



Legislative Fiscal Bureau

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Joint Committee on Finance

Paper #115

Utility Tax on Wholesale Electricity Sales (General Fund Taxes -- Public Utilities Taxes)

[LFB 2001-03 Budget Summary: Page 41, #1]

CURRENT LAW

Under current law, light, heat and power companies (LHPs) [including qualified wholesale electric companies] and electric cooperatives are generally subject to a state 3.19% gross revenues tax (license fee) on revenues from electricity sales. Gross revenues from the sale of gas services by an LHP are subject to a state tax at the rate of 0.97%. The state tax is in lieu of local property taxes.

In the case of an LHP that is not a qualified wholesale electric company, if the company's property is located entirely within a single town, village or city, it is subject to local assessment and taxation. For municipal LHPs subject to the tax, gross revenues from operations within the municipality are subtracted from total gross revenues for the purpose of determining the tax.

A qualified wholesale electric company is a generation facility in Wisconsin that is operated for the sale of electricity to an entity that sells electricity directly to the public. In addition, to meet the definition of a qualified wholesale electric company, the company must sell at least 95% of its net production of electricity to an entity that sells electricity directly to the public and must have a minimum total power production capacity of 50 megawatts. Under current law, a qualified wholesale electric company is interpreted by the Department of Revenue (DOR) as including a wholesale merchant plant (a generating company that sells electricity at wholesale, typically on the spot market) as long as it meets this minimum capacity requirement.

The gross revenues tax is paid in semi-annual installments of either 55% of the tax on gross revenues for the prior year or 50% of the estimated tax on gross revenues for the current year on May 10 and November 10. On the following May 10, a final adjustment payment or refund is made to reconcile the two prior installment payments with the actual assessment.

Currently, the 3.19% tax applies to sales of electricity whether they are at wholesale or retail. However, certain deductions can be made for the cost of power purchased by a public utility for resale. A private LHP may deduct from gross revenues either: (a) the actual cost of power purchased for resale if the company purchases more than 50% of its electric power from a nonaffiliated utility that reports to the Public Service Commission (PSC); or (b) 50% of the actual cost of power purchased for resale if that company purchases more than 90% of its power and has less than \$50 million in gross revenues. An electric cooperative may deduct from its gross revenue the actual cost of power for resale, as long as it purchases more than 50% of the power it sells from a seller that pays the state gross revenues tax.

GOVERNOR

Reduce the tax on wholesale electricity sales from 3.19% to 1.59% for a six-year period, beginning with gross revenues from calendar year 2003. Specify that all merchant plants would be subject to state taxation in lieu of local property taxes. [The provisions specific to merchant plants are discussed under Issue Paper #828.] In addition, modify current utility aid provisions under the shared revenue program to apply to property of LHPs subject to the proposed tax for selling electricity at wholesale and to property of wholesale merchant plants. [The shared revenue provisions are described under Issue Paper #829.]

The 1.59% tax on revenues from wholesale electricity sales would generally be administered under current law provisions for administering the 3.19% tax. In addition, the bill would specify that the term "apportionment factor" would have the same meaning for purposes of the tax on wholesale electricity sales as that used for the 3.19% assessment on LHPs. The apportionment factor combines payroll, property and sales factors to determine the fraction of a company's total gross revenues attributable to Wisconsin and therefore subject to the tax. [In other provisions, the bill would modify the definition of the "payroll factor" to specify that management and service fees paid by an LHP to an affiliated public utility holding company would be considered to be compensation paid by the LHP. The fiscal effect of this modification is expected to be minimal.]

DISCUSSION POINTS

1. Under the bill, gross revenue from sales of electricity at wholesale by an LHP or electric cooperative that owns an electric utility plant would be exempt from the 3.19% tax. Instead, a tax at the rate of 1.59% would be imposed on such sales. According to the administration, these provisions were included in the bill to encourage the development of merchant power plants and enhance energy supplies in the state.

2. The proposed tax rate for wholesale electricity would apply to tax assessments starting May 1, 2004, and ending with the assessment on May 1, 2009. Taxes are assessed on or before May 1 of the year following a calendar year in which revenues are generated. Therefore, these provisions would apply to gross revenues from calendar years 2003 through 2008.

3. The administration estimates that the annualized fiscal effect would be \$7.8 million (in current dollars). Based on historical growth in revenues from wholesale electricity sales, it is now projected that, under the bill, tax collections would be reduced by \$9.0 million annually.

4. As the reduced rate would first apply to tax assessments starting May 1, 2004, no fiscal effect was estimated by the administration for the 2001-03 biennium. However, the due date for the first installment of the May 1, 2004, assessment is in May, 2003. Therefore, it is estimated that the effect of these provisions would be a reduction in general fund tax collections of \$4.0 million in 2002-03.

5. It was the administration's intent that the tax for wholesale electricity sales would return to the 3.19% rate for revenues earned starting January 1, 2009. However, as drafted, the bill could be interpreted as completely excluding wholesale electricity sales from taxation after the expiration of the proposed 1.59% tax. The administration supports a modification to the bill to clarify that the tax rate on revenues from wholesale electricity sales would return to 3.19% for tax periods starting January 1, 2009.

6. The administration has indicated that it would not be opposed to delaying for one year the applicable date for the reduced tax rate. Under this option, the 1.59% tax rate for wholesale electricity would apply to tax assessments starting May 1, 2005, and ending with the assessment on May 1, 2010 (these assessments would be based on gross revenues from calendar years 2004 through 2009). The tax rate would return to 3.19% starting January 1, 2010. This change would eliminate the \$4.0 million fiscal effect in the 2001-03 biennium.

7. 1997 Wisconsin Act 204, an act relating to electric reliability, provided authorization for wholesale merchant plants to operate in the state. Act 204 defined a wholesale merchant plant as electric generating equipment and associated facilities in this state that do not provide retail service. A wholesale merchant plant may be owned by a person that is not a public utility or, with PSC approval, by an affiliated interest of a public utility. In the electric industry, the term "merchant plant" generally refers to a plant that sells on the spot market (rather than through long-term contracts with utilities, as is the case with some other wholesale electric companies).

8. In addition to authorizing merchant plants, Act 204 made it easier for such a plant to obtain the necessary certificate of public convenience and necessity (CPCN) from the PSC. It was expected that, under a deregulated environment, merchant plants would become a common means of meeting the state's need for additional generation.

9. Currently, there is one merchant plant operating in Wisconsin, the Mid-American Power plant in Cassville. Another merchant plant is under construction, and others that have been proposed. If a merchant plant has a minimum generating capacity of 50 MW, then it is subject to the state gross revenues tax on LHPs (in lieu of local property taxes). Smaller plants are taxed locally. [Under the bill, all merchant plants would be subject to the tax, including those with a capacity of less than 50 MW.]

10. In December, 2000, the Department of Revenue convened a study group to consider whether utility tax laws were appropriate for an electric power industry undergoing significant regulatory and structural change. The Department explained that the purpose of the group would be information gathering, to stimulate dialogue regarding the state's energy tax laws in the new environment. The group consisted of legislators, representatives of various components of the electric industry and representatives of electricity consumers. The group met four times between December, 2000, and February, 2001. After considerable debate as to whether to consider broad changes to the electric utility tax structure or narrower issues thought to be more urgent in nature, the study group focused on the narrower issues.

11. After the final meeting, the Secretary of DOR forwarded a recommendation to the Governor on behalf of the group that was consistent with the provisions under the bill to reduce the gross revenues tax on wholesale power sales from 3.19% to 1.59% for revenues from calendar years 2003 through 2008. The study group recommended limiting the tax reduction to a six-year period in recognition that the issue of the appropriate tax structure for this changing industry may need to be revisited. [In addition, there were two other recommendations from the group. The first pertained to repealing certain limits on utility shared revenue payments and to fully funding increases in such payments that would result from the repeal of the limits and the siting of future power plants. The final recommendation was to expand the use of new utility tax revenues to include other incentive payments to local governments, such as payments to communities to allow location of new transmission lines within their boundaries.]

12. A proposal to reduce taxes on wholesale electricity was first advanced by developers of merchant plants. One of the arguments was that power sold by a merchant plant to a Wisconsin investor-owned utility (IOU) would be subject to double taxation; first when sold by the merchant plant to the IOU and again when sold by the IOU to the final customer. Similar to the sales tax, the gross revenues tax applies to sales revenues. But a sales tax is applied only to the final retail sale, whereas the gross revenues tax applies each time that power is sold in the state.

13. The tax is imposed in lieu of local property taxes. Therefore, it is reasonable that both a merchant plant and the IOU in the situation described above should pay tax. Yet the equity of the tax can be questioned when it applies twice if the power is sold from an in-state merchant plant to an in-state utility but only once if the power is either: (a) generated and sold by a single in-state utility; or (b) purchased by an in-state utility from an out-of-state generator. Merchant plant developers believe that the nature of the state tax puts them at a competitive disadvantage with out-of-state electric companies that could sell to in-state utilities without paying the fee.

14. This issue is not unique to sales involving merchant plants. The state tax also applies twice in the case of an in-state utility selling power at wholesale to another in-state utility that subsequently sells the power to Wisconsin consumers. As described above under "Current Law," the state recognizes the concern with double taxation by offering certain deductions for purchased power. At present, there are no IOUs that can use the purchased power deduction provided for a private LHP that buys more than 50% of its electric power from a nonaffiliated utility regulated by the PSC, as none purchases more than 50% of its power. However, if non-utility generators in the

state begin to provide more of the state's power supply, IOUs will probably begin to qualify for this deduction. If the reduced rate on wholesale electricity were in effect and an IOU were to get the purchased power deduction, total tax collections would be reduced through the lower tax rate on the wholesale sale as well as the deduction of the power cost from the IOU's gross revenues.

15. The proposed rate reduction would lessen the effect of applying the tax twice on the sale of the same power. But it would not correct the structural problem of a tax that varies in total amount depending on who the sellers and buyers are. An alternative approach that would address the structural problem would be to maintain the 3.19% tax, but to eliminate the current law requirement that the 100% purchased power deduction applies only when an LHP or electric cooperative buys more than 50% of its power. This change would allow utilities to deduct 100% of the cost of power purchased from a nonaffiliated company that also pays the state tax. Under such a plan, a merchant plant selling to a Wisconsin IOU or electric cooperative would pay the 3.19% tax on the sale. The IOU or electric cooperative would deduct the cost of the purchase from its gross receipts when determining its tax. Based on information provided by DOR, it is estimated that this proposal would reduce general fund tax revenues by \$3.0 million annually (in 2002-03 dollars). If the proposal took effect starting with gross revenues from tax year 2003, the estimated effect would be a reduction in general fund tax revenues of \$1.5 million in 2002-03.

16. The tax on LHPs was imposed at a time when IOUs were primarily responsible for all three components of electricity supply: generation, transmission and local distribution to the end-user. The tax was typically imposed just once and yet encompassed all three components of the industry. A new landscape in which there is greater separation of the components may require a different kind of tax.

17. In May, 2000, the House Research Department of the Minnesota House of Representatives released a publication entitled "Electric Utilities: Taxation and Retail Restructuring." The report reveals that state taxes on the electric industry are complex and varied. A small number of states, including Wisconsin, rely on a tax on gross receipts. [Several states have recently replaced the gross receipts tax with a consumption tax.] The majority of states have some form of property tax (either state, local or a combination of both), sometimes in conjunction with other taxes. In Illinois, for example, electric utilities are subject to local property taxes on real property and to a state "electricity excise tax" that is collected by electricity suppliers.

18. The state of Iowa recently revised its electric utility tax structure. Through 1998, electric utilities in Iowa were subject to local property taxes. But effective January 1, 1999, Iowa replaced local property taxes on the industry with excise taxes on generation, transmission and local delivery of electricity. In addition, the state imposes a small state property tax on the industry.

Iowa's revised tax system was designed to be revenue-neutral. By separating the tax into components, Iowa's approach avoids the issue of double taxation. As the tax is spread among all components of the industry, no single component is overburdened. The system insures that activity within the state is taxed by the state, regardless of the final destination of the power. However, the excise tax on in-state generation is low enough that it is not viewed as a deterrent to out-of-state

competition.

19. In addition to the scope of the ways in which states tax the electric utility industry, the Minnesota report makes it clear that many states are currently exploring how to revise existing taxes in a changing environment. One approach would be to make incremental adjustments to the existing tax system to address current issues and to make additional changes as the restructured industry evolves. The administration's proposed temporary reduction in the tax on wholesale electricity sales is an example of this approach, which is supported by the DOR study group. Another option would be to follow Iowa's example and design a completely new tax structure that would work currently and that could also accommodate anticipated industry changes. In evaluating the administration's plan for Wisconsin, it is important to consider several issues: (a) the urgency of the need for additional generation; (b) the need for a tax cut to secure additional generation; (c) whether merchant plant development is a clear priority for the state; (d) other issues related to the electric industry; and (e) the cost of the proposal.

20. *The Need for Additional Generation.* The energy crisis in California has raised a general concern throughout the country about the adequacy of power supplies. In recent years, Wisconsin utilities have had to make public appeals for reduced power usage on hot summer days when high demand led to power failures in the area. It appeared that the state was in critical need of additional generation. However, the supply situation for the coming summer looks more promising. The Mid-America Interconnected Network (MAIN), an organization that oversees the region's electric reliability [including the transmission activities of the American Transmission Company (ATC) of Wisconsin], reports that power supplies for the Midwest this summer are expected to be more plentiful than in recent years because of power purchases, plant construction and transmission system improvements. The region is expected to have about 18% of its power supply in reserve at peak usage this summer.

21. *The Need for a Tax Cut to Secure Additional Generation.* The slightly longer-term supply picture also looks promising. State officials have estimated that Wisconsin needs 300 MW of new generation annually to meet growing demand. Based on information provided by the PSC, roughly 500 MW of generation capacity was added in the year 2000. In addition, plans to add more than 8,000 MW of capacity have been announced. Not all of the proposed plants will be built and not all of the power will be sold to in-state users. Nonetheless, the fact that there is so much interest in adding capacity calls into question the immediacy of the need for the state to provide tax incentives to power plant developers.

22. *The Need to Encourage Merchant Plant Development.* The administration has stated that the intent of the proposed tax cut on wholesale power sales is to encourage merchant plant development. When merchant plants were authorized in Wisconsin under Act 27, they were expected to become a significant source of additional power for the state. However, the energy crisis in California has illustrated some potential disadvantages of relying too heavily on non-regulated power producers.

The price of electricity sold by merchant plants is not subject to regulation, nor is there any

requirement that a merchant plant sell in the state in which it is located. When California's energy supplies tightened in recent months, prices of power increased significantly (along with speculation about power price gouging by independent electricity generators). Both California and New York, two of the first states to deregulate energy markets, are now considering punitive measures to prevent electricity generators from charging excessively high prices. Generators in the two states have argued that such measures could cause producers to avoid selling to markets in these states. Potential problems with the lack of regulation of independent suppliers have become more evident as states gain experience with a less regulated environment.

At least one Wisconsin IOU that had previously been in favor of encouraging utilities to purchase power from independent producers on the competitive wholesale market is now proposing to add its own power plants (as well as to buy some power from independents). A second Wisconsin IOU, with the support of a consumer advocacy group, has proposed an alternate structure that would provide for expanded capacity while maintaining state regulation. While independent power producers clearly will continue to have a role in supplying power, in the wake of California's experience, opinions may be changing on the extent of the desired role for merchant plants.

23. *Other Issues.* In the immediate future, a more pressing concern than whether enough power is being produced may be whether or not Wisconsin's transmission system will be able to deliver the power. MAIN reports that there have frequently been restricted transfer capabilities into and within Wisconsin in the past several years. The American Transmission Company has stated that Wisconsin's transmission system is being stressed and that there was recently a near overload of the line that could have caused rolling blackouts through a large portion of the Midwest. Company officials report that the United States Department of Energy recognizes a stretch of the ATC's transmission line carrying power into Wisconsin from Minnesota as one of the significant logjams in the nation's transmission system. [One of the recommendations of the DOR study group is that the state expand the use of new utility tax revenues to include other incentive payments to local governments (for example to provide incentives to communities to allow location of new transmission lines within their boundaries). However, no specific proposal was generated, nor is there a budget provision addressing this issue.]

Other issues related to the electric industry that should be considered along with any tax restructuring include the following:

a. Currently, the gross revenues tax is based, in part, on the proportion of a company's sales that are in the state. Yet there is no clarification on how the situs for inter-state sales is determined. The definition needs to be clarified to guarantee consistent treatment of such sales for purposes of the tax.

b. The DOR study group recommended the repeal of certain limits on the value on which utility aid payments for power plants are based and the per capita caps on such aid payments to municipalities and counties. The study group also recommended full funding increases for shared revenue for aid payments that would result from the repeal of the caps and limits and from the siting of future power plants. The bill would address these recommendations only in part, by providing

that shared revenue payments would be increased by any additional amount of utility aid resulting from the property of a wholesale merchant plant, beginning in 2002 (if the property did not exist in the previous year). The part of the study group recommendation on increasing incentives to local communities to accept a new power plant (whether or not the plant is a merchant plant) is not included in the bill, but it may be an important factor in the siting of new plants

24. *The Cost of the Tax Cut.* The reduced tax on wholesale electricity has been referred to as a method of promoting merchant plant development. However, the bulk of the estimated \$9.0 million annual cost of these provisions would come from reducing taxes on existing companies (which include one merchant plant). Because the provisions would apply to all wholesale sales of electricity (including those by IOUs and electric cooperatives), they would also reduce future growth of the existing tax base, even if no additional merchant plants were built.

25. Regardless of the exact future of the electric industry, it is clear that there will be at least some separation of the components of generation, transmission and local delivery of electricity. It is also clear that it is important to address concerns related to transmission and siting of plants in addition to generation. Based on these observations, it may be reasonable to take a comprehensive approach to the taxation of the electric utility industry, rather than making incremental changes to the current tax system.

ALTERNATIVES TO BILL

1. Approve the Governor’s recommendation to reduce the gross revenues tax for wholesale electricity sales to 1.59%, with modifications to do the following: (a) estimate a reduction in general fund revenues of \$4.0 million in 2002-03; and (b) specify that the tax rate on wholesale electricity sales would be 3.19% starting with revenues from such sales for calendar year 2009.

Alternative 1	GPR
2001-03 REVENUE (Change to Bill)	- \$4,000,000

2. Approve the Governor’s recommendation to reduce the gross revenues tax rate for wholesale electricity sales to 1.59%. However, specify that the reduced rate would apply to tax assessments starting May 1, 2005, and ending with the assessment on May 1, 2010 (these assessments would be based on gross revenues from calendar years 2004 through 2009). Provide that the tax rate would return to 3.19% of gross revenues earned starting January 1, 2010.

3. Delete the Governor’s recommendation. Instead, provide a 100% deduction from gross revenues for the cost of power purchased at wholesale (from a supplier that included the revenue from the sales in its gross revenues subject to the state tax) for the purpose of determining the tax for the LHP or electric cooperative purchasing the power. Provide that these provisions would take effect starting with the May, 1, 2004, assessments.

Alternative 3	GPR
2001-03 REVENUE (Change to Bill)	- \$1,500,000

4. Approve Alternative #3. However, specify that the 100% deduction for the cost of power purchased at wholesale would apply to tax assessments starting May 1, 2005.

5. Maintain current law. However, request that a Legislative Council Study Committee be appointed to study the question of state taxation of LHPs and electric cooperatives including taxes, the situs of a sale and incentives for local communities to accept power plants and transmission facilities.

6. Maintain current law.

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