reflect the economic activity being taxed.

This paper deals with the direct effects of electric industry restructuring on franchise fee revenues. If restructuring fulfills the promise of providing lower electricity rates and greater economic activity, it may potentially lead to economic growth, new investments and a larger tax base. The effects of such growth and investment on the franchise fee are difficult to quantify with a useful degree of accuracy. This paper should be taken in that context.

Franchise Fees

Franchise fees are implemented as part of a service agreement usually executed between local governments and a utility company. Local governments require utility companies to execute

The National Conference of State Legislatures' Partnership on State and Local Taxation of the Electric Industry was formed in 1997 as a forum for those with various roles in restructuring the electric industry. The partners include key state legislators, experienced state legislative staff and sponsors of NCSL's Foundation for State Legislatures who chose to participate in this project.

Distributed by the National Conference of State Legislatures

House Utilities
01-20-98
Attachment 2

Electric Industry Composition

Investor Owned Utilities (IOUs). IOUs are taxable corporations owned by shareholders. The rates that investor-owned utilities charge for electric service are regulated on a cost-of-service basis by federal or state and local regulatory agencies. Most, if not all, IOUs currently are vertically integrated, i.e., in the past they owned the generation, transmission and distribution assets required to serve the end user.

Rural Electric Cooperatives. Rural electric cooperatives are owned by their customers. As not-for-profits they do not own generation property. Rates charged by rural electric cooperatives are subject to regulation in some jurisdictions. Although most rural electric cooperatives are exempt from federal and state income taxes, they pay all other types of state and local taxes. Rural electric cooperatives are not vertically integrated, but may own generation property through generation and transmission (G&Ts) organizations. G&Ts are cooperative organizations that own power plants, generate electricity and transmit it at wholesale prices to distribution cooperatives, which are members of the G&T and provide distribution services to deliver power to end users. The formation of G&Ts allowed member systems to gain the benefits of sharing larger, more economical power plants while retaining the advantages of local ownership, control and operation. Distribution systems generally are bound to their G&Ts by an all-requirements contract, under which the distribution system agrees to purchase—and the G&T agrees to provide—all the distribution co-op's power needs. The distribution system agrees to pay rates sufficient to cover all the G&T's cost.

Public Power Systems. Public power systems, which are predominantly municipal utilities, are extensions of state and local governments. As such, they are generally not subject to federal or state income taxes. Depending on state laws, public power systems may pay sales taxes or gross receipts taxes. These organizations also may provide payments in lieu of taxes (transfers to the general fund and contributions of services to state and local governments). Public power systems can join to form joint action agencies; these consist of two or more electric utilities (usually municipally owned) that have agreed to join under enabling state legislation to carry out a common purpose—usually the provision of bulk power supply, transmission and energy-related services. This arrangement allows the utilities to operate as separate entities.

Federal Electric Utilities. Most of the electricity produced by these entities is sold for resale. These utilities generally are exempt from federal, state and local taxes. Bonneville Power Administration is an example of a federal electric utility.

Independent Power Producers. These producers include exempt wholesale generators (EWGs) and other nonutility generators. Independent power producers are subject to federal, state and local taxes, but the rates assessed may be different than those for other power producers.

Power Marketers. Power marketers negotiate electricity sales between the power producer and consumer. Power marketers are not defined as utilities, and therefore may be subject only to taxes levied on businesses and business transactions in the state.

service agreements to ensure service to all customers in a geographic area. Electric industry restructuring presents two main issues related to franchise fees:

- The effect of competition on franchise fee revenues, and
- The effect of franchise fees on effective competition.

State policymakers may want to consider the following issues as they determine how franchise fees fit into a restructured system:

- Which local governments assess franchise fees?
- The competitive position of incumbent utilities.
- Status and disposition of in-state power plants.
- How out-of-state electricity providers and power marketers fit into the local franchise fee assessment.
- The effect changes in the franchise fee system will have on state and local tax administration and collection efforts.
- Where changes in the tax are necessary, it may require state legislation, because many state statutes enable local governments to collect franchise fees.

A Definition of Franchise Fees

Franchise fees are implemented as part of a service agreement executed between local governments and a utility company. These service agreements are executed to ensure service to all customers in a territory. Service agreements outline the terms under which utility companies provide service to customers in a specific territory. These fees are intended to reimburse local governments for use of public rights-of-way and other public services. Franchise fees work much like a gross receipts tax. Specifically, a franchise fee typically is calculated on a percentage of the revenues derived from sales of electricity to customers in that territory. A franchise fee generally is imposed in lieu of licenses or permits that would otherwise be required.

In a restructured system, it is likely that local governments will no longer have only one electricity provider in their jurisdiction. Therefore, they may need to reconsider their franchise fee system to account for the multiple providers and may work with the state to achieve revenue neutrality in tax revenues.

Who Pays Franchise Fees?

Although there is variation among the states, franchise fees can be paid by investor owned utilities (IOUs), rural electric cooperatives and public power systems. When possible, franchise fees then are passed to the customer as a cost of doing business.

Franchise Fees and Electric Industry Reform: Some Hypothetical Examples

The following examples illustrate how utilities and others in the electric industry pay franchise fees and how those payments could be affected by electric industry restructuring (as shown in figure 1). The examples are a useful tool for explaining the topic. Questions for state policymakers are interspersed with the examples. The answers to these questions will help policymakers determine how to address this issue in their individual states. Any solutions described in the examples should be considered only as illustrative and not as recommendations for policy actions.

Franchise Fees Before Restructuring—Example A

Residents of the city of Metro, centrally located in State B, have purchased power from First National Power (a state-regulated, investor owned utility) for more than 25 years. As a condition of the service agreement between the city and the utility, First National Power pays Metro a franchise fee based on the percentage of revenues First National Power derives from customers in the city. The franchise fee has averaged about $1 million annually. Revenue from the franchise fee is placed in Metro's general fund.

Franchise Fees After Restructuring—Example B

State B recently enacted legislation that opened the electric industry in the state to competition. As a result, many out-of-state electricity providers began vying for business throughout the state. In Metro this meant that many consumers decided to purchase power from providers other than First National Power. For example, Amalgamated Electric, an investor owned utility in State A, offered a lower electric rate to residents in State B, and as a result, gained a 10 percent market share in the

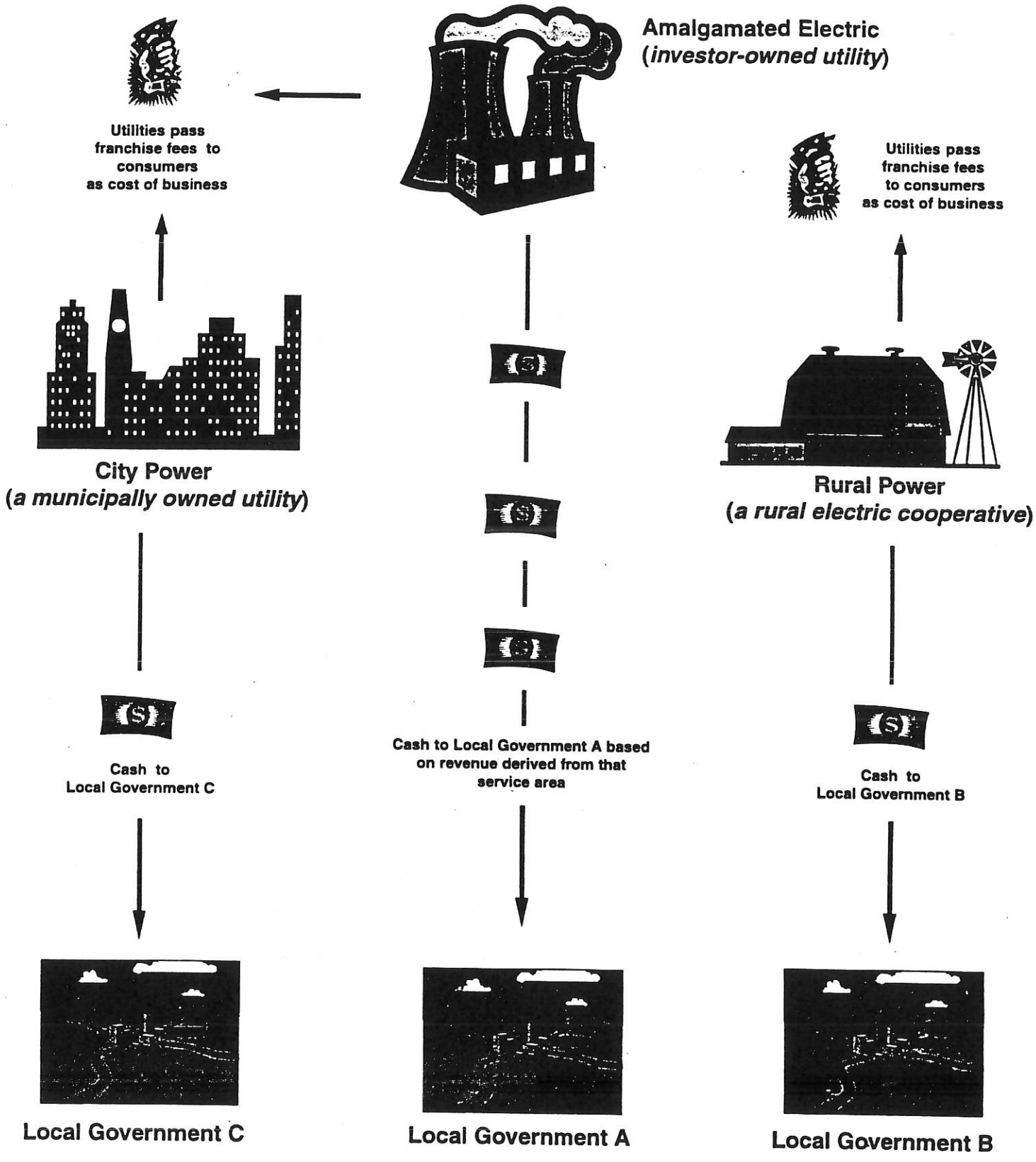
Federal Actions Affecting the Electricity Market

The Public Utility Regulatory Policies Act of 1978 (PURPA). PURPA was passed in response to the oil embargoes and natural gas shortages of the early 1970s, and was designed to encourage alternative generation sources. PURPA requires utilities to purchase power produced by small cogeneration or renewable energy facilities at contractual rates set out or approved by state utility commissions.

The Energy Policy Act of 1992 (EPACT). Proponents of competitive market mechanisms encouraged Congress to introduce competition into wholesale electric markets. EPACT encourages competition in several ways. It creates a new class of power company, the exempt wholesale generator, that can compete against electric utilities to supply electricity. In addition, owners of transmission lines will be required to let any electric generator use the lines at an approved and published price. In compliance with EPACT, the Federal Energy Regulatory Commission issued orders 888 and 889, which permitted utilities access to the transmission grid to enhance the sale and purchase of energy for resale. They do not apply to the retail or end-user customer.

Private Use Restrictions. The Tax Reform Act of 1986 (P.L. 86-272) directed the Internal Revenue Service to promulgate rules restricting the use of tax-free financing for private projects. As a result, public power providers who finance generation, transmission, or distribution may be unable to compete outside their service territory boundaries because of private use restrictions.

Figure 1. Franchise Fees (for exclusive service territory)—How They Currently Work



Question for State Policymakers: Do local governments in your state impose a franchise fee on utilities?

state. Amalgamated now supplies power to 20 percent of the Metro residents. Power marketers also have entered the electricity supply market in State B. One power marketer in particular—Marketer Inc.—has gained a 5 percent market share in the state. Marketer Inc. negotiates electricity sales between power producers and consumers. Marketer Inc.'s offices are located in State B, outside the city limits of Metro. Ten percent of Metro's residents have agreements to purchase electricity through Marketer Inc. Therefore, in the Metro market, First National has lost 30 percent of its revenue base from electricity generation.

The loss in customer base for First National Power has caused a decline in the amount of First National franchise fee payments to Metro. Metro is examining its franchise fee structure to determine if there are other means by which it recover this deficit. Metro does not have nexus to collect a franchise fee from Marketer Inc. and Amalgamated because the companies do not have a physical presence in the city.

Question for State Policymakers: How will local government revenues from franchise fees be affected by the changing electric industry?

Nexus

Nexus is the minimum connection the taxing state must have with the corporation or the activity being taxed in order to collect taxes from that corporation or activity. To legally uphold its authority to impose a tax, a state's interpretation of nexus cannot violate the Due Process Clause or the Commerce Clause of the U.S. Constitution. The concept of nexus was litigated in the 1992 case, *Quill Corporation v. North Dakota*, 504 U.S. 623 (1992), in the context of the mail-order catalog business. In that decision, the U.S. Supreme Court ruled that some kind of physical presence was necessary to support imposition of sales and use tax collection responsibility. Physical presence generally refers to having property or people in the state, either directly or through certain kinds of agency relationships.

Question for State Policymakers: Can local governments recover any losses in franchise fees from out-of-state and out-of-jurisdiction electricity providers?

Similar issues of jurisdiction are likely to arise in states that open their electric industry to competition. A state or local government may have jurisdiction to tax the company that resides within its borders, but not the business transactions that company performs with out-of-state companies or business transactions performed in it by an out-of-state company.

Because First National Power has been the sole electricity provider for much of State B, it has built a transmission and distribution infrastructure throughout the state. Amalgamated and Marketer Inc. have contracted with First National for use of its transmission and distribution capacity, including the distribution facility in Metro. The state regulatory commission regulates the fees First National Power charges to use its distribution system. The Federal Energy Regulatory Commission regulates the fees First National Power charges to use its transmission system. In other words, transmission and distribution remain regulated utility functions.

The loss in customer base for First National has caused an annual decline in the amount of First National's franchise fee payment to Metro. In expectation of future declines in First

National Power's market share within the city, Metro must determine if there are other means by which it can recover this deficit. The city plans to change its service agreement with First National Power so that the franchise fee payment is assessed on the value of electricity distributed through First National's Metro distribution facility rather than on the revenue derived from customer payments. The franchise fee will be assessed at $0.01 per each kilowatt hour of electricity passing through the facility. Metro's city managers forecast that, under this new agreement, First National will pay $1 million annually. First National will likely pass this cost on to Amalgamated and Marketer Inc. in the form of increased charges for use of its distribution facility.

Question for State Policymakers: Do local changes in franchise fee collection require changes in state statutes?

Options for State and Local Policymakers

These hypothetical examples illustrate some of the issues state and local policymakers need to examine during their discussion of the effects of electric utility industry restructuring on state and local taxation. The following options have been considered by states that have implemented restructuring

- *Limit the amount of franchise fees.* Because franchise fees are assessed by local governments, state legislators cannot eliminate them. However, they can impose an upper limit on the amount of franchise fees. If states limit franchise fees, they may need to consider redistributing some state tax revenues to local governments to make up for local deficits.

- *Assess an exit fee on customers that leave the electricity provider that pays the franchise fee.* In an attempt to prevent the erosion of franchise fees paid by a utility to a municipal government, the California Legislature adopted legislation that allows a surcharge to be applied to natural gas and electricity suppliers that replaces, but does not increase, franchise fees that would have been collected before restructuring occured. The California Public Utilities Commission establishes the surcharge, which is collected by the utility through distribution billing.

- *Impose the franchise fee on a different base.* In the hypothetical example, Metro imposed the franchise fee on the value of the electricity distributed from the distribution facility because Metro did not have the nexus to tax power providers that are located outside its limits. The franchise fee also could be reconfigured so that taxes are levied on the distribution facility revenues. This design should be considered on a state-by-state basis.

- *Eliminate the franchise fee and replace it with another form of taxation.* If the franchise fee is eliminated, some local governments could see a considerable decline in the amount of their general treasury funds. Therefore, policymakers may consider imposing a state tax on electricity providers and distributing the revenues to local governments. Issues

such as nexus should be considered when discussing how the state and local taxation system could be most effectively redesigned.

NCSL Electric Industry Tax Partners

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Minnesota House of Representatives

Mike Bull, Legislative Research
Minnesota House of Representatives

Representative Debra Danburg, Texas

Representative John Dorso, North Dakota

Representative Chase Hibbard, Montana

Representative Carl Holmes, Kansas

Senator Barbara Lee, California

Kevin McCarthy,
Connecticut Office of Legislative Research

Senator John O'Brien, Massachusetts

Senator Jack Reasor Jr., Virginia

Senator Michael Sanchez, New Mexico

Representative Jim Welsh, Oregon

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Gregg Cook, Principal, Government Affairs and Consulting

Center on Budget and Policy Priorities
Liz McNichol, Director, State Fiscal Project

Chemical Manufacturers Association
Jim McIntire, Vice President of State Affairs

Commonwealth Edison Company
Richard Roling

Edison Electric Institute
Tim Kichline, Manager, State/Local Government Affairs
Joan Esquivar, Manager of Finance

Enron
Gavin Russo, General Manager, Ad Valorem/State Government Affairs-Tax
Kathleen Magruder, Director, Government Affairs

National Rural Electric Cooperative Association
Alan Edwards, Manager, Regulatory Advocacy

Procter & Gamble
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Salt River Project
Russel Smoldon, Manager, State Government Relations

Sunflower Electric Power Corporation
Jayne Clarke, Senior Manager, Accounting

Special thanks to James Kane, *Arthur Anderson*, who donated services as special adviser to the Partnership.

The National Conference of State Legislatures' Partnership on State and Local Taxation of the Electric Industry was formed in April 1997 to provide a communications forum for those who have various roles dealing with restructuring of the electric industry, but who rarely have an opportunity to work together. The partners include key state legislators, experienced state legislative staff and sponsors of NCSL's Foundation for State Legislatures who chose to participate in the project. The Partnership has focused on several issues that legislators need to examine concerning state and local taxation of the electric industry in a restructured system. The resulting eight documents, designed to assist legislators in making informed policy decisions in their respective states, include:

- *Utility Taxation Overview*
  (ISBN 1-55516-589-3—Item #4129)
- *Introduction to Electric Industry Taxation*
  (ISBN 1-55516-590-7—Item #4130)
- *Gross Receipts Taxes in the Changing U.S. Electric Industry* (ISBN 1-55516-591-5—Item #4131)
- *Property Taxes in the Changing U.S. Electric Industry* (ISBN 1-55516-592-3—Item #4133)
- *Franchise Fees in the Changing U.S. Electric Industry* (ISBN 1-55516-593-1—Item #4132)
- *Net Income and Franchise Taxes in the Changing U.S. Electric Industry*
  (ISBN 1-55516-594-X—Item # 4134)
- *Sales Taxes in the Changing U.S. Electric Industry*
  (ISBN 1-55516-595-8—Item #4135)
- *Payments in Lieu of Taxes in the Changing U.S. Electric Industry*
  (ISBN 1-55516-596-6—Item #4136)

Series authored by Kelly Hill and
Matthew H. Brown, NCSL Energy Project

National Conference of State Legislatures

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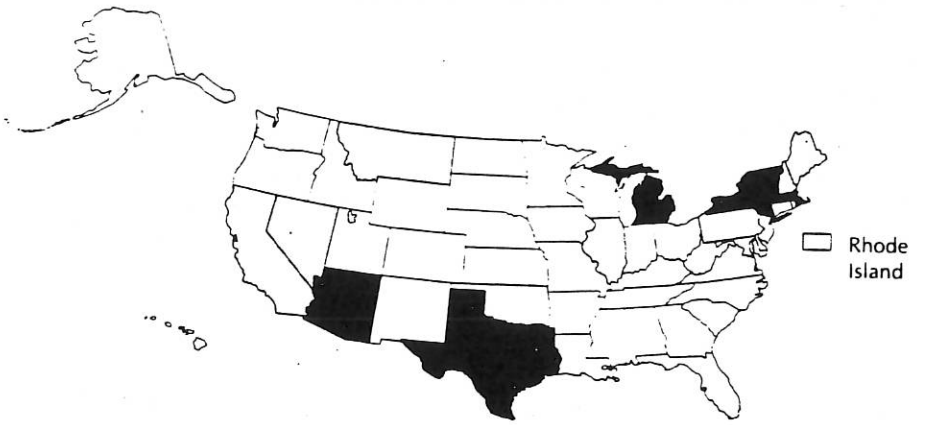
Figure 1: State Activities to Promote Electric Industry Restructuring



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Questions for State Policymakers:
- *Where are electric generating stations located in your state?*
- *Are the generating stations likely to do well or poorly in a competitive electricity market place?*
- *Does your state have taxing jurisdictions that rely heavily on property tax revenues from electricity generating stations?*

A few states have begun to examine the taxation issues raised by this transition. Among these, one of the most complex is property taxes. Property taxes generate a great deal of revenue for political subdivisions of the state—local governments, counties, schools and other special taxing districts such as parks, hospitals or watersheds. In some cases, the state also receives revenues from the property tax. Although local governments often collect the tax, state governments frequently assess, or value, utility property. States tax different types of property, use various methods to assign value to property and levy taxes on the property values in diverse ways. As a result, each state may have to analyze property taxes and restructuring in a context that reflects its own historical approach to taxing utility and other property.

This paper deals with the direct effects of electric industry restructuring on property tax revenues. If restructuring fulfills the promise of providing lower electricity rates and greater economic activity, it may lead to economic growth, new investments and a larger tax base. The effects of such growth and investments on the property tax base are difficult to quantify with a useful degree of accuracy and it is not the purpose of this paper to make assertions about the potential effects of restructuring. Restructuring also could yield lower electric rates, which would, in turn, offset some tax revenue losses. This paper should be taken in that context.

The objective of this paper is to give state policymakers the tools to understand the effects of electric industry reform on property taxes in their states. It will help policymakers participate in an informed debate and enhance their ability to make decisions with information about the property tax consequences of electric industry reform.

Context for Analysis of Property Taxes

The property tax is fundamentally a local tax—in most cases it raises revenues for political subdivisions of the state, not for state governments. But state statutes—and sometimes state constitutions—lay down the rules that govern how these political subdivisions levy property taxes. State governments are involved more actively in public utility property taxation than they are for most other kinds of property. As a result, despite the local character of property taxes, the responsibility for modifying the property tax structure lies largely with state legislatures.

Because the property tax funds local budgets rather than state budgets, restructuring will affect local revenues and local property taxpayers. Its effects may be noticeable where power plants are costly or inefficient; some states, therefore, will have only a small number of school districts or other political subdivisions of the state that will experience property tax revenue losses. Many areas have benefited for years from these power plants' property tax payments, during which time the power plants have contributed almost all their property tax revenues.

As a result, the effect of restructuring on property taxes will be dramatic but highly concentrated on those political subdivisions of the state. State budgets will be affected only if the legislature decides to offer additional state aid to the troubled subdivisions.

Some will observe that manufacturers or other businesses succeed, fail or change their shape or size as a result of changes in technology along with a wide range of economic and social factors. All these forces have a considerable effect on the property tax base. Observers further assert that the generation of electricity should be no different. Others will argue that it is the state-mandated change from monopoly to competition that is affecting property taxes, and that the state should address the property tax issue along with its restructuring legislation. State policymakers might consider property tax revenue losses within the context of potential restructuring benefits such as savings to government and increased property tax revenues. The issue is complex and deserving of attention; states, however, have a number of options at their disposal that may help them resolve the issue.

Federal Actions Affecting the Electricity Market

The Public Utility Regulatory Policies Act of 1978 (PURPA). PURPA was passed in response to the oil embargoes and natural gas shortages of the early 1970s, and was designed to encourage alternative generation sources. PURPA requires utilities to purchase power produced by small cogeneration or renewable energy facilities at contractual rates set out or approved by state utility commissions.

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Private Use Restrictions. The Tax Reform Act of 1986 (P.L. 86-272) directed the Internal Revenue Service to promulgate rules restricting the use of tax-free financing for private projects. As a result, public power providers who finance generation, transmission, or distribution may be unable to compete outside their service territory boundaries because of private use restrictions.

Property taxes contribute a great deal of revenue to political subdivisions of the state. Utility restructuring presents three issues related to property taxes:

- The effect of electric industry restructuring on property tax revenues.
- The effect of property taxes on effective competition among different types of electricity providers.
- The fact that property tax effects of restructuring could be highly concentrated on certain locations that host high-cost power plants. State budgets could be affected to the extent that they must provide aid to those locations.

Electric Industry Composition

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State policymakers may consider several major issues as they deal with property taxes. Among these are:

- The effect of restructuring on property tax revenues will vary depending on the approach that states use to value electric generating property and other facilities.

- Property tax revenues will change as a result of the status and disposition of in-state power plants or other electric company property.

- The property tax affects economic development. Its effect on economic development will become more important as electricity providers begin to operate more frequently across state boundaries. Property taxation policy may affect power plant developers' decisions to purchase or build power plants in particular states.

- Different valuation, assessment and tax rate setting methods can have a substantial effect on the competitive position of incumbent utilities and other electricity providers.

- States in which some political subdivisions face substantial property tax losses from the closure or revaluation of electric generating plants will need to consider how best to make up for that revenue loss through substitute taxes, increased property taxes for remaining taxpayers, reduced or more efficient government services or some combination of changes.

- Where change is necessary, it may require state legislation because most of the rules that govern revenue departments' activities are set in state statutes.

A Definition of Property Taxes

A property tax is imposed on the value of taxable property located in a state or taxing jurisdiction. Governments place property into categories, defining it as real, personal, tangible and intangible. Real property is usually land, buildings or objects. Personal property generally is an object that can be moved, such as a vehicle, table, chair or even, in some states, transmission lines. Intangible property is usually property that does not exist in physical, concrete form, such as trademarks, copyrights, trade names or patents.

Each state—and, in some cases, local governments—has its own definition of taxable property. Ohio, for instance, defines real property as land and improvements to the land. Real property in Ohio does not include the generation, transmission or distribution equipment of electric utilities. Ohio does not view this highly specialized equipment as an improvement to the land, and defines it as tangible personal property. In Ohio and many other states, it is the treatment of personal property that requires closest examination under restructuring.

Whether property is defined as real or personal may determine whether it is subject to tax and how it will be taxed. Some states tax real but not personal property. Others tax both types of property.

In addition to differentiating between real and personal property, states also distinguish between tangible and intangible property. Although many states do not tax the intangible property of most taxpayers, some states do assess and tax utilities' intangible property. The treatment of intangible property could assume much greater importance in a competitive marketplace than it now does in a regulated system.

Central vs. Local Assessment

Often, a state agency such as the department of revenue centrally assesses the real and personal property of regulated utilities. In states such as Connecticut, however, local tax assessors value utility property.

Central assessment refers to the process whereby a central agency such as a state department of revenue assigns a value to property. States use central assessment for property located throughout the state or country, in which all the parts are connected into an integrated entity. States often centrally assess railroads or utilities.

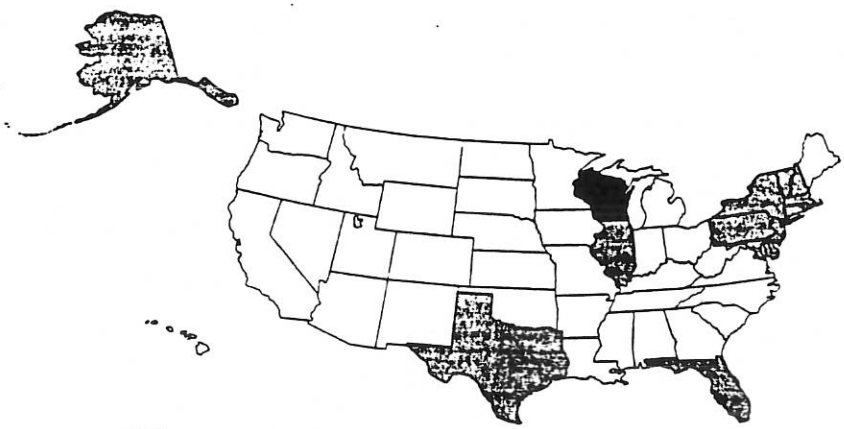
State statutes usually require local assessment on almost all types of property except railroads and utilities. Local assessment is more often applied to property that is located completely within a taxing jurisdiction. It also generally applies to businesses with locations in many parts of a state—such as supermarkets—in which each store of a 25-store chain might be seen as a free-standing operation. The chain's owner could sell one store and not affect the value of the other 24 supermarkets in the chain. Local assessors value the property.

Some states mix the central and local assessment process, even for the same utility property. In Minnesota, for example, a utility's structures, machinery and other personal property are centrally assessed, while local assessors value the utilities' land and nonoperating utility property.

A centrally assessed system often—but not always—uses the unit value method of assessment. The unit value approach considers the value of the entity as an integrated whole, not the sum of its parts. The theory behind unit valuation is that—in the example of a railroad—the sum of the value of a railroad company's track does not reflect the true value of the track to the company. That track comprises a critical component of the company's total operation as a unit. The unit value approach captures the value of the whole integrated company, and allocates a part of the company's value to each political subdivision in the state. As shown in

figure 2, some states centrally assess all utilities but use the unit value method only for investor owned utilities, not for cooperative utilities or public power systems.

Figure 2: Assessment status of Investor Owned Utilities (IOUs)



Questions for State Policymakers:
- *Does your state centrally or locally assess utility property?*
- *Does your state centrally or locally assess nonutility property?*
- *Does your state include intangible property value in both the central and local assessments?*

Whether states use a local or a central assessment process, the effect of restructuring will be concentrated on political subdivisions with large power plants. These political subdivisions sometimes derive as much as 85 percent of their tax revenue from a single power plant. These towns and cities have the most to gain or lose from electric industry restructuring, while political subdivisions with no major utility facilities will see little direct effect on their property taxes as a result of restructuring. The value of the transmission and distribution—or "wires"—system also will have an effect on tax revenues; in some cases there may be proposals to increase the value of the transmission and distribution system to offset some of the decrease in the value of power plants. The discussion of property taxes and electric industry restructuring is unique among the taxes examined in this series of papers in that it deals primarily with *local* and *localized* effects, such as effects on local school districts, that may require state-based solutions.

Who Pays Property Taxes?

Almost every retail electricity seller pays property taxes, although often in different ways and on a different basis. Because utilities have operated as regulated monopolies and can fre-

Questions for State Policymakers:
• Do the public power systems in your state participate as members of a joint action agency?
• If so, are property taxes paid by the joint action agency passed to its members?
• How do the methods used to assess property taxes on joint action agencies compare to the methods used to assess property taxes on other electricity providers?

quently pass their tax expenses to their consumers, their property tax burden generally has been higher than that of other nonutility businesses. If the industry shifts from regulation to competition, these differences will become quite important.

Investor owned utilities pay property taxes on all property that they own, including power plants, power lines and other property such as office space. In addition, sometimes they may be taxed on vehicle fleets and intangible property.

Rural electric cooperatives generally pay property taxes on all property they own, although they frequently are distribution companies that own and operate power lines and office space, not power plants. They pay property taxes on power plants through the wholesale power prices that they pay when they buy electricity from their own generation and transmission companies, investor owned utilities, power marketers or other suppliers.

Generation and transmission (G&T) organizations pay property taxes on their power plants and power lines. G&Ts are cooperative organizations that own power plants, generate electricity and transmit it at wholesale prices to distribution cooperatives, which are members of the G&T and provide distribution services to deliver power to end users. The formation of G&Ts allowed member systems to gain the benefits of sharing larger, more economical power plants while retaining the advantages of local ownership, control and operation. Distribution systems generally are bound to their G&Ts by an all-requirements contract, under which the distribution system agrees to purchase—and the G&T agrees to provide—all the distribution co-op's power needs. The distribution system agrees to pay rates sufficient to cover all the G&T's costs.

Public Power Systems

Municipally owned electric utilities generally do not pay local property taxes on utility property located within their assigned service territories because, in essence, the local government would be taxing itself. Like the cooperatives, they pay property taxes through the wholesale power prices they pay when they buy from an entity that pays property taxes. It is, therefore, important to learn the tax load of the municipal utility's electricity suppliers. Public power systems procure their power from joint action agencies, from their own generation facilities, from federal power agencies, rural electric generation and transmission organizations, or investor owned utilities. The proportion of power they procure from each of these entities varies within states and between states. In some cases, the municipal utilities pay payments in lieu of taxes (see accompanying paper on these payments) that are tied to a property tax they might otherwise be paying.

Joint action agencies consist of two or more electric utilities (generally municipally owned) that have agreed to join together under enabling state legislation to carry out a common purpose—usually the provision of bulk power supply, transmission and energy-related services. Joint action agencies generally pay the same property taxes as investor owned and cooperative utilities, and these taxes are passed to members of the joint action agency through the wholesale electric rates that the joint action agency charges the municipal utility. This arrangement allows the utilities to maintain separate identities. There currently are approximately 60 joint action agencies nationwide, with members in 34 states.

Nonutility generators pay property taxes on their property. Sometimes state statutes treat this property like utility property, while other times they treat it like general business property.

Power marketers pay property taxes like other nonutility businesses on any property that they own.

Changes in the Electric Industry that Could Be Reflected in Taxes

Restructuring the electric industry will result in major changes in the way that all types of electricity providers and their customers conduct business. The structure of their organizations may change, they may begin to try to sell power outside their state and traditional service territories, they will face competition in their own service territories, they may break their integrated companies into distinct parts, and they will begin to notice even more the taxes they pay. Many of the changes in the electric industry that are resulting from restructuring will have an effect on property taxes. These changes include:

- *New electricity providers.* New types of companies that previously have not sold electricity to retail customers will enter the retail electric market.

- *Restructuring the corporation.* Utilities may reconfigure their corporate structure and separate their generation, power delivery, customer service and billing or other functions into separate companies or subsidiaries. The power delivery, or wires, companies will remain regulated utility functions and will continue to be taxed as such.

- *Stranded costs or uneconomic assets.* In a restructured industry, the power plant owners will compete with each other to sell electricity at the retail level. Plants that can sell power cheaply will thrive, while high-cost power plants will have more difficulty recovering their costs. In this new system, utilities no longer will earn a return on their power plants simply by keeping them in use, as is the case under the current regulatory system. Some of these power plants may lose value because of the transition to the new system. Some observers refer to utilities' investments in these plants as stranded costs, while others

Questions for State Policymakers:
- *Are property tax rates on investor owned utilities, rural electric cooperatives and government utilities the same or different?*
- *Are rural electric cooperatives members of a G&T organization?*
- *If so, are G&T property taxes passed to its members?*
- *How do property tax assessment methods for G&Ts compare to methods to assess property taxes on other electricity providers?*

refer generically to high-cost power plants as uneconomic assets. The ways in which states address these issues may affect property values.

- *Sale of power plants.* Some utilities will sell their power plants to other utilities or to companies that are not utilities. Several of these sales already have taken place, most notably in New England, where New England Electric System sold its power plants to U.S. Generating Company, a subsidiary of California-based Pacific Gas and Electric. If nonutility generators are taxed differently from utilities, property tax assessments and revenues would be affected.

How to Determine Property Taxes

A combination of state governments and political subdivisions of the state use the following basic process to determine property taxes. This process varies from state to state and even among the 30,000 state political subdivisions throughout the country that receive funding from a property tax.

Define what Property to Tax. Jurisdictions tax real, personal, tangible or intangible property, and typically define in state statute the type of property that is included in each category.

Determine Property Values. States generally use three approaches to determine property values—the cost, income and market approach. Local governments or state departments of revenue carry out this task, usually with direction from a state statute.

Determine an Assessment Ratio for the Property. Some states have a classification system for different types of property. As a result, in some states utility property is assessed at a higher proportion of its value than nonutility property. This system classifies property according to its

Book and tax value reflect the fact that companies keep two sets of accounting books—one reflects the development of tax laws and regulations and the other reflects the development of generally accepted principles for nontax reporting purposes. The set of books for tax purposes reflect federal and state laws and regulations, while the books for "book" purposes reflect generally accepted accounting principles (GAAP). "Book" income is the income reported in the company's annual report and in filings to the Securities and Exchange Commission. Companies have an incentive to show good performance and ever-increasing income for these purposes. Companies have an incentive to show lower income to the state and federal taxing authorities, because their tax bill is based on their income. One important difference between tax and book income is its treatment of depreciation. Under book depreciation, a company with an asset worth $1 million might charge $100,000 against its income for 10 years (this is known as straight line depreciation). For its tax books the company might use a different depreciation method, charging its income more for the first few years and less in later years. This method reduces the company's income for tax purposes during the early years of owning the property. The different approaches to depreciation also mean that power plants will have different values on the utilities' book and tax accounting books.

use, so that one class might pay a property tax on 10 percent of its property's value while another class might pay on 75 percent of the property's value.

Identify the Location of the Property Values. Once a state assessor determines property values in a centrally assessed system, the value must be attributed to various taxing jurisdictions. States parcel out these values based on miles of power lines within each jurisdiction, the net book value of power plants and other methods. State statute or rules and regulations of the state revenue department usually set the method used to allocate utility property values.

Determine the Tax Rate or Mill Rate. This rate is determined by dividing the taxing jurisdiction's budget (that portion of the jurisdiction's budget that will be funded by property taxes) by the total taxable value in the area. States have different approaches to setting these rates. Some set the rates in statute, while others require voters to approve any increase in tax rates.

Restructuring and Property Taxes

Electric industry reform could affect each part of the property taxation process. The extent to which these reforms affect property taxes depends on each state's property taxing practices.

Define what Property to Tax

Most states define by statute which types of property they tax. These statutes define what is real and what is personal property. They also define which taxpayers pay a tax on each type of property. Many states define utility property differently from other business property. States generally tax real property, which includes land and most structures. Some states tax personal property. Most states include transmission and distribution lines in their definition of personal property, as well as attached machinery. Attached machinery, like a boiler or electricity generating turbine, constitutes a substantial portion of utility property. Some states also tax intangible property. The definitions that states set out in statute are one important part of the property tax issue.

Determine Property Values

Many states consider three approaches to determine property's value, and probably have developed unique computations for these approaches. Each also probably relies on one approach more heavily than others. State statutes and, sometimes, revenue department regulations usually dictate how to value utility and other property. The three approaches—cost, income and market—are defined as follows

- The *cost approach* uses replacement cost or reproduction cost, less depreciation, as its basis (the property's historical cost figures heavily in this valuation),

Questions for State Policymakers:
• What types of property are subject to the property tax in your state (real, personal, tangible or intangible property)?
• Do you treat utility property differently from nonutility property?
• If intangible property is subject to tax, how does your state define intangible property?

Questions for State Policymakers:
•On which of these approaches does your state rely most heavily for utility property?
• Are utility and nonutility property valued using the same approach?

- The *income approach* is based on a company's projected net operating income,
- The *market approach* uses as its basis market indicators such as sales of comparable assets or the company's stock and debt value.

A state may or may not use all three approaches when determining unit value. States generally use cost and income as the two primary factors, but also may use the market approach. The key, however, is how a state weights the factors. Minnesota, for example, centrally assesses investor owned electric utilities using the unit value approach, but uses only the cost and income approaches for determining actual value. After the state computes the total unit value of the company, it apportions the value on those two factors, with 90 percent assigned to the value derived from cost and 10 percent assigned to the value based on income.

The degree to which states weight each approach varies widely, and each state determines its own weighting formula independently. It is important to know the weighting formula when discussing property values. If, for example, the value from stock and debt is only weighted at 10 percent, then its effect on the overall total value is negligible. If all three factors are used and weighted equally, then all three have significant effects on the overall value of the property.

The Cost Approach

The cost approach relies on the sum of the adjusted cost, minus depreciation, of the taxpayer's assets. Local assessors almost always—and state assessors sometimes—use the cost approach. Inherent in the cost approach is the concept of property having some value if it is still in use. Therefore, property still in use will never be depreciated to a value of zero.

State laws or regulations usually require that electric generating property be assessed on one of two bases: (a) the property's historical cost, adjusted for inflation, minus depreciation and obsolescence, in which case the newer power plants pay a higher property tax than the older power plants; and (b) the cost to reproduce a similar piece of property, taking into account changes in technology. Few states use reproduction cost to value utility property, while some may not adjust property values for inflation. The cost approach is most sensitive to:

- Declining or increasing property values that result from the sale of utility assets,
- Different approaches to valuing utility and nonutility property, and
- Closure of a power plant that is unable to compete.

Sale of power plants. States and political subdivisions of the state will incur some tax consequences from the sale of power plants. Some sales, for instance, will require that the power plant be assessed at a new value that reflects its sales price.

Although Massachusetts-based New England Electric System has sold many of its power plants and several other large utilities have announced that they will sell power plants, overall there have been so few sales of power plants that it is difficult to determine with certainty how their sale will affect their taxable value. It is possible that selling a power plant will require recognition of a new value.

If a utility sells one of its power plants for $40 million less than the plant's tax value, for instance, that sale forces recognition of a new, lower value that is $40 million less than its previous taxable value. In some cases, utilities may sell their power plants and realize a gain on the sale. In these situations, the power plant's new owners may recognize a new and higher taxable value for the plant.

Closure of a power plant. Some power plants that have been operating in a regulated market will be unable to stay open under competition. If these plants close, their tax value falls to zero because they are no longer in use.

Power plants that utilities do not sell. If utilities restructure into holding companies with generation, distribution and other affiliates, the generation affiliate may no longer be classified as a utility for tax purposes.

Could power plants' value increase? Since the cost approach is based on either the historical cost or the cost of replacing power plants, it does not reflect greater market values unless the property is sold.

Property tax values of the regulated transmission and distribution system. The business of operating and maintaining the transmission and distribution wires will likely stay regulated for a number of years. Some argue that the value of this system will increase and perhaps offset some property tax revenue losses from devalued power plants. The value of the wires system might increase because of the importance of the wires network to the smooth operation of the market and because of the difficulty of siting and building new power lines. The power lines' owner controls a unique and valuable part of the utility system.

Unless the utility sells the lines, however, the cost approach to value will not yield a new taxable value for those power lines. The foundation of the cost approach is the historical cost of the property, with adjustments for the property's obsolescence and some other factors. The historical cost of the wires determines their value under the cost approach.

Questions for State Policymakers:
- *In some states, some types of property are not included in the valuation if property is owned by nonutilities, but is included in value if the property is owned by a utility. Do valuations for utilities and nonutilities include all the same types of property?*
- *For tax purposes, does your states' definition of utilities include competitive generating affiliates of holding companies?*

That historical cost could change if a utility sold its power lines at a higher price that reflected those power lines' higher value. One proposal that surfaced in New England became known as the "Grand Bargain," because it sought to offset the decreasing value of utilities' power plants with increasing values of the transmission and distribution wires. It is, therefore, possible that the system of utility wires may possess a greater value than is now recognized on their owners' books. The cost approach will recognize this higher value only if the utility sells its wires system for a profit.

The Income Approach

The income approach considers the net present value of utilities' projected net operating income. Some approaches simply take the company's previous year's income, assuming its income will remain constant, as an indication of its future income. Other approaches try to project the utilities' income for the next 20 years to 30 years. Net present value is the value, today, of the company's total net operating income for a number of years. The net present value reflects a discount rate that takes into account the estimated risk that the taxpayer's income could vary from projected levels. Under this analysis, a dollar earned tomorrow is less valuable than a dollar earned today; a dollar earned in three years is even less valuable. Further, income that is subject to greater risk will be discounted more heavily than income that is more secure.

Questions for State Policymakers: •What are the stranded cost or uneconomic asset estimates in your state? •How are the values of the power plants in your state likely to be affected by a move to competition?

The income approach is most sensitive to:

- Increased risk for electricity generators;
- Declining or increasing electricity prices, leading to reduced or increased net income,
- Increase in market share and, probably, increase in net income as a result,
- The loss of in-state or out-of-state sales to power providers that sell electricity from out of state;
- Loss of market share to in-state, nonutility providers that are not taxed as utilities, and
- Write-offs that may result from stranded costs.

Increased risk for electricity generators. Some analysts project that the business of generating electricity is likely to grow more risky as it moves from a regulated monopoly rate-of-return system to one based on market-set prices. A 1996 Bear Stearns report predicts that generating companies' bond ratings may fall, as a result, from their current "A" level to a level of "BBB."

This increased risk will translate to a higher discount rate that, when used to create a net present value of the generator's income, will produce a lower net present value of the income than in an (apparently) more predictable, regulated system.

The income approach depends not only on the income base of the taxpayer, but also on the dependability of that income base. The discount rate that is applied to the projected stream of income reflects that level of risk.

Electricity prices. If electricity prices decline, some—but not all—utility taxpayers' net income also may decline. Net income does not decline in direct proportion to electricity prices, however, because some companies may reduce their costs (become more efficient) even as electricity prices decline. By the same analysis, if electricity prices and net income increase, the company's value also may increase.

Loss of market share to out-of-state providers. If utilities lose in-state market to an out-of-state electricity provider, their in-state net income and taxable value probably will decrease. Unless the out-of-state utility owns taxable property in the state, the state's tax revenue would decrease as a result.

Increase in in-state or out-of-state sales. If cost-efficient utilities focus on increasing their sales to retail customers within their borders and also to neighboring states, their total net income may increase. If their total net income increases, the income approach will give the company a higher taxable value.

Loss of market to in-state, nonutility providers. If an in-state utility lost market share in its own state to an out-of-state utility, a power marketer or a nonutility generator, the state could lose tax revenues.

Property tax values of the regulated transmission and distribution system. Most analysts expect the business of operating and maintaining the transmission and distribution wires to stay regulated for a number of years. A wires company that is responsible only for maintaining and operating the power delivery system probably will continue to operate this system. The revenues of this wires company will likely remain subject to traditional price regulation by both state regulatory commissions and the federal government. As a result, this wires company will earn a predictable, low-risk and regulated return on its investment in its facilities.

This regulated return will yield a steady stream of income, but one that will be much different from that which today's integrated electric utilities earn from their investments in their wires system. As a result, the income approach to property valuation is unlikely to recognize a greater value for transmission and distribution assets.

Question for State Policymakers: • What are the projections for how the electricity retailers in your state will fare in a competitive electric marketplace?

The Market Approach

A few states rely on the market—or stock and debt—approach to assess utility property. The market approach relies on the utility's market value, plus its outstanding debt, to establish a value for the entire company. Because this value depends partly on the stock value of the company, the value will mirror the stock market's estimate of the future worth and income of the company. Stock and debt generally are not used because of the difficulty of separating the value of the company's electric operations from its nonelectric utility activities. Some utilities, in other words, are engaged in businesses other than the sale of electricity.

It is possible that property assessors will rely more heavily in the future on the market value of particular power plants. Also called the comparable sales approach, this approach relies on data from the sale of similar properties. The selling price of an office building of a certain size, age and condition located in the downtown area might serve as a guide for the property value of a similar office building. The market for electric power stations is not very active and, despite several recent sales of power plants in New England, there is little data on which to base a market value.

The market approach is most sensitive to any factors that could affect the company's stock value such as:

- Projected increases, decreases or volatility in the utilities' net income,
- Write-offs of stranded costs or uneconomic assets that may be reflected in net income,
- Loss of in-state companies' market share to out-of-state companies that have little or no taxable property in the state;
- Increase of in-state companies' market share in new markets that result in increased net income, and
- Increasing or decreasing power plant values that may be established as a result of comparable sales of power plants.

To the extent that the stock market value of a utility reflects its income projections, the market approach will track its income. If utilities develop new markets they are likely to fare well in the stock market. If a utility loses market share to other electricity providers, its income will dip and its prospects in the stock market will fall, as well.

Property tax values of the regulated transmission and distribution system. Most analysts expect a regulated wires company that is responsible only for maintaining and operating the

power delivery system to continue to operate the power delivery system. The revenues of this wires company likely will remain subject to traditional price regulation by both state regulatory commissions and the federal government. As a result, this wires company will earn a predictable, low-risk, regulated return on its investment in its facilities. The stock market will treat this wires company much as it treats today's integrated electric utilities, observing the risk that regulators might reduce its return on investment, but assuming that price generation will yield a steady stream of income.

Question for State Policymakers:
• If nonutilities begin to sell electricity to retail customers, should your state change its definition of utilities for property tax purposes or redefine utilities as any business that sells power?

Given the fact that these companies will continue to earn a regulated return on their investments, it is unlikely that the stock market's valuation of these wires companies will lead to a higher property tax value under the market approach to value.

Different approaches to valuing utility and nonutility property. Changing ownership of a power plant from a utility to a nonutility will mean that the property could be assessed locally instead of centrally on a unit value basis. In addition, nonutilities and utilities may have different assessment ratios. Finally, sales of power plants will have tax implications.

Decide what portion of that value to tax (classification of property). Some states classify property according to its use. In practice, this has meant that states sometimes treat utility property differently from nonutility property. Thus, a utility might pay a tax on 35 percent of the value of its property, while a nonutility business might pay a tax on 25 percent of the value of its property. In Ohio, electric generating property of investor owned utilities is assessed at 100 percent of its value while their transmission and distribution property of is assessed at 88 percent of its value.

As a result, not only the *type* of property but also the *amount* of property that is taxed varies among different electricity retailers. The description below illustrates different state approaches to classifying utility and other property.

Question for State Policymakers:
•How are property tax values apportioned among taxing jurisdictions in your state?

Define the Location of Property Values. States that centrally assess utility property allocate property values among taxing jurisdictions. They use various methods to make this allocation, including the original cost of the property, the number of miles of electric line in the taxing jurisdiction, the book value of power plants and other factors. Ohio apportions 70 percent of the value of generating plant to its location, while the remaining 30 percent, along with the value of the rest of the utility's property, is distributed in accordance with the location and cost of the utility's transmission and distribution system. This approach to allocation of property values has worked where utilities have been fully integrated, with generation, transmission and distribution property. In a restructured environment, utilities are less likely to be fully integrated entities.

Since high-cost power plants are the ones that are most likely to be worth less in a competitive market, and since their values are likely to decrease, towns that host high-cost power plants will lose a portion of their tax base, especially if the state uses book value to apportion property values.

Determine Tax Rate. Divide that portion the jurisdiction's budget funded from property taxes by the total taxable value in the area to determine a tax rate or mill rate.

Where utility property decreases in value, tax burdens will shift more heavily to nonutility property; jurisdictions will have to find replacement revenues or decrease their spending. These effects will be localized to jurisdictions with high-cost power plants. Jurisdictions that host low-cost plants or that have no power plants will see little of the direct effects illustrated below.

Taxing jurisdictions divide their total budget that is funded by property taxes by the total taxable value in their jurisdiction to arrive at a tax rate. For this example, assume:

- City budget: $1 million
- Taxable value in jurisdiction $100 million
- Tax rate: 1 percent of value

The tax is collected as follows:

• Utility (taxable property value of $80 million) would pay	$ 800,000
• A homeowner with a house valued at $100,000 would pay	$ 1,000
• Other business and residential taxpayers would pay	$ 199,000
Total city tax collections	$1,000,000

If the utility sells this power plant at half its assessed value to a nonutility generator, the power plant's new assessed value may fall. If, for instance, the assessed value of the plant falls to $40 million, then the city will lose $400,000 in property tax revenues.

This will be the situation in states that have constitutional or other limits on government's ability to raise property taxes.

• Utility (taxable property value of $40 million) would pay	$400,000
• A homeowner with a house valued at $100,000 would pay	$1,000
• Other business and residential taxpayers would pay	$199,000
Total city tax collections	$600,000

Some states allow property tax rates to be adjusted each year. In these states, the new formula would be as follows, assuming the same city budget.

- City levy: $1 million
- Taxable value in jurisdiction: $60 million
- Tax rate: 1.6 percent of value, or a 60 percent increase

• Utility (taxable property value of $40 million) would pay	$ 640,000
• A homeowner with a house valued at $100,000 would pay	$ 1,600
• Other business and residential taxpayers would pay	$ 358,400
Total city tax collections	$1,000,000

This will be the situation in states with constitutional or other limits on government's ability to raise property taxes.

If the city continues to levy $1 million, the tax shifts more heavily to nonutility property.

Bonding

Devaluation of utility property will affect some local governments' abilities to issue new general obligation bonds. Jurisdictions that contain significant utility property that loses value as a result of restructuring are more exposed to this issue.

The ability of the locality that hosts the nonutility company that now owns the power plant to issue new bonds is limited to 5 percent of the value of the property in the town. If that valuation decreases as a result of the devaluation of the power plant, the town's ability to issue new bonds will be restricted. This issue, like many property tax issues, will generate much greater concern in the localities that have high-cost power plants that may be devalued after restructuring. Political subdivisions that do not have these high-cost power plants or have low-cost power plants will not face this problem.

Options

States have several options that may help solve their property tax issues. The options described below assume that states have identified a problem with their current property tax system, have examined the possible property tax revenue decreases and the possible property tax revenue increases, and the possible government savings from less expensive electric providers.

Eliminate the property tax on the competitive electric industry and replace it with a different tax

The state could eliminate the property tax on all utility property and replace it with another tax. Iowa is considering the following proposal.

- Eliminate property taxes and implement a replacement tax based on energy or miles of transmission line. There would be a component for generation based on the amount of energy generated, a second component based on miles of transmission line and a third for energy consumed by the ultimate consumer. Each utility would have a different rate based on its current tax burden in the area in which it currently provides service.

  For example, if a competitor came into Utility A's territory, that competitor would pay tax at the same rate as Utility A. If that competitor came into Utility B's service area, the competitor would pay tax at the same rate as Utility B (which will be different than Utility A's rate). This same basic methodology is proposed to be used for PILOTs where each municipal utility will have a rate for itself and others selling to the ultimate consumer in its current service territory.

  A base amount of taxes to be collected would be established based upon payments in the most current year or an average of recent years. Reports showing the amount of taxes due would be provided to the Iowa department of revenue by each utility and by any competitor required to pay the tax. The utilities would continue to make payments directly to the local taxing jurisdictions based upon property taxes currently being paid. For example, if County X receives 15 percent of the property taxes currently paid by Utility A, it will receive 15 percent of the replacement taxes paid by Utility A.

The goals that were established in developing this methodology were:

- Revenue neutrality for local jurisdictions,
- Revenue neutrality among utilities, i.e., there should not be shifting of tax burden from the current system,
- Ease of administration, and
- Removal of tax costs as a factor in a competitive environment.

The state collects $150,000 in property taxes from all utilities. The $150,000 pays for the costs of administering the replacement tax system. Leaving this property on the tax rolls eliminates potential problems with local governments' bonding limitations.

Treat all types of electricity providers in the same way for purposes of property taxation as a way to reduce the influence of differing tax burdens on competitive electric markets
To the extent that electricity generators compete with each other, yet bear different tax burdens, some states may consider treating like property alike, regardless of who owns the property. Assessments would be based on the same types of property, for instance, and utilities no longer would be classified differently from other electricity providers. This approach will place all retailers in the state on the same basis. The difficulty of this approach is determining the common basis. Could it involve increasing other providers' electric rates to the level of the utilities? Or might it involve reducing the utilities' rates to those of other business property taxpayers? This approach also will require state policymakers to focus carefully on the different ways in which various entities pay taxes.

Shift property tax burden to the remaining monopoly functions
Much as integrated utilities have frequently had the ability to pass their tax expenses through to their customers, so will the remaining monopoly function of delivering power. States could examine possible methods of placing heavier tax burden on the wires companies that operate the transmission and distribution function.

Reduce the tax on in-state power plants
This approach may be appropriate for states that are attempting to attract power plants to their state. It will require careful consideration of the merits of attracting a power plant—even one that produces less tax revenue—and whether a property tax reduction will influence business location decisions compared with such factors as the proximity of the power plant to transmission lines, fuel sources, other power plants or large electric loads.

Increase state aid to the local jurisdictions whose tax revenues from utility property will substantially decrease
States may offer transitional state aid to jurisdictions that are hard-hit by property tax losses as a result of devalued or closed power plants. Funded either through the state general fund or perhaps through a non-bypassable fee that every electricity customer in the state would pay, this state aid would be designed to make up part or all of the property tax revenue losses in the areas that do experience such losses. State policymakers will need to address how long to continue this state aid, and at what level to offer it.

Decrease government expenditures
Political jurisdictions of the state may respond to the loss of revenue by becoming more efficient, offering fewer services or reducing the cost of the services that they offer to their customers.

Shift tax burden to non-utility property

Political subdivisions may elect to increase property taxes for the taxpayers that remain in the jurisdiction. Perhaps practical only in areas with minimal property tax revenue losses, this option may be combined with a concerted effort to reduce government expenditures.

NCSL Electric Industry Tax Partners

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Tax Implications of Electric Industry Restructuring

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Introduction to Electric Industry Taxation

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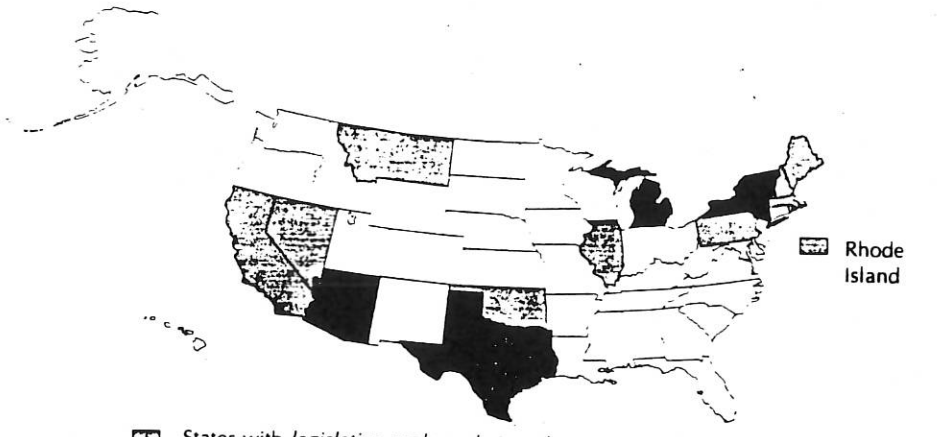
Figure 1: State Activities to Promote Electric Industry Restructuring



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Restructuring the electric industry requires legislators to address a number of issues. One component of discussions concerning electric industry restructuring is its effect on state and local taxes. Policymakers may want to assess the effect of restructuring on tax receipts and revenue demands in a manner that more fully reflects the new competitive marketplace. This report will give state policymakers historical background about electric industry taxation. It discusses the competitive position of different electric suppliers with different tax burdens, defines the types of taxes traditionally levied upon the electric industry (tax definitions may vary within the states) and gives legislators options to consider during discussions of the changing tax structure in a restructured system. Because each state has unique circumstances, electric industry tax decisions should be made in that context.

Electric Industry Taxation

Taxation of a regulated industry usually differs in several key respects from the taxation of unregulated entities. One of the major differences lies in the predictability of a regulated system revenue stream. For example, a regulated utility has a defined, exclusive service territory that provides a stable and predictable customer base.

As a result, hidden taxes are common in a regulated monopoly industry. Hidden taxes, generally, are taxes levied directly on an industry that then passes them on to the consumer as part of the overall price of the product. Such taxes are not listed as a specific line item on the consumer's bill. For example, if a 6.5 percent gross receipts tax is levied on an investor owned utility (IOU), the IOU may then increase its bill by 6.5 percent, but not show that amount as an incremental line item on the bill. That 6.5 percent is a hidden tax for consumers. Hidden taxes on a regulated monopoly have been an attractive option for policymakers because they allow revenues to be raised with little controversy.

Taxation of the electric industry is unique because many principles of taxation that apply to other industries are not applicable. For example, electric industry taxation differs from taxation of other nonutility industries in rates, assessment methods and valuation methods. The taxes also can vary within the industry based upon the utility's ownership. In addition, there are three separately taxable components to the industry—generation, transmission and distribution. The generation component of the industry is being restructured. At least initially, transmission and distribution are likely to remain regulated monopoly enterprises.

As the electric industry restructures, the participants in the marketplace will change. Therefore, state and local governments should determine how restructuring will affect their tax bases. Governments must determine what revenues may be increased in a competitive environment, what revenues may be reduced and methods they may want to use to address these

revenue changes. States may need to reevaluate their tax codes on a regular basis as the electric industry changes.

There has been a complex history of utility industry taxation in the states because each state addresses the issue individually. For example, Ohio assessment rates for utility property are substantially higher than for nonutility property. Investor owned utilities in Ohio annually pay about $1 billion in personal property taxes and gross receipts taxes. At the local level, this results in about $240 million in funding for school districts. In a competitive environment, electric providers will insist on taxation equal to other types of businesses. Given the potential decrease in revenue, including the possibility that some noncompetitive electric generating facilities may close, Ohio has begun to examine the effect restructuring would have on funding for the local education system.

Federal Actions that Affect the Electricity Market

The Public Utility Regulatory Policies Act of 1978 (PURPA). PURPA was passed in response to the oil embargoes and natural gas shortages of the early 1970s, and was designed to encourage alternative generation sources. PURPA requires utilities to purchase power produced by small cogeneration or renewable energy facilities at contractual rates set out or approved by state utility commissions.

The Energy Policy Act of 1992 (EPACT). Proponents of competitive market mechanisms encouraged Congress to introduce competition into wholesale electric markets. EPACT encourages competition in several ways. It creates a new class of power company, the exempt wholesale generator, that can compete against electric utilities to supply electricity. In addition, owners of transmission lines are required to let any electric generator use the lines at an approved and published price. In compliance with EPACT, the Federal Energy Regulatory Commission issued orders 888 and 889, which permitted utilities access to the transmission grid to enhance the sale and purchase of energy for resale. They do not apply to the retail or end-user customer.

Private Use Restrictions. The Tax Reform Act of 1986 (P.L. 86-272) directed the Internal Revenue Service to promulgate rules restricting the use of tax-free financing for private projects. As a result, public power providers that finance generation, transmission, or distribution may be unable to compete outside their service territory boundaries because of private use restrictions.

Definition of Taxes

Although there are differences among the states, the types of taxes and fees levied on utilities generally fall into the following categories:

- Property tax
- Gross receipts tax
- Corporate income tax
- Franchise tax
- Franchise fees
- Consumption tax
- Sales and use tax
- Commodity tax
- Payments in lieu of taxes
- Regulatory or public service consumer fees

Several of these taxes may be levied in combination. Alabama, for instance, imposes seven taxes on electric utilities—a utility gross receipts tax, a utility service use tax (ranging from 2 percent to 4 percent of gross receipts), a license tax of 2.2 percent of gross receipts, a corporate franchise tax of $10 on each $1,000 of capital stock, a corporate net income tax, a privilege tax on businesses that manufacture and

Electric Industry Composition

Investor Owned Utilities (IOUs). IOUs are taxable corporations owned by shareholders. The rates that investor-owned utilities charge for electric service are regulated on a cost-of-service basis by federal or state and local regulatory agencies. Most, if not all, IOUs currently are vertically integrated, i.e., they own the generation, transmission and distribution assets required to serve the end user.

Rural Electric Cooperatives. Rural electric cooperatives are not-for-profit corporations owned by their customers. Rates charged by rural electric cooperatives are subject to regulation in some jurisdictions. Although most rural electric cooperatives are exempt from federal and state income taxes, they pay all other types of state and local taxes. Rural electric cooperatives are not vertically integrated, but may own generation property through generation and transmission (G&Ts) organizations. G&Ts are cooperative organizations that own power plants, generate electricity and transmit it at wholesale prices to distribution cooperatives, which are members of the G&T and provide distribution services to deliver power to end users. The formation of G&Ts allowed member systems to gain the benefits of sharing larger, more economical power plants while retaining the advantages of local ownership, control and operation. Distribution systems generally are bound to their G&Ts by an all-requirements contract, under which the distribution system agrees to purchase—and the G&T agrees to provide—all the distribution co-op's power needs. The distribution system agrees to pay rates sufficient to cover all the G&T's cost.

Public Power Systems. Public power systems, which are predominantly municipal utilities, are extensions of state and local governments. As such, they are generally not subject to federal or state income taxes. Depending on state laws, public power systems may pay sales taxes or gross receipts taxes. These organizations also may provide payments in lieu of taxes (transfers to the general fund and contributions of services to state and local governments). Public power systems can join to form joint action agencies; these consist of two or more electric utilities (usually municipally owned) that have agreed to join under enabling state legislation to carry out a common purpose—usually the provision of bulk power supply, transmission and energy-related services. This arrangement allows the utilities to operate as separate entities.

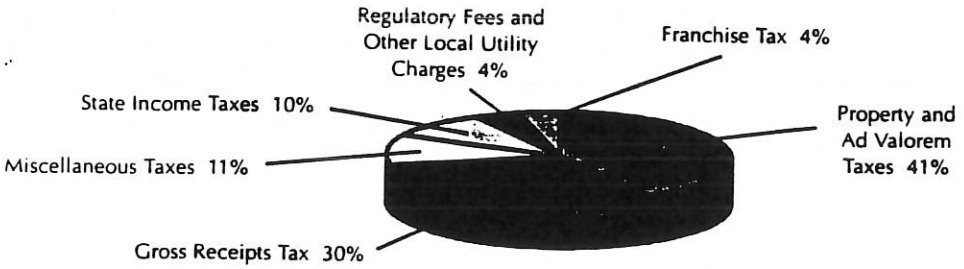
Federal Electric Utilities. Most of the electricity produced by these entities is sold for resale. These utilities generally are exempt from federal, state and local taxes. Bonneville Power Administration is an example of a federal electric utility.

Independent Power Producers. These producers include exempt wholesale generators (EWGs) and other nonutility generators. Independent power producers are subject to federal, state and local taxes, but the rates assessed may be different than those for other power producers.

Power Marketers. Power marketers are nonregulated, competitive buyers and sellers of electricity that may or may not produce the electricity they sell.

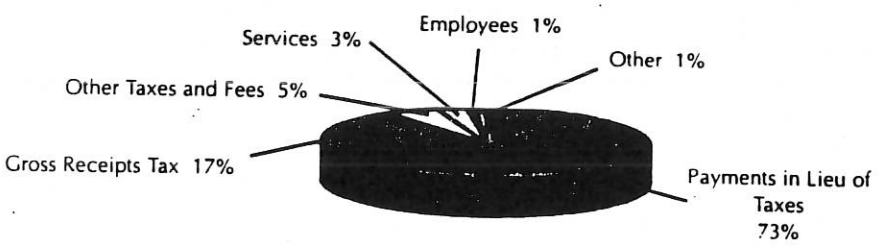
sell hydro power and a property tax. Some states, such as California, assess other environmental charges and fees on utilities in addition to taxes. Figures 2 through 4 show the types of taxes assessed by states and localities on various electricity producers.

Figure 2: State and Local Taxes for Investor-Owned Electric Utilities (1994)



Source: Compiled by Edison Electric Institute from Table 74, Detail of Taxes—Electric Department Only Investor-Owned Electric Utilities, *EEI Statistical Yearbook of the Electric Utility Industry*, 1994, and Federal Energy Regulatory Commission Form 1.

Figure 3. Types of Payments and Contributions from Public Power Systems to State and Local Governments



Source: American Public Power Association study, 1994 data.

Figure 4: State and Local Taxes for Electric Co-ops

Source: National Rural Electric Cooperative Association, 1996 data.

To have a common understanding of the kinds of taxes imposed on the electric industry, it is useful to define those taxes. Although the definitions can vary by state, the following definitions will be applied in this series.

Property Tax
A property tax is imposed on the value of real or personal property located within the taxing jurisdiction. Some states have their own, often unique, definition of real and personal property. Whether property is defined as real or personal may determine whether it is subject to tax, how it will be classified and valued for assessment, how assessments are equalized and at what rate it will be taxed. Some states tax real property only and other states tax both real and personal property. The real and personal property of regulated utilities typically is centrally assessed by a state agency, generally the state's department of revenue. However, in some other states, utility property is assessed locally.

Gross Receipts Tax
A gross receipts tax generally is a levy applied to total revenues from a company's sales without the benefit of any deductions. The tax is imposed directly on the seller based upon total revenue receipts and is considered a general business cost. It differs from a sales tax in that it is a tax on the selling company rather than on the purchaser. However, the gross receipts tax usually is passed to the customer indirectly in the form of increased energy cost.

Corporate Income Tax
A corporate income tax is imposed on the net income of a corporation earned within a state. In the case of multi-state companies, states are afforded great latitude in determining the income earned within their borders. Generally, states compute income by starting with federal taxable income. Some states view each company as a separate trade or business (separate company states) and compute income on a company-by-company basis. Other states regard a trade or business as a single entity regardless of the corporate structure and will compute income and apportionment on the unitary business.

Corporate Franchise Tax (Capital Stock Tax)
A corporate franchise tax is a tax imposed on companies that conduct business in the taxing state. Generally, a corporate franchise tax is based on the net worth of the corporation. The tax is considered a general business cost. However, some states impose a corporate franchise tax based on the net income of the corporation. Commerce Clause limitations arising under Article 1, Section 8 of the U.S. Constitution may restrict a state's ability to impose a franchise tax on an out-of-state business.

Franchise Fee
Franchise fees are paid as part of a service agreement between state and local governments

and a utility company. Service agreements outline the terms under which utility companies provide service to customers in a specific service territory. As part of a service agreement, state and local governments impose a franchise fee. Franchise fees work much like a gross receipts tax. Specifically, a franchise fee usually is calculated on a percentage of the revenues derived from sales of electricity to customers in the franchise territory. A franchise fee generally is imposed in lieu of licenses or permits that otherwise would be required.

Consumption Tax

A consumption tax is a tax on the consumption of an item or service by an end consumer. A consumption tax can be a set amount for each unit consumed or produced or it can be based on a percentage of the total cost of purchasing the items or services. Some states limit the tax to specific types of commodities, while other states impose the tax regardless of how the item or service is produced.

Sales and Use Taxes

A sales tax is a tax imposed on the retail sales price of tangible personal property purchased for use or consumption in the taxing state. Sales and use taxes are counterparts. States that tax sales also impose use taxes at the same rates. The use tax was designed to capture revenues on purchases not subject to the state sales tax, namely purchases by out-of-state vendors that are not responsible for collecting tax on interstate transactions. If a sale is subject to the state sales tax, it generally would not be subject to the state use tax, and vice versa.

Sales tax is withheld and remitted by the seller of goods, while the use tax is remitted by the consumer. State sales and use taxes generate significant tax revenues for the states. States may impose their sales and use taxes on the sale of electricity. This tax is collected from the customer by the electric supplier and passed to the state. Historically, states have exempted many energy and nonenergy items from state sales and use taxes. But electric suppliers are responsible for sales taxes assessed on their purchases (such as office equipment, vehicles or other nonexempted supplies).

Commodity Tax

A commodity tax is a tax imposed on the delivery of a commodity to an end consumer for use within a state. The tax is usually a rate per unit (e.g. kilowatt hour) rather than a tax based upon income or gross receipts. The tax normally is imposed on the company that makes final delivery to the end consumer within a state. Typically, a commodity tax is imposed on and included in the price of such items as gasoline, oil, electricity, natural gas, cigarettes and alcohol.

Payment in Lieu of Taxes (PILOT)
A payment in lieu of taxes or transfer to the general fund is a cash payment or comparable free services made by a utility to the local government jurisdiction in which it is located. In the case of public power systems, for example, the utility is not subject to local property taxes because it is owned by the municipality. Often, the local government will establish an annual payment or transfer in lieu of receiving property tax revenues. There may be a formula for computing the payment, or the amount may be negotiated each year. Some jurisdictions differentiate between payments that are computed by formula or set by contract (payments in lieu of taxes), and payments that are determined on an annual basis (transfers to the general fund), but typically these two terms are used interchangeably.

Regulatory or Public Service Fee
A regulatory or public service fee is imposed on utilities to cover the costs of regulatory activities. This fee is based on the gross receipts of a utility. The rate of the tax is significantly less than a standard gross receipts tax. Most states set an upper limit on a regulatory fee.

Federal Constitutional Issues

When examining the implications restructuring may have on state and local taxation, state policymakers should be aware of the federal constitutional issues that may arise because a state's ability to impose a tax is restricted by constitutional and statutory limitations. The major constitutional issues concerning a state's ability to impose taxes relate to the Equal Protection Clause, the Due Process Clause, the Commerce Clause, the Supremacy Clause and the Import/Export Clause protections.

Equal Protection Clause Limitations on State Taxation
The Equal Protection Clause of the 14th Amendment to the U.S. Constitution provides that no state shall deny to any person within its jurisdiction equal protection under the law. The Equal Protection Clause prohibits discrimination among taxpayers within the same classification. The Equal Protection Clause does not prevent a state from treating one class of individuals or entities differently from others. Discriminatory taxation is permitted under the Equal Protection Clause if the discrimination is rationally related to a legitimate state purpose.

Due Process Limitations on State Taxation
The 14th Amendment to the U.S. Constitution provides that no state can deprive anyone of life, liberty or property without due process of law. This limitation has been interpreted to mean that no state may levy any tax unless there is "some definite link, some minimum connection, between the state and the person, property or the transaction it seeks to tax" *(Miller Bros. Co. vs. Maryland*, 347 U.S. 340, 344 [1954]). This minimum connection is commonly referred to as nexus. The U.S. Supreme Court (the Court) has stated that the due process test is

"whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state" *(Wisconsin vs. J.C. Penney Co.,* 311 U.S. 435 [1940]). Furthermore, the Court ruled that "purposeful availment of an in-state market by an out-of-state company will satisfy the due process nexus requirement *(Quill Corp. vs. North Dakota* 504 U.S. 623 [1992]).

The due process limitation has been litigated extensively in the state tax area. A review of the Court's case law on the issue of nexus reveals that some physical presence in the taxing state is required to justify a tax. However, issues of intangible property and economic presence have been hotly debated in recent years. Typically, any due process challenge related to a state tax is coupled with a Commerce Clause argument.

Commerce Clause Limitations on State Taxation

The Commerce Clause provides that Congress shall have the power to regulate commerce between the states. The purpose of the Commerce Clause is to promote a national and international economy that is insulated from impediments by the states. The Commerce Clause has been used to declare unconstitutional any tax that imposes an undue burden on interstate commerce.

The mere fact that a state imposes a tax that affects interstate commerce is not, per se, a violation of the Commerce Clause. Since Congress has not yet addressed the issue, Supreme Court decisions have been used to define the parameters of the Commerce Clause. The Court uses a four-pronged test to determine the constitutionality of a tax affecting interstate commerce. A state tax will survive scrutiny under the Commerce Clause if: 1) substantial nexus exists, 2) the tax is fairly apportioned, 3) the tax does not discriminate against interstate commerce and 4) the tax is fairly related to the services and benefits provided by the state. What constitutes "substantial nexus" under the Commerce Clause requirement remains a matter of considerable controversy and litigation between taxpayers and state governments.

Supremacy Clause Limitations on State Taxation

Article 6 of the Constitution provides that "This Constitution, and the laws of the United States ... shall be the supreme law of the land." This provision is commonly referred to as a Supremacy Clause. The Supremacy Clause embodies the doctrine of immunity, which is used to prohibit direct state taxation of the federal government and its agencies. The Supreme Court has considered the Supremacy Clause's effect on numerous state taxes. In *U.S. vs. New Mexico,* 455 U.S. 720 (1982), the Court ruled on the constitutionality of a sales tax on the sale of tangible personal property to a government contractor. The Court held that immunity is appropriate only "when the levy falls on the United States itself, or an agency or institution so closely connected to the government that the two cannot realistically be viewed as separate entities" *(U.S. vs. New Mexico,* 455 U.S. 738 [1982]). The court found that the legal inci-

dence of the tax fell on the contractor rather than the federal government, even though the federal government bore the cost of the tax.

Import/Export Clause Limitations on State Taxation

Article 1, section 10, clause 2 of the U.S. Constitution provides that "no state shall, without the consent of the Congress, lay any imposts or duties on imports or exports, except what may be absolutely necessary for executing its inspecting Laws; and the net Produce of all Duties and Imposts laid by any State on Imports or Exports, shall be for the Use of the Treasury of the United States; and all such Laws shall be subject to the Revision and Control of the Congress." Generally, the Import/Export Clause prohibits states from imposing taxes on imports and exports. Under the Court's decision in *Michelin Tire Corp. vs. Wages*, 423 U.S. 276 (1976), a nondiscriminatory tax on goods may be sustained where the tax is imposed on an import that no longer is in transit or where the tax is imposed on an export before it has physically begun transit to a foreign destination (*Michelin Tire Corp. vs. Wages*, 423 U.S. 295 [1976]).

Conclusion

Some flexibility in state policies may be necessary to accommodate the changing electric industry. States have begun to modify those policies in anticipation of electric industry restructuring and in response to the restructuring of other utilities. For example, New Jersey was one of the first states to take action to change its tax code. New Jersey eliminated the gross receipts and franchise tax collected by the electric, gas and telecommunication utilities and replaced it with a corporate business tax.

As states explore tax issues in more depth, they will be better equipped to determine which taxation options are appropriate to meet their needs. They then can be prepared to implement those taxes in the new system.

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The effect of electric industry restructuring on state and local taxes should be part of these policy debates because electric industry restructuring may cause a shift in expected revenues and thereby affect state and local budget planning. In a restructured electric market, policymakers may need to revise the state's tax system to more fully reflect the economic activity being taxed.

This paper deals with direct effects of electric industry restructuring on payments in lieu of taxes (PILOTs). If restructuring fulfills the promise of lower rates and greater economic activity, it will lead to economic growth, new investments and a larger tax base. These effects on PILOTs are difficult to quantify with a useful degree of accuracy and it is not the purpose of this paper to make assertions about the potential benefits of restructuring. This paper should be taken in that context.

Payments in Lieu of Taxes (PILOTs)

PILOTs are used by many local governments to raise revenue for the general fund and to obtain services for the municipality. Utility restructuring presents two main issues related to PILOTs:

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Electric Industry Composition

Investor Owned Utilities (IOUs). IOUs are taxable corporations owned by shareholders. The rates that investor-owned utilities charge for electric service are regulated on a cost-of-service basis by federal or state and local regulatory agencies. Most, if not all, IOUs currently are vertically integrated, i.e., in the past they owned the generation, transmission and distribution assets required to serve the end user.

Rural Electric Cooperatives. Rural electric cooperatives are owned by their customers. As not-for-profits they do not own generation property. Rates charged by rural electric cooperatives are subject to regulation in some jurisdictions. Although most rural electric cooperatives are exempt from federal and state income taxes, they pay all other types of state and local taxes. Rural electric cooperatives are not vertically integrated, but may own generation property through generation and transmission (G&Ts) organizations. G&Ts are cooperative organizations that own power plants, generate electricity and transmit it at wholesale prices to distribution cooperatives, which are members of the G&T and provide distribution services to deliver power to end users. The formation of G&Ts allowed member systems to gain the benefits of sharing larger, more economical power plants while retaining the advantages of local ownership, control and operation. Distribution systems generally are bound to their G&Ts by an all-requirements contract, under which the distribution system agrees to purchase—and the G&T agrees to provide—all the distribution co-op's power needs. The distribution system agrees to pay rates sufficient to cover all the G&T's cost.

Public Power Systems. Public power systems, which are predominantly municipal utilities, are extensions of state and local governments. As such, they are generally not subject to federal or state income taxes. Depending on state laws, public power systems may pay sales taxes or gross receipts taxes. These organizations also may provide payments in lieu of taxes (transfers to the general fund and contributions of services to state and local governments). Public power systems can join to form joint action agencies; these consist of two or more electric utilities (usually municipally owned) that have agreed to join under enabling state legislation to carry out a common purpose—usually the provision of bulk power supply, transmission and energy-related services. This arrangement allows the utilities to operate as separate entities.

Federal Electric Utilities. Most of the electricity produced by these entities is sold for resale. These utilities generally are exempt from federal, state and local taxes. Bonneville Power Administration is an example of a federal electric utility.

Independent Power Producers. These producers include exempt wholesale generators (EWGs) and other nonutility generators. Independent power producers are subject to federal, state and local taxes, but the rates assessed may be different than those for other power producers.

Power Marketers. Power marketers negotiate electricity sales between the power producer and consumer. Power marketers are not defined as utilities, and therefore may be subject only to taxes levied on businesses and business transactions in the state.

- The effect of competition on PILOTs, and
- The effect of PILOTs on effective competition.

Although PILOTS have been decided at the local level, state policymakers may want to consider the following points as they determine how PILOTs fit into a restructured system:

- The way local governments assess PILOTs will affect the competitiveness of different electricity retailers.
- Public power systems may see a decrease in electricity sales, but could still be required by local governments to provide local governments with PILOTs equal to those before restructuring.
- Changes in state taxation could impose new taxes on electricity providers without taking account of their current level of payments and contributions to local governments. Therefore, legislators should be aware of PILOTs and the role they play in local government operations.
- The effect changes in the PILOT system will have on local tax administration and collection efforts.
- The potential of overlapping new taxes in a restructured electric system with PILOTs already in place.
- State legislators cannot eliminate PILOTs, but may be able to limit them.

A Definition of Payments in Lieu of Taxes

A payment in lieu of tax or transfer to the local government's general fund is a cash payment or services provided at no charge by an electric utility to its local government. In the case of public power systems, the utility is a part of local government; it is not subject to local property taxes. Instead, the local government establishes an annual payment or transfer in lieu of tax revenues based upon the public power system's general revenues. There may be a formula for computing the payment, or it may be an amount negotiated each year. Some jurisdictions differentiate between payments that are computed by formula or set by contract (payments in lieu of taxes), and payments that are determined on an annual basis (transfers to the general fund), but typically these two terms are used interchangeably.

Various services also may be provided to municipal governments as PILOTs. Examples of these services include free street lighting, holiday lights, traffic control lighting, highway lighting, electricity for local government facilities, use of utility employees and unbilled services for special events. In some cases, the monetary value of these services is worth as much as several million dollars annually.

Who Pays Pilots?

PILOTs are, to a large extent, paid by public power systems. However, other electricity pro-

viders also may pay them, including investor owned utilities, rural electric cooperatives and federal electric utilities.

Public power systems, predominantly municipal utilities, are extensions of state and local governments that operate on a not-for-profit basis. As such, public power systems generally are not subject to federal or state income taxes or local property taxes within the municipal boundaries. Historically, it has been sound public policy that one level of government does not tax another level of government in recognition of the legitimate purposes and services provided by each. For one level of government to mandate a tax on another would result in a shifting of taxpayer money and essentially would impose a tax on self service.

Public power systems provide a dividend to the owner-customers (residents of the municipality) in the form of a payment to the general fund (PILOT), reduced rates, or a combination of the two.

Federal Actions Affecting the Electricity Market

The Public Utility Regulatory Policies Act of 1978 (PURPA). PURPA was passed in response to the oil embargoes and natural gas shortages of the early 1970s, and was designed to encourage alternative generation sources. PURPA requires utilities to purchase power produced by small cogeneration or renewable energy facilities at contractual rates set out or approved by state utility commissions.

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Private Use Restrictions. The Tax Reform Act of 1986 (P.L. 86-272) directed the Internal Revenue Service to promulgate rules restricting the use of tax-free financing for private projects. As a result, public power providers who finance generation, transmission, or distribution may be unable to compete outside their service territory boundaries because of private use restrictions.

Payments in Lieu of Taxes and Electric Industry Reform: A Hypothetical Example

The following example illustrates how utilities and others in the electric industry pay PILOTs and how those payments could be affected by electric industry restructuring. The example is a useful tool for explaining the topic. Questions for state policymakers are interspersed with the example. The answers to these questions will help policymakers determine how to address this issue in their individual states. Any solutions described in the example should be considered only as illustrative and not as recommendations for policy actions.

Example A

City Power, a public power system (municipally owned) operates in State A's capital city. City Power has been responsible for providing electricity to the municipality since 1898. Two other utilities are located in State A—Rural Power, a rural electric cooperative, and Amalgamated Electric, an investor owned electric corporation. City Power, Rural Power and Amalgamated Electric all own power plants that are located in State A.

Questions for state policymakers:
• Who pays PILOTs in your state?
• What percentage of electricity providers pay PILOTs?

Amalgamated Electric and Rural Power pay property taxes. Amalgamated also pays federal and state income taxes. City Power is exempt from income taxes, but it provides the municipal government with several payments in lieu of taxes (PILOTs). City Power PILOTs include:

- A $6 million payment to the municipal government's general fund.
- Street lighting (valued at $750,000 annually).
- Unbilled services for special events, such as holiday lighting (valued at $100,000 annually).
- Specialized equipment and personnel to assist other municipal departments (valued at $250,000 annually).

City Power pays property and gross receipts taxes as part of the cost of the electricity it purchases under wholesale agreements with the state joint action agency and Amalgamated Electric.

Payments in Lieu of Taxes after Restructuring

With passage of State A's new legislation allowing competition among electricity providers, City Power, Amalgamated Electric and Rural Power are competing with each other and with other power providers that have entered the market. The other providers now include First National Power, an investor owned utility located in State B, and Marketer Inc., a power marketer. Power marketers purchase power from the power producer and sell it to the customer.

In a restructured electricity market, public power providers may see their sales increase, decrease or remain relatively stable. Each scenario could have a different implication for PILOTs, depending on how they are calculated. If sales remain stable, municipal jurisdictions could continue to impose PILOTs similar to those currently in place. However, potential changes in public power market share should be considered by state and local policymakers. In particular, a loss in market share could result in a decrease of revenues to local government if the PILOT is calculated as a percent of gross electric revenue. If the PILOT is calculated as a percent of net assets, the payment to the city may remain constant, but the financial viability of the utility may be affected. If the utility then needs to raise rates, it may continue to lose market share. PILOTs also may be assessed in a flat amount. In this case, the utility may lose

Questions for state policymakers:
• What are the values of Payments in Lieu of Taxes to local governments in your state?
• Does your state have any jurisdiction over limiting or setting PILOTs?

market share, but it would not be evident in the PILOT. In this situation, a utility would still need to try to recoup its losses, and may raise its rates.

Before State A's restructuring initiatives, City Power began building a power plant. The new plant came online in 1997. With the increased generation capacity, City Power no longer needed a wholesale contract with Amalgamated Electric. In fact, it became a wholesale electricity provider to Municipal Electric, a public power company in State B. City Power lost 17 percent of its competitive electricity market share to other power providers, but increased its customer base by attracting retail customers outside its service territory. In the cases where City Power did not have transmission and distribution capacity, it was able to use the transmission and distribution facilities of other electricity providers. As a result, City Power increased its gross revenue by 2 percent.

When the annual agreement between the municipality and City Power was up for review, the city council determined that the PILOTs should be increased. Rather than increasing City Power's cash payment, the city council required them to provide energy for traffic control (valued at $45,000).

The restructuring efforts in State B had a different effect on Municipal Power's ability to provide PILOTs. State B is a home rule state. Broadly defined, home rule allows for local self-government. Local governments, unlike states, have only derivative powers and constitutional and legislative provisions for home rule are enacted for the purpose of giving authority to counties and municipalities over certain matters. In State B, the municipal home rule powers are constitutionally based. The state constitution also limits the sales that Municipal Power can make outside city or village limits to a percentage of their total load. Therefore, not withstanding a revision in State B's constitution, while Municipal Power will continue to have home rule authority, it also will continue to be limited in the power sales it can make in a restructured electric industry.

As retail customer choice becomes widespread in State B and nationwide, Municipal Power finds that a number of its customers inside city limits that are part of national chains come to city council and announce their desire to purchase power from Marketer Inc., which has secured arrangements for the national accounts. As a result, during the first year of restructuring, Municipal Power's market share decreases by 12 percent. They are stepping up customer retention and economic development efforts, but plan to ask city council to reduce their PILOTs based on sales figures.

Options for State and Local Policymakers

These hypothetical examples illustrate some of the issues state policymakers need to examine during discussions of the effects of electric industry restructuring on state and local taxation. If there are PILOTs in your state, some of the following options may be useful to consider.

State Policymaker Options

- *States may have the authority to limit PILOTs.* The question of how to ensure a continued revenue stream to local government without unduly draining revenues from its public power system is an issue that by necessity must be decided at the local, rather than the state level. However, in some instances state legislators do have the ability to limit PILOTs, and should take into account PILOTs and other contributions made by electricity providers to their local governments when considering any changes to the current tax system.

- *Impose a state tax on all electric energy use in the state.* Proposals have been made in some states (such as Minnesota) to eliminate a portion of the property tax that currently is paid by investor owned utilities. This could be replaced by a per kilowatt-hour tax paid by all utilities. The revenues would be collected by the state and redistributed to local governments on a revenue-neutral basis. However, this has raised concerns that customers of electric providers who pay PILOTs would be required to pay a new tax without receiving any of the benefits.

Question for state policymakers: Are public power providers in your state limited in their ability to make electricity sales outside municipal limits?

Local Policymaker Options

- *Include all PILOTs in distribution wheeling component.* This option would still require the local public power utility to make the payments or provide the services, but it would be collected from all retail customers or other providers using the distribution system.

- *Replace PILOTs with a local franchise fee payable by all providers.* While PILOTs are only between different segments of local government, franchise fees could apply to all electricity providers. This fee could be structured as a rate per commodity delivered.

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Special thanks to James Kane, *Arthur Anderson*, who donated services as special adviser to the Partnership.

The National Conference of State Legislatures' Partnership on State and Local Taxation of the Electric Industry was formed in April 1997 to provide a communications forum for those who have various roles dealing with restructuring of the electric industry, but who rarely have an opportunity to work together. The partners include key state legislators, experienced state legislative staff and sponsors of NCSL's Foundation for State Legislatures who chose to participate in the project. The Partnership has focused on several issues that legislators need to examine concerning state and local taxation of the electric industry in a restructured system. The resulting eight documents, designed to assist legislators in making informed policy decisions in their respective states, include:

- *Utility Taxation Overview*
  (ISBN 1-55516-589-3—Item #4129)
- *Introduction to Electric Industry Taxation*
  (ISBN 1-55516-590-7—Item #4130)
- *Gross Receipts Taxes in the Changing U.S. Electric Industry* (ISBN 1-55516-591-5—Item #4131)
- *Property Taxes in the Changing U.S. Electric Industry* (ISBN 1-55516-592-3—Item #4133)
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- *Sales Taxes in the Changing U.S. Electric Industry*
  (ISBN 1-55516-595-8—Item #4135)
- *Payments in Lieu of Taxes in the Changing U.S. Electric Industry*
  (ISBN 1-55516-596-6—Item #4136)

Series authored by Kelly Hill and
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National Conference of State Legislatures

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Tax Implications of Electric Industry Restructuring

A Series by the NCSL Partnership on State and Local Taxation of the Electric Industry

Sales Taxes in the Changing Electric Industry

As with the telecommunications, natural gas and airline industries, the electric utility industry is in the midst of a fundamental transformation. Indeed, one no longer can accurately characterize it as solely the utility industry. Wholesale competition is robust today, with dozens of sellers of electricity as a result of the Public Utility Regulatory Policies Act of 1978, the Energy Policy Act of 1992 and the actions of the Federal Energy Regulatory Commission in orders 888 and 889. Retail customers in at least a dozen states will be able to choose their electricity providers as the result of legislation or comprehensive regulatory packages enacted in those states. It is not only utilities that now are selling electricity. Electric companies that operated in the retail electricity sales business as state-regulated monopolies for more than 50 years will face competition not only from each other, but also from other companies that previously sold no retail electricity.

In states that reform their electric industry, utilities no longer will be restricted to service territories in which they operate as monopolies. These utilities—whether they be investor owned, public power systems or rural electric cooperatives—may find themselves in competition with each other and with new electricity providers like power marketers or independent power producers. The utilities may begin to sell electricity across service territories and state boundaries to customers that previously had no choice of electric companies. They also may break from their regulated vertical structure—in which one company owns and coordinates the power generation, transmission, distribution, accounting, billing and customer service functions—into separate companies. Some may even sell these functions so they can focus on only one business activity. Many mergers already have occurred, both between utilities and between utilities and companies that do not produce electricity. Some electric companies suggest they will not remain electric companies but will offer, for a single price, an array of services to their customers, including internet access, electricity, telephone and cable service and even security services. In time, the electric utility bill may bear little resemblance to its current appearance.

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Questions for state policymakers:
• Does your state assess a sales tax on electric utilities or other electricity providers' purchases?
• Does your state assess a sales tax on the sale of electricity at retail?
• Which transactions are exempt from the sales tax?

In many states' these changes will require a reexamination of the tax system that has been applied to regulated monopoly businesses. The sales tax is likely to be affected by the greater number of interstate electricity sales, new billing options, the combination of electric utilities with other non-electric businesses and other elements of the restructuring of today's electric utilities.

This paper deals with direct effects of electric industry restructuring on sales tax revenues. If restructuring fulfills the promise of lower rates and greater economic activity, it will lead to economic growth, new investments and a larger sales tax base. These effects on the tax base are difficult to quantify with a useful degree of accuracy and it is not the purpose of this paper to make assertions about the potential benefits of restructuring. This paper should be taken in that context.

In a restructured market, sales tax revenues will increase in some places and decrease in others. The objective of this paper is to give state policymakers the tools to understand the effects of electric industry reform on these taxes. It will aid policymakers to participate in an informed debate and enhance their ability to make decisions with information about the franchise and income tax consequences of electric industry reform.

Main Findings

The sales tax is susceptible to changes in the electric industry as a result of three general factors:

- *Electricity Prices.* A decrease in electricity prices will lead to a decrease in sales tax revenues. An increase in electricity prices will produce greater sales tax revenues.
- *Nexus.* States may not be able to require out-of-state electricity providers to collect their sales tax.
- *Information Quality and Availability.* New methods of billing for electricity may make it difficult to ascertain an electricity price on which to base a sales tax.

Questions for state policymakers:
• How much revenue does your state derive from the sales tax.
• What proportion of this revenue is derived from electric utilities?

Allowing companies other than the monopoly distribution company to bill for electricity and collect sales taxes may make it more difficult to collect the sales tax. There are, nonetheless, other policy factors aside from the sales tax that have led many states to encourage that billing be done by nonutilities.

Where change is necessary, it will require state legislation; most of the rules that govern revenue departments' activities can be found in state statute.

Sales and use tax

A sales tax is imposed on the retail sales price of tangible personal property that is purchased for use or consumption in the taxing state. Sales and use taxes are counterparts. If a sale is subject to the state sales tax, it generally would not be subject to the state use tax and vice versa. State sales and use taxes generate significant tax revenues for states. States may impose their sales and use tax on the sale of electricity. Historically, states have exempted many energy and nonenergy items from state sales and use taxes. Almost every state exempts some form of energy or energy-related equipment.

Electric utilities collect sales taxes from their customers and send their collections to the state or taxing jurisdiction. Electric utilities also pay sales tax on many of their equipment purchases. The sales tax revenues go directly to the state general fund. They are neither returned by a formula to political subdivisions of the state, nor are the revenues from the sales tax generally designated for one purpose, such as school funding. The sales tax often is a very significant part of state or local governments' tax revenue stream.

Who Pays the Sales Tax?

Customers of all electricity providers pay the sales tax. The companies that distribute electricity to those customers collect the tax as a part of the electric bill, and remit the tax revenues to the state or political subdivision of the state. State law exempts some state transactions or customers from the sales tax. Many states levy a sales tax on commercial or business customers and exempt residential electricity users. Some states subject only a portion of the bill to a sales tax—for example, only the generation or only the transmission and delivery component of the bill may be subject to a sales tax. Customers of all types of electricity providers pay a sales tax, including power marketers, regulated investor owned utilities, rural electric cooperatives and public power systems. In most states customers pay this tax at the same rate, regardless of the type of company from which they buy their power.

Federal Actions Affecting the Electricity Market

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Power Marketers. Power marketers negotiate electricity sales between the power producer and consumer. Power marketers are not defined as utilities, and therefore may be subject only to taxes levied on businesses and business transactions in the state.

Electricity providers of all types sometimes pay a sales tax on purchases of equipment or other property. Many states exempt these purchases from a sales tax. Certain municipal utilities may not pay a sales tax on equipment purchases made within their own municipal boundaries.

Sales Taxes and Electric Industry Reform: A Hypothetical Example

The following example illustrates how utilities and others in the electric industry pay sales taxes and how those payments could be affected by restructuring electric industry. The example is a useful tool for explaining the topic. However, it should not be taken as a recommendation to pursue a specific policy. Questions for state policymakers are interspersed with the example. The answers to these questions will help determine how to address this issue in their individual states.

Sales Taxes Before Restructuring: A Hypothetical Example

Consider Amalgamated Electric, a hypothetical electricity provider in State A's newly competitive electric marketplace. Before the restructuring of the electric industry in State A, Amalgamated Electric collected the sales tax from its customers. This sales tax was based on 5 percent of the customer's electric bill. Embedded in the customers' electric rate is another sales tax, the one Amalgamated Electric pays its own suppliers for purchases of equipment. The sales tax has been easy to levy and collect, because Amalgamated Electric is a convenient and willing sales tax collector. In addition, it has been easy to ascertain the amount and price of electricity for which its customers have paid.

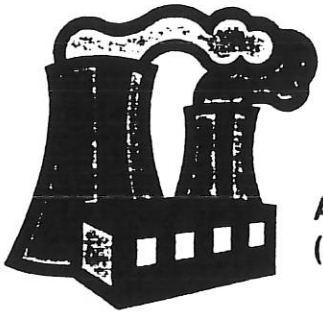
AMALGAMATED ELECTRIC	CUSTOMER NAME JOHN SMITH	ELECTRIC SERVICE 09/29/97 READING 08/28/97 READING	10000 ACTUAL 9000 ACTUAL	
ACCOUNT NO. 1234567890	ENERGY TOTALS TOTAL ELECTRIC	32 DAYS	1000 KWH @ $.08/KWH	$80.00
DUE DATE OCT 13, 1997	AVERAGE/DAY			
AMOUNT DUE $84.00	TAX INFORMATION	SALES TAX	5.00%	$ 4.00
DATE OF BILL OCT 01, 1997		TOTAL CHARGES		$84.00

Figure 1: Sample Bundled Electric Bill

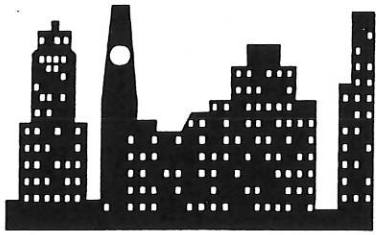
With restructuring, the sales tax becomes more complex. Many state tax issues are actually related to the way in which electricity providers bill for their products and services. These new bills may reflect new corporate structures or new methods of addressing an issue such as

Figure 2: Sales Taxes—How Currently Work

Customers pay sales tax on electricity purchases, collected by each kind of utility and remitted to state or locality



Amalgamated Electric (*investor-owned utility*)



City Power (*a municipally owned utility*)

Rural Power (*a rural electric cooperative*)

stranded costs. Some parts of the formerly bundled electric bill may no longer be subject to the sales tax.

Questions for state policymakers:
• Who currently pays the sales tax?
• Who is exempted?
• On what part of the electric bill does your state levy the sales tax?

Sales Taxes After Restructuring

Since restructuring, Amalgamated Electric separated its company into several smaller ones under a holding company that is still called Amalgamated Electric. Amalgamated Generation only generates electricity, and has become a wholly-owned subsidiary of the holding company, Amalgamated Electric. Deregulated Amalgamated Generation now competes for new business with Marketeer Inc. and Western Power, another electricity provider based in State B. Amalgamated Generation, Western Power and the Marketeer Inc. sell electricity at market regulated prices. Each sends power through lines that are owned and operated by Amalgamated Transmission and Distribution (ATD), another member of the Amalgamated Electric family of companies. Amalgamated Transmission and Distribution remains a regulated monopoly.

These electric providers' customers will probably continue to pay for and receive the same services they received under a regulated industry, and they may still pay for all those services on one bill. After State A allows competition in electricity generation, the bill will be divided among different functions, and payments will go to different entities. Not all elements of the unbundled electric bill will be subject to tax.

These companies' electric bills appear different, too. Amalgamated Generation, Marketeer Inc. and Western Power break their bills into several parts that might look like figure 3:

AMALGAMATED ELECTRIC	**CUSTOMER NAME**	**ELECTRIC SERVICE**		
	JOHN SMITH	POWER DELIVERY		$.02
ACCOUNT NO.		GENERATION		$.04
1234567890	ENERGY TOTALS	COMPETITION TRANSITION CHARGE		$.015
	TOTAL ELECTRIC	PUBLIC BENEFITS CHARGE		$.003
DUE DATE	AVERAGE/DAY	TOTAL		$.078
OCT 13, 1997				
AMOUNT DUE	TAX INFORMATION	32 DAYS	1000 KWH @ $.078/KWH	$78.00
$81.90				
DATE OF BILL		SALES TAX	5.00%	$ 3.90
OCT 01, 1997		TOTAL CHARGES		$81.90

Figure 3: Sample Unbundled Electric Bill

Customers now receive a bill that separates amd itemizes several different charges that previously had been bundled together in one rate. This itemized bill reflects different, separate charges from the regulated electricity delivery company, Amalgamated Transmission and Dis-

Question for state policymakers: Will your state be able to establish nexus over the transactions made out-of-state to sell electricity to customers in your state?

tribution; the state-administered energy efficiency, low-income customer and renewable energy support program [1]; the price of energy from Western Power; and the sales tax.

Who Will Collect the Sales Tax?

Amalgamated Electric, as the only company billing customers for their electricity use, has long collected the sales tax for State A. With competition, Amalgamated Electric may no longer be the only company to bill customers for their electricity use. Marketeer Inc. or Western Power also may bill their customers for electricity use, as might other electricity suppliers, including Amalgamated Generation.[2] These companies use their electric bill as a way to communicate with their customers. Green power marketers, for instance, who may charge their customers a premium price for power from environmentally-friendly sources, might use their bills and bill inserts to communicate with their customers about the factors contributing to the premium that is paid for this type of electricity.

State A may not be able to require out-of-state electricity providers—such as State B-based Western Power—to collect its sales tax. If State A allows companies other than Amalgamated Transmission and Distribution to bill customers, it will be more difficult to collect a sales tax. In attempting to require Western Power to collect a sales tax, State A could encounter a nexus problem.

Nexus

Nexus is the minimum connection the taxing state must have with the corporation or the activity being taxed. To legally uphold its authority to impose a tax, a state's interpretation of nexus cannot violate the Due Process Clause or the Commerce Clause of the U.S. Constitution. The concept of nexus was litigated in the 1992 case *Quill Corporation vs. North Dakota*, 504 U.S. 623 (1992) in the context of the mail-order catalog business. In that decision the U.S. Supreme Court ruled that some kind of physical presence was necessary to support imposition of sales and use tax collection responsibility. Sales tax is similar to a gross receipts tax in that it is assessed on the company's revenue. Physical presence generally refers to having property or people in the state, either directly or through certain kinds of agency relationships.[3]

Similar issues of jurisdiction are likely to arise in states that open up their electric industry to competition. A state may have jurisdiction to tax the company that resides within its borders, but not the business transactions that the company performs with out-of-state companies or business transactions performed in the state by an out-of-state company.

What Can States Tax?

During the electric industry restructuring process, some states may choose to allow utilitites to recover partially, the prudently incurred, verifiable and non-mitigable uneconomic assets, often referred to as stranded costs. Should state A allow for the recovery of Amalgamated

Electric's stranded costs, the portion of the bill that is earmarked to pay for these costs may not be subject to sales tax. Some argue these funds simply flow to Amalgamated Electric as an additional state assessment on the price of electricity and should therefore not be subject to sales tax.

Sales Tax on Generation

Some states define the sales tax as one that is levied on sales from a regulated utility. If electricity generation no longer is state-regulated, the Amalgamated Generation, Western Power or Marketeer Inc. portion of the bill may not be subject to sales tax. Instead, the tax might be levied only on the regulated entities' portion of the bill—that being Amalgamated Transmission and Distribution. In the example above, only $.02 per kWh, would, therefore, be subject to sales tax.

State-Required Charges for Renewable Energy, Energy Efficiency or Low-Income Customer Support

Western Power collects fees that are dedicated to State A's programs to help preserve energy efficiency, renewable energy or other public benefit programs. State A's government might operate those programs with the money that these fees provide. If these fees are broken out on the bill and are dedicated to a specific government-administered program, should they then be subject to tax? To the extent that these fees are no longer part of the price of electricity, but are instead an additional charge that the government requires to be levied on the product, they may not be taxable. In the example above, $.003 per kWh might no longer be subject to sales tax.

Stranded Cost Securitization

California, Pennsylvania, Montana and Rhode Island legislatures have let electric utilities securitize some of their costs related to uneconomic assets. If State A allows securitization of part of Amalgamated Electric's stranded costs, the portion of the electric bill that repays the securitized bonds may not be subject to sales tax.

This securitization would affect the 1.5 cents per kilowatt-hour (kWh) that all customers in State A pay to compensate Amalgamated Electric for its stranded costs. If Amalgamated Electric securitizes 100 percent of its stranded costs, customers instead might pay 1.4 cents per kWh. Now, however, the 1.4 cents is pledged, as a state-legislatively guaranteed property right, to pay off bonds that either a state authority or Amalgamated Electric issued. State legislation structures these bonds so that they are secure and highly rated. In fact, the 1.4 cents per kWh flows through Amalgamated Electric directly to a third party, a special purpose entity designed especially to pay off these bonds. Amalgamated Electric does not have access to these funds, and legislation has pledged them to pay off specific bonds. Some may argue that these funds simply flow through Amalgamated Electric as an additional state assessment on

the price of electricity and, therefore, should not be subject to sales tax.

What Components of the Bill Will States Know?
In a regulated monopoly system, states approve electric rates and utility companies bill their customers for electricity and sales taxes on electricity. Historically, states have had access to information about the price of electricity.

However, in a competitive environment, State A and the federal government might approve only the price of delivering—not generating—electricity. Particularly when out of state retailers like Western Power use Amalgamated Transmission and Distribution's lines to sell to State A customers, Amalgamated Transmission and Distribution or State A may not know the price that Western Power charges for energy.

Western Power may argue that it should not have to divulge its price to ATD and in fact, Western may argue that ATD's holding company, Amalgamated Electric, has an unfair benefit because it can gain access to more information about Western Power's pricing strategies than Western Power can about Amalgamated Electric's pricing. Knowing what Western Power charges for electricity could give Amalgamated the opportunity to offer Western Power's customers a price just slightly below that of Western, while Western does not have the equivalent information about Amalgamated's customers to be able to do the same.

As a result, it is possible that states will have access only to information about the price of delivering electricity, not generating it, and they may not be able to collect a tax on the generation component of the energy bill.

What Billing Options Might Competitive Electric Providers Use?

Mergers, New Services and the Price of Electricity
If Amalgamated Generation follows the lead of many electric companies, it later may merge with a natural gas, telephone, internet, cable or even a security services provider. Known as convergence mergers, these mergers will allow customers to work with one company for all services and pay a single bill, as shown in figure 4.

That bill could differ significantly from the electric bill now sent out by Amalgamated Electric. For instance, it might offer a bundle of services at a fixed price. However, it might not express a charge per kilowatt hour of electricity that the consumer uses. If State A bases its sales tax on a price per kilowatt hour of electricity, new billing techniques that make it difficult, if not impossible, to define an electricity price could also make it difficult to define a sales tax.

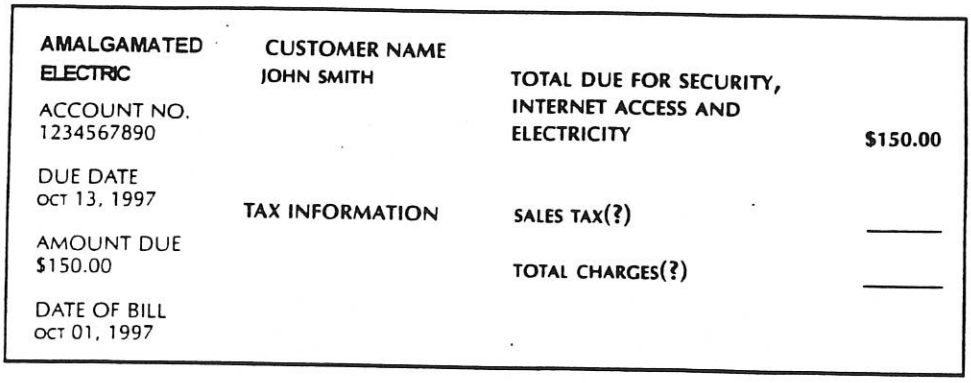


Figure 4: Sample Electric Bill With a Fixed Charge for Several Services

What Will Happen to the Price of Electricity?

Sales tax revenues fluctuate with electricity prices. Because sales taxes are based on a percentage of the price of electricity, a higher electricity price will produce greater sales tax revenues and lower electricity prices will generate lower sales tax revenues. It is unlikely, however, that many people would consider lower prices undesirable simply because they generate less sales tax revenue.

Options for State and Local Policymakers

- *Address the nexus issue by requiring electricity providers that sell electricity in the state to set up an office in the state.* New Jersey passed legislation with this requirement. The requirement in New Jersey is based on the health and welfare of the citizens of the state, deeming electricity to be an essential product, one that is important to the interests of the state and, therefore, different from other products, such as clothing available from mail order. Several other states are considering this requirement, but it has not been tested in the courts.

- *Examine sales tax exemptions, and alter the mix of companies and transactions that currently are subject to the sales tax.* Consider alternative taxes as a way to replace lost revenue from the income or corporate franchise tax (see other papers for details on these possibilities).

- *Assume a price for electricity, and levy a tax based on that assumed price.* In cases where states do not know the price of electricity, it may be possible to assume a price, and levy a tax based on that assumed price. That assumed price could be a regional average price or a price based on the price of electricity in a particular year.

Notes

1. These additional charges might be charges that all customers are required to pay—so-called non-bypassable charges such as fees to cover stranded costs, or other fees to cover public benefits programs such as energy efficiency, or low-income customer support. These charges, formerly included in the electric company's electric rate, but are stated separately on the electric bill.

2. States have a choice. They may either require the "distribution company" such as Amalgamated Transmission and Distribution, to do all the billing for all electricity consumers, or the state may allow all electricity providers to do their own billing.

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Thank you to James Kane, Arthur Anderson, who donated services as Special Advisor to the Partnership.

The National Conference of State Legislatures' Partnership on State and Local Taxation of the Electric Industry was formed in April 1997 to provide a communications forum to those having various roles dealing with restructuring of the electric industry who rarely have an opportunity to work together. The partners include key state legislators, experienced state legislative staff and sponsors of NCSL's Foundation for State Legislatures who chose to participate in the project. The Partnership has focused on several issues that legislators need to examine concerning state and local taxation of the electric industry in a restructured system. The resulting eight documents, designed to assist legislators in making informed policy decisions in their respective states, include:

- *Utility Taxation Overview* ISBN 1-55516-589-3 Item #4129
- *Introduction to Electric Industry Taxation* ISBN 1-55516-590-7 Item #4130
- *Gross Receipts Taxes in the Changing U.S. Electric Industry* ISBN 1-55516-591-5 Item #4131
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National Conference of State Legislatures

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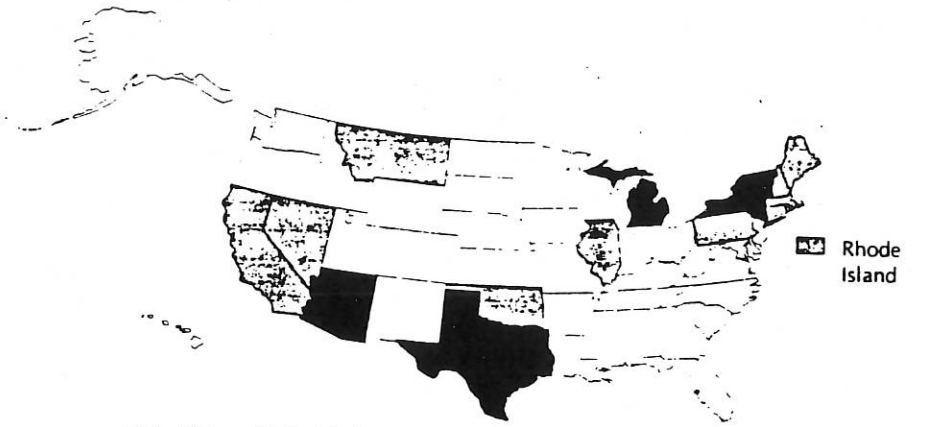
Tax Implications of Electric Industry Restructuring

A Series by the NCSL Partnership on State and Local Taxation of the Electric Industry

Overview of Effects of the Changing Electric Industry on State and Local Taxes

As with the telecommunications, natural gas and airline industries, the electric utility industry is in the midst of a fundamental transformation. Indeed, one no longer can accurately characterize it as solely the utility industry. Wholesale competition is robust today, with dozens of sellers of electricity as a result of the Public Utility Regulatory Policies Act of 1978, the Energy Policy Act of 1992 and the actions of the Federal Energy Regulatory Commission in orders 888 and 889. As shown in figure 1, retail customers in at least a dozen states will be able to choose their electricity providers as the result of legislation or comprehensive regulatory packages enacted in those states. It is not only utilities that now are selling electricity. Electric companies that operated in the retail electricity sales business as state-regulated monopolies for more than 50 years will face competition not only from each other, but also from other companies that previously sold no retail electricity.

Figure 1: State Activities to Promote Electric Industry Restructuring



The National Conference of State Legislatures' Partnership on State and Local Taxation of the Electric Industry was formed in 1997 as a forum for those with various roles in restructuring the electric industry. The partners include key state legislators, experienced state legislative staff and sponsors of NCSL's Foundation for State Legislatures who chose to participate in this project.

Distributed by the National Conference of State Legislatures

Why Are States Considering Competition among Electricity Generators?

Possible Federal Action

At least six proposals are circulating in the U.S. Congress that would require states to allow competition among electricity providers. Some of these proposals include a grandfather clause that allows states that have already begun competition to continue with their own plans. This is not guaranteed, however, especially if the federal proposal differs significantly from the state plan. Some federal legislation would mandate states to allow competition, but would give states the authority to design many elements of their competition plan on their own, as long as the state plans meet federal guidelines.

Changes in Technology, a Market Glut of Power and Decreasing Fuel Prices

Many states' new approaches to regulating the industry are in response to changes in the business of generating electricity. New technologies have decreased the cost of generating electricity, and steadily decreasing natural gas prices[1] have further reduced the cost of generating electricity with natural gas turbines. In addition, many new power plants began operation in the late 1980s, creating far more generating capacity than needed. This oversupply of electricity pushed the spot market, short-term price of electricity to historic lows. It now is possible to obtain power from this spot market or these new power plants at a price lower than many utilities are selling it for at retail. Some electricity consumers have argued that the current system of regulated monopolies should be eliminated. Advocates for competition argue that a system of price regulation—in which each utility is allowed a geographically-defined service territory and can pass its approved costs to customers—is not as efficient as an electric market in which customers can shop for their electricity provider. By 1998 the system that regulated these monopolies will have begun a fundamental change from state regulation of prices to market-based regulation of prices; at least 2.5 million Americans will have the opportunity to choose their electricity supplier.

This transformation is affecting the market for generating electricity, but is having relatively little effect on the physical system of delivering power to customers through transmission and distribution wires. The wires system that delivers electricity to customers is likely to continue to operate as a price-regulated monopoly, at least in the immediate future. Consequently, the effort to restructure the electric market focuses on bringing competition to the generation segment of the industry.[2]

Utility Restructuring and Taxes

A little-noticed aspect of the early stages of electric industry transformation has been its effect on state and local taxes. Many state legislatures are now beginning to focus on:

- The effect of restructuring on state and local tax revenues, and
- The effect of tax policy on competition.

States are approaching the issue in different ways:

- *Pennsylvania* and *New Jersey* have made changes to their electric-industry tax system in an attempt to make it more compatible with a competitive electric industry.

- *Nevada* and *Oklahoma* have asked their state revenue departments to study the issue and report to them, even as they make the transition to competition.

- State legislatures in *Minnesota, Arizona* and *New Mexico* have delayed the transition from regulation to competition in part because they want to understand the effect of electric industry restructuring on taxes, and the effect of taxes on competition.

Federal Actions that Affect the Electricity Market

The Public Utility Regulatory Policies Act of 1978 (PURPA). PURPA was passed in response to the oil embargoes and natural gas shortages of the early 1970s, and was designed to encourage alternative generation sources. PURPA requires utilities to purchase power produced by small cogeneration or renewable energy facilities at contractual rates set out or approved by state utility commissions.

The Energy Policy Act of 1992 (EPACT). Proponents of competitive market mechanisms encouraged Congress to introduce competition into wholesale electric markets. EPACT encourages competition in several ways. It creates a new class of power company, the exempt wholesale generator, that can compete against electric utilities to supply electricity. In addition, owners of transmission lines are required to let any electric generator use the lines at an approved and published price. In compliance with EPACT, the Federal Energy Regulatory Commission issued orders 888 and 889, which permitted utilities access to the transmission grid to enhance the sale and purchase of energy for resale. They do not apply to the retail or end-user customer.

Private Use Restrictions. The Tax Reform Act of 1986 (P.L. 86-272) directed the Internal Revenue Service to promulgate rules restricting the use of tax-free financing for private projects. As a result, public power providers that finance generation, transmission, or distribution may be unable to compete outside their service territory boundaries because of private use restrictions.

Purpose of These Reports

The objective of this series of brief documents is to help state policymakers understand the potential effect of the changes in the electric industry on state and local tax revenues, the effect of state and local tax policy on competition and the policy options available to them.

Armed with these documents, states that choose to restructure their electric industry may be able to do so with a better understanding of the implications of that reform on their tax policy. Any effects of the tax structure on competition or potential effects of competition on tax revenues should be the result of the states' informed choices instead of inadvertent consequences of uninformed choices.

Electric Industry Composition

Investor Owned Utilities (IOUs). IOUs are taxable corporations owned by shareholders. The rates that investor-owned utilities charge for electric service are regulated on a cost-of-service basis by federal or state and local regulatory agencies. Most, if not all, IOUs currently are vertically integrated, i.e., they own the generation, transmission and distribution assets required to serve the end user.

Rural Electric Cooperatives. Rural electric cooperatives are not-for-profit corporations owned by their customers. Rates charged by rural electric cooperatives are subject to regulation in some jurisdictions. Although most rural electric cooperatives are exempt from federal and state income taxes, they pay all other types of state and local taxes. Rural electric cooperatives are not vertically integrated, but may own generation property through generation and transmission (G&Ts) organizations. G&Ts are cooperative organizations that own power plants, generate electricity and transmit it at wholesale prices to distribution cooperatives, which are members of the G&T and provide distribution services to deliver power to end users. The formation of G&Ts allowed member systems to gain the benefits of sharing larger, more economical power plants while retaining the advantages of local ownership, control and operation. Distribution systems generally are bound to their G&Ts by an all-requirements contract, under which the distribution system agrees to purchase—and the G&T agrees to provide—all the distribution co-op's power needs. The distribution system agrees to pay rates sufficient to cover all the G&T's cost.

Public Power Systems. Public power systems, which are predominantly municipal utilities, are extensions of state and local governments. As such, they are generally not subject to federal or state income taxes. Depending on state laws, public power systems may pay sales taxes or gross receipts taxes. These organizations also may provide payments in lieu of taxes (transfers to the general fund and contributions of services to state and local governments). Public power systems can join to form joint action agencies; these consist of two or more electric utilities (usually municipally owned) that have agreed to join under enabling state legislation to carry out a common purpose—usually the provision of bulk power supply, transmission and energy-related services. This arrangement allows the utilities to operate as separate entities.

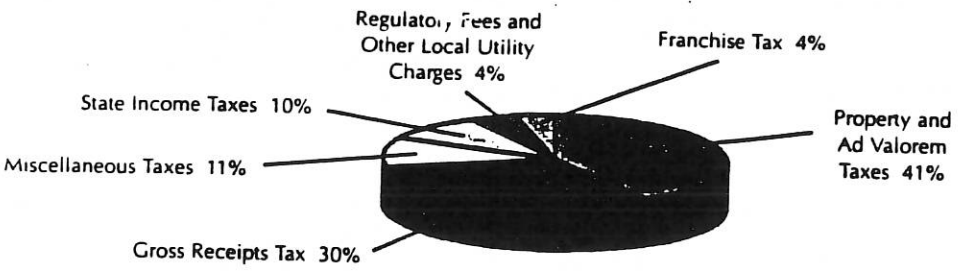
Federal Electric Utilities. Most of the electricity produced by these entities is sold for resale. These utilities generally are exempt from federal, state and local taxes. Bonneville Power Administration is an example of a federal electric utility.

Independent Power Producers. These producers include exempt wholesale generators (EWGs) and other nonutility generators. Independent power producers are subject to federal, state and local taxes, but the rates assessed may be different than those for other power producers.

Power Marketers. Power marketers are nonregulated, competitive buyers and sellers of electricity that may or may not produce the electricity they sell.

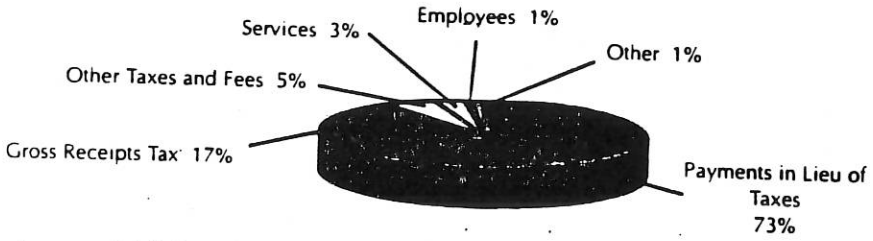
Figures 2 through 4 show the types of taxes assessed by states and localities on various electricity producers.

Figure 2: State and Local Taxes for Investor Owned Electric Utilities (1994)



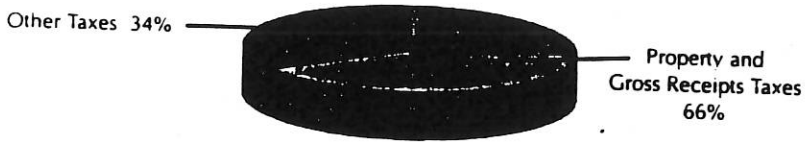
Source: Compiled by Edison Electric Institute from Table 74, Detail of Taxes—Electric Department Only Investor Owned Electric Utilities, *EEI Statistical Yearbook of the Electric Utility Industry*, 1994, and Federal Energy Regulatory Commission Form 1.

Figure 3. Types of Payments and Contributions from Public Power Systems to State and Local Governments



Source: American Public Power Association Study, 1994 data.

Figure 4: State and Local Taxes for Electric Co-ops



Source: National Rural Electric Cooperative Association, 1996 data.

How to Determine if Electric Industry Taxation Is an Issue in Your State

Just as every state's electric industry is different, so, too, is every state's system of taxing the electric industry. As a consequence, tax policy will require a great deal of scrutiny in some states, somewhat less attention in other states and only minor adjustments in the rest. State policymakers may find it helpful to review the following questions to determine the importance of tax concerns to the electric industry restructuring debate.

Compare Your State to Others in Your Region

- New technologies and other pressures are rapidly changing the business of generating electricity. All states and the U.S. Congress are considering the merits of reforming the electric industry. How is your state considering retail competition?

- How far have other states in your region moved toward allowing competition among electricity generators and providers?

- How do taxes in your state compare to those of other states in your region? Might taxes be a factor in convincing electricity generators or electricity providers to locate inside or outside your state?

Examine the Effect of Tax Policy on Competition

- The competitive electric industry will be characterized by new types of providers selling electricity from both within and outside your state. Are electric utilities in your state taxed or assessed at a different rate from other in-state electricity providers or other manufacturing businesses?

- Are effective tax rates for utilities higher than those for other businesses?

- Competition also may result in out-of-state providers entering the market in your state. Are out-of-state electricity providers taxed differently from in-state providers? If so, how similar are the tax burdens?

- Does your state tax law adequately address nexus, which is your ability to tax companies or transactions that may be located outside your state?

- Does your state adequately address interstate electricity sales?

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- How will the restructuring of the electric industry affect tax payments from all types of electricity providers (power marketers, public power systems, rural electric cooperatives, investor owned utilities) in your state?

Examine the Effect of Restructuring on State and Local Tax Revenues

- How much of your state and local revenues are derived from electric utilities?

- Have you considered the possibility of increased fluctuations in your tax revenues as a result of industry restructuring? Is your tax and revenue department or ways and means committee aware of this possibility?

- Are there power plants in your state that may lose value in a competitive electric market? Are there power plants or other electric utility resources that may become more valuable in a competitive electric industry?

- In some states, property tax revenue will decrease as a result of the lower value of power plants in a competitive electric industry. In some states property tax revenue also may increase. To what extent do the taxing jurisdictions in your state depend on property taxes to fund their activities?

- Are your local governments' franchise fees based on gross receipts? Does your state levy a gross receipts tax on utilities?

- Does your state or do local governments in your state have bonding and borrowing limitations that are based on a predicted tax revenue stream or a specified percentage of assessed valuation?

- If your goal is tax revenue neutrality after restructuring your electric industry, what are the candidate taxes to replace your current tax revenues, and who (homeowners, businesses, etc.) will pay them?

- How much do state and local governments now pay in electricity bills, how much might they expect to save as a result of restructuring, and could those savings offset any tax revenue losses?

- Are there jurisdictions in which power plants make up a large share of the property tax base?

Other Concerns

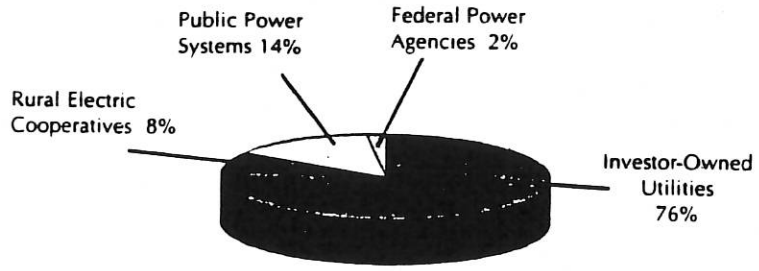
- Does your state use electric rates to finance social policies and goals such as energy efficiency, renewable energy and low-income assistance programs?

Because of the possible shift from monopoly to competition in many states, the way that states tax electricity generators and electricity providers may gradually begin to have more in common with the way that they tax other businesses that are not run as monopolies. Considerations that have heretofore been less paramount in electric industry taxation—such as comparative tax burdens on competing energy industries or the burden of taxes on households, commercial businesses or industry—will become increasingly important as the electric industry continues this transformation.

Overview of State Tax Policy and Electric Industry Restructuring Policy

When state legislatures created regulations and agencies to govern the electric industry in the first part of this century, their goal was to shape an industry that would provide reliable electricity at a reasonable price. As figure 5 shows, the industry that formed around these state—and later federal—laws grew to serve 98 percent of the American public through four types of electricity providers.

Figure 5: Percentage of U.S. Electricity Sold (by Provider Type)



Source: Energy Information Administration, Office of Coal, Nuclear, Electric and Alternative Fuels; *Electric Sales and Revenue, 1995*, Dec. 1996.

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When state legislatures wrote these laws, they concluded that the electric industry—the nation's most capital-intensive industry—was a natural monopoly that was closely entwined with the public interest. As a result most states gave each retail seller of electricity a service territory in which it could sell electricity without competition. In exchange for receiving this monopoly, the retail sellers agreed that the state could regulate many aspects of their business. This regulation applied in almost every state to investor owned utilities. In varying degrees in different states, rural electric cooperatives and public power systems are regulated at the local or state level.

In general, the states moved quickly to regulate the investor owned utilities' electricity prices through cost of service regulation. One objective of this action was to regulate the prices of these monopoly providers of electricity.

Cost of service regulation allows utilities to recover the costs of their reasonable and prudent investments in power plants, power lines, offices and equipment. The system also allows them to pass their approved expenses—like personnel or state and local taxes—to their ratepayers. In addition to recovering their costs, utilities also could earn a reasonable profit on certain investments—power plants or power lines, for example. These investments collectively make up what is known as the utilities' rate base. State regulatory commissions decide what is a reasonable profit and what are reasonable investments. In this cost of service regulatory system, a power company might build a power plant for $100 million and recover $5 million each year for 20 years plus a return of 11 percent. The utilities' ratepayers pay for this power plant, the utilities' other reasonable costs, plus the reasonable rate of return.

Utility commissions can disallow some expenditures from the rate base if they appear too high or unnecessary. Major investments—like electric power plants—undergo the most scrutiny, and sometimes are only partially allowed into the rate base. The cost of service approach has not been sufficient to prevent significant disparities in rates among electric utilities even within the same state. These disparities have arisen because of management decisions by individual utilities, because of different timing of the need for new power plants among utilities, because of state and federal regulatory decisions, and for various other reasons.

Other expenditures receive less scrutiny in some states, and utility commissions have long allowed them to be passed to customers as a matter of course, with the understanding that the utilities have little control over these expenses. Utility taxes are an example of this type of expense. In this respect, utilities are different from other business taxpayers, which attempt to pass tax expenses to their customers, but have less opportunity to pass those expenses on to their customers. Utilities became tax collectors for the state, rather than taxpayers, because they have almost always had the legal right to pass their tax expenses to their customers. Utilities became an attractive means through which state legislatures could quietly raise rev-

enues. These taxes that utilities essentially collected for the state became known as hidden taxes.

With the exception of the sales tax, most taxes that states or other governmental units levy on electric utilities are included as part of the electric rate, assumed to be simply part of the cost of generating, transmitting and distributing power. The utilities have been a politically convenient means through which to levy taxes. For their part, while many electric utilities fight these taxes in the legislature, they know that they will be able to pass their tax expenses to their captive retail customers and that they face no competition from other electricity retailers with a different tax burden.

As a result of this situation, utilities have become a surrogate tax collector for the government in many states. To the extent that these taxes are passed to customers in their electric rates, it is the ratepayers who have borne this burden some parts of the country; taxes have become a significant proportion of utility rates. In a market where utilities have little or no competition, these organizations have become an important source of cash for state and local governments.

Investor owned utilities, rural electric cooperatives and public power systems each are affected by this tax burden, but each to a different extent and each by different taxes. Rural electric cooperatives and investor owned utilities pay many of the same taxes, although sometimes at different rates from one another. Public power systems pay some traditional taxes, but more often make payments in lieu of taxes, or payments to the local government of which they are a part. The rate at which public power systems pay these taxes and the method that is used to determine them vary significantly from one political subdivision and state to another. Like the investor owned utilities, both rural electric cooperatives and public power systems have become a source of revenue for state governments and their political subdivisions.

Utilities in some states have spent little time or energy fighting these taxes, while in other states the utilities have vigorously opposed them. If, as in some states, electric rates are capped (held by legislation or regulation below a certain level) the utility may not be able to pass the tax costs to customers. Utilities are becoming increasingly sensitive to their taxes in a restructured, competitive environment because their state and local tax burden is large. For example:

- At Consolidated Edison in New York City, 21 percent of the price of each kilowatt-hour (kWh) charged to consumers consists of state and local taxes.

- At Chicago's Commonwealth Edison, 15 percent of the per kWh electricity price charged to consumers consists of state and local taxes.

- Industrial customers of Wichita-based Kansas Gas and Electric pay a 26 percent state and local tax load per kWh.

The Relationship between Taxes and Electric Industry Restructuring

The relationship between state and local governments and the utility monopoly may have to change now that utilities in many states no longer will have state sanctioned monopolies. Investor owned utilities, rural electric cooperatives and public power systems—both in-state and out-of-state—may change their structure to compete in the generation of electricity with each other as well as with a new type of competitor called a power marketer. Power marketers will buy electricity from any company that is willing to sell it, and then will resell the power to its own customers. These power marketers may own no power plants, have little other tangible property and may operate from an office in a state that has no income tax. In many states, all these competitors will be taxed differently and, in some cases, may be taxed at rates lower than the utilities.

The Effect of Competition on Tax Revenues

Some states may find that their tax revenues will decrease if they use a tax code that originally was set up to deal with regulated monopolies to now tax a competitive electric marketplace. Several organizations have posited figures by which tax revenues could fall. These estimates will vary depending upon the methodology used to make the estimates and upon who makes them, but it appears clear that some states will lose some revenue if they move to competition without also changing their tax system. Other states may actually see an increase in tax revenues as a result of competition. Just how much revenue each state loses or gains will depend a great deal upon how the state tax system currently is set up and what changes it makes to accommodate electric industry competition.

Some electricity taxes are based on the gross receipts of the electricity sellers. If the price of electricity falls, so also will the receipts of the electric companies. California, for instance, predicts that restructuring will reduce the price of electricity by 20 percent. Rhode Island has suggested that it will save 10 percent, and others have estimated similar savings. If utility revenues do fall by 10 percent to 20 percent, the gross receipts tax revenues will decrease by the same amount unless the consumption of electricity rises enough to compensate for the decrease in price, or unless governments save enough money on their own electric bills to make up for the tax revenue loss.

A few states may find that the tax revenues shift, so that those who are accustomed to receiving the revenues—often school districts, parks or local governments—may no longer receive the revenue. In other words the revenues from some taxes—such as property taxes and franchise fees and taxes—that dedicate their receipts to distinct geographic areas or distinct purposes could decrease, while the revenues from other taxes with revenues directed to the states' general fund could increase. This means that some states may have to examine ways to reallocate revenues from a few taxes to compensate for decreasing revenues from others.

The Effect of Tax Policy on Competition

In a business in which the largest consumers of electricity might choose their electric company based on a quarter-cent difference in price, the tax burden on competing electricity providers will affect just how effective competition is at eliminating the most inefficient electricity suppliers.

Electricity prices may differ because of varying tax burdens among sellers. As a result, the tax structure may make it difficult to determine the effectiveness of competition

Most states will need to determine how to reform their tax policy to align it with competitive electric markets. This reform will require careful thought and negotiation. Some states may find it useful to define the goal of the tax policy changes according to the following suggestions.

Tax Policy Considerations

Tax Revenue Neutrality

Without changes to the tax code, some states will lose or gain tax revenues when the industry moves from monopoly to competition. Meeting a goal of tax revenue neutrality would guarantee that the state or local governments do not see a decline or increase in their tax revenues as a result of competition.

Neutrality of Effect on Various Taxpayer Classes

New taxes will affect taxpayers differently. Meeting a goal of neutrality of effect on the various taxpayer classes would guarantee that homeowners, industrial companies and commercial companies of all income levels will at least be no worse off under competition than they were under the monopoly system and that the change in tax burden will not fall disproportionately on any one class of taxpayers. Some suggest that states should focus on the hidden taxes.

Competitive Neutrality

One general principle of a quality revenue system is that taxes should be neutral in their effect upon behavior. Taxes should not affect a consumer's choice between two products or the

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choice of one production technique over another. Competition in the electric industry will mean that companies and organizations now may have a choice of buying from a range of electricity providers that may be located in state or out of state. Meeting a goal of competitive neutrality would mean that tax policy would not affect the consumer's choice by affecting the price. In other words, the goal would be that tax policy not determine which type of producer wins market share.

Tax Policy to Meet Larger Societal Goals

States use tax incentives to promote environmental or other social goals. A tax policy designed to meet larger societal goals would attempt to guarantee that, for instance, some renewable energy resources receive a tax break to encourage fuel diversity in the state.

Tax Policy as an Economic Development Tool

States use tax policy to bring jobs to the state and to increase the tax base. A tax policy designed to encourage economic development goals might, for instance, encourage power plants to locate in the state. Tax policy, electricity prices and other factors can combine to form a good or bad economic development climate for all businesses in a state.

State tax policy goals probably will be a combination of these goals. Indeed, it is unlikely that states will be able to meet any of these goals with precision or perfection. The objective of this NCSL Partnership is to give states guidance to make informed decisions without unexpected tax consequences, and to allow competitive electric markets to operate efficiently, with tax policy not the determinant of the market's efficiency.

Notes

1. The price of natural gas has generally been declining; some seasonal price increases do occur, however, as happened during the winter of 1996.

2. For convenience, many talk of deregulating the generation component of electric sales. Actually, generation, the sale of power and many power-related services are being unbundled and deregulated. There may be power marketers that do not generate power and there will be many generators who do not sell their power at retail.

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Special thanks to James Kane, *Arthur Anderson*, who donated services as special adviser to the Partnership.

The National Conference of State Legislatures' Partnership on State and Local Taxation of the Electric Industry was formed in April 1997 to provide a communications forum for those who have various roles dealing with restructuring of the electric industry, but who rarely have an opportunity to work together. The partners include key state legislators, experienced state legislative staff and sponsors of NCSL's Foundation for State Legislatures who chose to participate in the project. The Partnership has focused on several issues that legislators need to examine concerning state and local taxation of the electric industry in a restructured system. The resulting eight documents, designed to assist legislators in making informed policy decisions in their respective states, include:

- *Utility Taxation Overview*
  (ISBN 1-55516-589-3—Item #4129)
- *Introduction to Electric Industry Taxation*
  (ISBN 1-55516-590-7—Item #4130)
- *Gross Receipts Taxes in the Changing U.S. Electric Industry* (ISBN 1-55516-591-5—Item #4131)
- *Property Taxes in the Changing U.S. Electric Industry* (ISBN 1-55516-592-3—Item #4133)
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- *Net Income and Franchise Taxes in the Changing U.S. Electric Industry*
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- *Sales Taxes in the Changing U.S. Electric Industry*
  (ISBN 1-55516-595-8—Item #4135)
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National Conference of State Legislatures

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Tax Implications of Electric Industry Restructuring

A Series by the NCSL Partnership on State and Local Taxation of the Electric Industry

Franchise Taxes and Corporate Net Income Taxes in the Changing Electric Industry

As with the telecommunications, natural gas and airline industries, the electric utility industry is in the midst of a fundamental transformation. Indeed, one no longer can accurately characterize it as solely the utility industry. Wholesale competition is robust today, with dozens of sellers of electricity as a result of the Public Utility Regulatory Policies Act of 1978, the Energy Policy Act of 1992 and the actions of the Federal Energy Regulatory Commission in orders 888 and 889. As shown in figure 1, retail customers in at least a dozen states will be able to choose their electricity providers as the result of legislation or comprehensive regulatory packages enacted in those states. It is not only utilities that now are selling electricity. Electric companies that operated in the retail electricity sales business as state-regulated monopolies for more than 50 years will face competition not only from each other, but also from other companies that previously sold no retail electricity.

In states that reform their electric industry, utilities no longer will be restricted to service territories in which they operate as monopolies. These utilities, whether they be investor owned, public power systems or rural electric cooperatives, may find themselves in competition with each other and with other new electricity providers like power marketers, aggregators or independent power producers. The utilities may begin to sell electricity across service territories and state boundaries to customers that previously had no choice among electric companies. They also may break away from their regulated, vertical structure—where one company owned and coordinated the power generation, transmission, distribution, back office and customer service functions—into separate companies. Some may even sell these functions so that they can focus on just one business activity. The states that are encouraging this restructuring are doing so for different reasons. States with high-cost electricity hope that competition will reduce its cost. States with low-cost power producers often see the potential for growth in their companies' market share outside their state.

These changes may, indeed, produce benefits. In many states they also will require a reexamination of the tax system that has developed around regulated monopoly businesses. Two similar taxes that are likely to be affected by the greater number of interstate electricity sales

The National Conference of State Legislatures Partnership on State and Local Taxation of the Electric Industry was formed in 1997 as a forum for those who are concerned about restructuring the electric industry. The partners include key state legislators, experienced state legislative staff and sponsors of NCSL's Foundation for State Legislatures who chose to participate in this project.

Distributed by the National Conference of State Legislatures

Question for state policymakers:
• Does your state assess a corporate net income tax on electric utilities?
• Does your state assess a corporate net income tax on non-utility businesses? Does your state assess a franchise tax on electric utilities or on non-utility businesses?
• How much revenue does your state derive from each of these taxes?
• What proportion of this revenue is derived from electric utilities?

and the restructuring of today's electric utilities are the state or local franchise tax and the income tax.

This paper deals with the direct effects of electric industry restructuring on income and franchise tax revenues. If restructuring fulfills the promise of providing lower rates and greater economic activity, it will lead to economic growth, new investments and a larger franchise and income tax base. These effects on the tax base are difficult to quantify with a useful degree of accuracy and it is not the purpose of this paper to make assertions about the potential effects of restructuring. This paper should be taken in that context.

In a restructured market, franchise and income tax revenues will increase in some places and decrease in others. The objective of this paper is to give state policymakers the tools to understand the effects of electric industry reform on these taxes. It will aid policymakers to participate in an informed debate and enhance their ability to make decisions with information about the franchise and income tax consequences of electric industry reform.

Franchise Taxes and Net Income Taxes

Main Findings

Corporate franchise and income taxes contribute less revenue to state governments than other taxes such as the property tax or the sales tax. Often, however, tax payments from utilities constitute a large percentage of the total corporate net income tax collections. Utility restructuring presents two issues related to these taxes:

- The effect of restructuring on franchise and income tax revenues, and
- The effect of franchise and income taxes on effective competition.

The franchise tax and corporate income tax are susceptible to changes in the electric industry as a result of the three general factors discussed below.

Income Base and Net Worth

- A decrease in net taxable income will lead to a decrease in tax receipts for the income tax and, depending on its base, for the franchise tax. An increase in net taxable income will lead to an increase in tax receipts.
- For franchise taxes based on the net worth of the taxpayer, a decrease in net worth will lead to a decrease in tax receipts. An increase in net worth will increase tax receipts.

Nexus

- States may not be able to tax many out-of-state electricity providers. It may be more difficult to levy an income tax on out-of-state electricity providers than to levy a franchise tax on out-of-state providers.

Apportionment

The increase in interstate sales of electricity will have a major effect on franchise tax and net income tax revenues.

- The allocation and apportionment formula that states use will be an important factor in the effect of electric industry reform on both franchise taxes and corporate income taxes.
- States that are home to utilities that increase their out-of-state market share probably will see an increase in their franchise tax and income tax revenues.
- States that rely heavily on the property and payroll of the taxpayer as a way to apportion income may face income tax revenue losses as a result of restructuring.
- States' ability to tax some new forms of electricity providers will be determined by whether they tax on a unitary or separate company basis.
- Where change is necessary, it will require state legislation because most of the rules that govern revenue departments' activities can be found in state statute.

Federal Actions Affecting the Electricity Market

The Public Utility Regulatory Policies Act of 1978 (PURPA). PURPA was passed in response to the oil embargoes and natural gas shortages of the early 1970s, and was designed to encourage alternative generation sources. PURPA requires utilities to purchase power produced by small cogeneration or renewable energy facilities at contractual rates set out or approved by state utility commissions.

The Energy Policy Act of 1992 (EPACT). Proponents of competitive market mechanisms encouraged Congress to introduce competition into wholesale electric markets. EPACT encourages competition in several ways. It creates a new class of power company, the exempt wholesale generator, that can compete against electric utilities to supply electricity. In addition, owners of transmission lines will be required to let any electric generator use the lines at an approved and published price. In compliance with EPACT, the Federal Energy Regulatory Commission issued orders 888 and 889, which permitted utilities access to the transmission grid to enhance the sale and purchase of energy for resale. They do not apply to the retail or end-user customer.

Private Use Restrictions. The Tax Reform Act of 1986 (P.L. 86-272) directed the Internal Revenue Service to promulgate rules restricting the use of tax-free financing for private projects. As a result, public power providers who finance generation, transmission, or distribution may be unable to compete outside their service territory boundaries because of private use restrictions.

Corporate Franchise Tax

The net income and franchise taxes are often very similar. A corporate franchise tax is a tax imposed on companies that conduct business in the taxing state. In a few states it is used as a substitute for an income tax. Generally, a corporate franchise tax is based on the net worth of the corporation. However, some states impose a corporate franchise tax based on the taxable net income earned by the corporation. Commerce Clause limitations may restrict a state's ability to impose a franchise tax on an out-

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Electric Industry Composition

Investor Owned Utilities (IOUs). IOUs are taxable corporations owned by shareholders. The rates that investor-owned utilities charge for electric service are regulated on a cost-of-service basis by federal or state and local regulatory agencies. Most, if not all, IOUs currently are vertically integrated, i.e., in the past they owned the generation, transmission and distribution assets required to serve the end user.

Rural Electric Cooperatives. Rural electric cooperatives are owned by their customers. As not-for-profits they do not own generation property. Rates charged by rural electric cooperatives are subject to regulation in some jurisdictions. Although most rural electric cooperatives are exempt from federal and state income taxes, they pay all other types of state and local taxes. Rural electric cooperatives are not vertically integrated, but may own generation property through generation and transmission (G&Ts) organizations. G&Ts are cooperative organizations that own power plants, generate electricity and transmit it at wholesale prices to distribution cooperatives, which are members of the G&T and provide distribution services to deliver power to end users. The formation of G&Ts allowed member systems to gain the benefits of sharing larger, more economical power plants while retaining the advantages of local ownership, control and operation. Distribution systems generally are bound to their G&Ts by an all-requirements contract, under which the distribution system agrees to purchase—and the G&T agrees to provide—all the distribution co-op's power needs. The distribution system agrees to pay rates sufficient to cover all the G&T's cost.

Public Power Systems. Public power systems, which are predominantly municipal utilities, are extensions of state and local governments. As such, they are generally not subject to federal or state income taxes. Depending on state laws, public power systems may pay sales taxes or gross receipts taxes. These organizations also may provide payments in lieu of taxes (transfers to the general fund and contributions of services to state and local governments). Public power systems can join to form joint action agencies; these consist of two or more electric utilities (usually municipally owned) that have agreed to join under enabling state legislation to carry out a common purpose—usually the provision of bulk power supply, transmission and energy-related services. This arrangement allows the utilities to operate as separate entities.

Federal Electric Utilities. Most of the electricity produced by these entities is sold for resale. These utilities generally are exempt from federal, state and local taxes. Bonneville Power Administration is an example of a federal electric utility.

Independent Power Producers. These producers include exempt wholesale generators (EWGs) and other nonutility generators. Independent power producers are subject to federal, state and local taxes, but the rates assessed may be different than those for other power producers.

Power Marketers. Power marketers negotiate electricity sales between the power producer and consumer. Power marketers are not defined as utilities, and therefore may be subject only to taxes levied on businesses and business transactions in the state.

of-state business. The tax is considered a general business cost. In some states, an upper limit is set on a single taxpayer's franchise tax payment; in Illinois, for instance, the franchise tax payment is capped at $1 million.

Income Tax

A corporate income tax is imposed on a corporation's net income that is earned within a state. As with the franchise tax, commerce clause limitations may restrict a state's ability to impose an income tax on an out-of-state business. States are afforded great latitude in determining the income earned within their borders. Generally, states compute income by starting with federal taxable income. Some states view each company as a separate trade or business—separate company states—and compute income on a company-by-company basis. Other states regard a trade or business as one entity regardless of the corporate structure and will compute income and apportionment on the unitary business. This income base is further modified to allow or deny other deductions.

Businesses that conduct trade in several states often pay taxes in all the states in which they do business. In the case of both the income and the franchise tax, once the multistate business's overall income or net worth base is established, the tax is apportioned or allocated among the states. Typically, the apportionment is based upon a combination of factors, including property, payroll and sales. Different states rely more heavily on one or another factor to allocate each tax among states; however, many states rely more heavily on property and sales to allocate the franchise tax. An apportionment formula requires the computation of the percentage of property, payroll and sales within a state or political subdivision as compared to the total for the company. This percentage would be applied to the modified income to determine income earned within a state or political subdivision.

The state (or political subdivision) collects the franchise or income tax revenues, which are deposited directly to the general fund. They are not sent by a formula to political subdivisions of the state, nor are the revenues from the income tax generally designated for one purpose, such as school funding. Corporate income taxes and franchise taxes generally do not comprise a large proportion of states' total business taxes. In Minnesota, for instance, corporate franchise taxes based on net income comprise about 6.4 percent of total state general fund revenues. However, income tax receipts from utilities often represent a significant portion of total corporate income taxes that states collect, because utilities generally conduct a large proportion of their business inside their home state. Minnesota's utilities make about 9.5 percent of those total franchise tax payments.

A major issue confronting all states that impose an income tax or a franchise tax that is based on net income, in addition to constitutional limitations, is the statutory limit that Public Law 86-272 imposes upon a state's ability to levy an income tax on a business that conducts opera-

tions in a multistate environment. Public Law 86-272 provides that a state cannot impose an income tax on a business if the company's activities within the state are limited to mere solicitation of sales. This higher standard to which the income tax is held could make it more difficult to impose an income tax on out-of-state electricity sales, although this has not been tested in the courts. Scholars disagree as to the reach of PL86-272. Specifically, many scholars believe PL86-272 only provides protection to sellers of tangible personal property. If this is true, an issue arises as to whether or not electricity is tangible personal property. States are divided on the nature of electricity as tangible personal property. This issue typically has been addressed for sales tax purposes. The corporate franchise tax is not subject to this higher standard.

Who Pays the Corporate Franchise and Income Taxes?

- *Investor owned utilities* are subject to the income tax and the corporate franchise tax.
- *Power marketers* are subject to the income tax and the corporate franchise tax.
- *Public power systems,* as not-for-profit organizations, do not pay the corporate income or franchise tax. See the accompanying paper on payments in lieu of taxation for a discussion of payments that public power systems do make.
- *Rural electric cooperatives* and their generation and transmission organizations generally do not pay the corporate income or franchise tax because they are not-for-profit organizations. Some cooperatives are taxable and therefore are subject to corporate income tax; all non-profit entities are subject to the unrelated business income tax.

Corporate Franchise and Net Income Taxes and Electric Industry Reform: A Hypothetical Example

The following example illustrates how utilities and others in the electric industry pay the income and franchise taxes and how these payments could be affected by restructuring of the electric industry. Any solutions described in the example should be considered only as illustrative and not as recommendations for policy actions. Questions for state policymakers are interspersed with the example. The answers to these questions will help policymakers determine how to address this issue in their individual states. Below, examples A, B and C describe the relationship between income and franchise taxes and restructuring.

Taxes Before Restructuring

Consider Amalgamated Electric, Rural Power and City Power, three electricity providers in

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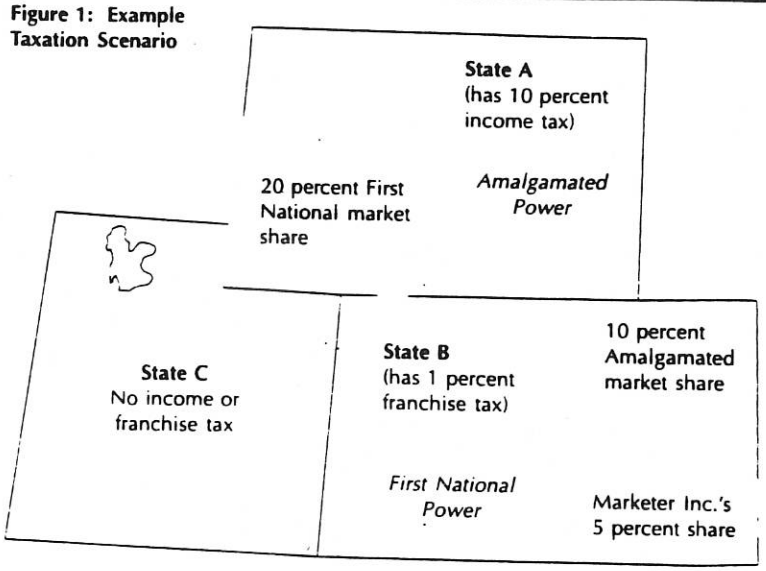
State A's newly competitive electric marketplace. Until recently, these three organizations operated in their own service territories, selling power to customers that had little choice but to buy from them. With passage of State A's new legislation allowing competition among electricity providers, these three utilities now are competing with each other, with a power marketer that has begun doing business in the state and with a utility—First National Power—that has a power plants in State B, but none in State A. First National Power also has restructured its company, and is considering the merits of establishing a holding company in State C. State C has no corporate franchise or income tax. Both Amalgamated Electric and First National Power have an identical net income of $100 million and a net worth of $1 billion.[1] First National Power captured 20 percent of the competitive electric market in State A.

Since State B also passed legislation to allow competition in the electric industry, Amalgamated Electric is selling to customers in its market and has done well enough that it has taken 10 percent of the competitive electric market in State B. The power marketing company—Marketer Inc.—has captured an additional five percent of the competitive market in State B. Both states A and B have corporate net income taxes on utilities. State C has no corporate income tax.

Figure 1: Example Taxation Scenario



States are shown for illustrative purposes only. No conclusions regarding tax policies should be based on the information on this map.

State A figures its corporate income tax on the basis of Amalgamated Electric's revenues minus its expenses. Like the difference between book and tax values for property, Amalgamated Electric's taxable income is different from the income that it shows in its annual or quarterly report for book purposes.

State B figures its corporate franchise tax partly on the basis of a taxpayer's net worth—or, essentially, the market value of its outstanding stock—and partly on the basis of the taxpayers' net income.

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Since Amalgamated Electric began operation as a regulated monopoly, it has paid income tax on the basis of 100 percent of its net income because it made all its sales in State A and because 100 percent of its property and payroll also were located in that state. Similarly, because State B allocates the corporate franchise tax on the basis of the taxpayers' property and sales, and because First National Power's sales and property have long been almost exclusively in State B, nearly 100 percent of First National Power's franchise tax payments have gone to State B. Until the new restructuring laws in States A and B, the income tax situation was relatively simple.

Franchise Taxes and Income Taxes After Restructuring

More sales of electricity across state borders or utility service territories could make it difficult for many states or local governments to maintain their current revenues from either the income or franchise tax.

Nexus

Amalgamated Electric has also lost some market share to The Marketer Inc. and to First National Power. Neither of these companies located offices in State A. In attempting to tax these out-of-state providers, State A encounters a nexus problem.

Nexus is the minimum connection the taxing state must have with the corporation or the activity being taxed to collect taxes from that corporation or activity. To legally uphold its taxing authority, a state's interpretation of nexus cannot violate the Due Process Clause or the Commerce Clause of the U.S. Constitution. The concept of nexus was litigated in the 1992 case, *Quill Corporation v. North Dakota*, 504 U.S. 623 (1992) in the context of the mail-order catalog business. In that decision, the U.S. Supreme Court ruled that some kind of physical presence was necessary to support imposition of sales and use tax collection responsibility. Physical presence generally refers to having property or people in the state, either directly or through certain kinds of agency relationships. Similar issues of jurisdiction are likely to arise in states that open their electric industry to competition.

The income tax is unique among taxes that involve the nexus issue in that states must meet a higher nexus standard to establish nexus over a company or a transaction. Indeed, it can be difficult to establish nexus over a company in the new electric marketplace. Public Law 86-272 states that mere solicitation of sales is not sufficient to establish nexus. This narrower definition of nexus is meant to allow the free flow of commerce among states, without requiring a seller based in one state to pay income tax to the multiple states in which it has customers. In the case of electricity sales, it may mean that out-of-state power marketers or out-of-state utilities will not often be subject to income taxes in the state in which they are selling electricity. Until Public Law 86-272 is tested in the courts, it will not be certain that it will apply to electricity sales.

In the hypothetical example of Western Power and The Broker Inc. selling to customers in State A, it is unlikely that State A will be able to collect a corporate income tax on either

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Western's or The Marketer Inc.'s sales in that state.

A. Question for state policymakers: Will your state be able to establish nexus over the companies that will be selling electricity in your state?

Although the standard for establishing nexus is not as high for a franchise tax that is based on net worth, many of the same nexus concerns apply. It may not always be possible to assert nexus on out-of-state companies in order to levy a franchise tax.

Apportionment, Tax Revenues and Restructuring

States' methods of apportioning income or net worth among themselves, for multi-state utilities, will affect the amount of income or franchise tax they collect from these multi-state companies. The example below is simplified in an effort to explain the influence of different apportionment formulas, and the effect of the loss or gain of market share on state or local tax revenues.

Now that Amalgamated Electric has captured 10 percent of State B's market, but lost 20 percent of the market in its own state to First National Power. State A's and State B's tax situation will be as follows.

Both State A and State B assess income taxes on Amalgamated Electric based on a formula[2] that includes:

Questions for state policymakers:
•On what basis does your state impose an income or franchise tax?
•Does it rely more heavily on property, payroll or sales taxes?

- The property that Amalgamated Electric has in State A,
- The payroll that Amalgamated Electric has in State A, and
- The sales that Amalgamated Electric makes in State A.

State A levies a 10 percent income tax on taxable income. State B levies a 1 percent franchise tax on net worth of the taxpayer.

In Amalgamated Electric's case:

- Property in State A: 100 percent.
- Payroll in State A: 100 percent.
- Sales in State A: 90 percent (the remainder are in State B, as a result of retail wheeling).
- Average: 96.6 percent.

The average of these three is 96.6 percent, so State A will be able to collect income taxes on

96.6 percent, or $96.6 million of Amalgamated Electric's income. Its income tax revenue from Amalgamated will be $9.66 million.
State B collects a franchise tax via a formula that looks at:

- Property located in State B,
- Sales that take place in State B.

In First National Power's case:

- Property: First National Power maintains 100 percent of its property in State B;
- Sales: First National Power makes 70 percent of its sales in State B.

Therefore, State B will be able to collect a franchise tax on 85 percent ($850 million) of First National Power's net worth. Its franchise tax revenue from First National Power will be $8.5 million.

By focusing on a large sales force and offices located within its borders, State A may be able to assert nexus over First National Power. Its tax collections from First National Power will not make up for its losses from Amalgamated Electric.

- Property: First National Power maintains 1 percent of its property in State A.
- Payroll: First National Power maintains 2 percent of its payroll in State A.
- Sales: First National Power makes 20 percent of its total sales in State A.

State A will be able to tax 7.66 percent ($7.66 million) of First National Power's income, making its income tax revenue from First National Power $766,000.

Further Loss of Market for Amalgamated Electric, Gain of Market for First National Power

Effect on State A
If First National Power takes 40 percent of Amalgamated Electric's market share, State A will collect some additional income tax revenue from First National Power, but will lose income tax revenue from Amalgamated Electric.

Amalgamated Electric:

- Income: $80 million, with reduced sales in-state.

- Property: 100 percent in State A.
- Payroll: 100 percent in State A.
- Sales: 90 percent of Amalgamated's sales are in-state, but its total sales are reduced.
- Average: 96 percent.

State A will collect income tax on the basis of 96 percent of Amalgamated's total income, but its collections will decrease because Amalgamated's total income decreases to $80 million. It collects its 10 percent income tax on the basis of $77.3 million, for net collections of $7.73 million, a reduction of $1.93 million.

First National Power:

- Income with increased sales in Amalgamated Electric's former territory: $120 million.
- Property in State A: 1 percent.
- Payroll in State A: 2 percent.
- Sales in State A: 40 percent.
- Average: 14.3 percent.

State A now will collect taxes on the basis of 14.3 percent of First National Power's net income. First National Power now will pay State A on the basis of 14.3 percent of $120 million in income—or $1.68 million in income taxes—an increase of $950,000 in collections from First National Power.

This tax on First National Power's income will not compensate for the loss of Amalgamated's income tax revenues. In fact, State A loses $980,000 as a result of its own utility's loss of market to First National Power. This loss results not only from Amalgamated Electric's decreased income, but also from State A's apportionment formula. State A's formula yields a lower tax base from income taxes from electricity providers that have no property or payroll in the state.

Effect on State B

State B, with a utility that flourishes in a competitive market, gains revenue with First National Power's success out of state. It now collects revenue from First National Power's higher net worth. It also gains from use of the same apportionment formula, which relies heavily on First National's property, which is located in State B, and from First National's sales.

First National Power:

- Property in State B: 100 percent.
- Sales in State B: 50 percent.

Question for state policymakers: Is your state's method of apportioning income and net worth among multi-state electricity providers set up such that your tax collections will decrease or increase after restructuring? (The answer to this question depends both on the way your state apportions income and on the success of your state's electricity providers, both in and out of state.)

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State B will be able to collect corporate franchise tax on 75 percent of First National Power's net worth, as opposed to previously collecting on 85 percent of its net worth. Even if First National Power's net worth increases by 15 percent to $1.15 billion, State B will collect its 1 percent franchise fee on $862.5 million of the company's net worth, resulting in a slight increase of $12.5 million.

Net Income Taxes and the Holding Company

Some electricity providers will alter their corporate structure to make it possible to reduce their total tax bill. If the federal and state legislative laws that govern the structure of utility businesses change as a result of electric industry restructuring, First National Power and many other utilities will be able to alter their corporate structure in ways that heretofore have been impossible.[3] Some utilities may choose to form a holding company that has various subsidiaries that perform different functions and meet different tax planning needs.

For example, suppose First National Power forms a holding company, based in State C, with two subsidiaries. State C has no income or franchise tax. The operating subsidiary operates in State B. It runs power plants, power lines and customer service functions. It also operates on a very slim margin of profit. Meanwhile, all payments are remitted to another subsidiary company based in State C. This company is connected to the operating subsidiary through its holding company parent, but it may be very difficult for State B to establish nexus over the profit-making subsidiary. These profits, meanwhile, are not taxed in State C.

Question for state policymakers: Does your state tax on a separate company or a unitary basis?

State B's ability to levy a tax on the net income or the net worth of the State C-based subsidiary will lie in State B's definitions of how it taxes a company. If it taxes companies as unitary corporations, then it levies income taxes based on the net income of the holding company's combined income and apportionment factors. In this case, State B would be able to tax First National Power's income.

If State B taxes companies as separate corporations, it may be able to tax only the income of the operating subsidiary over which it has nexus in State B. It will have no ability to tax the profit-generating subsidiary that is based in State C, and cannot claim a connection on the basis of the parent company. Separate reporting states usually have provisions in their laws that allow tax administrators to attach these transfer pricing issues (i.e., if First National Power is artificially shifting its profits to the subsidiary in state C). These provisions are difficult to administer, because they require proving that the formula apportionment does not reflect economic reality. States occasionally do use these provisions, but typically only in extreme cases.

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Options for Policymakers

- *Evaluate who is currently subject to the corporate income tax, and expand the number of entities that are subject to that tax to include companies that were previously exempt from the tax.*
  In conjunction with eliminating its gross receipts tax, New Jersey made many other companies subject to the income tax that had not previously been subject to it .
- *Change the method of apportionment to be more heavily weighted to sales.*
  This option is likely to benefit states that predict they will lose market share to out-of-state providers. It will not be beneficial to states that predict that their in-state utilities will be successful out-of state. This change would have broad implications that may be considered in a larger context than simply electric industry taxation.

- *Change from separate to unitary method of taxation.*
  This option may assist states that are attempting to capture tax revenues from companies that have structured themselves as holding companies in which an in-state operating company generates little income, and any income is generated out of state by a sales company. This change would have broad implications that may be considered in a larger context than simply electric industry taxation.

- *Address the nexus issue by requiring electricity providers that sell electricity in the state to set up an office in the state.*
  New Jersey passed legislation with this requirement. The requirement in New Jersey is based on the health and welfare of the citizens of the state, deeming electricity to be an essential product that is important to the interests of the state and, therefore, different from other products, such as clothing available from mail order. Several other states are considering this requirement, but it has not been tested in the courts.

- *Consider other alternative replacement taxes as a way to replace lost revenue from the income or corporate franchise tax.*
  See other papers in this series for details on these possibilities.

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Notes

1. These identical net worth and income figures are simplifications made to ease the comparison of the two companies' tax burdens.

2. States use various formulas to allocate income and corporate franchise taxes. In general, states rely more heavily on property and sales to allocate the franchise tax. Some states, such as Arizona, rely exclusively on sales to allocate taxpayers' income. Many also weight their formula so that it relies most heavily on sales.

3. The federal government is considering major changes to, or the repeal of, the Public Utility Holding Company Act, which in part governs the structure of investor owned utilities in the United States

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Thank you to James Kane, Arthur Anderson, who donated services as Special Advisor to the Partnership.

The National Conference of State Legislatures' Partnership on State and Local Taxation of the Electric Industry was formed in April 1997 to provide a communications forum to those having various roles dealing with restructuring of the electric industry who rarely have an opportunity to work together. The partners include key state legislators, experienced state legislative staff and sponsors of NCSL's Foundation for State Legislatures who chose to participate in the project. The Partnership has focused on several issues that legislators need to examine concerning state and local taxation of the electric industry in a restructured system. The resulting eight documents, designed to assist legislators in making informed policy decisions in their respective states, include:

- *Utility Taxation Overview* ISBN 1-55516-589-3 Item #4129
- *Introduction to Electric Industry Taxation* ISBN 1-55516-590-7 Item #4130
- *Gross Receipts Taxes in the Changing U.S. Electric Industry* ISBN 1-55516-591-5 Item #4131
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Tax Implications of Electric Industry Restructuring

A Series by the NCSL Partnership on State and Local Taxation of the Electric Industry

Gross Receipts Taxes in the Changing U.S. Electric Industry

As with the telecommunications, natural gas and airline industries, the electric utility industry is in the midst of a fundamental transformation. Indeed, one no longer can accurately characterize it as solely the utility industry. Wholesale competition is robust today, with dozens of sellers of electricity as a result of the Public Utility Regulatory Policies Act of 1978, the Energy Policy Act of 1992 and the actions of the Federal Energy Regulatory Commission in orders 888 and 889. As shown in figure 1, retail customers in at least a dozen states will be able to choose their electricity providers as the result of legislation or comprehensive regulatory packages enacted in those states. It is not only utilities that now are selling electricity. Electric companies that operated in the retail electricity sales business as state-regulated monopolies for more than 50 years will face competition not only from each other, but also from other companies that previously sold no retail electricity.

The effect of electric industry restructuring on state and local taxes should be part of these policy debates because electric industry restructuring may cause a shift in expected revenues and thereby affect state and local budget planning. In a restructured electric market, policymakers may need to revise the state's tax system to more fully reflect the economic activity being taxed.

This paper deals with the direct effects of electric industry restructuring on gross receipts tax (GRT) revenues. If restructuring fulfills the promise of providing lower electricity rates and greater economic activity, it may potentially lead to economic growth, new investments and a larger tax base. The effects of such growth and investments on the gross receipts tax base are difficult to quantify with a useful degree of accuracy and it is not the purpose of this paper to make assertions about the potential benefits of restructuring. This paper should be taken in that context.

The National Conference of State Legislatures' Partnership on State and Local Taxation of the Electric Industry was formed in 1997 as a forum for those state legislators restructuring the electric industry. The partners include key state legislators, experienced state legislative staff and sponsors of NCSL's Foundation for State Legislatures who chose to participate in the project.

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Gross Receipts Taxes

Gross receipt taxes (GRT) are used by several states to raise revenue for the general fund. Some states earmark GRTs to fund specific programs such as education or to distribute revenues to municipal local governments. Utility restructuring presents two main issues related to GRTs:

- The effect of competition on GRT revenues, and
- The effect of GRT on effective competition.

State policymakers may want to consider the following points as they consider GRTs in a restructured system

- How states assess GRTs could affect the competitiveness of different electricity suppliers.
- GRT revenues are likely to decrease as an indirect result of lower electricity costs but, if overall electricity consumption increases as a result of restructuring, GRT revenues may increase if lower electricity costs are offset by increased competition.
- If a state cannot collect GRT on out-of-state electricity providers, GRT revenues may decrease if in-state electricity providers lose market share to out-of-state sellers and taxable receipts do not increase.
- In states where the GRT applies only to utilities, GRT revenues are likely to decline as the market opens to more non utility retailers.
- Securitization could have an effect on GRT revenues.
- The impact of changes in the GRT system in a competitive electricity market on local government revenues should be considered by states where local governments levy GRT.
- The effect of changes in the GRT system on state and local tax administration and collection efforts.
- Where change is necessary, it will require state legislation because most of the rules that govern revenue departments' activities are in state statute.

A Definition of Gross Receipts Tax

A gross receipts tax is a levy applied to total revenues from a company's sales without the benefit of any deductions. The tax is imposed directly on the seller as based upon total revenues and is considered a general business cost. It differs from a sales tax in that it is a tax on the selling company rather than on the purchaser. However, the gross receipts tax generally is passed to the customer indirectly in the form of increased energy cost. In some states, local jurisdictions also can impose the GRT.

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Not every state has a GRT, but those that do usually deposit the proceeds in the state treasury without particular designations or purposes. However, a few states earmark GRT revenues generated from utilities for specific programs, including education, the public utility commissions, county health and social service programs, as a local tax replacement and as general funds distributed directly to local jurisdictions.

Electric industry restructuring could have mixed results for state GRT revenues. In a monopoly electric market, the utility providing electricity controlled all aspects of power generation, transmission and distribution. Restructuring efforts may unbundle these into separate systems by specifically focusing on opening generation capacity to competition. States may need to reexamine their current GRT system to determine how these individual components of the electric industry will be taxed.

States may see a fluctuation in GRT revenues in a restructured environment. For example, those states with low-cost power generation could see an increase in GRT revenues because the competitive market will favor these low-cost power companies. Similarly, states with high-cost power plants may see a decrease in GRT revenues. Such a decrease could have a potentially significant effect on programs for which those funds are earmarked or may require a tax rate increase on remaining monopoly functions. However, legislatures that have restructured their state's electric industry have done so with the intent that competition will increase economic growth in the state. This economic growth could offset some or all of the losses in electric industry taxation revenue. The true results of restructuring on GRT revenues may not be known until competition is in place, and could vary over time.

Who Pays Gross Receipts Taxes?

Although there is variation among the states, GRT can be paid by investor owned utilities (IOUs), rural electric cooperatives, public power systems and independent power producers.

Federal Actions Affecting the Electricity Market

The Public Utility Regulatory Policies Act of 1978 (PURPA). PURPA was passed in response to the oil embargoes and natural gas shortages of the early 1970s, and was designed to encourage alternative generation sources. PURPA requires utilities to purchase power produced by small cogeneration or renewable energy facilities at contractual rates set out or approved by state utility commissions.

The Energy Policy Act of 1992 (EPACT). Proponents of competitive market mechanisms encouraged Congress to introduce competition into wholesale electric markets. EPACT encourages competition in several ways. It creates a new class of power company, the exempt wholesale generator, that can compete against electric utilities to supply electricity. In addition, owners of transmission lines will be required to let any electric generator use the lines at an approved and published price. In compliance with EPACT, the Federal Energy Regulatory Commission issued orders 888 and 889, which permitted utilities access to the transmission grid to enhance the sale and purchase of energy for resale. They do not apply to the retail or end-user customer.

Private Use Restrictions. The Tax Reform Act of 1986 (P.L. 86-272) directed the Internal Revenue Service to promulgate rules restricting the use of tax-free financing for private projects. As a result, public power providers who finance generation, transmission, or distribution may be unable to compete outside their service territory boundaries because of private use restrictions.

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Electric Industry Composition

Investor Owned Utilities (IOUs). IOUs are taxable corporations owned by shareholders. The rates that investor-owned utilities charge for electric service are regulated on a cost-of-service basis by federal or state and local regulatory agencies. Most, if not all, IOUs currently are vertically integrated, i.e., in the past they owned the generation, transmission and distribution assets required to serve the end user.

Rural Electric Cooperatives. Rural electric cooperatives are owned by their customers. As not-for-profits they do not own generation property. Rates charged by rural electric cooperatives are subject to regulation in some jurisdictions. Although most rural electric cooperatives are exempt from federal and state income taxes, they pay all other types of state and local taxes. Rural electric cooperatives are not vertically integrated, but may own generation property through generation and transmission (G&Ts) organizations. G&Ts are cooperative organizations that own power plants, generate electricity and transmit it at wholesale prices to distribution cooperatives, which are members of the G&T and provide distribution services to deliver power to end users. The formation of G&Ts allowed member systems to gain the benefits of sharing larger, more economical power plants while retaining the advantages of local ownership, control and operation. Distribution systems generally are bound to their G&Ts by an all-requirements contract, under which the distribution system agrees to purchase—and the G&T agrees to provide—all the distribution co-op's power needs. The distribution system agrees to pay rates sufficient to cover all the G&T's cost.

Public Power Systems. Public power systems, which are predominantly municipal utilities, are extensions of state and local governments. As such, they are generally not subject to federal or state income taxes. Depending on state laws, public power systems may pay sales taxes or gross receipts taxes. These organizations also may provide payments in lieu of taxes (transfers to the general fund and contributions of services to state and local governments). Public power systems can join to form joint action agencies; these consist of two or more electric utilities (usually municipally owned) that have agreed to join under enabling state legislation to carry out a common purpose—usually the provision of bulk power supply, transmission and energy-related services. This arrangement allows the utilities to operate as separate entities.

Federal Electric Utilities. Most of the electricity produced by these entities is sold for resale. These utilities generally are exempt from federal, state and local taxes. Bonneville Power Administration is an example of a federal electric utility.

Independent Power Producers. These producers include exempt wholesale generators (EWGs) and other nonutility generators. Independent power producers are subject to federal, state and local taxes, but the rates assessed may be different than those for other power producers.

Power Marketers. Power marketers negotiate electricity sales between the power producer and consumer. Power marketers are not defined as utilities, and therefore may be subject only to taxes levied on businesses and business transactions in the state.

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Gross Receipts Taxes and Electric Industry Reform: Some Hypothetical Examples

The following examples illustrate how utilities and others in the electric industry pay GRT and how those payments could be affected by electric industry restructuring (see also figure 1). Questions for state policymakers are interspersed with the examples. The answers to these questions will help policymakers determine how to address this issue in their individual states. Any solutions described in the examples should be considered only as illustrative and not as recommendations for policy actions.

Example A

Amalgamated Electric Company is an investor owned electric corporation that operates primarily in State A, but has begun selling electricity across state boundaries in wholesale and retail markets. Two other utilities also are located in State A—Rural Power, a rural electric cooperative and City Power, a public power system. Amalgamated Electric, Rural Power (in this example, Rural Power is a member of a generation and transmission cooperative[1]) and City Power all own power plants that are located in State A.

State A imposes a 2 percent GRT on utility sales with the revenues going to the state's general fund. All three pay the GRT and pass the cost to their consumers as a cost-of-business figured into the rate charged for electricity.

Questions for State Policymakers:
•Does your state impose a gross receipts tax?
•Do the local jurisdictions in your state impose GRT?
•How much revenue is raised by the GRT?

Gross Receipts Taxes After Restructuring

Example B

Amalgamated Electric has served the residential customers in State A since its establishment early in the century. It now operates some power plants that have built a reputation for dependable, consistent and inexpensive operation. Recently, one of the states (State B) in which Amalgamated sells electricity in the wholesale market has opened its electricity markets to retail competition. Amalgamated sees a financial opportunity to sell electricity across the border and begins marketing its services to these potential retail customers. Because the power plant used by the main power producer in State B—First National Power—is old and inefficient, Amalgamated is able to offer a lower electricity price and gains a 10 percent market share in that state. Another 5 percent of the market share was gained by a power marketer—Marketer Inc.—that negotiates electricity sales between the power producer and consumer. Since power marketers are not defined as utilities in State B, and since the GRT in State B applies only to utilities, the sales by power marketers are not subject to GRT. For purposes of the example, it is assumed that the total amount of electricity consumed in State B remains constant.

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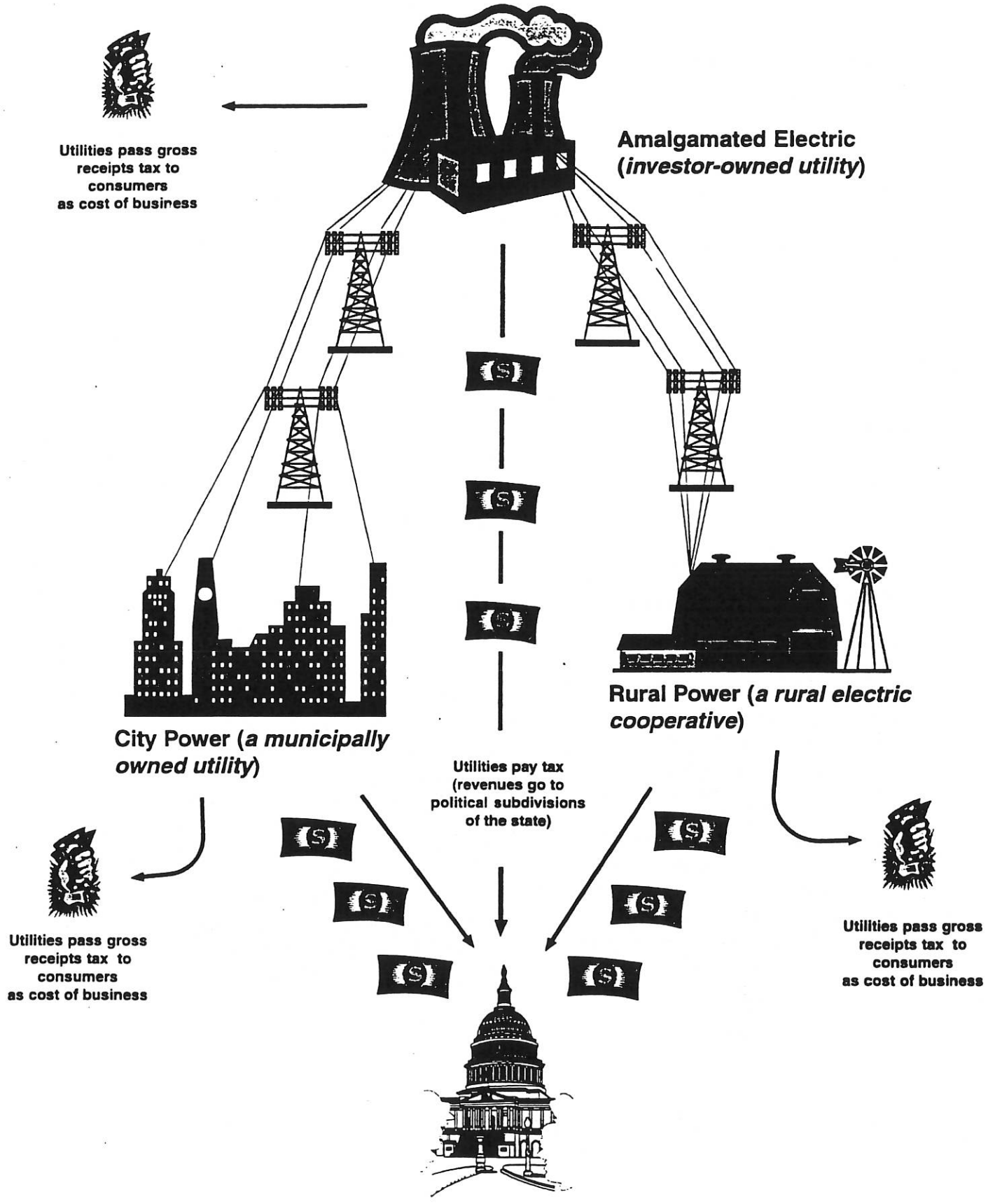
Figure 1. Gross Receipts Taxes—How They Currently Work



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These changes in State B's electricity markets cause changes in State B's GRT revenues because the revenues from the generation of electricity out-of-state may not be subject to the GRT. Policymakers in State B need to determine if they have nexus to tax these revenues.

Question for State Policymakers: •How does unbundling of generation, transmission and distribution capacities affect state GRT revenues?

Nexus

Nexus is the minimum connection the taxing state must have with the corporation or the activity being taxed in order to collect taxes from that corporation or activity. To legally uphold its authority to impose a tax, a state's interpretation of nexus cannot violate the Due Process Clause or the Commerce Clause of the U.S Constitution. The concept of nexus was litigated in the 1992 case, *Quill Corporation vs. North Dakota*, 504 U.S. 623 (1992), in the context of the mail-order catalog business. In that decision, the U.S. Supreme Court ruled that some kind of physical presence was necessary to support imposition of sales and use tax collection responsibility. Sales tax is similar to GRT in that it is assessed on the company's revenue. Physical presence generally refers to having property or people in the state, either directly or through certain kinds of agency relationships.

Similar issues of jurisdiction are likely to arise in states that open up their electric industry to competition. A state may have jurisdiction to tax the company that resides within its borders, but not the business transactions that company performs with out-of-state companies or business transactions performed in it by an out-of-state company.

Question for State Policymakers: •Do you have nexus to tax out-of-state electricity providers?

Example C

State B imposes a 5 percent GRT on utility sales that are earmarked for the state public education fund. State B's GRT generates $10 million annually. In this example, before restructuring, State B did not have to worry about the potential revenue loss because First National Power was the primary electricity provider. Restructuring legislation changed this and now Amalgamated Electric, an out-of-state company, can sell power in State B. Although State B can impose a GRT on the electric companies within its borders, it may not have the nexus to tax Amalgamated for the 10 percent of sales that occur in State B. If State B cannot establish nexus, its GRT revenues will decline by 10 percent.

Question for State Policymakers: •Are gross receipt tax revenues in your state earmarked for specific programs?

Example D

State B has jurisdiction to tax the power marketer—Marketer Inc. The power marketer is headquartered in State B, but it is taxed as an in-state business, not as a utility, because it is only brokering sales, not actually generating electricity from its own plant. As a result, a GRT is no longer paid on the 5 percent of electricity sales conducted by Marketer Inc. Because State B earmarks its utility GRT for school funding, there is now a 5 percent reduction in those revenues. If less expensive electric rates result from State B's restructuring efforts, increased growth in other sectors of the economy may offset the loss in GRT revenues.

Question for State Policymakers:
• Is the gross receipts tax in your state assessed on all businesses or only on utilities?
• If it is assessed on all businesses, is the rate different for utilities?

Example E

First National Power, the primary electricity provider in State B before restructuring, has found itself with an aging power plant and higher taxes (including GRT) than its competitors. It is now considering forming a holding company that will be located in State C, which has no GRT. First National Power would be reconfigured into a holding company that controls a generation facility (First National Power's plant in State B), a wires company and a sales company, all located in State C. First National Power will continue to produce electricity and sell it to consumers in State B, much as it has for the past 60 years. However, all the revenues generated by electricity sales from the First National Power plant would go to State C and not be subject to the GRT; if State B lacks the nexus to collect GRT on those electricity sales, State B will see a large reduction in the GRT revenues. State B may see the need to reconfigure its tax system to try to collect a tax on sales made by the out-of-state company. Numerous utilities may explore ways to revise their corporate structure to reduce their total tax bill.

Taxable Revenue

Other aspects of electric industry restructuring may have an indirect effect on taxable revenues. Competition in the electric industry is meant to lower customers' electricity costs by opening the marketplace to multiple providers. However, lowering costs may indirectly lower GRT revenues. For example, California's restructuring legislation requires a 10 percent reduction in residential electricity rates. If consumption levels remain stable, tax revenues are likely to decline by 10 percent as well. But if less expensive electricity rates result in growth in other sectors of the economy the loss in revenue may be partially offset through other taxes.

Question for State Policymakers:
• If securitization is being used to finance utilities' stranded costs, are the revenues earmarked to pay the bondholders and are they considered taxable revenue?

Example F

Policymakers in State A have been observing the implementation of electric industry restructuring in State B and have decided to move forward with it in their state. One question that arose during restructuring debates in State A is how Amalgamated will recover the stranded costs on its power plant.[2] Amalgamated argued that, in the past, the state public utility commission allowed it to recover its costs over a 30-year period by passing these costs to consumers. In a restructured system, the utility no longer operates in a state-designated service territory and, therefore, no longer has the assured customer base from which to recover its costs. After determining that Amalgamated Electric is indeed entitled to be compensated for some of its stranded costs, as determined by the Public Utilities Commission, the legislature decided securitization was the best way to address this concern.

Example G

Amalgamated Electric makes the argument that the funds it collects to pay off the securitization bonds are earmarked solely to pay off these bonds and should not be counted as taxable revenue for the utility. If this argument prevails, securitization will, in effect, siphon off a portion of the taxable revenue.

Options for Policymakers

These hypothetical examples illustrate some of the issues state policymakers need to examine during discussions of the effects of electric utility industry restructuring on state and local taxation. The following options have been considered by states that have implemented restructuring:

- *Replace the GRT with other taxes, or limit it to regulated components of the electric industry such as the transmission or distribution sectors.* The state GRT could be eliminated and replaced with a tax that can be assessed equally on all electricity providers. Although New Jersey has not restructured the electric industry in the state, the deregulation of other utilities in the region prompted it to eliminate its GRT over a five-year period. Assembly bill 2825 (1997) eliminates the GRT and franchise taxes previously collected by electric, gas and telecommunications utilities. Instead, these utilities will be subject to the state's corporate business tax. Additionally, the state's existing sales and use tax, with certain exceptions, will be applied to retail sales of electricity and natural gas, and a transitional energy facility assessment will be applied on these utilities.

- *Determine which areas of the state or local budgets will be most seriously affected by a reduction in GRT. Possibly earmark a portion of the taxes levied upon out-of-state sources toward that deficit.* For example, when New Jersey eliminated the GRT it also revised its method for distributing funds to local municipalities from state taxation of gas and electric public utilities and certain telecommunication companies, and from sales of electricity, natural gas and energy transportation service. Assembly bill 2824 (1997) guarantees local municipalities an annual state aid distribution of at least $730 million from tax revenues that will replace the GRT, franchise taxes and unit-based energy taxes.

- *Explore the nexus issue to determine if there is a way to offset the losses in GRT.*

- *If local jurisdictions in the state collect GRTs, states may want to consider how local governments will be affected in a restructured system, and determine whether the state should take steps to redesign the GRT system and find replacement taxes.* Pennsylvania recently enacted legislation with a revenue neutrality provision. Section 4 of HB 1509 (1997) specifically states that, "It is the intention of the General Assembly to establish this revenue replacement at a level necessary to recoup losses that may result from the restructuring of the electric industry and the transition thereto." Starting January 1, 1999, the act extends the GRT to nonutility suppliers as well as to municipal utilities and cooperatives for sales outside their established service territories.

By December 1, 1998, and from October 1, 1999, through 2002, the Pennsylvania Revenue Department must publish the tax rate in the state bulletin. The 2002 rate continues indefinitely. The department must adjust the rate to reflect changes in electricity sales above a 1995 base and total gross receipts. The adjustment can result in a surcharge or credit.

Notes

1. G&Ts are cooperative organizations that own power plants, generate electricity and transmit it at wholesale to distribution cooperatives. The distribution cooperatives are members of the G&T and provide distribution services for the delivery of power to end users. The formation of G&Ts allowed member systems to gain the benefits of sharing larger, more economical power plants while retaining the advantages of local ownership, control and operation. Distribution systems (in this case Rural Power) generally are bound to their G&Ts by an all-requirements contract, under which the distribution system agrees to purchase—and the G&T agrees to provide—all the distribution co-op's power needs. The distribution system agrees to pay rates sufficient to cover all the G&T's cost. By guaranteeing the G&T a sufficient revenue stream, the all-requirements contract provides the primary security for nearly all G&T borrowings.

2. Stranded costs are those costs a utility would have recovered through rates under a regulated system, but won't be able to recover in a competitive system. Examples of these costs include new power plants and transmission systems.

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Special thanks to James Kane, *Arthur Anderson*, who donated services as special adviser to the Partnership.

The National Conference of State Legislatures' Partnership on State and Local Taxation of the Electric Industry was formed in April 1997 to provide a communications forum for those who have various roles dealing with restructuring of the electric industry, but who rarely have an opportunity to work together. The partners include key state legislators, experienced state legislative staff and sponsors of NCSL's Foundation for State Legislatures who chose to participate in the project. The Partnership has focused on several issues that legislators need to examine concerning state and local taxation of the electric industry in a restructured system. The resulting eight documents, designed to assist legislators in making informed policy decisions in their respective states, include:

- *Utility Taxation Overview*
  (ISBN 1-55516-589-3—Item #4129)
- *Introduction to Electric Industry Taxation*
  (ISBN 1-55516-590-7—Item #4130)
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