

1996-97 REPORT OF FERC'S TAX DEVELOPMENTS COMMITTEE

I. OVERVIEW

The ongoing restructuring of the energy industry has significant tax implications. To a large degree, the primary tax considerations pertaining to barriers of "competitiveness" involve state and local taxes, since state and local taxing authorities have long viewed traditional public utilities as very efficient tax collectors. In this regard, major policy considerations that achieve a "level playing field" between historically regulated entities and new unregulated entities competing for the market, also create a level playing field among competing entities based in different states. Moreover, the transition to competition, and the "unbundling" of disparate utility functions, pose serious challenges to the ongoing viability of the "unit valuation" approach to assessing utility property for property taxes, an approach which derives the value of the individual component parts of a utility system from the value of the utility company as a whole.

By contrast, federal tax issues are a major (if not the major) consideration pertaining to the financial and legal structures employed to ease transition from the regulated cost-of-service monopoly to market competition. In particular, federal tax considerations are playing a major role regarding issues such as recovery of stranded costs, "securitization," and the relative benefits of functional separation of generation from other utility activities versus legal divestiture. Moreover, the increasing use of market-based pricing for generation, the use of rate caps, incentives and performance based pricing, compared to the traditional rate-base pricing, cost of service and pricing for transmission and distribution function, are beginning to raise questions about the assumptions underlying normalization and other special federal tax rules applicable to public utilities.

II. STATE AND LOCAL TAXATION

A. Legislation

Historically, electric and gas utilities have been subject to an array of special or unique taxes not generally levied on ordinary business corporations. These taxes include gross revenue or receipt taxes, and special franchise taxes. Additionally, many states have classified property tax systems which assess utility property at higher ratios of value or at higher tax rates than non-utility property. A general consensus is beginning to emerge that tax regimes that discriminate against utilities vis-a-vis non-utilities now increasingly in direct competition with utilities are anti-competitive, and should be replaced with consumption taxes of general applicability, and least with respect to utilities' generation and merchant

functions.¹ It is also generally agreed, however, that transitional mechanisms need to be implemented to preserve and protect tax revenues, particularly for localities heavily dependent on utility tax revenues. It is also becoming recognized that mechanisms need to be employed to prevent the constitutional requirements of "nexus" from enabling out-of-state marketers from circumventing state and local taxes on energy transactions. Finally, it is being recognized that transmission and distribution functions remain optimal sources of tax revenue because they will remain monopolistic.

The State of New Jersey has recently enacted sweeping energy tax reform.² Under this reform, the state's 12-13% Gross Receipt and Franchise Tax (GR&FT) will be replaced by a 6% sales and use tax on all retail sales of natural gas or electricity (including transportation and delivery components). Additionally, all utilities doing business in New Jersey will now be subject to the State's 9% Corporate Business Tax (CBT) (i.e., net income tax). To project against municipal tax revenue erosion, a Transitional Energy Facilities Assessment (TEFA) of approximately 6% will be collected on all retail energy sales, and phased out over a five year period. To prevent the TEFA from putting utilities at a competitive disadvantage vis-a-vis unregulated competitors, the TEFA will be assessed entirely with respect to transmission and distribution services, and will not affect the generation and merchant activities of utilities. New Jersey will preserve its real property tax exemption on utility property other than land and buildings. To prevent out-of-state marketers from circumventing the sales and use tax requirements due to a lack of "nexus" all marketers seeking to do retail business in the state will be required to establish a place of business within the state as a condition of being permitted to make retail sales within the state.

Numerous other state legislatures have been examining state energy tax regimes within the framework of energy restructuring. Pennsylvania's Electricity Generation and Customer Choice and Competition Act,³ for example, which provides for the phase-in of full customer choice, contains a "true-up" mechanism to preserve energy tax revenues at historic levels. It also imposes a reciprocity requirement that all retail sellers of electrical energy within the state subject themselves to the gross-receipt tax.

Other states considering energy tax reform within the framework of electricity restructuring include New York (e.g., proposed bill endorsed by Governor Pataki to phase-out gross receipt tax⁴); Ohio (e.g., utility sponsored proposals to reduce assessment ratio on generation equipment from

1. See, e.g., NATIONAL COUNCIL ON COMPETITION AND THE ELEC. INDUS., FEDERAL, STATE AND LOCAL IMPLICATIONS OF ELECTRIC UTILITY INDUSTRY RESTRUCTURING (1996). For a more detailed analysis of federal tax rulings and decisions impacting on regulated industries, see SECTION OF PUB. UTIL., COMMUNICATIONS AND TRANS. LAW, ABA, 1997 ANNUAL REPORT, TAXATION AND ACCOUNTING (1997).

2. S.B. 31, 207th Leg. Sess. (N.J. 1997); A.B. 2825, 207th Leg. Sess. (N.J. 1997).

3. 66 PA. CONS. STAT. §2801 (1996).

4. S.B. 3486, 220th Leg., Spec. Sess. (N.Y. 1997).

100%, to 25% ratio applicable to other business property, and to replace the state's 4.75% gross receipt tax with a corporate franchise (i.e., net income) and use or excise tax); and Massachusetts (e.g., pending legislation sponsored by former Governor Weld which would make utility and non-utility owned generation plant eligible for exemptions available for manufacturing equipment, but with a transitional mechanism to phase-in local tax revenue reductions).⁵ In other states, including Texas and Minnesota, the impact of high property taxes on the competitiveness of local utilities under restructuring, and of customer choice on local tax revenues have been dominant themes in the restructuring debate.

B. Court Cases

1. Sales and Use

In a landmark case, *General Motors Corporation v. Tracy*,⁶ the United States Supreme Court held that the interstate commerce and equal protection clauses of the United States Constitution did not bar the State of Ohio from exempting market rate retail sales of natural gas by local distribution companies (LDCs) from sales and use taxes, while not similarly exempting such sales when made by unregulated gas marketers. The majority opinion, written by Justice Souter, did not dispute that exemption, in fact favored LDC's who were based in Ohio at the expense of out-of-state marketers. The Court held, however, that this disparity was sustainable because LDCs and independent marketers were not similarly situated, in that the former had an obligation to serve small "captive" customers, while the latter did not. The Court held that: 1) the State of Ohio had a strong interest in ensuring that these captive customers were not "frozen out of their houses" in winter, and; 2) the Court had always recognized that such interests were compatible with the Commerce Clause. The Court declined to opine regarding the extent to which this disparate tax scheme, in fact served to protect the interests of captive customers, concluding that it was "institutionally unsuited to gather the facts upon which economic predictions can be made, and professionally untrained to make them." This decision has implications pertaining to state regulation of energy beyond the taxation context.

2. Property Tax

A lower court decision filed in November 1996, *Long Island Lighting Company vs. Town of Brookhaven*,⁷ the trial court determined that during the years preceding its abandonment in 1989, the \$5.4 billion Shoreham nuclear plant, though licensed by the NRC, ready for operation, and in rate base, in fact had a market value of zero for real property tax purposes because strong political opposition had made its becoming fully operational

5. H.B. 4311, 181st Gen. Ct., Reg. Sess. (Mass. 1997).

6. *General Motors Corp. v. Tracy*, 117 S. Ct. 811 (1997).

7. *Long Island Lighting Co. v. Town of Brookhaven*, Index Nos. 91-18238 (N.Y.S. Sup. Ct., Suffolk Cty. 1996).

highly improbable. The court held that the \$4.0 billion "regulatory asset" which LILCO received in 1989 in return for agreeing to abandon Shoreham was not a reflection or measure of the plant's market value prior to abandonment, since (according to the court) this payment was intended merely to place LILCO in a strong financial position, not to reimburse it for the lost value due to the abandonment. The \$1.1 billion refund judgment which would result if the decision were enforced could bankrupt the local school district and other municipalities, and is a major impetus underlying the proposed state takeover of LILCO through the Long Island Power Authority. This decision is not only significant because of the huge sum involved, but because in many respects, the issues in the Shoreham property tax case foreshadow issues which will be arising frequently as market competition permeates the electric generation industry and utilities with nuclear assets begin recovering stranded cost and decommissioning plants.

As electricity is progressively becoming subject to the same market forces as manufacturing plants in other industries, many issues concerning which property is, or is not assessable, are arising. One major issue concerns the treatment of "intangibles," which contribute greatly to the value of business enterprises, but are generally exempt under state personal and real property tax laws. Intangibles are playing an increasingly important role in the energy business as the industry increasingly moves away from traditional cost-of-service, rate-of-return regulation. Another major issue is whether (and to what extent) generation plant equipment should be eligible for exemptions and tax incentives accorded to machinery and equipment used in manufacturing under state property tax law. Electric generation under traditional rate regulation has not generally been considered a manufacturing activity under these exemptions. Historically, these issues did not arise because most utility property was assessed under the "unit valuation method," which drives the taxable value of property based on the value of the entire utility company, rather than the physical or operational characteristics of individual properties. Additionally, the traditional "cost-plus" nature of the electric generation business has led utilities to be less aggressive in challenging assessments that deregulated industries.

In *In re Western Resources, Inc.*,⁸ the court held that the value of applications software used by a utility in its energy management functions was not assessable as tangible personal property in its own right, but only insofar as it enhanced the value of other utility property. The Court remanded an assessment made under the unit value to the Kansas Board of Tax Appeals to determine whether the assessment had improperly included the full value of applications software. The decision, which follows on the heels of numerous other decisions addressing the issue of intangibles under the unit valuation method, reflects the increasing difficulty of applying this method with the erosion of traditional models of rate regulation, and the introduction of new types of property and property rights.

8. *In re Western Resources, Inc.* 919 P.2d 1048 (Kan. Ct. App. 1996).

In *Oregon Community School District v. The Property Tax Appeal Board*,⁹ the Court upheld a Property Tax Appeal Board decision stating that power generating machinery and equipment at Byron Nuclear Plant should have been classified as non-assessable personal property. There, the county which had assessed this property as realty had classified the "process related" equipment used in other industries as personal property.

As utilities come under increasing competitive pressure, they are asserting arguments for uniformity of taxation under state constitution uniformity provisions, and under federal and state equal protection clauses. For example, pipelines have long argued that there should be uniformity in the taxation of pipeline and railroad property, even though the federal 4-R Act, which prohibits discriminatory taxation of railroad property, does not apply to pipelines. Thus, in *ANR Pipeline Co. v. Department of Revenue of Wisconsin*,¹⁰ ANR sought the same level of personal property tax exemption granted to railroads based on the uniformity clause in Wisconsin's Constitution. The pipeline was seeking treatment similar to that accorded railroads in settlement of 4-R Act litigation. While not addressing the issue of uniformity, the Court of Appeals reversed dismissal of the action to permit ANR an opportunity to lay a factual groundwork. In *ANR Pipeline Co. v. Lafaver*,¹¹ the pipelines brought a similar proceeding in Kansas. In this decision, the Court rejected a jurisdiction argument for dismissal under the Eleventh Amendment.

III. FEDERAL TAXATION

A. Stranded Cost Recovery

Tax issues are intertwined with the issue of stranded cost recovery, and with the proposed use of "securitization" as a financial device to mitigate the rate of impact of stranded cost recovery. In large part, this is because the "tax basis" of most stranded generation assets has been reduced far below rate base value through use of accelerated depreciation and other tax-book timing differences. Under the doctrine of "normalization," the recoverable tax expense of utilities borne by ratepayers is computed as if these timing differences did not exist, and the income tax expense reimbursements recovered by utilities during the early lives of assets generally far exceeds income taxes actually due. The excess tax reimbursements are accumulated and held by utilities until the deferred taxes become due, and are generally treated in the interim as reductions to the tax base.

Deferred income taxes (including also deferred investment tax credits and excess deferred income taxes) are huge, comprising, for example, about \$2.7 billion of PECO Energy's initial \$7.1 billion claim for stranded costs in the ongoing restructuring proceedings before the Pennsylvania Public Utility Commission. The treatment of these deferred taxes under

9. *Oregon Community Sch. Dist. v. Property Tax Appeal Bd.*, 674 N.E.2d 129 (Ill. App. Ct. 1996).

10. *ANR Pipeline Co. v. Department of Revenue*, 568 N.W.2d 37 (Wis. Ct. App. 1997).

11. *ANR Pipeline Co. v. Lafaver*, No. 96-1089-JTM, 1996 WL 363047 (D. Kan. June 26, 1996).

restructuring are problematic in terms of calculating the deferred tax component of stranded costs in the first instance, deciding the interplay of stranded cost recovery determinations under state restructuring law and the IRC's normalization requirements, and in terms of the financial structure of stranded cost recovery, whether through securitization or otherwise.

In the first state utility commission decision on a stranded cost recovery claim, pertaining to PECO Energy's effort to securitize a portion of its stranded cost recovery claim on an interim basis, the Pennsylvania PUC concluded that the issues concerning the appropriate recovery of (or allowance with respect to) tax costs and credits, as well as the appropriate method for determining the new present value of recoverable deferred tax obligations, were inherently too complex and controversial to be addressed on an expedited basis.¹² An overarching issue in this regard is the extent to which state legislatures or regulatory commissions may take the net benefits of normalization to utilities into account in determining what is the appropriate level of stranded cost recovery.

Federal tax issues play an even more central role in the viability of securitization as a mechanism to mitigate the rate of impact of stranded cost recovery. At least three states, (California, Pennsylvania, and Rhode Island), have enacted laws for securitizing stranded cost recovery. Under securitization proposals, the present capital structure of equity and debt finance of stranded investments, will be replaced by non-recourse debt financing obtained through the asset backed securities (ABS) market. The proceeds of the ABSs will be received by the utility up-front and used to prepay existing debt and reduce equity capital, through stock repurchase or the distribution of a special dividend. This ABS will be collateralized by irrevocable Competitive Transition Charge (CTC) obligations which are legislatively imposed on ratepayers to fund stranded cost recovery. Consistent with procedures typically used in the ABS market, the utilities will transfer their rights to the CTC revenue stream in a "true sale" to a Special Purpose Entity (SPE) or a other third party for the benefit of the bondholders. A large portion, if not most, of the anticipated rate benefits of this securitization will result from the decrease in federal tax expense from replacing non-deductible dividends and retained earnings associated with equity financing, with tax deductible interest payments associated with debt financing.

The promised rate benefits of securitization will be available, however, only if the Internal Revenue Service treats the utility's receipt of the irrevocable CTC obligation and its transfer of this obligation to the SPE in return for the ABS issuance proceeds being treated as a non-taxable refinancing rather than as the receipt of taxable income. Several affected utilities are pursuing private letter ruling from the IRS. Absent the receipt of such rulings, counsel for the utilities may be asked to render opinions on these issues.

12. Pennsylvania Pub. Util. Comm'n. v. PECO Energy Co., Nos. R-00973877C0001, R-00973877C0002, 177 Pub. Util. Rep. 4th 417 (Pa. P.U.C. 1997).

B. Income Issues

1. Contract Termination Gain

Private Letter Ruling 9631010 involves the characterization of payments received by an electric utility by a gas supplier in consideration for termination of a long-term gas supply contract that was particularly favorable to the utility. The Service held that these payments were with respect to personal property which was a capital asset to the utility, and hence, had to be treated as gain from the sale of a capital asset. This ruling may be problematic for utilities seeking to claim ordinary loss deductions with respect to payments made on the termination of unfavorable gas supply contracts.

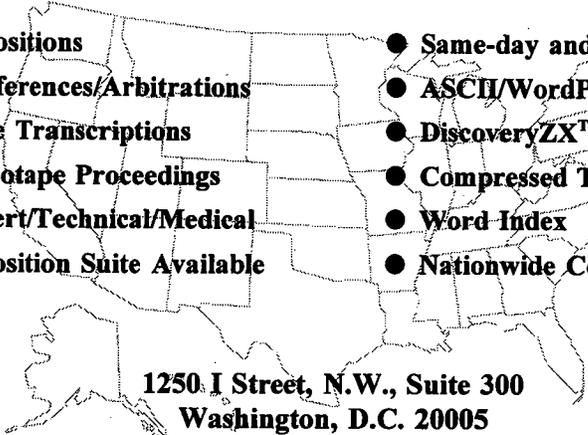
2. Contributions in Aid of Construction

While contributors of capital are not included in taxable income under IRC section 118(a), under section 118(b) contributions in aid of construction (CIACs) are generally treated as taxable income. CIACs are usually made by customers to utilities to induce utilities to extend service. In Private Letter Ruling 9622029, a local gas distribution company agreed to connect the facility of a local electric utility directly to an interstate pipeline in order to prevent the utility from bypassing the local distribution system. The interstate pipeline agreed to reimburse the local distribution company for certain incremental facilities associated with the interconnect. Analogizing these facilities to those interconnecting a utility to a PURPA qualifying facility, because their primary function was to facilitate the sale of the interstate pipeline's gas, the Service held that these payments were non-taxable contributions to capital.

In Private Letter Ruling 9622029, the Service held that payments to a utility made by public entities, to relocate transmission and distribution lines to accommodate public rights-of-way, and to allow improvement of highways, were non-taxable contributions to capital and not CIACs.

In Technical Advice Memorandum 9641004, the Service held that prepaid excess capacity payments by a utility to a qualified facility (QF) must be capitalized and included as an inventoriable cost of purchased electricity in the year otherwise deductible. The state public utility commission permitted the QF to receive these prepaid capacity payments from the utility prior to the plant's actual in-service date. The Service concluded that these payments should be capitalized by the utility under IRC Section 263, and amortized as an intangible asset under IRC Section 167 because they create a significant long-term right to the utility to receive future capacity.

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