Commonwealth of Virginia

Department of Taxation

Report to the Commission on Electric Utility Restructuring

of the Virginia General Assembly

And the Governor of the Commonwealth of Virginia

Report on the Impact of Electric Utility Regulation on the Tax Systems of the Commonwealth of Virginia

Pursuant to the 4th Enactment of Chapters 888 (HB 3068)

and 933 (SB 1416) of the Acts of Assembly of 2007

November 30, 2007

COMMONWEALTH *of* VIRGINIA

Department of Taxation

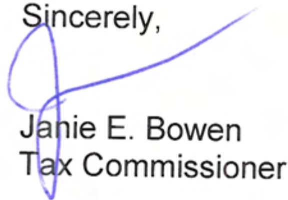
November 30, 2007

TO: The Honorable Timothy M. Kaine
Governor, Commonwealth of Virginia

The Honorable Thomas K. Norment, Jr.
Member, Senate of Virginia
Chairman, Commission On Electric Utility Restructuring
and
Members of the Commission On Electric Utility Restructuring

The Department of Taxation is pleased to transmit its report regarding the study of the tax aspects of electric utility reregulation. This report is required pursuant to Enactment 4 of the identical Chapters 888 (HB 3068) and 933 (SB 1416). Please let me know if you have any further questions.

Sincerely,



Janie E. Bowen
Tax Commissioner

JEB/joc

Preface

Authority

Enactment 4 of the identical Chapters 888 (HB 3068) and 933 (SB 1416) of the Acts of Assembly of 2007 provided:

> 4. That the Department of Taxation shall (i) conduct an analysis of the potential implications of the provisions of this act, as compared to previous law, on the system of taxation of the Commonwealth and the revenues generated thereby, and (ii) report its findings and any recommendations with respect thereto to the Commission on Electric Utility Restructuring by November 1, 2007.

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Executive Summary

Following the passage of Senate Joint Resolution (SJR) 118 of 1996 the Virginia General Assembly began a study of electric utility industry restructuring. The study was commissioned to determine whether the restructuring of the retail electricity market was possible and in the public interest. Proponents of electric utility restructuring asserted that restructuring would allow electricity customers to purchase electricity from the providers of their choosing. In 1997 the Senate passed SJR 259 in order to continue the study of the feasibility of restructuring the retail electricity market. SJR 259 required the State Corporation Commission (SCC) to develop a restructuring plan to be presented to the joint subcommittee on electric utility industry restructuring. The SCC reported that a majority of states had either deregulated their electric utility industry or were in the process of considering such a move.

In 1998, the joint subcommittee developed legislation restructuring the electric utility industry to be introduced in the 1999 session of the General Assembly. The legislation was introduced as Senate Bill 1269. The bill contained a two-year phase in of generation customer choice for all electricity customers as well as a seven-year rate cap. Senate Bill 1269 was passed by both the Senate and House and signed into law by the Governor on March 25, 1999.

Following passage of SB 1269 a task force tracked the progress of the electric utility market and made yearly reports to the General Assembly. In 2003 the task force made its first report regarding the state of retail electric competition. The task force reported that there was no increase in retail competition in the electric utility industry. Of the more than 2 million customers who had the right to choose their own electric provider only 2,375 residential customers and 23 commercial customers were purchasing electricity from an alternate supplier.

During the 2003 Session of the Virginia General Assembly the task force also noted that the actual corporate income tax liability due from electric utility providers was significantly smaller than initially expected. In order to correct this revenue shortfall, a minimum tax for electric suppliers was added to the corporate income tax. The tax was set at 1.45% of gross receipts, less the state portion of the consumption tax.

By 2007 nearly all of Virginia's 3.1 million electricity customers had the right to choose their supplier however; competition remained stagnant with very few of these customers actually using an alternate supplier.

The 2007 Session of the General Assembly enacted reregulation legislation (Chapters 888 and 933). The legislation re-established retail rate regulation for the majority of customers by January 1, 2009.

The electric utility industry restructuring legislation did not require that the system of taxation immediately revert to the gross receipts tax that was in place prior to

deregulation. Instead, the legislation required the Department of Taxation to conduct an analysis of the potential implications on the system of taxation and the revenues generated. The absence of competition would permit a return to the gross receipts tax, but does not require it. The minimum tax on electric utilities, based on gross receipts, coupled with the consumption tax, is designed to approximate the revenue that the Commonwealth received under the former tax structure. Therefore, there is no need to incur the expense involved with a major change in the tax structure.

In the future, however, the current minimum tax rate and the consumption tax rates may need adjustment. Should competition develop the minimum tax may have the same detrimental impact on competition as the former tax structure. Because they are based on kilowatt-hours consumed, state and local revenue from the consumption taxes will not keep pace with inflation and may require periodic increases.

When electric utilities are included in a consolidated federal and Virginia income tax return, the losses of other affiliates may considerably reduce the tax liability of the group. Existing law prohibits the State Corporation Commission from considering the impact of consolidated filing on regulated rates. This could result in consumers reimbursing the electric utility for income taxes that may never be paid. The SCC should be given the authority to consider the impact of consolidated filing on regulated rates.

Implications of Electric Utility Restructuring on the System of Taxation

Background - Regulation

The General Assembly began studying the structure of the electric utility industry following the passage of Senate Joint Resolution (SJR) 118 of 1996. At this time more than 40 states and the District of Columbia were considering making the move to an unregulated electric utility industry. The study was commissioned to determine whether restructuring the retail electricity market to develop competition was possible and in the public interest. Proponents of electric utility restructuring asserted that restructuring would allow electricity customers to purchase electricity from the providers of their choosing. Those in favor of restructuring the electric utility industry also asserted that conventional delivery of electricity through franchised service territories was both expensive and inefficient.[1]

The joint subcommittee held four meetings between the 1996 and 1997 sessions of the Virginia General Assembly. At these meetings representatives of investor owned utilities, electric cooperatives, independent power producers, and municipal power systems as well as environmental and consumer groups appeared before the subcommittee to present their ideas and concerns regarding electric utility restructuring. The joint subcommittee also heard from members of the State Corporation Commission (SCC) staff who summarized the thoughts of the agency's commissioners regarding electric utility restructuring. The SCC observed that Virginia's electricity market was moderately priced, reliable and stable and concluded that the Commonwealth would benefit the most by moving slowly towards restructuring while analyzing retail competition in other markets.[2]

At the 1997 session of the General Assembly the joint subcommittee recommended the continued study of electric industry restructuring. The General Assembly complied with this recommendation in passing SJR 259. This resolution continued the joint subcommittee's study of the potential retail electricity market and directed the SCC to develop a restructuring plan to be presented to the joint subcommittee on electric utility industry restructuring. Before receiving the restructuring plan developed by the SCC, the joint subcommittee considered the federal electric restructuring efforts as well as those in other states, considered technical restraints on competition, received reports from interested parties such as electric service providers, environmental groups and consumer groups and for the first time considered the effects of restructuring on the system of taxation.[3] The joint subcommittee noted that a majority of states had either

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[1] Restructuring the Electric Utility Industry, Senate Document 28, 1997.
[2] Id.
[3] For a detailed explanation of the historical effects of restructuring on the system of taxation see "Background – Taxation" infra.

deregulated their electric utility industry or were in the process of considering such a move.[4] The joint subcommittee also noted that congress was seriously considering taking action to remove federal barriers to restructuring at the state level rather than having the federal government take more control of the electricity industry.[5]

In November of 1997 the SCC presented its plan for restructuring to the joint subcommittee. In the plan there would be a study phase from 1998 to 2001 during which there would be rate experiments, pilot programs, and regional power exchange. From 2000 to 2002 the plan called for a legislative and regulatory review of the study phase. Finally the plan called for restructuring to begin in 2003 and finish by 2005.

Several electric industry restructuring bills were introduced in the 1998 General Assembly Session.[6] Senate Bill 688 contained a comprehensive 5-year plan for restructuring the electric utility industry in Virginia. The bill called for restructuring to begin in 2000 and be completed by 2004. This bill and two bills related to the system of taxation of the electric utility industry (SB 619 and SB 620) were carried over to the 1999 session.

The General Assembly did pass SJR 91 during the 1998 Session which directed the joint subcommittee to continue its work by developing a comprehensive restructuring plan of the Commonwealth's utility market. The General Assembly also passed HB 1172 which created an outline for Virginia's transition to retail competition in the sale of electricity. The bill mandated that the transition to retail competition begin by 2002 and made 2004 a target date for the completion of the transition to competition.[7]

In 1998 and 1999, the joint subcommittee developed legislation restructuring the electric utility industry to be introduced in the 1999 session of the General Assembly. While developing this legislation the joint subcommittee considered policy options in four different areas: (1) structure and transition, (2) stranded costs, (3) consumer, environment and education and (4) electric utility taxation. A task force was assembled to address each of these four areas. The task forces met throughout the year with joint subcommittee meetings interspersed throughout to receive progress reports. In November a drafting group met and used the information provided by the task forces to draft a bill for the restructuring of the electric utility industry. Senate Bill 1269 was the final recommendation of the joint subcommittee. The bill contained a two-year phase in of generation customer choice for all electricity customers as well as a seven year rate cap. The customer choice phase in was scheduled for 2002-2004 and the rate cap was scheduled for 2001-2007. Under the bill transmission and distribution were to remain regulated for the foreseeable future. The SCC was given the task of regulatory oversight of the restructuring process.[8]

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[4] Final Report of the Joint Subcommittee Studying Restructuring of the Electric Utility Industry, Senate Document 40, 1998.
[5] Id.
[6] See 1998 House Bill 1172, 1998 Senate Bills 619, 620 and 688, and 1998 Senate Joint Resolutions 45, 46 and 91.
[7] See 1998 House Bill 1172.
[8] See 1999 Senate Bill 1269

After its introduction SB 1269 was assigned to the Senate Committee on Commerce and Labor and was considered at length in the Utilities Subcommittee. Several amendments to the bill were proposed by the subcommittee but the bill remained largely unchanged.[9] The bill passed the Senate and was communicated to the House.

Once in the House SB 1269 was assigned to the Corporations, Insurance and Banking Committee. A special subcommittee examined the bill and recommended several amendments which were adopted by the Committee. The full House passed the bill and the Senate concurred with the House. Thereafter, SB 1269 was sent to the Governor and signed into law on March 25, 1999.

Senate Bill 1269 established the Legislative Transition Task Force to work collaboratively with the SCC in conjunction with the phase in of retail competition in electric services in Virginia.[10] The task force was directed to (i) determine whether electricity providers should be permitted to discount rates, (ii) monitor recovery of stranded costs, (iii) examine utility worker protection, (iv) examine reliability concerns (v) examine assistance for low income households, (vi) examine renewable energy programs, and (vii) examine energy efficiency programs.[11] The task force was further directed to make annual reports of the progress of each phase of transition to retail competition and make recommendations to maintain Virginia's position as a low cost electricity market and ensure that consumers were benefiting from retail competition.[12]

The task force met several times between 1999 and 2000 and made several recommendations to the General Assembly during the 2000 session.[13] The task force recommended:

- That the SCC begin reporting to the task force with a recommended schedule for implementing competition for metering and billing services
- The implementation of a consumer education program to be funded by regulatory taxes
- Elimination of the possibility that incumbent electric utilities could be assessed a charge if the projected market price for generation and other services exceeded the capped rate for services
- Changing the local tax to be levied on the amount of power consumed rather than the cost of power consumed
- Expanding the study of low income energy assistance programs

[9] See Report of the Joint Subcommittee Studying Restructuring of the Electric Utility Industry Senate Document 34, 1999.
[10] See Report of the Legislative Transition Task Force Established Under The Virginia Electric Utility Restructuring Act, Senate Document 54, 2000.
[11] Id.
[12] Id.
[13] Id.

The task force also recommended several clarifying amendments to 1999 SB 1269. All of the recommendations of the task force were enacted by the General Assembly during the 2000 Session.[14]

In the year between the 2000 Session and 2001 Session two major issues confronted the task force. On October 19, 2000 the SCC ordered functional separation of the generation, distribution and transmission services of incumbent electricity providers which brought attention to the issue of default rates after the expiration of the capped rate period in 2007. Another issue that the task force considered was the price spikes, power shortages and other problems facing California. The task force determined that prohibitions on long term contracts, requirements that power be purchased daily and retail price caps were in large part the cause of the issues in California.[15]

In the 2001 Session the task force endorsed several bills as a method of continuing to fine tune the restructuring process in Virginia. These bills included:

- SB1420 which addressed default service rates, functional separation issues, competition for metering and billing services and other related matters.
- SJR 467 which directed the task force to study procedures applicable to the construction of new electricity generating facilities in Virginia.
- HB 2469 which allowed for an income tax deduction for contributions to a utility company's emergency energy program.
- HB 2473 which designated the Department of Social Services as the agency responsible for coordinating state efforts to ensure that low income Virginians energy needs were met.
- HB 2472 which recommended that a definition of renewable energy be added to the restructuring act.
- HB 2470 which recommended that criteria be established pursuant to which an electricity provider may designate certain electricity as green energy.
- SB 896 and HB 1935 allowing municipal electric utilities to expand their service areas in certain circumstances.
- SB 1257 granting public service corporations eminent domain rights in certain circumstances.

In 2003 the task force made its first report regarding the state of retail electric competition. The task force reported that there had been a decrease in retail market activity in Virginia and nearby states.[16] As of 2003 Virginia had no residential

[14] See 2000 Senate Bills 163, 532 and 585, See Also 2000 Senate Joint Resolutions 95 and 154.
[15] See Report of the Legislative Transition Task Force Established Under The Virginia Electric Utility Restructuring Act, Senate Document 39, 2001.
[16] See Report of the Legislative Transition Task Force Established Under The Virginia Electric Utility Restructuring Act, Senate Document 17, 2003.

competitive offers below the price of incumbent utility providers in the state. The task force noted that two barriers to competition were the risks of the exercise of market power in wholesale markets and reductions in new power plant construction.[17]

As of September 1, 2002 of the more than 2 million customers who had the right to choose their own electric provider only 2,375 residential customers and 23 commercial customers were purchasing electricity from an alternate supplier.[18] The task force also reported to the General Assembly on the status of regional transmission entities, energy infrastructure and reliability, the implications of capped rates, stranded costs recovery and revenue from taxes. The task force recommended several bills to the general assembly in the 2003 session. The following bills were passed at the recommendation of the task force:

- HB 2543 delayed the date by which an incumbent electricity supplier was required to join a regional transmission entity.
- HB 2637 suspended the restructuring act for the Old Dominion Power Company utilities effective July 1, 2003.
- HB 2318 extended the work of the task force from July 1, 2005 to July 1, 2008.

During the interim between the 2003 and 2004 General Assembly Sessions the task force heard testimony on the following issues:

- The state of the competitive retail market in Virginia.
- Stranded costs.
- Status of Federal legislation.
- The damage caused by hurricane Isabel.
- The Blackout of 2003.
- The integrity of Virginia's transmission systems.
- Proposed changes to the Restructuring Act.

Following the meetings the task force endorsed six legislative proposals for the 2004 Session of the Virginia General Assembly:

- Extension of the capped rate period in Virginia.
- A change in the minimum stay requirement to allow a large industrial or commercial power purchaser to accept market based pricing from the incumbent utility provider after purchasing power from an alternative supplier.

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[17] Id.
[18] Id.

- A proposal to authorize a municipality to aggregate the energy load of commercial, residential or industrial retail customers on an opt-in opt-out basis.
- A proposal extending by two years certificates granted by the SCC to construct and operate electrical generation facilities.
- A proposal to change the net metering maximum from 25 KW to 500 KW
- A proposal to prohibit the Commonwealth from selling the set asides allocated to new sources of air emission.

The task force met four times during the 2004-2005 interim. During these meetings it received testimony on numerous issues, including:

- The efforts of Appalachian Power and Dominion Virginia Power to obtain the approvals required to complete the transfer of control of their transmission assets to the PJM Interconnection regional transmission organization (RTO). RTOs are entities created to operate transmission grids and ensure short-term system reliability, independent of control by incumbent utilities and other market participants. Functioning RTOs are viewed as necessary to the development of a competitive retail market for electric generation.
- The likely effect of the provision of Senate Bill 651 of 2004 that established an incentive for the construction of a coal-fired generation facility in Southwest Virginia. The Restructuring Act provides that an investor-owned distributor that has been designated a default service provider and that constructs a coal-fired generation facility that utilizes Virginia coal in the coal field region in order to meet its native load and default service obligations will be allowed to recover the costs of the facility, plus a fair rate of return on its investment, through its default service rates.
- The role of renewable energy resources (including wind, landfill gas, wood waste, and solar power) in meeting Virginia's future electric energy needs.
- The SCC's Report on the Development of a Competitive Retail Market for Electric Generation within the Commonwealth. As was stated in previous years' reports, retail competition is legally permitted in Virginia, but (aside from a few thousand customers purchasing green power in Northern Virginia) there is no actual competition, as competitive providers are not marketing power to retail customers in Virginia. In other states that have restructured their electric utilities, little competitive activity is occurring, particularly among residential customers.
- The Office of the Attorney General's report on electric utilities' recovery of stranded costs. The report compared average annual stranded cost recoveries for 2001-2003 to potential stranded cost exposure for 2003. Scott Norwood, the consultant who prepared the report, observed that higher market prices equate to lower potential stranded costs, and that estimates of potential stranded costs are inherently uncertain, due to volatility in generation market prices and other factors. Under the "base case" scenario (assuming a market price of 4.53

cents/kWh with a 10 percent return on equity for investor-owned utilities and 2.0 times interest earned ratio for cooperatives), the potential stranded cost exposure for 2003 ($157.4 million) was estimated to be about half the average annual stranded cost recovery over 2001-2003 ($350.4 million). The potential stranded cost exposure for the post-transition period, without capped rates and wires charges, remained significant if market prices were to fall below 4 cents/kWh. Assuming market prices stay high, as they had for the prior 18 months, significant additional mitigation of stranded costs should be achieved through the extension of capped rates beyond 2007, and there would be the potential for over-recovery of stranded costs.

- The perspective of Virginia's electric cooperatives on the restructuring of Virginia's system of regulating the provision of electric utility service to introduce retail competition for generation.

The task force also commissioned legislation to encourage the use of renewable energy in Virginia. The group working on such legislation recommended that an independent, unbiased study be conducted of the purported benefits and costs of renewable energy, including health, economic, employment and other benefits arising from increased use of renewable energy sources. The purpose of the proposed study was to measure these externalities in comparison to the generally higher production costs of renewable energy. The study would seek to determine if, on balance, the purported benefits outweigh the increased costs of renewables, by monetizing the purported benefits and comparing the value of the benefits to the financial costs.

The task force did not receive any legislative proposals at any of its meetings in the 2004-2005 interim. As a consequence the task force endorsed no legislation for the 2005 session.

During the 2005-2006 interim the task force received testimony on the following issues:

- The SCC's report on the development of a competitive retail market for electric generation within the Commonwealth.
- The Office of the Attorney General's report on electric utilities' recovery of stranded costs.
- The Virginia Center for Coal and Energy Research's report, prepared at the Restructuring Commission's request, on issues relating to the increased use of renewable energy sources to meet Virginia's future energy needs.
- Dominion Generation's report on the savings to its Virginia customers resulting from the 2004 legislation freezing Dominion's fuel factor until mid-2007, which report also addressed the savings from capped rates.

During its testimony before the task force the SCC observed that current wholesale market prices for electricity were very high as a result of a combination of factors,

including high natural gas prices and a wholesale regulatory scheme that allowed the price of the last unit of power dispatched to meet load obligations, which typically is natural gas-fired, to set the market price. As a result, consumers in other states that had deregulated, particularly where incumbent utilities have divested their generation units, and that had ended transition periods insulating consumers from market-based prices, were facing higher electricity prices. This situation was reported to have led to the closure of the Eastalco aluminum smelter in Maryland, where the shift to market-based rates would have resulted in a $72 million annual increase in electricity costs.

In reaction to concerns expressed by the SCC and others regarding the effects of exposing ratepayers to market-based rates after the end of the capped rate period, the chairman of the task force asked the SCC to consider establishing a system of periodically providing the members of the task force with information regarding the experiences of other states that have deregulated their electric utilities.

By 2007 nearly all of Virginia’s 3.1 million electricity customers had the right to choose their supplier but competition remained stagnant with very few of these customers actually using an alternate supplier. The report on the status of competition also indicated that there was a strong likelihood that, after capped rates end, the prices paid by Virginia's electricity consumers would rise precipitously. While post-2010 market conditions cannot be known with certainty, it was anticipated that prices could be significantly higher than current capped rate levels. These higher prices are likely to yield extraordinarily high returns to base load coal and nuclear generating resources. However, the report concluded that to the extent that base load resources remained inside the incumbent utility, the units would remain subject to state jurisdiction and the Commonwealth's policymakers could mitigate, in a non-confiscatory manner, potentially high retail rate levels.

When speaking before the task force Dominion Resources introduced a plan that would end the scheduled restructuring of Virginia's electric utilities. The plan had three main elements. Capped rates would end in December 2008. Retail choice would cease for all but large industrial customers with a load of at least five megawatts. When capped rates end, rates of investor-owned utilities will be set under a new cost-of-service model that provides, among other features, that a return on equity will be set by adding 6% to the yields on investment grade long-term utility bonds, subject to adjustments of up to 0.5% based on generation performance, operations and efficiency.

In 2007 the General Assembly enacted Chapters 888 (HB 3068) and 933 (SB 1416) of the Acts of Assembly of 2007 that re-established retail rate regulation for the majority of Virginia’s electric utility customers by January 1, 2009.

Background - Taxation

Governments typically impose taxes on regulated utilities that are significantly higher than the taxes imposed on unregulated businesses. For the most part, this high tax

burden has little impact on the financial status of regulated utilities because it can be embedded in their rates and passed on to their customers, and their competitors, if any, will be paying the same taxes and charging similarly regulated rates.

Between the 1997 and 1998 General Assembly sessions the joint subcommittee first considered the issue of the system of taxation as it related to restructuring the electric utility industry. The joint subcommittee questioned the constitutionality of imposing the gross receipts tax then in effect[19] on out-of-state electricity suppliers. The subcommittee was concerned that without the gross receipts tax there would be a significant decrease in the approximately $95 million in revenue that the state was receiving from Virginia's electric utilities.[20] The subcommittee was also concerned about the potential decrease in local revenues that were tied to local taxation of utility assets. In particular, if certain local machinery were idled there would be a decrease in the revenue generated from the taxing of those assets.

When a regulated entity faces competition from an unregulated business, however, the higher tax burden of the regulated utility creates a significant competitive disadvantage. Recognizing this[21], the General Assembly enacted a replacement tax structure for electric providers several years before deregulation began.[22] Other states took different approaches to the tax aspects of de-regulation.[23]

- New Jersey eliminated the gross receipts and franchise taxes on electricity suppliers prior to deregulation.[24] Instead of a gross receipts tax the state subjected electricity suppliers to the corporate income tax and applied the state's sales and use tax to retail sales of electricity.

- Maryland began to subject electricity suppliers to the corporate income tax upon deregulation.

- Iowa eliminated a gross receipts tax prior to restructuring the electricity distribution industry. Rather than subjecting suppliers to the corporate tax Iowa levied taxes on the generation of electricity and the transmission of electricity as well as a consumption tax based on kilowatt hours.

- Illinois and New Hampshire introduced consumption taxes on electricity purchased for use and consumption rather than resale.

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[19] See infra "Before 2001"
[20] Final Report of the Joint Subcommittee Studying Restructuring of the Electric Utility Industry, Senate Document 40, 1998.
[21] See "Restructuring of the Electric Utility Industry," Senate Document 34 (1999).
[22] Chapter 971, Acts of Assembly of 1999, and Chapters 427 and 614, Acts of Assembly of 2000.
[23] See National Conference of State Legislature "State Taxation in a Restructured Electric Industry" March 31, 2000 available at http://www.ncsl.org/slides/energy/taxrstrc/sld001.htm (last viewed Oct 4, 2007).
[24] New Jersey AB 2825 (1997).

- Connecticut, Pennsylvania and Rhode Island continued to levy the gross receipts tax on electricity suppliers.

The highlights of the Virginia changes for the large, investor owned utilities are as follows (taxes for municipal utilities and cooperatives varied):

Before 2001

- Electric utilities paid a state tax on its gross receipts at the rate of 2%, and were exempt from the corporation income tax.

- Electric utilities also paid a state regulatory tax on gross receipts at a maximum rate of 0.2%, but this rate was reduced based upon the cost to regulate the utilities. It was set at around 0.11% annually.

- Localities imposed a tax on utilities at the rate of 0.5% of gross receipts.

- Localities also imposed taxes on the consumers of electricity that were collected by the utility and remitted to each locality. Rates varied.

After 2000 Senate Bill 1286 was introduced in the 1999 Session of the Virginia General Assembly. It was designed to address the problem of subjecting out-of-state electricity suppliers to the gross receipts tax. The bill also attempted to address the potential revenue shortfall resulting from the move away from the gross receipts tax.[25] As passed and signed by the Governor the results of SB 1286 were that:

- Electric utilities are subject to the corporation income tax.

- Consumers pay a consumption tax with three components: state tax, regulatory tax, and local tax. The tax is measured by kilowatt-hours consumed and the rate declines as consumption increases. The rates were set to approximate the revenue received under the former tax structure after taking into account projected income tax revenues from electric suppliers.[26]

2004 Minimum Tax During the 2003 Session of the Virginia General Assembly, the task force noted that the actual corporate income tax liability due from electric utility providers was significantly smaller than initially expected. Accordingly the following change in the tax code was proposed:

- A minimum tax for electric suppliers was added to the corporate income tax. The tax is 1.45% of gross receipts less the state portion of the consumption tax.

[25] See Report of the Joint Subcommittee Studying Restructuring of the Electric Utility Industry Senate Document 34, 1999.
[26] See Fiscal Impact Statement on SB 681 (2004).

According to the Fiscal Impact Statement on the 2004 legislation creating the minimum tax (SB 681), the consumption tax rates were based upon the following:

> The objective for changing the system of taxation for electric suppliers under deregulation was to make the change result in revenue neutrality, with the sole exception of exempting government entities. At the time of deregulation, the gross receipts tax collected from electric utilities was approximately $100 million. Included in the $100 million was $13 million in gross receipts tax paid by Government entities.
>
> In order to recover the remaining $87 million in revenue, an estimate was made of the amount of corporate income tax that would be paid annually by electric suppliers. The balance of the revenue, after deducting the estimated amount of corporate income revenue, would be paid by the consumers of the electricity through the consumption tax.
>
> Based on the returns submitted by the electric suppliers, corporate income tax revenue was projected to be about $21 million per year. For the 2001 taxable year, Virginia electric suppliers reported a total of $3.8 million in corporate income tax liability. For the 2002 taxable year, Virginia electric suppliers reported a total of $3.4 million in corporate income tax liability.

The rationale for setting the minimum tax rate at 1.45% instead of 2.0% was not explained, but appears to be attributable, at least in part, to the impact of government consumers. When the former utility gross receipts tax was embedded in the cost of electricity, governments bore the economic burden of the tax in the same manner as consumers, but governments are exempt from the consumption taxes.

A significant factor that caused of the difference between the projected $21 million in corporate income tax revenue and actual reported liability of less than $4 million is likely to have been the impact of consolidated returns. Corporations that are part of an affiliated group of corporations may elect to file a consolidated Virginia return under certain circumstances. In a consolidated return the losses of one corporation may offset the income of profitable corporations and reduce the tax liability of the affiliated group. If an investor-owned utility is part of an affiliated group of corporations that previously had elected consolidated filing, any losses of non-utility corporations would offset the utility's taxable income. Thus, the consolidated tax liability may be significantly lower than the liability of the utility alone if it had filed its own separate income tax return.

That the impact of consolidated filing was a factor is supported by the inclusion of a provision in the legislation imposing the minimum tax that specifies how the tax is to be computed when the utility is included in a consolidated return.

Impact of Reregulation on Taxation

The reregulation of electric utilities has no direct impact on the taxation of electric utilities. The fact that electric utilities are again regulated may open the possibility of returning to the former gross receipts tax structure, but there is no necessity to do so. While the revenue from the former gross receipts tax structure was greater and more predictable than income tax revenue, the current combination of consumption tax and minimum tax on gross receipts offers equivalent predictability, and has been designed to produce approximately the same revenue (except for government consumption).

The advantages of returning to the former gross receipts tax would be:

- Revenues would be slightly greater because federal, state, and local governments would bear the burden of the tax embedded in the rates for the electricity they purchase.
- Revenues would be more predictable.
- Future revenue growth would be driven by both economic growth and inflation. Because the consumption tax is based on kilowatt-hours, its revenue will not be affected by inflation.

The disadvantages of returning to the former gross receipts tax would be:

- While retail and wholesale competition did not appear to the extent expected,[27] there is some competition. Reinstating the former gross receipts tax may distort economic choices to some extent, especially if competition develops in the future.
- Changing the tax structure is not simple or cheap. Many people, agencies, local governments, and businesses (utilities and consumers) were involved in developing the current tax structure, and a lot of effort was made in consumer education. TAX, the SCC, utilities and local governments all had to make significant systems changes to implement the new tax structure.
- If the former tax structure is restored and competition becomes feasible in the future, the Commonwealth would have to change its tax structure yet again.
- Should the investor-owned electric suppliers become significantly more profitable in the future, the income tax plus the consumption tax would be greater than the

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[27] State Corporation Commission, "Status Report: The Development of a Competitive Retail Market for Electric Generation within the Commonwealth of Virginia," September 1, 2007, retrieved from http://www.scc.virginia.gov/caseinfo/reports/2007_ceur.pdf on September 20, 2007.

former gross receipts tax. The probability of this happening, however, is unknown.

Therefore, TAX does not see a compelling reason for an immediate return to the former tax structure merely because of the re-regulation of electric utilities. This issue, however, must be monitored and revisited in the future. As general inflation and other factors peculiar to the energy sector of the economy increase the cost of supplying electricity, the regulated rates will increase. Revenue from the former gross receipts tax would automatically grow with rates, as would the current minimum tax. The consumption tax, however, will grow only with consumption and will not be affected by changes in the regulated electric rates. The state portion of the consumption tax is not an issue because it is a factor in computing the minimum tax. The lack of inflationary growth in the state revenue from the regulatory tax and local revenue will potentially create pressure in the future to adjust the consumption tax rates to deal with SCC cost increases for the regulatory process and local revenue needs. The consumption tax rates would need periodic increases to keep pace with inflation, or revision to base them on gross receipts.

Other Issues

Rate Setting

A provision of the legislation reregulating electric utilities may, in some situations, require rate payers to reimburse electric utilities for income taxes that the federal and state governments may never receive. The legislation requires the SCC, when regulating rates, to consider the separate federal and state income tax liability and ignore the consolidated tax liability and any benefit adjustments from the income and losses of other affiliates. See Code of Virginia § 58.1-585.2 A.10. The justification for this rule is that the regulated utility and its ratepayers did not fund the operations that produced the tax losses which reduced the consolidated tax liability. Instead, these results are due to investments in non-regulated businesses and/or debt retained by the parent company, the costs of which are excluded from the ratemaking process.

Affiliated groups of corporations typically have a tax sharing agreement specifying which corporation pays how much of the consolidated tax liability. Depending on the agreement, the benefit of the offset of profit and losses may go to the parent corporation or it may be directly shared with the profitable corporations. If the loss generating sister company begins to generate a profit the requirements of a typical tax sharing agreement would allow it to recover the loss used by the group, thus increasing the amount that the other members of the group must contribute to the group's consolidated liability. In this situation the loss causes only a deferral of the consolidated tax liability for a few years. On the other hand, when the sister company never generates a subsequent profit the loss defers the consolidated tax liability indefinitely.

For rate setting purposes, immediate recognition of taxes deferred for only a few years may greatly simplify the rate setting process and better match the full cost with current rates consistent with the justification for looking only at regulated operations. Nevertheless, when taxes are deferred indefinitely in a consolidated return it may not be appropriate to require consumers to bear the economic burden of taxes that are unlikely ever to be paid in order to subsidize money-losing investments in unregulated businesses. The minimum tax reduces the impact of this issue for state taxes, but the Internal Revenue Code has no similar minimum tax on electric utilities.

A better alternative would be to grant the SCC the authority to consider all of the facts and circumstances related to an electric utility's separate and consolidated tax liability in setting rates.

Stranded Payments

If the General Assembly decides to return to the former tax structure, it is possible that during the transition to the new tax structure some estimated tax payments and various credit carryovers may not absorbed by the final tax liability or refunded in the usual manner. These payment and incentive credit carryovers would have to be transferred to the new tax system, or it may be appropriate to compromise and settle the Commonwealth's potential exposure to future refund claims as part of the transition. *Code of Virginia* § 58.1-3 prohibits the disclosure of more specific taxpayer information about this issue.

Minimum Tax Rate

The minimum tax rate has been set at a level calculated to ensure that the Commonwealth never receives less than the approximate revenue it would have received under the old tax structure. As noted above, this tax policy can feasibly be maintained as long as electric utilities are not subject to significant competition. As competition develops, however, the minimum tax rate may be as much a hindrance to competition as the old tax structure.

One area in which competition may develop is in providing electricity to large consumers. The law reregulating electric suppliers allows certain large purchasers of electricity to continue choosing their electricity service provider.[28] It is possible that avoiding the minimum tax embedded in the rates may make it economically viable for a large customer to leave its incumbent electricity service provider. The impact on tax revenue of such a move is impossible to predict because any potential loss in revenue may be offset by increased tax revenue from the customer and the alternate supplier. The Commission should monitor the development of competition and whether the minimum tax, to the extent it is embedded in rates, affects the choice of electric suppliers.

[28] See Va. Code § 56-577

When the telecommunications industry was switched from the old tax structure to the corporate income tax in 1989, a minimum tax and credit were included that initially preserved the Commonwealth's revenue, but gradually phased the minimum tax rate from 1.2% to the current 0.5% over 7 years. If competition develops in the electric industry it may be appropriate to consider phased reductions in the minimum tax rate.

Sales and Use Tax Exemption

In addition to tax changes related to deregulation there was also a noteworthy change in the taxation of electricity providers as part of during the 2004 tax reform. Prior to 2004 tangible personal property used in the manufacturing of electricity was exempt from sales and use tax.[29] The Virginia Code exempted all public service corporations from the sales tax and equipment used in the manufacturing of electricity was also included in the manufacturer's exemption from the sales and use tax.

As part of the 2004 tax reform the exemption from the sales and use tax was rescinded for all public service corporations, excepting railroads.[30] In addition, specific language was added to *Va. Code* § 58.1-609.3 stating that the manufacturers exemption from the sales and use tax did not apply to tangible personal property used by any corporation in the generation of electric power. With the elimination of the sales tax exemption public service corporations were authorized to recover the amount of additional sales and use tax paid as a surcharge on the customer's bill.[31] Thus electricity suppliers were able to pass this tax on to their customers.

Conclusion

Based on the forgoing, TAX recommends that no immediate changes be made to the tax system applicable to electric utilities. The Commission on Electric Utility Restructuring should monitor the development of competition in the electric utility industry and evaluate whether rate adjustments should be made for the existing minimum tax on electric utilities or the consumption tax. The Commission should further consider whether the existing statutorily mandated treatment of taxes paid with consolidated returns in regulating rates is desirable and whether the State Corporation Commission should be given broader authority to analyze the impact of consolidated tax filing on regulated rates.

[29] See Va. Code § 58.1-609.3 (before 2004).
[30] See Chapter 3 2004 Acts of Assembly Sp. Session I
[31] See Va. Code § 58.1-3833