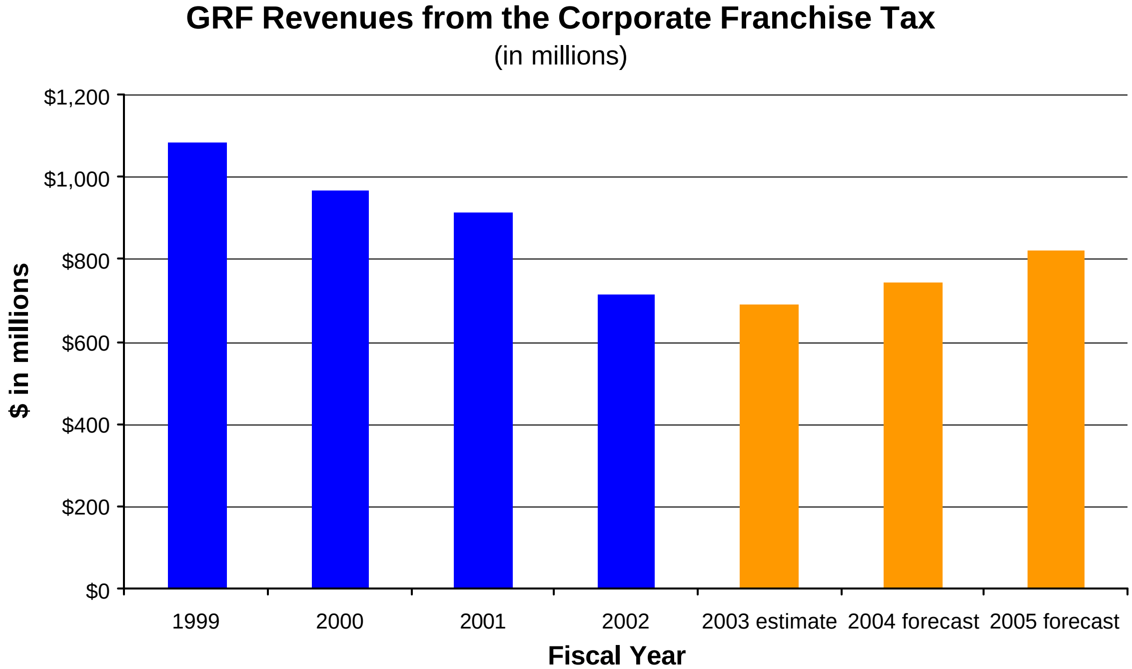
Corporate Franchise Tax

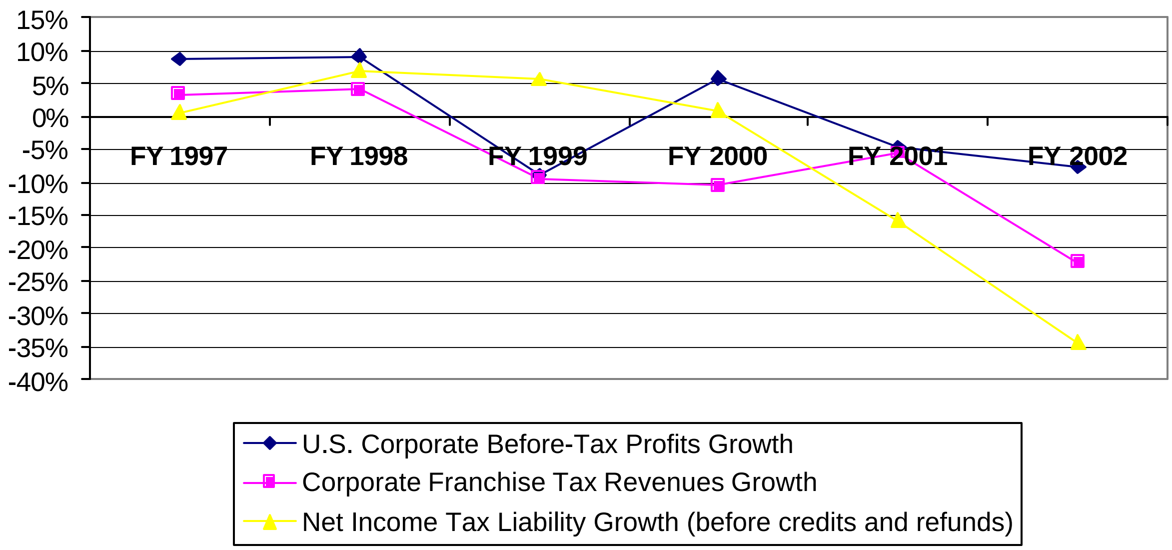


	FY 1999 Actual	FY 2000 Actual	FY 2001 Actual	FY 2002 Actual	FY 2003 Estimate	FY 2004 Forecast	FY 2005 Forecast
Corporate Franchise	$1,084.1	$969.4	$915.3	$712.3	$690.0	$742.1	$821.5
growth	-9.4%	-10.6%	-5.6%	-22.2%	-3.1%	7.6%	10.7%

The franchise tax has two bases: the net worth base (generally determined as net book value of assets minus the net carrying value of liability) and the net income base (generally, the Ohio portion of the federal taxable income with exclusions and additions as required by statute). Differing tax rates apply to each tax base. The corporate taxpayer calculates its Ohio tax liability under the two bases and pays the higher of the two tax liabilities. H.B. 215 (FY 1998-1999 Operating Budget) decreased the net worth tax rate from 5.82 mills to 4 mills and capped the net worth tax liability at $150,000 for each corporation, effective in FY 1999. The full impact of those net worth tax changes have decreased the cushioning effect of the net worth tax base on franchise tax revenues in an environment of lower corporate net income and profits. In addition, more and more new firms are taking advantage of alternative forms of business organization (such as limited liability company), which are not generally subject to the corporate franchise tax. Instead, this net business income is taxed under the personal income tax as a pass-through entity, which has helped contribute to increased volatility in that tax.

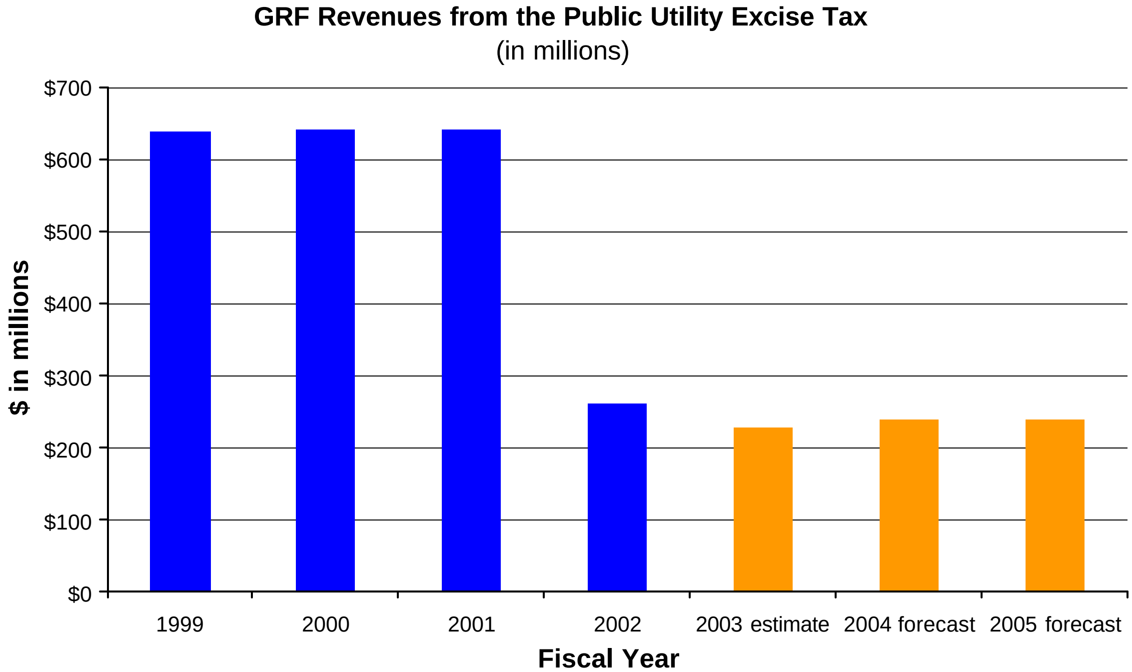
LSC derives its forecasts of baseline corporate franchise tax (CFT) revenues from projections of U.S. corporate profits. Translating a corporate profits forecast into a franchise tax forecast is not straightforward because of the dual base of the franchise tax (net worth or net income), the fact that corporations often have taxable years that do not coincide with calendar years, and corporations' decisions on the timing and use of statutory tax credits. In the past, the net worth tax base kept revenues from falling as sharply as profits in recessions or downturns. During the current downturn, it has had less of a cushioning effect. The cap on net worth tax liability of $150,000 shifted many of the corporations to the net income basis (which is not capped). This caused franchise tax revenues to decline greatly as corporate profits fell and the net income tax liability fell. Regardless of a firm's net worth, its net worth liability would at most be the cap amount.

Growth in corporate franchise tax revenues and corporate profits



An analysis of tax revenues in the last few years shows that the elasticity of the corporate franchise tax revenues with respect to U.S. corporate profits has increased. The graph also suggests that this elasticity is asymmetrical. During a period of economic growth, the growth in corporation franchise tax revenues is slower than the growth in U.S. corporate profits. During a downturn, the decline in Ohio franchise tax revenues would be larger than the decline in U.S. before-tax profits. Forecasted corporate franchise tax revenues are based on the profit forecast and elasticity estimates for the next two years. LSC expects a negative growth in franchise tax revenues in FY 2003. U.S. before-tax profits are forecasted to grow 12.6% in 2003 and 17.8% in 2004. Ohio franchise tax revenues are expected to grow at the rates of 7.6% in FY 2004 and 10.7% in FY 2005.

Public Utility Excise Tax



	FY 1999 Actual	FY 2000 Actual	FY 2001 Actual	FY 2002 Actual	FY 2003 Estimate	FY 2004 Forecast	FY 2005 Forecast
Public Utility	$637.6	$642.1	$640.5	$260.1	$228.7	$239.3	$238.3
growth	-5.3%	0.7%	-0.2%	-59.4%	-12.1%	4.6%	-0.4%

The public utility excise tax -- also known as the gross receipts tax -- is a tax on the intrastate revenues of public utilities. The tax is levied on local telephone companies, natural gas utilities, pipeline companies, heating companies, waterworks, and water transportation companies. All companies subject to the tax pay a tax of 4.75% of gross receipts except pipeline companies, who pay a tax of 6.75% of gross receipts. Historically the largest single contribution to the tax came from electric companies, but they were removed from the tax by S.B. 3 of the 123rd G.A., which accounts for the sharp drop in tax receipts shown in the graph above for FY 2002. The tax receipts lost because of dropping electric companies from this tax were intended to be replaced by corporate franchise tax payments and by payments to the newly created kilowatt-hour tax, which was created by S.B. 3. Thus, receipts under the kilowatt-hour tax are somewhat less than the amount historically paid by electric companies under this tax.

In FY 2002 natural gas companies accounted for 55.1% of the receipts under the tax, local telephone companies accounted for 39.8% of the receipts, and electric utilities accounted for 4.0% of the tax with their last payment in November of 2001. During FY 2003 electric companies received refunds worth $11.6 million through December under the tax. A Department of Taxation official reports that it is expected that electric companies have now received all the refunds they are due under the tax, so the forecast assumes no receipts from or refunds to electric utilities after December 2002. Because all other utility companies accounted for under 1.5% of receipts in FY 2002, the discussion that follows will be restricted to the assumptions underlying the forecast for the receipts from natural gas companies and from local telephone companies.

Natural Gas Utilities

Natural gas utilities paid $143.3 million under the tax in FY 2002. The tax is paid by utilities, not marketers. Non-utility companies that sell gas on a retail basis under the Choice Program do not pay the tax, but they are supposed to collect sales tax on their sales. Most industrial customers are in practice exempt from the sales tax due to the exemption for direct use in manufacturing. Participation in the Choice Program has grown gradually: as of December 2002, 40.1% of residential customers statewide were enrolled in a Choice Program compared with 39.0% in February 2002. Similarly, 39.6% of commercial customers were enrolled in a Choice Program in December 2002, up from 38.6% in February 2002. In both cases, the share of natural gas customers still subject to the tax (i.e., those not enrolled in a Choice Program) in December was 98.3% of the share subject to the tax in February. This trend is projected to continue, with the percentage of households subject to the tax in FY 2004 being 98.3% of the percentage subject to the tax in FY 2003, and similarly in FY 2005. While we believe that enrollment increases in Choice Programs are the most likely outcome over the next two years, unexpected news could swing customers away from them, or accelerate the recent enrollment trend, in a dramatic fashion. That would change receipts for this tax, but it should be balanced by changes in sales tax receipts in the opposite direction.

Even more than the effects of enrollment in a Choice Program, the receipts from the tax depend on changes in the market price of natural gas and the volume of gas used. Forecasts of these changes are taken from the Global Insight (formerly DRI-WEFA) economic forecast for the U.S. published in January 2003. The following table presents the Global Insight forecasts of natural gas usage and price changes nationwide between the first quarter of the preceding calendar year to the first quarter of the year shown in the table:

DRI-WEFA forecast of changes in U.S. natural gas prices, volumes used		
Year	**Price**	**Volume**
2003	12.9%	5.8%
2004	-4.2%	2.8%
2005	0.9%	1.3%

The relatively high growth in both price and volumes from the first quarter of (CY) 2002 to the first quarter of 2003 is due to unusually cold winter temperatures in most of the country east of the Rocky Mountains. The effects of this relatively cold weather will continue to be felt in FY 2004, and customers who are on a budget plan will likely have to pay an increased amount toward the end of the budget plan period, which shows up in tax receipts received by the state in August.

The natural gas forecast applies the Choice Program adjustment factor described above along with the growth rates in the table to arrive at a forecast of $127.8 million in FY 2003, $128.8 million in FY 2004, and $129.4 million in FY 2005.

Local Telephone Companies

Local telephone companies paid $103.4 million under the tax in FY 2002. The tax applies to local companies like SBC/Ameritech and Cincinnati Bell, but not to cellular or long-distance companies. It also does not apply to emerging companies that offer local telephone services using network resources that belong to a local telephone company, who are referred to in the industry as competitive local exchange carriers. Sales by these carriers, wireless companies, and long-distance companies are taxed under the sales tax.

The amount paid by local telephone companies has fallen for two straight fiscal years going into FY 2003, but data on receipts through the first half of this fiscal year indicate that receipts will grow to a projected $108.6 million this year. This projected increase is based heavily on a reduction in refunds to utilities in November 2002 compared with November 2001. This reduction seems to be due to telephone utilities losing less market share to competitors who are not subject to the tax than was expected when advance tax payments were made. Nevertheless, data from the Federal Communications Commission indicate that local telephone companies lost market share for analog business lines in both 2000 and 2001, while they lost market share for residential lines in 2001. Therefore tax receipts from local telephone companies are projected to resume their former downward trend after FY 2003, falling by 1.5% per year. This yields a forecast of $107.0 million in FY 2004 and $105.3 million in FY 2005.