

- The bill eliminates the gross receipts tax on electric companies and rural electric cooperatives. It subjects the electric companies to the corporate franchise tax and establishes a new kilowatt-hour tax, in part, to replace revenues lost from the gross receipts tax. 59.976% of revenue from the kilowatt-hour tax is deposited into the state GRF. The changes appear to be offsetting.
- The deregulation of retail electric services is likely to reduce the cost of electricity to the state. In FY 1998 the state spent \$38.8 million on electricity. A 3% decrease in the price would result in a cost saving of over \$1 million per year.
- Increased expenditures of the Public Utilities Commission (PUC) and the Office of the Consumers' Counsel (OCC) are based on estimated expenses of these agencies. The bill contains no additional appropriation authority. Any such authority would be funded by assessments on utilities.

Local Fiscal Highlights

LOCAL GOVERNMENT	FY 2002	FY 2003	FUTURE YEARS
School districts			
Revenues	\$138.6 million loss offset by \$138.6 million gain	\$138.6 million loss offset by \$138.6 million gain	\$138.6 million loss offset by gain likely in excess of \$138.6 million
Expenditures	- 0 -	- 0 -	- 0 -
Other Local Governments			
Revenues	\$59.4 million loss offset by \$59.4 million gain	\$59.4 million loss offset by \$59.4 million gain	\$59.4 million loss offset by \$59.4 million gain
Expenditures	- 0 -	- 0 -	- 0 -
School districts and other Local Governments			
Revenues	\$5 million gain	\$5 million gain	\$5 million gain
Expenditures	Potential decrease	Potential decrease	Potential decrease
Municipal corporations			
Revenues	\$13 million potential gain	\$13 million potential gain	\$13 million potential gain
Expenditures	- 0 -	- 0 -	- 0 -

Note: For most local governments, the fiscal year is the calendar year. The school district fiscal year is July 1 through June 30.

- Changes in electric utility property value reduce property tax revenues to schools and local governments, but the revenue is replaced by revenues from the newly created kilowatt-hour tax that are distributed to school districts and other local governments via the property tax replacement fund. School districts receive 25.9 percent of the replacement revenues and local governments receive 11.1 percent.
- Increases in revenues to school districts and other local governments result from the additional revenues for the fixed-sum levies. Increased revenues to municipalities result from applying the municipal income tax to the income of electric utilities.
- Schools and other local governments are also likely to benefit from reductions in the price of electricity resulting from electric deregulation.

Detailed Fiscal Analysis

The bill provides for competition in retail electric services to begin on January 1, 2001. It revises the taxes on electric companies and rural electric companies to be more consistent with the new market structure.

The bill establishes a market development period to facilitate the transition of utilities and utility customers to the new market structure. The Public Utilities Commission (PUC) is charged with overseeing the transition to competition. Electric companies are required to file their transition plans with the PUC. The PUC must in turn approve or disapprove the plans based on guidelines established in the bill. Utilities may receive transition revenues during the market development period. The PUC is charged with determining the amount of transition revenues to be recovered in accordance with the guidelines established in the bill.

The bill revamps the state's current low-income energy assistance and energy efficiency programs. It codifies the percentage of income payment program (PIPP) with respect to the electric portion and establishes it in the Department of Development, along with the home energy assistance program (HEAP). It also moves the Ohio energy credits program from the Department of Taxation to the Department of Development.

The bill establishes several programs in the Department of Development geared toward enhancing energy efficiency of low-income and other residential, small commercial and small industrial consumers in the state. It establishes a universal service fund to provide funding for the low-income energy assistance programs and an energy efficiency revolving loan fund to fund the energy efficiency revolving loan program. And it creates the Public Benefits Advisory Board to ensure that energy services are provided to low-income customers in the state in an affordable manner.

The bill makes the following tax changes:

- 1) With respect to the public utility property tax:
 - a) It reduces the assessment rate on generation and other non transmission and non distribution property,
 - b) It changes the definition of true value for new generation property, and
 - c) It changes the apportionment of generation property.
- 2) It eliminates the gross receipts tax with respect to the sales of electric power and it establishes the corporate franchise tax as the tax that electric companies are required to pay for the privilege of operating in Ohio,
- 3) It allows for the taxation of electric company profits under the municipal income tax,
- 4) It establishes a kilowatt-hour tax to recover and replace the revenue lost due to the changes in the public utility property tax and the replacement of the gross receipts tax with the corporate franchise tax, and
- 5) It provides for the replacement of revenues lost by school districts, counties, and other local governments due to the changes in the property tax.

The changes are designed to be revenue neutral. The Tax Department has estimated the cost of the tax provisions to be as follows:

Electric Utility Tax Revenue			
Revenue target/Loss from current sources		Gain from replacement sources	
Assessment rate reductions on electric utility property	\$198	Implementation of new public utility excise tax kWh tax base	\$552
Replacement of public utility excise tax gross receipts tax base	\$423	Removal of electric utility exemption from corporate franchise tax	\$74
Revenue commitment due to fixed-dollar levies	\$5		
Total	\$626	Total	\$626

Dollars are in millions.

Provisions affecting state agencies

The Public Utilities Commission (PUC)

The bill requires the PUC to adopt rules necessary for the commencement of competitive retail electric service within 180 days of the effective date of the bill. The PUC is also to adopt rules regarding the minimum service quality, safety, and reliability requirements for noncompetitive retail electric services (to the extent the authority to do so is not pre-empted by federal law). It is also to develop minimum service standards.

Suppliers of competitive retail electric services (supply, power marketing, etc.) are to be certified by the PUC regarding their managerial, technical, and financial capability to provide service. The PUC is to grant or deny any certification within 30 days of the initial application. The Commission may suspend or rescind a certification if the PUC determines that the utility, company, cooperative, or aggregator has failed to comply with applicable certification standards.

Each electric utility supplying retail electric service in the state is to file a plan with the PUC for the provision of retail electric service during the market development period within 90 days after the effective date of this bill, in accordance with rules established by the PUC. The plan is to include unbundling, a corporate separation plan, a consumer education plan, and other technical matters, as required by the PUC.

The transition plan may also include an application for the opportunity to receive transition revenues. The PUC may require refiling of any plan found to be inadequate. Within 45 days after the utility files the transition plan, any person having a real and substantial interest in the plan may file preliminary objections with the PUC. Within 90 days after the utility files, the Commission staff is to file with the Commission a report of its recommendations. The Commission is to file a final order approving or modifying a transition plan within 275 days after the utility files the plan – but no later than October 31, 2000. An interim plan may be issued if necessary.

The PUC is to monitor service to ensure competition. If the Commission finds that competition has declined, it is to ensure that service is provided at compensatory, fair, and nondiscriminatory rates and services. It may declare that additional services (such as retail ancillary services,

metering, billing, and collections) may also be offered on a competitive basis, if the Commission finds that market conditions would warrant that declaration. During the market development period the PUC and the OCC are to report on a biennial basis their findings regarding the effectiveness of competition in the supply of competitive retail electric service in the state to the standing committees of the legislature having primary jurisdiction over public utility matters.

According to the PUC, it would cost \$650,278 in FY 2000 and \$449,295 in FY 2001 to implement the provisions of S.B. 3. The agency would require 8 additional staff members, as follows:

Additional staff required by the Public Utilities Commission to implement S.B. 3			
Position (number)	Cost/FY 2000	Cost/FY 2001	Department
Assistant Attorney General (1)	\$44,054	442,678	Attorney General
Attorney Examiner (1)	\$60,786	\$55,465	Legal
Utility Analyst (1)	\$43,547	\$40,357	Utilities
Customer Services Investigator (2)		\$77,000	Consumer Services
Enforcement (3)	\$150,891	\$137,795	Consumer Services
Total Payroll	\$299,278	\$353,295	

The additional staff in the Attorney General’s department reflects the more complex legal environment that the commission will be operating in with the implementation of electric restructuring. The commission anticipates needing additional legal advice and legal representation, in general, and expects an increase in workload with respect to rule-making, rate-filing, market oversight functions, and additional Commission enforcement authority.

The attorney examiner would be required to assist the Commission with the new proceedings that would be initiated for each utility as it prepared its plan for the transition. Each company plan would be filed as a separate case, and an additional attorney examiner would be needed to assist with resolving discovery disputes and conducting hearings. Additional court reporting expenses would also be incurred. The attorney examiner would also help with the certification process to be established for electric utilities, electric service companies, cooperatives, and governmental aggregators. The commission also anticipates an increase in the number of complaints filed to resolve disputes between marketers, retail customers and/or electric utilities.

The bill establishes a market monitoring and assessment function for the PUC. It requires the Commission to initiate a proceeding to determine if ancillary services, metering, and/or billing should be competitive services. The utility analyst position would be filled by an entry level economist who would be responsible for tracking and monitoring indicators of market power abuse and who would help to assess the likely impact of any proposed mergers.

The two customer service investigators reflect the experience of Pennsylvania during its recent transition to competition. The Pennsylvania public utilities commission hired 3 additional customer service representatives and contracted with an outsourcing agency for additional assistance. At the height of restructuring activity, 12 full-time employees were assigned to the Pennsylvania commission to help provide information and answer questions from the public. The Ohio PUC plans to contract with an outsourcing agency for staff during promotional time. It does

anticipate the need to hire 2 additional full-time staff in FY 2001 to handle the increased calls due to electric choice educational promotions.

Finally, the PUCO will need to dedicate staff to develop and implement new rules within six months, including codes of conduct for suppliers and subsidiaries, rules for consumer protection, and minimum service standards. After developing the policies, the new staff would be required to help enforce the policies as competition is implemented.

In addition to personnel needs, the Commission would incur additional expenses for court reporting services, maintenance and equipment, and added space requirements. Total expenses would be as follows:

Public Utilities Commission total expenses for implementation of S.B. 3		
Object	Cost/FY 2000	Cost/FY 2001
Total Payroll	\$299,278	\$353,295
Court reporting services	\$30,000	\$30,000
Maintenance	\$36,000	\$42,000
<i>Equipment</i>		
Computers	\$7,500	\$3,000
Modular	\$22,500	\$9,000
Total Equipment	\$30,000	\$12,000
Space for additional staff	\$225,000	
Total	\$650,278	\$449,295

PUC operating expenses are funded out of an assessment on utilities based on the appropriation made for the agency each fiscal year. The current version of the budget bill (H.B. 283) contains no funds to defray the increased costs to the agency associated with electric deregulation.

The Office of the Consumers' Counsel (OCC)

The OCC would also incur additional costs for consumer education and outreach. Based on an addendum to the OCC budget submission, the OCC estimates that it would need 9 additional staff members to provide adequate outreach, customer education and assistance to prepare Ohio's residential utility consumers for choice in electric supply. The additional personnel required include 4 outreach and education specialists, one outreach and education liaison, one consumer service complaint investigator, two hotline specialists, and one information specialists. The cost of these 9 positions would be \$487,563 in FY 2000 and \$482,563 in FY 2001 (taking into account the additional pay period in FY 2000).

In addition the OCC would incur additional expenses for maintenance and equipment. These expenses include printing and mailing, producing media materials, and other educational tools. They include travel and vehicle expenses, additional office equipment and renovations. The OCC estimates these maintenance and equipment expenses to be \$1,291,928 in FY 2000 and \$1,071,928 in FY 2001. The OCC's estimates are based on an analysis of the consumer education activities carried out by the states of Connecticut, Pennsylvania, and California, in conjunction with their electric restructuring activities. In those states, multi-agency consortia

were established to oversee the consumer education activities and to ensure that a consistent, unified message regarding electric restructuring was presented throughout the state.

Total additional estimated expenses for the OCC for FY 2000 and 2001 would be \$1,779,491 and \$1,554,491, respectively. Like the PUC, the OCC is funded out of an assessment on utilities based on the appropriation made for the agency each fiscal year. The current version of the budget bill (H.B.283) contains no funds to defray the increased costs to the agency associated with electric deregulation.

Consolidation of Low-Income and Energy Efficiency Programs

The bill consolidates the state's low-income energy assistance programs – in so far as they deal with electric energy usage – with the Department of Development. These programs currently include the percentage of income payment program (PIPP) – an uncodified program established and administered by the PUC – the Ohio energy credits program, which is administered by the Department of Taxation, and the home energy assistance program (HEAP), which is currently administered by the Department of Development.

Percentage of income payment program (PIPP)

The PIPP program was established to avoid the problem of curtailment of electric or gas service to low income customers in the winter heating months because the customer cannot afford to pay his or her bill. The program allows low-income energy consumers to pay no more than 15 percent of their income on their winter heating expenses. (Specifically, no more than 10 percent to their primary heating source and 5 percent to their secondary heating source.) Any amount they owe a utility in excess of that is not forgiven but must eventually be paid. Amounts owed by PIPP customers in excess of payments are known as “arrearages.” Each utility keeps a record of its PIPP arrearages. Arrearages on a utility's books for more than 2 months are spread out among all of its customers in the form of a PIPP “rider.” The rider is a specific charge per kilowatt-hour. The original PIPP customer still owes the utility for his or her arrearage, but the utility is able to recover the bulk of the arrearages in a rate surcharge.

The PIPP rider and the accumulated arrearages differ widely by utility. In 1995 DP&L residential electric consumers paid an average rider of \$.09 per month, while a Columbus Southern Power (CSP) consumer paid \$.28 per month and an Ohio Edison consumer paid \$.73 per month. In May 1998, Ohio Edison's total PIPP arrearages – after 16 years of the program – amounted to \$65.3 million. The cumulative arrearages of CSP were \$24.3 million; and the cumulative arrearages of DP&L (including gas customers) were \$14.9 million.

Ohio energy credits program (OECF)

The Ohio energy credits program provides winter heating assistance to very low-income elderly and disabled Ohioans. It is currently administered by the Department of Taxation, largely because the qualifications are tied to the determination of an applicant's income. The program is funded out of the state GRF.

Both the costs of the program and the administrative expenses are funded out of the state GRF. In FY 1998, the program costs and the administrative costs were \$6.7 million and \$715,650 respectively. Program costs have been falling because the income guidelines have not been adjusted to keep up with inflation. A provision in H.B. 283 would tie the income guidelines to the GDP deflator. The appropriation for the program for FY 2000-2001 in H.B. 283 is currently \$7.5 million per year.

The costs of the program would not change in the transfer to the Department of Development. However, the Tax Department would still have some duties with respect to the determination of who would qualify for the program, since that is based on confidential income data. Therefore, it is not clear how moving the agency would affect the administrative costs.

Home energy assistance program (HEAP)

The low-income home energy assistance program (HEAP) is funded by a federal block grant (Li-HEAP) - so the amount of revenues available to this program is never known until October in any given year. The moneys are used to assist low-income households in meeting energy costs. Part of the block grant is also used to fund home weatherization assistance projects (HWAP) for low-income households. Often Li-HEAP funds are used in conjunction with the PIPP program in order to keep PIPP arrearages down. The Department of Development has had a good deal of experience working with utilities and with the Public Utilities Commission in administering Li-HEAP funds. In FY 1998, the agency spent \$48.8 million on home energy assistance. It spent \$7.6 million on weatherization.

The bill establishes an energy efficiency and weatherization program to help reduce the energy bills of certain low-income energy users, who are also large users of energy. It also establishes an education program for consumers eligible to participate in the low-income energy assistance program. And it establishes a universal service fund to provide funding for the low-income customer assistance programs.

Program consolidation and funding

The bill consolidates the four existing low-income energy assistance programs (PIPP, OECP, HEAP and HWAP) and authorizes the director of development - beginning July 1, 2000 - to administer them along with the two new programs created by the bill. The Tax Commissioner and the PUC are to assist the director of development with the program consolidation. The consolidation is to provide for efficient program administration along with a one-stop application and eligibility determination for consumers at the local level. This latter purpose is significant, since consumers have in the past been able to apply for some of the programs through their utility's neighborhood office. These offices are disappearing as the utilities attempt to rationalize their activities to prepare for competition.

The consolidated program is to be funded out of the universal service fund. Revenues to the universal service fund include a (1) surcharge on retail electric service, (2) certain customer payments under PIPP, and (3) revenues remitted from municipal electric utilities and rural cooperatives that opt to participate in the program. Presumably a GRF appropriation would continue to fund the Ohio energy credits program component, and the HEAP program would still receive the Li-HEAP monies from the federal government.

The universal service rider

The surcharge is the universal service rider and it is to replace the current PIPP rider on a customer's electric bill beginning July 1, 2000. The surcharge varies by electric distribution company. For the first five years after the starting date of electric competition, the universal service rider must be the sum of (a) the level of the PIPP rider in existence on the effective date of this section of the bill, (b) an amount equal to the level of funding for low-income energy efficiency programs included in electric utility rates as of the effective date of this section, and (c) any additional amount necessary and sufficient to fund the low-income energy assistance programs. Because the current PIPP rider may not adequately reflect the current costs of the

program to a utility, the PUC is required to conduct an audit of the PIPP program by July 1, 2000, in order to establish a new PIPP baseline for each utility to be used in determining the universal service rider.

PIPP payments in the universal service fund

The PIPP payments deposited in the universal service fund are comprised of the arrearage payments that a PIPP or former PIPP customer made to a utility on or after July 1, 2000 for percentage of income payment program debt owed the utility. It is assumed that the utility has already recovered this money in the PIPP rider. Alternatively, the utility may retain the right to collect the debt, but it would then remit to the department of development all the program revenues received by the utility for that customer.

Energy efficiency revolving loan program and fund

The bill also establishes an energy efficiency revolving loan program to help fund certain energy efficiency projects throughout the state. It is funded through the energy efficiency revolving loan fund.

The energy efficiency revolving loan program funds investments in products, technologies, or services for residential, small business, local government, non profit, agricultural, or other such entity to improve energy efficiency in a cost-effective manner using the most appropriate standards and best practices in the context of the total facility or building.

Revenues to the energy efficiency revolving loan fund include a surcharge on retail electric distribution rates. This surcharge is based on an aggregate revenue target for a given year divided by the number of customers of electric distribution utilities in the state in the prior year. The aggregate revenue target, as well as the surcharge, is determined by the director of development. The revenue target cannot exceed \$15 million in any year through 2005 and cannot exceed \$5 million in any year after 2005. The surcharge would be collected by the distribution company and remitted to the director of development on a quarterly basis.

Additional revenues to the fund include revenues from energy efficiency revolving loan program loan repayments and revenues remitted to the director of development by municipal electric companies and rural electric cooperatives that decide to participate in the program.

In general, the funding for these new or enhanced programs comes from existing sources – such as, revenues embedded in current electric rates or surcharges on top of rates. In that sense the programs do not represent an increase in governmental programs as much as a consolidation of programs.

Tax Changes

Property tax changes

The bill makes three major changes to the valuation of public utility property:

- a) It reduces the assessment rate on generation and other non-transmission and non-distribution property,
- b) It changes the determination of true value for new generation property, and
- c) It changes the apportionment of generation property.

Changes in assessment rates

The generation property of for-profit electric companies is currently assessed at 100 percent of true value; the rest of their tangible property is assessed at 88 percent of true value. All property of rural electric companies is currently assessed at 50 percent of true value.

The bill reduces the assessment rate on all non-transmission and distribution property – that is, all generation and other – of both for-profits and rural electrics to 25 percent. Assessment rates on transmission and distribution property are not reduced. It also reduces the assessment rates on fuel rods that are used in electric generation but owned by non-electric companies from 88 to 25 percent.

In tax year 1998 the total value of all electric company personal property was \$8.3 billion. Roughly 44 percent of that was generation. Of the property assessed at 88 percent, about 91 percent is categorized as transmission or distribution; the remainder (9%) is categorized as “other.” Thus, the bill would reduce approximately 48 percent (generation and other) of the current value of electric company property to 25 percent. The total cost of these changes – based on tax year 1998 millage rates – would be \$193.2 million. Adding in the cost of reducing the assessment rate on fuel rods (annual cost of \$4.7 million), the total cost would be \$197.9 million.

Since school districts receive approximately 70 percent of total property tax revenue, 70 percent of the property tax loss – or approximately \$138.6 million – would be incurred by school districts. The remainder (\$59.3 million) would be incurred by other local taxing districts.

Changes in definition of true value

The true value of most electric property (the non-generating property) is equal to the original cost less annual allowances for depreciation determined by the Tax Department. The true value of electric generating property is defined somewhat differently. Currently, the true value of electric generating property is defined as the value of “the equipment's or property's cost as capitalized on the company's books and records less fifty per cent of that cost as an allowance for depreciation and obsolescence.” In other words, fifty percent of book cost. The bill would retain that definition for existing generation facilities but would define the true value of new generation facilities or of newly sold generation facilities the same way that it is defined for other electric property.

It is difficult to project the impact of this provision on the taxable value of existing property. Some power plants are likely to be sold with the advent of deregulation of electric generation, and those plants sold at more than an arm's length transaction would be moved to the new schedule. However, it is difficult to predict what the impact of this would be on the property's taxable value. Many generating facilities in other states have been sold at greater than book value; but some of this additional value is recorded as “good-will” – an intangible, which would not add to the taxable value of the plant. Many of the plants in Ohio currently have more than one owner, and one of the things one would expect in a deregulated environment is for the utilities to rationalize their ownership of these plants. For example, the managing owner of a plant could trade its ownership share of other plants or buy out the other owners of the plant. The plants are unlikely to be valued differently under this scenario.

Changes in the apportionment of generation property

Electric utility property – like most public utility tangible property – is apportioned throughout the state in accordance with the location of the company's property. In the case of most electric generation equipment, 70 percent of the value of the generating plant is allocated to the district

where the plant is located. The remainder is apportioned, along with the rest of the company's tangible property, in accordance with the location of the company's transmission and distribution property.

For generation facilities with a book value in excess of \$1 billion dollars - that is, for Perry Nuclear Power Plant – the apportionment formula is somewhat different. For Perry only the first \$420 million of valuation is apportioned in accordance with the 70 percent rule. The rest is apportioned in accordance with the location in Ohio of the transmission and distribution systems of the five companies that are part owners of Perry. As a result, nearly \$200 million of the valuation of Perry that would under the general apportionment formula be allocated to Perry Local School District in Lake County is instead shared with 317 other school districts throughout the state.

The bill situs all generation property. That is, it allocates the value of all such property to the district where the property is located. Consequently, the true value of electric property in the taxing districts that host electric power plants would increase, while that of the non-power plant districts would fall. However, with the assessment rate reductions, the value of electric utility property will fall in all districts.

The apportionment change does not appreciably affect the anticipated aggregate local property tax loss due to the assessment rate reduction. Although different amounts of property are allocated to districts with different tax rates, and their property tax loss may be greater than or less than it would be under the current apportionment scheme, these differences seem to wash out in the aggregate. According to the Tax Department, the assessment rate reductions under the revised apportionment provisions would result in an aggregate property tax loss of \$193.1 million. (It does not affect the revenue loss from the assessment rate change on fuel rods.)

Since the revenue losses due to the change in the apportionment scheme are covered by the property tax replacement mechanism (discussed below) – just like the revenue losses due to the assessment rate change, the change in the apportionment mechanism makes a great deal of sense. As mentioned above, it is expected that a restructured electric power industry will result in the rationalization of plant ownership. Under the current apportionment formula, both the change in ownership of a plant and the formation of a subsidiary would affect which taxing districts received what portion of the value. This could change annually in a rapidly evolving industry – producing seemingly arbitrary swings in district property values. By situsing the value of the plant, the school district where the plant is located is assured of receiving the property tax revenues derived from the plant, regardless of the owner of the plant – assuming, of course, that the plant continues to operate. The other districts do not have property value apportioned in and out of the district due to the current ownership structure of the company, but they are, at the same time, reimbursed for their property tax loss on a predictable basis.

Replacement of the Gross Receipts Tax with the Corporate Franchise Tax

The Gross Receipts Tax

Electric utilities – like other most public utilities in the state – are currently subject to the public utility excise tax (also known as the gross receipts tax). The public utility excise tax is a state tax, with 95.2 percent of revenues deposited in the state General Revenue Fund (GRF). The remainder is deposited in the local government funds (4.2% to the local government fund [LGF] and 0.6% to the local government revenue assistance fund [LGRA]). The tax is based on the intrastate revenues of utilities. Competition is expected to increase the amount of electricity

purchased from out-of-state. Such electricity would be exempt from the tax. This would cause state revenues to fall. The tax also raises a competitiveness issue, since electric companies located in Ohio would have to pay the tax on a large portion of their sales in Ohio, but companies located out-of-state could more easily avoid the tax. Consequently, the bill replaces the current gross receipts tax with the corporate franchise tax and a kilowatt-hour tax.

Tax year 1998 public utility excise tax liabilities based on the intrastate gross receipts of electric companies – including both for-profit and rurals but excluding the non-electric revenues of joint companies – were certified in November 1998 at \$423 million. (This takes into consideration the \$16.2 million in coal tax credits that the companies receive on an annual basis.) The elimination of this revenue source would cost the GRF, the LGF, and the LGRAF, \$402 million, \$17.8 million, and \$2.5 million, respectively. The revenue loss to each of these funds would be made up by the corporate franchise tax and a portion of the new kilowatt-hour tax.

The electric companies and rural electric companies would continue to pay the gross receipts tax through June 2001. Under current law the tax is paid in three installments – in October, in March and in June – with each payment ultimately equal to 1/3 of the company's gross receipts liability for the period from May 1 to April 30. A reconciliation payment is made (or a refund is received) in November after the Tax Department certifies the company's liability for the current tax year.

The bill provides for three payments for tax year 2001 (from May 1, 2000 to April 30, 2001); however, the third payment is only ¼ rather than 1/3 of the current estimated liability.

The Corporate Franchise Tax

The bill subjects the electric companies – but not the rural electric companies – to the corporate franchise tax. It also allows the electric companies to claim the coal tax credit against the corporate franchise tax but does not allow for any carry over of credits in excess of possible tax losses. The electric companies would first be liable for the tax in the 2002 tax year – i.e., beginning in January 1, 2002, the companies would pay corporate franchise taxes on their 2001 net income.

The Tax Department estimated that the tax would raise approximately \$74 million per year from the for-profit electric companies in the state. Again, this number is net of the estimated \$16.2 million in coal tax credits that the utilities would be able to claim against the tax. They would, of course, be able to take advantage of many of the other tax credits available with the corporate franchise tax – such as, the day care tax credit and, conceivably, the jobs creation tax credit.

The four large electric companies in the state (AEP, CInergy, DP&L and FirstEnergy) estimated that their corporate franchise tax liability for tax year 1998 (based on 1997 income and current rates) would have been \$142.2 million if they had been subject to the tax in 1998. This estimate, however, does not take into consideration the adjustments to net income to account for depreciation expenses on the Ohio tax basis of their assets included in the current version of the bill. Taking that adjustment into consideration – but assuming a slight shorter amortization period and a different apportionment provision, the companies estimate that they would have paid \$132.3 million on 1997 net income (net of coal tax credits).

LBO does not have an independent estimate of the likely revenue from this source. The utilities' calculation is based on historical data. However it reflects circumstances that are unlikely to carry into the future. Regulation both guarantees a return in excess of expenses and it restricts much activity to within the state. In a competitive environment, returns are likely to be narrower and utilities will have somewhat greater discretion over where their income-earning activity takes place. This could result in the utilities' net income under competition falling short of that

projected on the basis of historical returns. The Tax Department also has the benefit of experience. In 1987 the interexchange telecommunications companies switched from the gross receipts tax to the corporate franchise tax and in 1990 the railroads did likewise. In neither case, did the revenue from the corporate franchise tax come close to the amount projected by the respective industry before the switch. On the other hand, neither of these industries received “transition revenues,” an item that could substantially enhance the net income of the electric utilities for the duration of the market development period.

The bill used the Tax Department’s \$74 million estimate to devise the bill’s initial “revenue neutral” tax structure. Of this \$74 million, \$70.4 million would be deposited in the state GRF, \$3.1 million would be deposited in the LGF, and \$0.4 million would be deposited in the LGRAF.

The bill contains three significant provisions concerning the treatment of electric companies with respect to the corporate franchise tax. First, it defines the sale of electricity as the sale of a service. Secondly, it adjusts the definition of net income to take into consideration the Ohio tax basis of assets acquired before electric restructuring. Third, it adjusts the calculation of the tax in tax year 2002 to avoid making electric companies pay twice for the privilege of operating in Ohio. Each of these provisions has – or is likely to have – an impact on corporate franchise tax revenue.

Treatment of electricity as a service

The formula for the apportionment of net income in Ohio relies heavily on the sales factor (60 percent sales, 20 percent property, 20 percent payroll). For this purpose, the bill treats the sale of electricity as the sale of a service rather than the sale of tangible property. This has the effect of allocating all of a company’s sales to the state if the company is for the most part located within the state and allocating all of a company’s sales out of the state if the company is located (headquartered) outside of the state. Under this apportionment formula, the state would only gain corporate franchise tax revenues from the existing utilities and would gain little or no revenue from suppliers headquartered in other states. (If a firm owned a generating plant in Ohio, some income would be apportioned to Ohio due to the property factor.) Thus, the growth of corporate franchise tax revenue from electric utilities would depend on the fortunes of the firms currently headquartered in the state. Revenues would be sensitive to changes in corporate structure and would be subject to manipulation as the companies reorganized in the face of competition.

Privilege year adjustment

The corporate franchise tax is a “privilege” tax – corporations pay it in exchange for the privilege of operating in the state in a given tax year. S.B. 3 replaces the public utility excise tax “privilege” tax with the corporate franchise tax as the tax electric companies pay for the privilege of operating in the state. The last year covered by the public utility excise tax privilege tax is May 2001 through April 2002, and the first year covered by the corporate franchise tax privilege tax is January 1, 2002 through December 31, 2002. Due to the 4-month overlap (January through April 2002), the electric companies’ corporate franchise tax liability in 2002 is calculated as 2/3 the amount of the liability based on the companies’ net income in the 2001 taxable year. Thus, the companies’ estimated liability in 2002 (based on the Tax Department’s estimate) would be \$44 million (i.e., two-thirds of \$90 million minus \$16 million – the coal tax credits are not similarly reduced. Of course, if the utilities’ estimates are correct, FY 2002 revenues would be \$84.5 million.) The tax payments would be made in three separate installments – 1/3 of the liability in each of January, March, and June 2002.

Establishment of a kilowatt-hour tax

The bill establishes a tax on the amount of electricity distributed to electricity consumers in the state. The tax is graduated by levels of usage for each 30-day period. The following table shows the tax rate and the estimated revenue by usage class.

Kilowatt-hours distributed to an end-user	Rate per kilowatt-hour	Estimated annual revenue
The first 2,000 kWh	\$.00465	\$256.8 million
2,001 to 15,000 kWh	\$.00419	\$124.8 million
15,001 kWh and above	\$.00301	\$170.4 million
Total		\$552.0 million

The tax rates fall slightly as usage rises. However, all users would pay the same rate for the first 2,000 kilowatt-hours. All who used more than 15,000 kWh per month would pay the same tax on the first 15,000 kWh. The different usage classes approximate the three classes of consumers. Most residential consumers use less than 2,000 kWh per month, so virtually all of their usage would be taxed at the higher rate. A typical residential consumer uses approximately 750 kWh per month, which translates into a total tax of \$3.49 per month. Most commercial establishments use between 2,000 and 15,000 kWh per month; and a large number of industrial users use in excess of 15,000 kWh per month.

A tax on kilowatt-hours avoids some of the pitfalls of a sales-based tax. First, it is not necessary to know the price of the product in order to levy or collect the tax. What, after all, is the price of electricity? Does it include transition costs? Does it include the universal service charge? Levying the tax on the quantity provides for easier administration of the tax. The tax can be collected from the distribution company even if the distribution company did not supply the electricity – but only provided the delivery services. The distribution company would know how much it delivered even if it didn't know how much was paid for it.

Collecting the tax from the distribution company resolves the problem of nexus. Nexus means that a company has sufficient business relations with a state to give the state taxing authority over the company. Property or employees engaged in business in the state will suffice to establish nexus. Electric distribution companies in Ohio will have nexus in Ohio. However, utilities and other suppliers in neighboring states that sell power to Ohio customers may not have nexus.

Provision for self-assessment

A problem with the kilowatt-hour tax arises with very large industrial users. The kilowatt-hour tax essentially replaces the gross receipts tax, which is essentially a tax based on price. Industrial consumers currently pay prices that are slightly more than half the price paid by residential consumers. So, their current corresponding tax per kilowatt-hour would translate into something slightly more than half that paid by residential consumers. The kilowatt-hour tax that would be paid by large industrial customers in the bill is closer to two-thirds that of the residential consumers. While the higher tax rate may not appear burdensome to most residential users, it could cause problems for some large industrial users in the state. For example, LBO estimates that the average primary metal producer in the state uses an average of 2,552,223 kilowatt-hours of electricity per month (based on 1992 data from the U.S. Census Bureau and the Ohio Public Utilities Commission). At the rates established by the bill, that would amount to a tax payment of \$7,700 per month.

The bill resolves the problem faced by large electric users by allowing for self-assessment. That is, large electric users that demand in excess of 20 megawatts of electricity on average over a year's time could pay a 7 percent tax on their electricity purchases. (This includes many industrial consumers and very large commercial establishments, such as large office towers.) This avoids the problems of nexus and price confidentiality. However, the bill does not define price, so it is not clear what self-assessors would be paying 7 percent of. The Tax Department estimates that if the price of electricity is less than 4.3 cents per kilowatt-hour, taxpayers who qualify will save money if they self-assess. Since the average price paid for electricity by industrial users in Ohio in 1997 was 4.16 cents per kilowatt-hour, it is likely that many large users would benefit from the tax. LBO does not at this time have an estimate of the impact of this provision on the bill, but it would likely result in a loss of revenue vis-à-vis the revenue estimates given above.

Disposition of replacement tax revenues

The electric companies would first be subject to the kilowatt-hour tax in May 2001 with the first remission of revenues to the state in June. The revenues would be divided among the GRF (59.976%), the LGF (2.646%), the LGRAF (0.378%), the school district property tax replacement fund (25.9%), and the local government property tax replacement fund (11.1%), with the caveat that some of the revenues that would otherwise be deposited in the school district replacement fund are to be deposited in the state GRF to defray the cost of the "state education aid offset." The bill creates both the school district property tax replacement fund and the local government property tax replacement fund.

Assuming that the state collects \$552 million annually in revenues, the revenues would be distributed as follows (ignoring, for the moment, the state education aid offset): \$331.1 million to the state GRF, \$14.6 million to the LGF, \$2.1 million to the LGRAF, \$143 million to the school district property tax replacement fund, and \$61.3 million to the local government property tax replacement fund. If revenues from the kilowatt-hour tax exceed \$552 million, all of these funds would benefit proportionately. If revenues fall short of \$552 million, the loss would be shared proportionately.

School district and local government replacement payments

The changes the bill makes affect local property values and, in turn, affect local property tax revenues of school districts and other local governments and taxing districts. These effects range from small for most districts to significant for a few districts. However, the bill also implements a revenue replacement mechanism that mitigates the revenue losses resulting from the changes in the property values. The mechanism differs somewhat between school districts and other local governments. The school district replacement mechanism is tied in with the school foundation aid funding formula. The replacement mechanism for local governments relies more on phasing the districts off the replacement formula. But for both school districts and other local governments, the bill creates a fund that continues to generate revenues for school districts and local governments beyond the time when the last replacement payment is made.

Determination of Replacement Revenue

The property tax changes would first take effect in calendar year 2001 and would first affect property tax revenues in CY 2002. Before the tax changes take effect the Tax Commissioner is required to determine certain values.

First, the Tax Commissioner must determine the “Tax Value Loss” based on 1998 property values for each taxing district. This tax value loss is computed only once, and this property value difference is used to calculate the revenue replacement amounts for each school district for the duration of the replacement payments.

The tax value loss is equal to the difference between the actual 1998 assessed values on electric company tangible property and what the 1998 assessed values would be if the property were valued in accordance with the changes made by Senate Bill 3. The values to be used in calculating the tax value loss are those that appear on the preliminary assessments of the property issued in 1998. These values are used to guard against possible tax losses due to on-going court cases – such as *Duquesne v. Tracy*, which is currently being considered by the Ohio Supreme Court. Even if public utility property values fall due to successful litigation on the part of the electric companies, the state would still base the tax value loss and any subsequent replacement revenues on the higher valuation. So, taxing districts are in a sense “guaranteed” certain replacement revenues, even though they are not guaranteed that the tax base that they are calculated on would continue beyond tax year 1998 (calendar year 1999 collections).

Second, the Tax Commissioner must also determine the revenue associated with the tax value loss for both fixed-rate and fixed-sum levies in existence in the taxing district in 1998. Fixed-sum levies include bond levies and school emergency levies.

A reduction in property values in a taxing district would result in a loss of tax revenues equal to the change in the property values times the sum of the *fixed-rate levies* levied on the property – this is called the fixed-rate levy loss. All taxing districts will receive annual replacement revenues for at least 5 years equal to their fixed-rate levy loss. Some will receive replacement revenues for up to 15 years.

The fixed-sum levies would not result in any property tax loss. Fixed-sum levies are set to raise a specific amount of money. If valuation changes, the tax rate adjusts (up or down) to raise the required amount. Therefore the valuation changes created by S.B. 3 would not have a direct impact on the amount of revenue received by the taxing district from fixed-sum levies. However, if a taxing district is sufficiently dependent on electric company property, the valuation changes could create problems for other taxpayers in the district, as the tax rate adjusts upward to raise the required amount of revenues. S.B. 3 provides additional revenues for districts whose combined tax rate on fixed rate levies in 1998 would increase by more than 1/4 mill as a result of the valuation change. The payments would last for 5 years, in the case of school emergency levies. In the case of bond levies, they would last for the duration of the levy.

State Education Aid Offset

A change in taxable value will also generally affect the amount of state aid a school district receives. Currently, school districts are guaranteed a certain level of funding per pupil. The guaranteed amount is equal to the amount of revenue that 23 mills would raise on approximately \$186,000 of valuation per pupil. If valuation falls, state aid increases by the change in value times the 23 mills. S.B. 3 takes the impact of the change in valuation on state aid into consideration in determining how each district receives its replacement revenues. Beginning in FY 2003, the Department of Education is to determine a district’s state aid first using current property tax values and then using property values which add back in the tax value loss calculated by the Tax Department. The difference is equal to the “State Education Aid offset.” School districts are reimbursed for this part of their tax revenue loss through the foundation formula. Any revenue loss not reimbursed through the formula is paid directly to the school district through payments from the school district property tax replacement fund. If all school

districts were on the foundation formula, the state education aid offset would in FY 2003 equal approximately \$63 million.

Not all school districts receive state aid via the foundation formula. Approximately 10 percent of districts receive state aid via the “guarantee.” Essentially, school districts are guaranteed the same level of state aid they received in 1998. If the amount of state aid a district received in 1998 is greater than the amount it would receive via the formula in any fiscal year, a district would receive the guarantee amount.

About half of the districts currently on the guarantee are so because their valuation exceeds the formula amount (currently \$186,000 per pupil). The rest are on the guarantee because recent valuation increases or decreases in enrollment have led to reductions in the formula amount they would receive. The change in valuation due to the changes in electric company property values could push a district with a significant amount of electric company property (i.e., a generation district) off of the guarantee, but it is unlikely to affect the funding status of most school districts. However, annual increases in the school funding formula will likely push more districts on to the formula.

Timing and duration of property tax replacement payments to school districts

All school districts receive property tax replacement payments for 5 years - beginning in calendar year 2002. Valuation changes in calendar year 2001 affect foundation aid payments beginning in fiscal year 2003 (July 2002 through June 2003). However, property tax losses are first incurred in the second half of fiscal year 2002. Consequently, the first property tax replacement payment to school districts (made in spring of 2002) does not take into consideration the state education aid offset. Each school district receives a payment equal to one-half of its tax value loss times the sum of the fixed rate levies (The payments are to be made twice a year, hence any payment is equal to one-half of the total replacement payment to be made for a year). In subsequent years - from July 2002 through December 2006 - school districts receiving foundation aid will receive part of their replacement payments via additional foundation aid and part through the school district property tax replacement fund. School districts not on the formula for any time period will receive their total tax revenue loss payments from the school district property tax replacement fund for that time period.

Beginning in calendar year 2007, school districts receive additional payments only if the inflation-adjusted property tax loss incurred by the school district exceeds the cumulative increase in state aid since fiscal year 2002. This calculation takes into consideration the increase in state aid due to the initial property tax loss, as well as subsequent increases in state aid, which occur annually, as the state raises the per-pupil-funding amount.

Most school district will not receive additional replacement tax payments after this time. The exceptions include school districts that remain on the guarantee and school districts with substantial amounts of electric company property (i.e., generation school districts). Over time many of these districts will be phased off. The attached chart (Chart 1) demonstrates the comparison between the inflation-adjusted property tax loss and the increases in state aid for a district with high electric property value. (The chart assumes annual average increases in state aid of 3.5 percent, along with annual inflation rates of 2.6 to 2.8 percent.) The bars on the graph show the annual replacement revenues the district receives annually until the cumulative increase in state aid exceeds the inflation-adjusted property tax loss. This example is not typical of most districts. Most districts will reach the break-even point in 2002 or 2003. They will, however, continue to receive replacement revenues until 2006.

However, even as property tax replacement payments are discontinued, school districts will continue to receive revenues from the property tax replacement fund on a per-pupil basis. Revenues distributed to school districts on a per-pupil basis are to be used for capital improvements. Based on 1997 ADM numbers, 25.9 % of an estimated \$552 million in kilowatt-hour tax revenues would produce an amount equal to roughly \$78.50 per pupil.

Timing and duration of property tax replacement payments to other local governments

The other local governments receive replacement revenues for 15 years, as well. However, they do not receive annual increases in funding from the state based on notions of adequate funding levels to assist in determining how long they should continue to receive replacement revenues. Consequently, after the first five years of receiving replacement revenues equal to their fixed-rate levy loss (plus any additional amount due to fixed-sum levies), the local governments begin to receive replacement revenues equal to 80 percent of their fixed-rate levy loss. The remainder is allocated within each county to the taxing districts in part on the basis of their tax value loss and in part on a per capita basis. The revenue replacement mechanism is ultimately phased out after a total of 15 years; and the new formula – based in part on a per capita formula and in part on a valuation formula – is used to determine the distribution of the revenues in the local government tax replacement fund.

□ *LBO staff: Doris Mahaffey, Senior Economist*

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Chart 1 - School district property tax replacement mechanism for school district with high electric utility valuation



