

STATE AND LOCAL TAXATION

of the

ELECTRIC INDUSTRY

in

TEXAS

THE ASSOCIATION OF ELECTRIC COMPANIES OF TEXAS

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INTRODUCTION AND SUMMARY

The electric industry is a major source of state and local tax revenue in Texas. Approximately \$1.9 billion in state and local levies derived from electric service in 2002, almost all of it -- \$1.8 billion -- from the investor-owned service segment.

Investor-owned electric companies (IOECs) are subject to state gas, electric and water gross receipts tax, public utilities gross receipts assessment, corporate franchise tax, state and local sales taxes, property taxes, municipal franchise charges, and in markets open to retail competition, a system benefit fee. In 2002 these taxes amounted to more than eleven percent of retail electric sales (Table 1).

	1998	1999	2000	2001	2002
Gas, Electric, & Water Utility Tax	\$196.9	\$191.5	\$209.1	\$247.5	\$215.9
Public Utilities Gross Receipts Assessment	21.2	24.3	24.4	29.5	26.9
State Sales & Use Tax (Paid)	42.1	74.9	60.6	60.6	62.4
State Sales & Use Tax (Collected)	227.3	209.4	225.4	248.5	237.1
Corporate Franchise Tax	81.1	121.8	84.8	81.2	133.1
System Benefit Fee	n/a	n/a	79.0	67.3	110.6
<i>Subtotal, State Taxes</i>	<i>568.6</i>	<i>621.9</i>	<i>683.3</i>	<i>734.6</i>	<i>786.0</i>
Property Taxes	440.4	444.1	392.8	426.6	433.4
Local Sales & Use Taxes (Paid)	9.7	11.6	12.9	11.2	10.2
Local Sales & Use Taxes (Collected)	115.5	112.9	123.9	141.0	125.8
Municipal Franchise Fees	409.9	413.0	428.3	485.3	448.0
<i>Subtotal, Local Taxes</i>	<i>975.5</i>	<i>981.6</i>	<i>957.9</i>	<i>1,064.1</i>	<i>1,017.4</i>
TOTAL, STATE & LOCAL TAXES	\$1,544.1	\$1,603.4	\$1,641.2	\$1,798.7	\$1,803.4
Receipts from Retail Electric Sales	\$14,504.6	\$14,244.0	\$15,865.0	\$18,198.6	\$16,183.2
Taxes as Percent of Receipts	10.6 %	11.3 %	10.3 %	9.9%	11.1%

Source: Association of Electric Companies of Texas

Tax policy has not been uniformly applied to electric service, and tax burdens on electric consumption vary significantly by type of service company.

Municipally-owned utilities (MOUs) are exempt from all taxes save the obligation to collect sales tax on sales of electricity to commercial users; and rural electric cooperatives (RECs), while subject to property taxes, municipal franchise fees, and the public utilities gross receipts assessment, are exempt from the gas, electric and water gross receipts tax, corporate franchise tax, the system benefit fee, and payment of state and local sales taxes on purchases (Table 2).

	<u>IOEC</u>	<u>MOU</u>	<u>REC</u>
Gas, Electric, & Water Utility Tax	\$215.9	Exempt	Exempt
Public Utilities Gross Receipts Assessment	26.9	Exempt	\$3.2
State Sales & Use Tax (Paid)	62.4	Exempt	Exempt
State Sales & Use Tax (Collected)	237.1	\$24.9	12.6
Corporate Franchise Tax	133.1	Exempt	Exempt
System Benefit Fee	110.6	Exempt	Exempt
Property Taxes	433.4	Exempt	34.2
Local Sales & Use Taxes (Paid)	10.2	Exempt	Exempt
Local Sales & Use Taxes (Collected)	125.8	13.2	3.3
Municipal Franchise Fees	448.0	Exempt	6.1
TOTAL, STATE & LOCAL	\$1,803.4	\$43.4	\$59.4
Receipts from Retail Electric Sales	\$16,183.2	\$2,816.2	\$2,000.0
Taxes as Percent of Receipts	11.1%	1.4%	3.0%

Sources: Association of Electric Companies of Texas; estimates for MOUs & RECs based on data from Texas Public Power Association, Texas Electric Cooperatives, Comptroller of Public Accounts, Public Utility Commission

GAS, ELECTRIC & WATER UTILITY TAX

Rate, Base, and Allocation

A tax is imposed on each utility company located in an incorporated city or town having a population of more than 1,000 according to the most recent federal census (Section 182.022, Tax Code).

Utility companies subject to tax include electric companies, natural gas distribution companies, and water utility companies that make local sale and distribution. In areas

open to retail electric competition the tax applies to retail electric providers (REPs), and does not apply to transmission and distribution utilities (TDUs) that do not make retail sales of electricity to ultimate consumers.

The tax rate varies by municipal population. Tax is assessed at 1.997 percent of gross receipts from sales in cities of population 10,000 or more; 1.07 percent of gross receipts from sales in cities of population 2,500 or more but less than 10,000; and 0.581 percent for cities of population greater than 1,000 but less than 2,500.

The tax revenue is allocated 75 percent to the general revenue fund, 25 percent to the foundation school fund.

Exceptions to Base or Rate

A utility company owned and operated by a city, town, county, water improvement district, or conservation district is exempt (Section 182.026, Tax Code).

Electric cooperatives are exempt from the utility tax due to exemption from all excise taxes as provided in the Electric Cooperative Corporation Act (Section 161.062, Utilities Code). However, should an electric cooperative opt into competition, a retail electric provider owned, operated or controlled by the cooperative will be subject to tax (Section 182.027, Tax Code).

History and Outlook

The tax was originally imposed in 1907 at tax rates of 0.5 percent for the 2,500 to 9,999 city population interval and 1.0 percent for cities of population 10,000 or more. Tax rates were subsequently increased four times, with the current rates adopted in 1959.

About 88 percent of revenues from the tax derives from sales of electricity, and 12 percent from sales of natural gas. Tax collections from water companies are negligible.

Tax levied at the maximum 1.997 percent tax rate is responsible for 94.4 percent of the tax collected from electric companies, 4.7 percent of electric company tax collections is from levies at the 1.07 percent tax rate, and just 0.8 percent of electric company tax collections is due to tax levied at the bottom rate of 0.581 percent of gross receipts.

Tax revenues vary with electricity consumption and electricity prices, which are correlated with prices for the energy resources used for electricity generation. In recent decades, the tax has exhibited rapid growth in periods of energy price inflation, notably from 1975 through 1977 following the Arab oil embargo and from 1981 through 1983 following the second major OPEC oil price hike. Tax revenues also grew markedly in fiscal year 2001 due to the spike in natural gas prices, which have subsequently abated. After peaking as a share of total state tax collections at 1.84 percent in fiscal 1983, the tax share has fairly steadily declined, accounting for 1.08 percent of total state tax collections in fiscal 2003.

PUBLIC UTILITIES GROSS RECEIPTS ASSESSMENT

Rate, Base & Allocation

An assessment is imposed on the gross receipts of each public utility, including local telephone companies and interexchange telecommunications providers, retail electric providers, and electric cooperatives, within the jurisdiction of the public utility commission, for the purpose of defraying costs of administering the Public Utility Regulatory Act (Sec. 16.001, Utilities Code).

The assessment is equal to one-sixth of one percent of the public utility's, retail electric provider's, or electric cooperative's gross receipts from rates charged to the ultimate consumer in this state.

The assessment is collected by the comptroller and allocated to the state general revenue fund.

History and Outlook

The assessment was originally enacted in 1975 as part of the Public Utility Regulatory Act (PURA), first producing revenue for fiscal year 1977.

Since inception, the assessment at a rate of one-sixth of one percent of gross receipts has yielded significantly more general revenue than has been required for administration of PURA. In recent and current budget cycles, general revenue appropriations to the public utility commission and the office of public utility counsel for administration of PURA have consumed less than a third of assessment revenues. For the current biennium, the share of forecast assessment revenues appropriated for administration of PURA has fallen to 25.9 percent. The preponderance of assessment revenues, in excess of \$30 million annually, is spent for other purposes as part of the state general revenue budget (Table 3).

**Table 3
Public Utility Gross Receipts Assessments
(\$ Million)**

<u>Biennium</u>	<u>Public Utility Assessment Revenues</u>	<u>General Revenue Expenditures</u>		<u>PUC/OPUC Expenditures as Percent of Assessment</u>	<u>Excess Assessment</u>
		<u>PUC</u>	<u>OPUC</u>		
1976-77	\$ 9.5	\$ 1.9	-	19.9 %	\$ 7.6
1978-79	22.0	6.0	-	27.2	16.0
1980-81	24.9	5.7	-	23.1	19.1
1982-83	56.8	7.2	-	12.7	49.6
1984-85	53.4	14.4	\$ 1.4	29.6	37.6
1986-87	52.5	12.5	1.3	26.4	38.6
1988-89	51.3	12.5	1.4	27.2	37.3
1990-91	56.4	17.2	2.2	34.5	37.0
1992-93	56.6	19.1	2.5	38.1	35.0
1994-95	86.0	19.3	2.7	25.5	64.0
1996-97	70.1	23.4	3.2	37.9	43.5
1998-99	57.7	23.2	3.1	45.7	31.4
2000-01 #	86.8	23.3	3.6	30.9	60.0
2002-03*	85.1	23.4	3.4	31.4	58.4
2004-05*	90.4	20.5	2.9	25.9	67.0

Sources: Comptroller of Public Accounts, Legislative Budget Board
* Budgeted amounts
Net of System Benefit Fund

SALES AND USE TAX

The sales and use tax is the largest source of state tax revenue, yielding \$14.277 billion and accounting for 54.6 percent of state tax collections in fiscal year 2003. The tax applies generally to items of tangible personal property purchased or used in the state unless specifically exempted, and to selected services. The state sales tax rate is 6.25 percent, and additional city, county, transit authority or special district sales taxes up to a cumulative local maximum rate of two percent may apply, for a maximum sales tax rate of 8.25 percent.

Electricity purchased for commercial use is subject to tax. Electricity purchased for residential consumption is exempt, as is electricity used directly in manufacturing. Additionally, other exempt uses include electricity used in minerals extraction, agriculture, electrical processes such as electroplating or electrolysis, overhaul or repair of certain jet turbine engines, provision of certain national security and defense related services to the U.S. or foreign governments, and use by an electric utility engaged in purchase of electricity for resale (Sec. 151.317, Tax Code).

When the exemption of residential use was enacted in 1978, an exception was provided for the city sales tax. The majority of cities continue to levy city sales tax on residential use of electricity.

Electric companies incur significant costs and thus tax expense for items subject to state and local sales and use tax.

Taxable items used by electric companies include office equipment, furnishings and supplies and tangible personal property used in transmission and distribution of electricity, including transformers, cable, switches, breakers, regulators, fuses, resistors, insulators, and lines, conduit, towers, and poles, et al.

Items used directly in the generation of electricity for sale are exempt manufacturing equipment. This includes, among other things, steam production equipment and fuel, flow through tanks, cooling towers, generators, transformers, switches, breakers, fuses, reactors, resistors, insulators, control room equipment, pumps, compressors and hydraulic units used to generate electricity for ultimate sale (Sec. 151.318 (a)(4), Tax Code).

CORPORATE FRANCHISE TAX

Rate, Base & Allocation

Corporations and limited liability companies doing business in Texas are subject to franchise tax for the privilege of the liability veil provided to those forms of business organization by state law.

Tax due is the greater of 0.25 percent of corporate net worth (taxable capital) or 4.5 percent of earned surplus (corporate net income plus compensation of officers). Taxable capital and earned surplus for multi-state firms are apportioned to the state based on gross receipts from sales in the state.

Investor-owned electric companies typically are incorporated or are organized in affiliated groups that include corporations subject to the franchise tax. Franchise taxes paid by investor-owned electric companies have typically exceeded \$80 million annually in recent years, and rose to \$133 million in 2002.

The tax is paid to the comptroller and deposited to the state general revenue fund.

Exceptions to Base or Rate

An electric cooperative corporation incorporated under Chapter 161, Utilities Code, that is not a participant in a joint powers agency is exempted from the franchise tax (Sec. 171.079, Tax Code).

Municipally-owned utilities are exempt, as the state constitution bars state taxation of municipal corporations.

As an incentive for renewable power, businesses engaged exclusively in manufacture, sales or installation of solar energy devices are exempt from franchise tax (Sec. 171.056, Tax Code).

For incorporated business consumers of electricity, there is a modest franchise tax deduction of 10 percent of the amortized cost of solar energy devices (Sec. 171.107, Tax Code).

SYSTEM BENEFIT FEE

Rate, Base & Allocation

A nonbypassable fee is imposed on transmission and distribution utilities in service areas open to competition. The fee is not to exceed 65 cents per megawatt, and is to be allocated to customers based on kilowatt hours used.

Fee revenue is deposited to an account in the general revenue fund.

System benefit fees are nominally dedicated to the following regulatory purposes in order of priority: 1) finance of a ten percent reduction in electric rates for low-income electricity customers; 2) customer education programs and administrative expenses incurred by the Public Utility Commission and the Office of Public Utility Counsel for purposes of implementing competition; 3) targeted energy efficiency programs for low-income electricity customers; 4) a school funding loss provision to compensate the school finance system for any net reduction in property tax revenues from electric utility property attributable to industry restructuring; and 5) finance of additional reductions beyond ten percent to as much as twenty percent in electric rates for low-income customers. (Sec. 39.903, Utilities Code, as amended by HB 1902, 77th Leg.)

However, the dedication of system benefit fee revenues was overridden by the 78th Legislature (HB 3318 and HB 3378, 78th Leg., Regular Session), and consequently the fee revenues may be diverted to other general revenue purposes.

History and Outlook

About \$13.1 million in system benefit fees was assessed on investor owned utilities in 2000 for PUC and OPUC administrative expenses and the customer education program related to preparation for retail customer choice.

Another \$65.9 million was assessed in 2000 and \$67.3 million in 2001 to finance payments to the foundation school fund to compensate for gross property tax revenue declines from electric generating assets, principally nuclear and coal-fired plants.

For 2002 and 2003, the PUC levied the fee at the statutory maximum of 65 cents per megawatt, mostly to finance electricity rate reductions for low-income customers.

For 2004 and 2005, the fee will continue to be levied at 65 cents per megawatt, or about \$130 million per year, although the discount for low-income customers was scaled back from 17 percent to 10 percent, in order to finance other general revenue programs in the general appropriations act (HB 1, 78th Leg., Regular Session).

PROPERTY TAX

The principal source of tax revenues for Texas political subdivisions – public school districts, counties, cities, and special districts such as hospital districts and municipal utility districts – is the property, or ad valorem tax.

The property tax base consists generally of all real and business personal property, unless exempt by constitutional mandate or constitutionally sanctioned local option. All taxable property is to be appraised and assessed at 100 percent of fair market value, unless constitutionally eligible for special appraisal. Exemption policies vary by type of jurisdiction, and among jurisdictions of the same type when provided on a local option basis.

Electric companies have major investments in taxable property, principally generating plant and transmission and distribution infrastructure. Property taxes have been the second largest state or local tax expense for investor-owned electric companies, generally in excess of \$400 million annually in recent years (Table 4).

Table 4
Property Taxes Paid by
Investor-Owned Electric Utilities
(\$ Million)

	1998	1999	2000	2001	2002
School District	\$295.0	\$294.2	\$244.7	\$270.4	\$276.8
County	78.6	79.9	75.1	87.9	85.4
City	37.3	39.7	40.9	42.5	43.1
Special District	29.6	30.3	32.2	25.9	28.1
TOTAL, PROPERTY TAXES	\$440.4	\$444.1	\$392.8	\$426.6	\$433.4

Source: Association of Electric Companies of Texas

After enactment of electric industry restructuring legislation (SB 7, 76th Leg.), generating plants in tax year 2000 were for the first time appraised on a stand-alone basis rather than as part of regulated monopolies. The major effect of this change was a large reduction in the appraised values of the two nuclear generating facilities in the state, the South Texas Project in Matagorda County (Palacios ISD) and Comanche Peak in Somervell County (Glen Rose ISD). The taxable value of the South Texas Project declined by 55.5 percent and that of Comanche Peak by 71.3 percent, a combined reduction of some \$5.75 billion in appraised value on the two plants.

American Electric Power and CenterPoint Energy make compensatory payments to Matagorda County for loss of county tax base, and Texas Utilities makes compensatory payments to Somervell County (these are included as county property tax expenses in Table 4).

MUNICIPAL FRANCHISE FEES

Municipal governments typically levy fees on electric companies for use of public rights-of-way. Prior to the start of competition, these fees were levied on the gross receipts of electric companies from sales within city limits. Effective January 1, 2002, the fees are now levied on a per kilowatt hour basis.

Franchise fees are the largest state or local tax expense of electric utilities, amounting to \$448 million in 2002.

Section 182.025, Tax Code provides:

(a) An incorporated city or town may make a reasonable lawful charge for the use of a city street, alley, or public way by a public utility in the course of its business.

(b) The total charges, however designated or measured, may not exceed two percent of the gross receipts of the public utility for the sale of gas, electric energy, or water within the city.

The statutory limitation of municipal franchise charges to two percent of utility gross receipts has long been ignored. Although franchise fees vary among municipalities, the typical franchise fee has been four percent of gross receipts. The excess of the fees over the statutory authorization has been rationalized as the product of an extrastatutory voluntary agreement between a city and the utility that serves its citizens.

Municipal franchise fees on investor-owned electric companies are currently governed by Section 33.008, Utilities Code.

Franchise fees are now levied on the distribution of electricity on the basis of a per kilowatt hour charge rather than as a percent of a distribution utility's gross receipts. The

per kilowatt hour charge equals total electric utility franchise fee revenue to a city in 1998 divided by total kilowatt hours of electricity delivered to consumers in the city in 1998.

The charge imposed shall be equal to the total electric franchise fee revenue due the municipality from electric utilities for calendar year 1998 divided by the total kilowatt hours delivered during 1998 by the applicable electric utility to retail customers whose consuming facilities' points of delivery were located within the municipality's boundaries. The compensation a municipality may collect from each electric utility or transmission and distribution utility providing distribution service shall be equal to the charge per kilowatt hour determined for 1998 multiplied times the number of kilowatt hours delivered within the municipality's boundaries. (Sec. 33.008(b), Utilities Code)

These franchise fees shall be considered a reasonable and necessary operating expense of a distribution utility and shall be included in the nonbypassable delivery charges that a customer's retail electric provider must pay under Section 39.107 to the utility serving the customer (Sec. 33.008(c), Utilities Code).

The per kilowatt hour charge is in lieu of levies on gross receipts under franchise agreements extant September 1, 1999; upon expiration of such franchise agreements, cities and distribution utilities may agree to a different amount or method of determining franchise fees. (Sec. 33.008(f), Utilities Code)