

Implications of the Absence of a Use Tax on Utilities for Education Funding

Report Number 2003-124

January 2003

Prepared for
The Florida Senate

Prepared by
Committee on Finance and Taxation

[COMMENT1]

Table of Contents

Summary	separate document
Background	1
Methodology	2
Findings	3
Gross Receipts Tax and Deregulation in the Utilities Industry	3
Deregulation of U.S. Natural Gas Markets	3
Deregulation of Natural Gas Sales in Florida	6
Recent Developments in Natural Gas Deregulation in Florida	7
Natural Gas Deregulation and Its Effect on Gross Receipts Tax Revenue	10
Estimating the Revenue Impact of Out-of-State Gas Purchases	12
Impact on Public Education Capital Outlay Fund	13
Related Issues	15
Conclusions and Recommendations	17
Appendix	1
Appendix A – Natural Gas Transportation: Quantity and Revenue	3

Background

Section 203.01, F.S., imposes a tax of 2.5 percent upon the gross receipts of every person that receives payment for any utility service, defined in s. 203.012, F.S., as electricity for light, heat, or power; and natural or manufactured gas for light, heat, or power. Until 2000, utility service taxable under this law was defined to include telecommunications services, but ch. 2000- 260, L.O.F., specifically imposed a gross receipts tax on communications services, and telecommunications services were removed from the definition of utility service.

The gross receipts tax was created in 1931, and in 1963 the Florida Constitution was amended to place all gross receipts tax revenue in a trust fund for university and junior college capital outlay, and to allow bonds to be issued for this purpose. The Constitution was amended again in 1974 to allow gross receipts tax revenue to be bonded for public school capital outlay expenditures.

From 1931 until 1990 the gross receipts tax rate was 1.5 percent. In 1990 it was raised to 2.0 percent, on July 1, 1991, it was increased to 2.25 percent, and on July 1, 1992 it was increased to its present rate of 2.5 percent. Communications services are taxed at 2.37 percent.

Since 1990, deregulation of natural gas markets has allowed some consumers to purchase gas from out-of-state third-party suppliers or marketers. These purchases are not subject to the Florida gross receipts tax, and neither are charges for transportation of natural gas. Florida companies that sell natural gas are placed at a competitive disadvantage because their sales are taxed, and consumers who buy from Florida companies pay higher prices for natural gas. Funding for public education capital outlay is also reduced by the purchase of untaxed natural gas by Florida consumers.

Florida has not experienced deregulation in the wholesale or retail electricity markets, although the issue has been studied and legislation was filed in 2000 to create a study commission on electricity industry issues.¹ The bill did not pass, but Governor Bush used it as a model to create the Energy 2020 Study Commission by executive order. The Commission's purpose was to determine what Florida's electric energy needs will be over the next 20 years, and how best to supply those needs in an efficient, affordable, and reliable manner that will ensure adequate electric reserves. It appears that deregulation of the electric industry in Florida is not imminent, but when it does occur it will create a situation parallel to that in the natural gas industry, with unequal taxation of electricity bought from in-state and out-of-state providers.

¹ SB 2020, By Senator Tom Lee (2002 Regular Session)

Methodology

Staff collected information on changes in national and Florida natural gas markets since deregulation was introduced, and used data from the Public Service Commission, the Florida Municipal Natural Gas Association, and certain municipal gas utilities to determine the extent of untaxed purchases. Information on natural gas prices was taken from the Energy Information Administration/Monthly Energy Review September 2002. This information, plus gross receipts tax revenue history and forecasts, was used to estimate the magnitude of tax loss resulting from these untaxed purchases and its impact on PECO funding.

Findings

Gross Receipts Tax and Deregulation in the Utilities Industry

When the gross receipts tax was enacted, and for most of its history, utility services were provided by regulated monopolies. The gross receipts tax was a stable revenue source, and collection of the tax from utility providers was efficient and easy to administer. Even though the statutory imposition of the tax is on the person who receives payment for any utility service, it is understood that the tax is passed on to consumers of the utility services, and the law provides for separately stating the tax on the customer's bill. (S. 203.01(4), F.S.) The law also provides for taxation of electricity produced by cogeneration or by small power producers, or any person other than a cogenerator or small producer who produces electrical energy for his or her own use. (S. 203.01(1) (d) and (e), F.S.)

There is no gross receipts tax imposed on electricity or natural or manufactured gas purchased outside the state for use in the state. Retail sales of electricity have not been deregulated in Florida, and are unlikely to be deregulated in the immediate future², but natural gas purchases outside the state for use in the state have been occurring since 1990, and have become a significant part of the market. These sales are not subject to gross receipts tax, and this creates significant problems:

- There is unequal treatment of natural gas users, with those who purchase from local distribution companies paying a price that includes tax and those who purchase from third-party suppliers or marketers outside the state paying a lower, untaxed price;
- Local distribution companies are disadvantaged compared to out-of-state suppliers; and
- Funding for school construction is reduced.

Deregulation of U.S. Natural Gas Markets

When the gross receipts tax was enacted, and for many years thereafter, natural gas was provided by local distribution companies (LDCs), which were monopoly providers in their markets and which were regulated by the states where they were doing business. Prices charged by these businesses were set by public service commissions, and competition was limited. Deregulation of natural gas markets

² See "Review of Florida's Wholesale Electricity Market," Report Number 2002-147, prepared by the Florida Senate Committee on Regulated Industry.

began in 1978 when, responding to problems of interstate natural gas shortages, Congress enacted the Natural Gas Policy Act and began the process of deregulating the price of natural gas. This law provided for the phased decontrol of natural gas wellhead prices. Consumption of gas increased as prices fell, but the act did little to promote and expand access to the wellhead market for gas.

In 1985, the Federal Energy Regulatory Commission (FERC) developed new regulations for interstate pipelines, which changed their role in the delivery of natural gas. Order No. 436 instituted open-access, non-discriminatory transportation of natural gas. It allowed downstream customers to buy gas from entities other than the pipeline owners. The deregulation of wellhead prices was completed when Congress enacted the Wellhead Decontrol Act of 1989. The House Committee on Energy and Commerce Report stated that FERC's current competitive open access pipeline system should be maintained, and urged FERC to improve "the competitive structure in order to maximize the benefits of decontrol."³

Order No. 436 allowed natural gas pipelines to phase in transportation service, and most took advantage of the opportunity. In 1992, FERC issued Order No. 636 which mandated open access by requiring the separation of natural gas sales and transportation services. Pipelines could no longer sell gas. The purpose of these orders was to end the pipelines' monopoly of natural gas and bring gas prices in line with cost of production.

The market for natural gas comprises producers, pipeline companies, storage companies, LDCs, marketers, and consumers. Some companies in the industry perform more than one function, but it is possible to segregate the market by functions typically provided by each market participant.⁴

Producers are firms that explore for new gas resources and produce gas from existing sources. The market for natural gas purchased from producers at the wellhead is unregulated; producers negotiate prices and delivery terms with final consumers or with other firms, such as marketers and LDCs. Some natural gas moves directly to transmission pipelines, the rest is processed to remove noxious gases and separate out hydrogen and light hydrocarbon liquids for sale to other industries.

³ *United Distribution Companies v. Federal Regulatory Commission*, 88F. 3d 1105, 1125 (U.S. App. D.C. 1996), citing H.R. Rep. No. 29, 101st Session. 6 (1989), as cited in FL PSC Memorandum dated Feb. 3, 2000 re Docket No. 96075-GU – Proposed Rule 25-7.0335, F.A.C.

⁴ *U.S. Natural Gas Markets: Recent Trends and Prospects for the Future*, (Washington, D.C., Energy Information Administration Office of Integrated Analysis and Forecasting, May 2002) p. 2.

Pipeline companies connect to the natural gas production facilities or processing plants and deliver gas to their customers. Pipeline companies do not own the gas they deliver, but instead sell the service of transporting gas from suppliers to storage firms, which have developed facilities to store natural gas for later use, LDCs, or end-use customers.

LDCs (local distribution companies) are companies that control local natural gas distribution facilities. Historically they were local monopoly natural gas utilities whose rates were regulated by state public utility commissions. Since deregulation, they may function as transporters of gas owned by end-use customers, or they may be both sellers and transporters of natural gas. Transportation customers may also choose to have the LDC to provide scheduling, fuel acquisition, and delivery functions (the “merchant” function) for them.

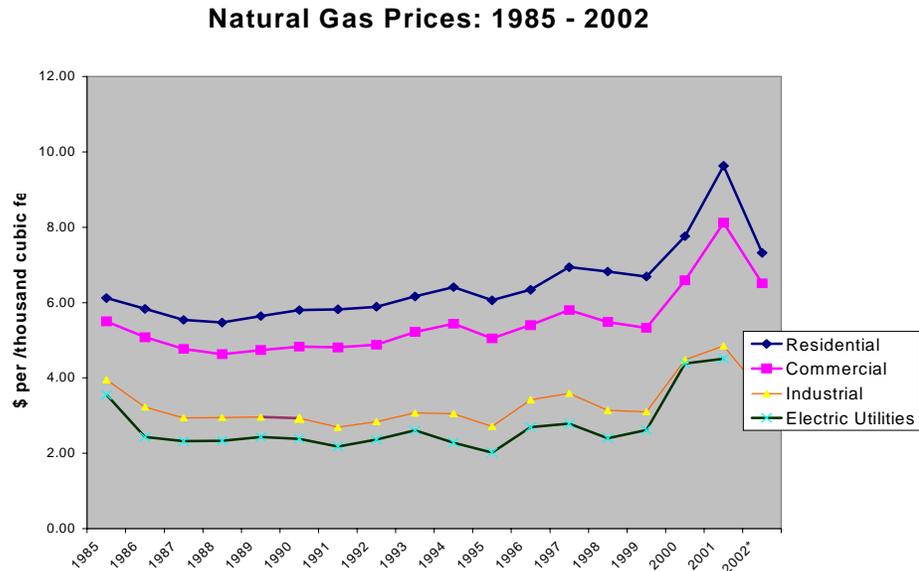
Marketers are unregulated firms that typically perform the “merchant” function for natural gas customers, usually offering a package of supply, storage, and pipeline delivery services. The number of marketers has increased substantially since FERC Order 636 separated the merchant and transportation functions. Marketers are often affiliated with pipeline companies, LDCs, or producers.

Natural gas consumers include industrial, commercial, and residential users and electricity generation facilities. The table shows United States consumption by sector for 2000.⁵

Sector	Market Share
Industrial	39 %
Commercial	16 %
Residential	24 %
Electricity Generation	21 %

⁵ *Ibid.* p. 5.

The chart below shows average U.S. prices for each user category since 1985.



Source: Energy Information Administration/Monthly Energy Review September 2002

Deregulation of Natural Gas Sales in Florida

In 1990, the Florida Public Service Commission began to accommodate new competition for local distribution companies in supplying end-users in local markets by approving the purchase of natural gas by an end user from a source other than its local distribution company. It became possible for large users of natural gas to purchase from outside the state through a marketer. The end-user paid the marketer for the gas and separately paid a Florida business to deliver it.

In 1996, a rule was proposed by the PCS to require Florida's investor-owned natural gas companies to offer transportation service to all nonresidential customers. In 2000, rule 25-7.005, F.A.C., was adopted. It provides all non-residential natural gas customers with the option of purchasing gas directly from a supplier other than the utility serving the territory where the customer is located. It also allows utilities to offer transportation of natural gas to residential customers when it is cost-effective to do so.

The market response to these regulatory changes has been dramatic. In 1990, seven percent of all natural gas provided by investor-owned companies was transported. By 1994, 55 percent of all gas provided by these companies was transported, and this figure rose to 71 percent by 2001. There are seven investor-owned natural gas utilities in Florida. In 2001 five of them offered transportation as well as sales, and transported gas accounted for 71 percent of total throughput. Peoples, City Gas, and Chesapeake, the three largest gas utilities, each transported more gas than they sold.

Natural Gas Transported by Investor-Owned Utilities

	Total Volume of Natural Gas Usage (Therms)	Percentage of Total Usage Transported
1988	681,939,592	0.00%
1989	730,035,555	0.00%
1990	781,345,470	7.04%
1991	864,473,469	32.77%
1992	900,605,886	42.97%
1993	918,589,581	48.49%
1994	1,087,701,978	55.20%
1995	1,305,351,729	57.40%
1996	1,165,824,080	55.35%
1997	1,223,889,734	61.34%
1998	1,224,890,859	60.87%
1999	1,382,389,846	67.47%
2000	1,460,828,983	68.80%
2001	1,430,225,897	71.09%

Source: FL PSC

At least 7 of Florida's 31 publicly-owned natural gas companies provide transportation services for some customers. In FY 2001-02, More than 41 million therms (one therm = 100,000 cubic feet) of natural gas were transported by these public utilities.⁶

Recent Developments in Natural Gas Deregulation in Florida

In the spring of 2002, the Florida division of Chesapeake Utilities Corporation and Indiantown Gas Company petitioned the PSC to allow them to convert all

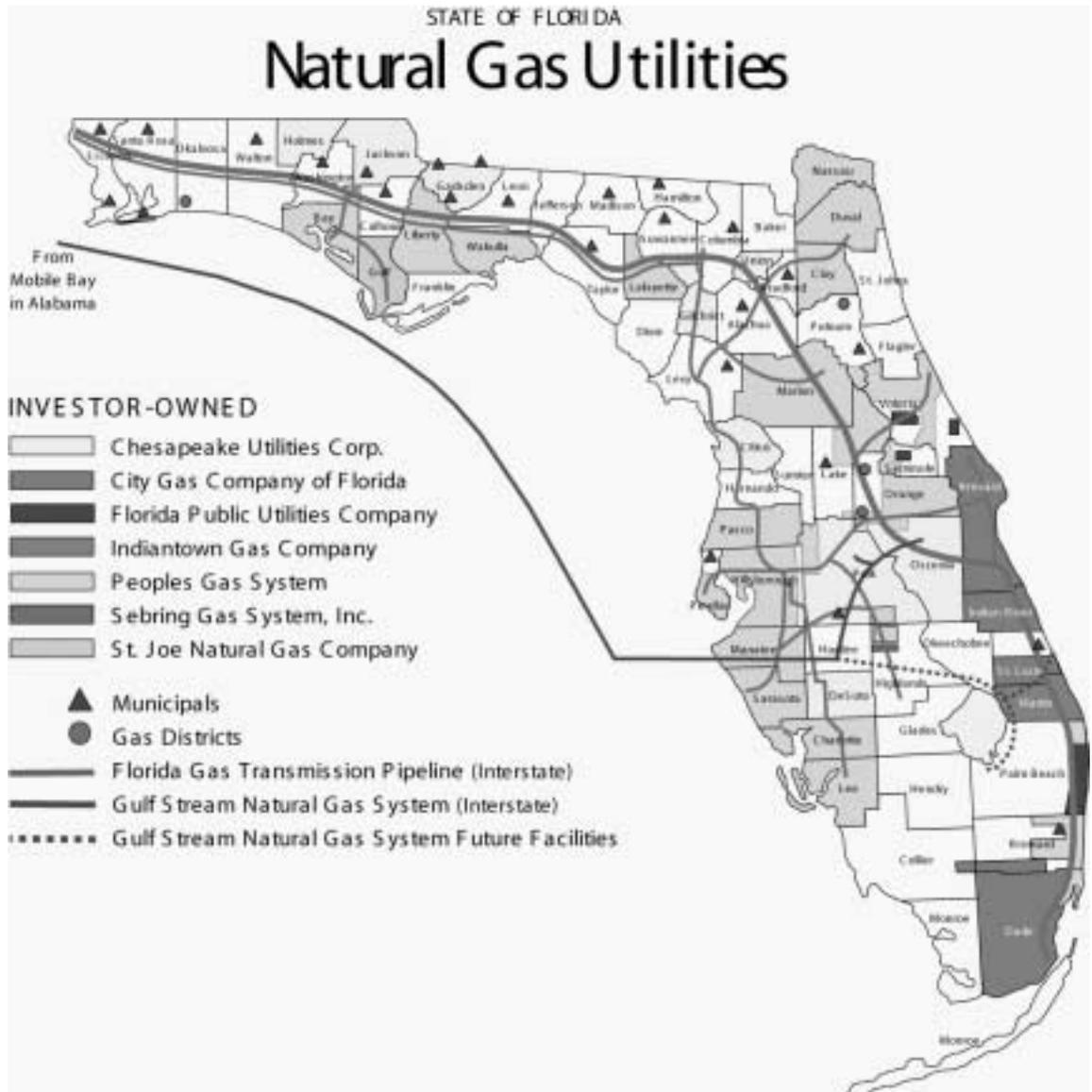
⁶ Based on a survey of members of the Florida Municipal Natural Gas Association

remaining sales customers to transportation service and to exit the merchant function. When Rule 25-7.0335 was adopted by the PSC in 2000, the Florida Division of Chesapeake Utilities Corporation offered transportation service to non-residential customers that accounted for approximately 70 percent of the company's total system throughput. By the end of 2001, more than 96 percent of the company's total throughput of natural gas was transported from out-of-state vendors. The company's remaining sales customers included 663 low-usage non-residential customers (representing 2.5 percent of total throughput) and 9,587 residential customers (representing 1.5 percent of throughput). At this small level of sales service, the company asserted that it would be increasingly difficult to sell gas at competitive prices. Indiantown Gas Company transported 30 percent of its total system throughput at that time.

Under the proposals, a Transitional Transportation Service would be established to facilitate the conversion of the remaining sales service customers to aggregated customer pools. These pools would be administered by qualified gas marketers, who would be capable of combining the gas supply requirements of customers in the pools with other customers served by the Pool Manager, both on and off Chesapeake's and Indiantown's distribution systems. The proposals suggested a three-phase process, beginning with a two-year period during which each company's sales customers would receive gas supply service through one qualified Pool Manager selected by the companies, and allowing the customers to choose one of two pricing options: a monthly indexed price or a fixed price. The second phase would expand the choices available, and in the final phase customers would be free to choose any Pool Manager authorized to deliver gas on the companies' distribution systems, and prices and other terms would be negotiated with no constraints imposed by the companies.

In November 2002, the PSC approved⁷ the first phase of the petitions, and authorized Chesapeake and Indiantown to convert all remaining sales customers to transportation service and to terminate merchant function as an experimental and transitional pilot program. The companies are required to provide interim reports after the first year of the program as well as final reports at the end of two years.

⁷ PSC-02-1646-TRF-GU and PSC-02-1655-TRF-GU



Source: FL PSC

Natural Gas Deregulation and Its Effect on Gross Receipts Tax Revenue

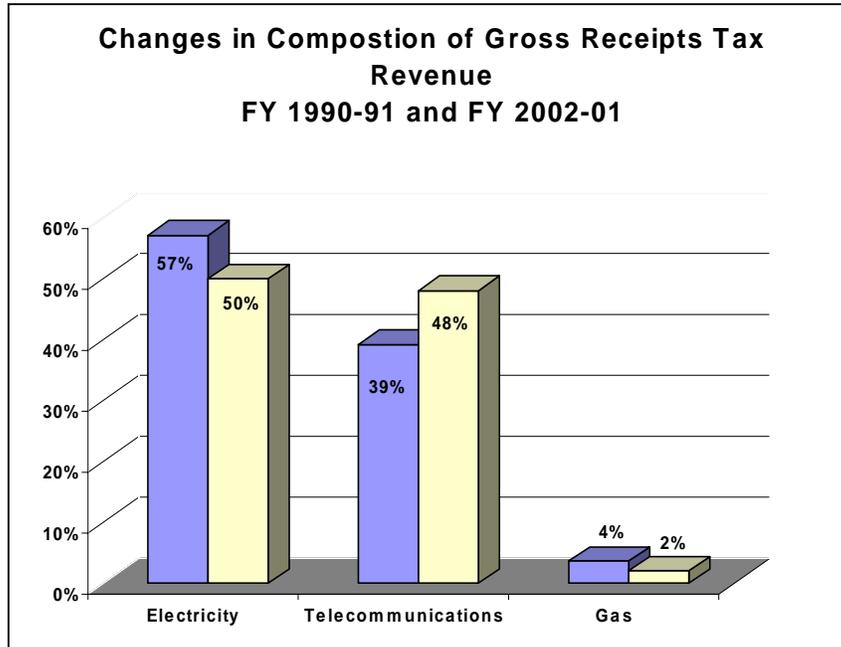
Until 1990, all natural gas purchases in Florida were made from local distribution companies that owned the pipelines through which the gas was delivered to the final consumer. The origin of the gas did not matter to the final consumer, because a Florida gas company bought the gas that flowed through its transportation system and resold it to the consumer. The price of natural gas included any costs associated with transporting it to the end-user, and gross receipts tax was calculated on the entire cost of the delivered product.

Changes adopted in 1990 allowed Florida customers to purchase gas from out-of-state vendors. In these transactions, the purchase of gas was not subject to gross receipts tax because the tax is on the vendor, which was not a Florida business. A 1992 Technical Assistance Advisement by the Department of Revenue⁸ stated that the gross receipts tax was not applicable to charges for transportation services only, because the statute imposes a tax on persons who receive payment for a utility service, and transportation does not meet the statutory definition of utility service. Because of changes due to deregulation, the gross receipts tax base has been significantly reduced. Since 1990 the amount of natural gas purchased from out-of-state suppliers has grown to over 70 percent of all gas supplied by privately-owned companies.

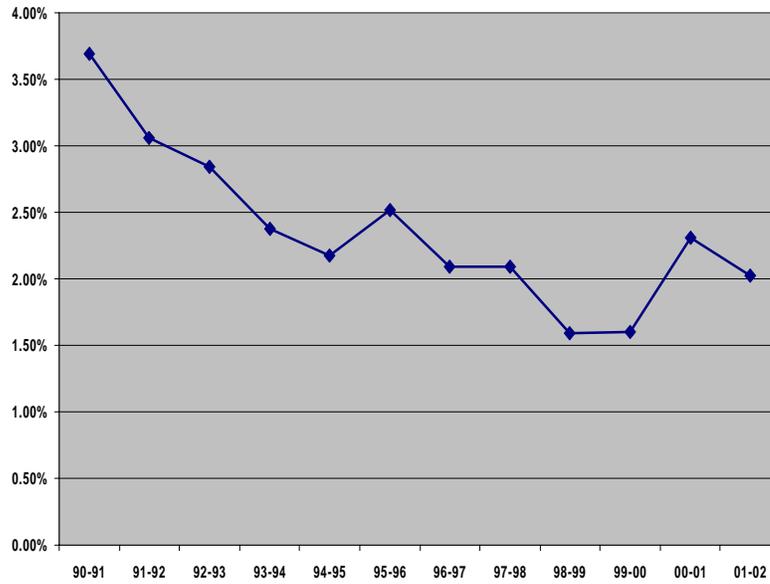
Purchase of natural gas from outside the state is no longer limited to large end-users. Rule 25-7.0335, described above, requires Florida's investor-owned natural gas utilities to offer transportation service to all non-residential customers and authorizes the transportation of natural gas to residential customers when it is cost effective to do so.

The effect of changes on the way natural gas is sold in Florida can be seen in the state's gross receipts tax revenue history. Gross receipts tax revenue has grown by almost 270 percent since 1985-86 (including rate increases in 1990, 1991, and 1992), but receipts from natural gas have grown much more slowly. In FY 1990-91 gross receipts tax revenue attributable to natural gas was 3.7 percent of total collections. This percentage has trended downward since then, and by 2001-02 it had fallen to 2 percent of total gross receipts tax revenue.

⁸ TAA#92(b)6-001



Percent of Gross Receipts Tax from Natural Gas



Source: FL Revenue Estimating Conference Gross Receipts Tax Revenue Estimate, Oct. 2002.

Estimating the Revenue Impact of Out-of-State Gas Purchases

The revenue impact of out-of-state natural gas purchases can be estimated by looking at the quantity of transported gas and estimating how much tax revenue would be generated if it were sold by in-state suppliers. The Florida Public Service Commission provided data for the quantity of gas transported and transport revenue received by investor-owned utilities. Additional information was supplied by municipal utilities.

Estimation Methodology: The quantity of gas transported by Florida utilities for each calendar year is converted to fiscal years and multiplied by the national average price for industrial gas users in that year.⁹ This amount is multiplied by the appropriate gross receipts tax rate for that period, to estimate the revenue loss associated with the sales price of the untaxed gas consumed in Florida. The revenue earned by utilities for transporting this gas is also converted to fiscal years and multiplied by the appropriate gross receipts tax rate. The sum of these estimates for each year is the estimated gross receipts tax loss.

Potential sources of error in the estimate: Assuming that the price paid for gas by these customers was the national average price for industrial users may understate the actual price, especially in later years as commercial end-users have switched to transported gas. These purchasers would have paid higher prices for natural gas than industrial users, and the associated loss in gross receipts tax is greater. Since 1985, the national average commercial gas price has been 80 percent higher than the industrial price, and the average residential price has been 100 percent higher. Another potential source of error is that some transported gas goes directly to end-users and is not distributed by local utilities. The available data do not allow inclusion of these purchases. A final potential error is that available survey data may not include all transportation by municipal utilities.

⁹ Table 9.11 Natural Gas Prices, Energy Information Administration/ Monthly Energy Review September 2002, p. 133.

Estimated Gross Receipts Tax Revenue Loss from Out-of-State Natural Gas Purchases (\$ millions)

Fiscal Year	Value of Out-of-State Purchases	GRUT Loss on Out-of-State Purchases	Transportation Charges Not Subject to Tax	GRUT Loss on Transportation Charges	Total GRUT Loss
88-89	0.0	0.0	0.0	0.0	0.0
89-90	8.1	0.1	4.1	0.1	0.2
90-91	47.9	1.0	13.6	0.3	1.2
91-92	97.0	2.2	21.5	0.5	2.7
92-93	128.8	3.2	23.4	0.6	3.8
93-94	166.3	4.2	31.2	0.8	4.9
94-95	199.2	5.0	27.5	0.7	5.7
95-96	218.4	5.5	27.2	0.7	6.1
96-97	252.9	6.3	35.5	0.9	7.2
97-98	259.4	6.5	36.8	0.9	7.4
98-99	267.9	6.7	50.0	1.2	7.9
99-00	380.1	9.5	47.1	1.2	10.7
00-01	487.9	12.2	82.7	2.1	14.3

Based on FL PSC Annual Gas Reports, data supplied by municipal gas utilities, and U.S. Natural Gas Prices reported in the Energy Information Administration/Monthly Energy Review September 2002

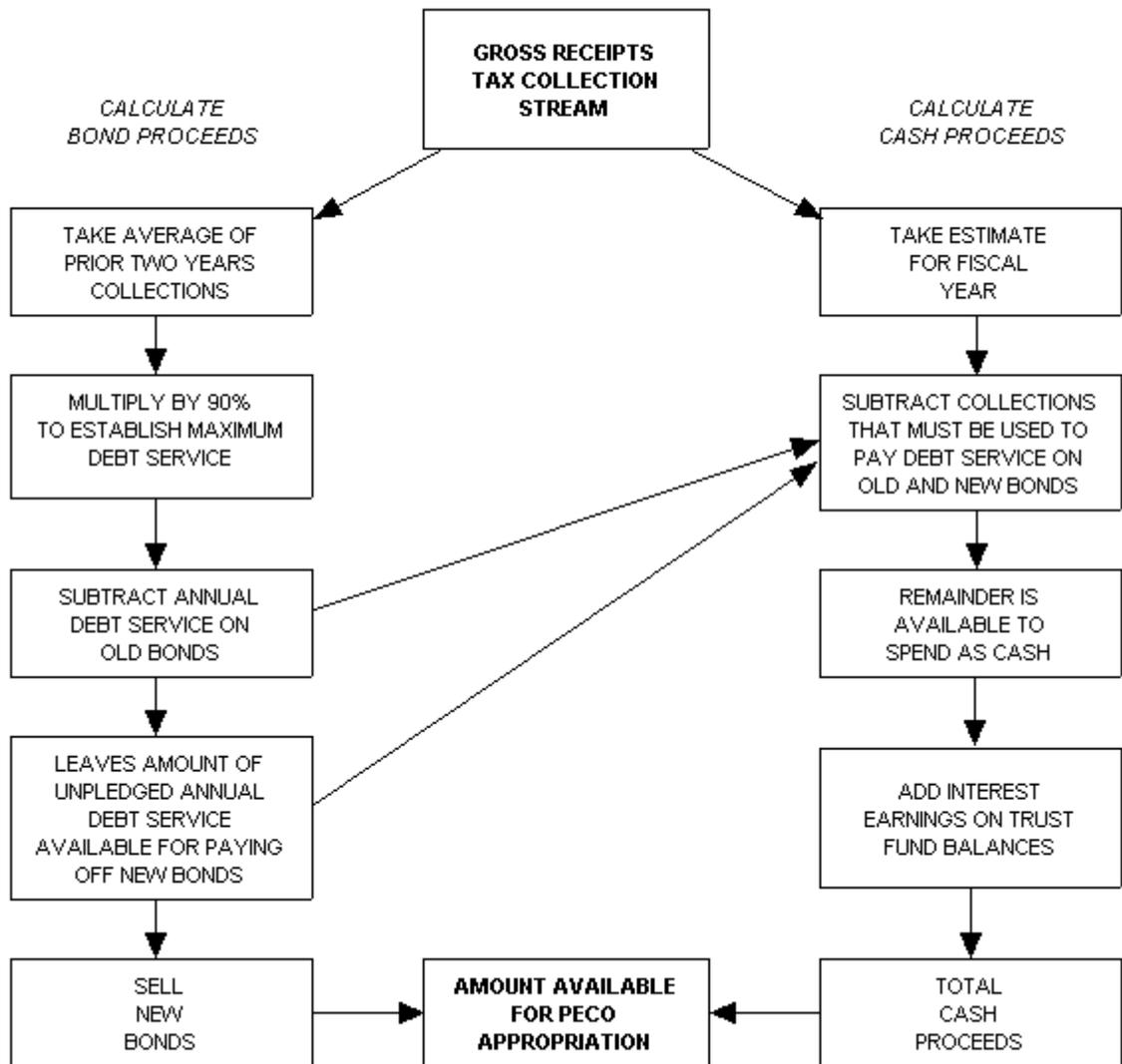
Impact on Public Education Capital Outlay Fund

The Florida Constitution provides that gross receipts tax revenue must be placed in the Public Education Capital Outlay (PECO) Fund, and used to pay for capital projects at universities, community colleges, vocational technical schools, or public schools. These capital projects may be financed by bonds pledging the full faith and credit of the state, and the amount of bonds issued may not exceed 90 percent of the average amount of gross receipts tax revenue from the two preceding years.

Available PECO funds for any given year are made up of bond proceeds and cash proceeds. Both estimates begin with the Gross Receipts Tax. The maximum debt service capacity is determined and the amount of already existing debt is subtracted, leaving the amount available to support new bonds. The state then sells the new bonds and places the proceeds in the trust fund for spending on a set

of projects which are stipulated in the Appropriations Act. Any tax collections not needed for paying debt service can be spent as cash. These remaining tax collections are combined with interest earnings of the trust fund to pay for the remainder of the PECO appropriation.

HOW THE GROSS RECEIPTS TAX BECOMES A PECO APPROPRIATION



In a normal year, most of the amount available for PECO spending (about 75%) comes from the sale of bonds. It is important to remember that a PECO bond sale is made each year, which obligates a portion of the Gross Receipts Tax collection stream into the future. In other words, the state gives up a portion of the future tax

collections in order to enjoy the benefit of having a larger amount to spend on projects in the present. At current interest rates and bond terms, this means giving up about \$1 in revenue for 30 years for every \$15 that is spent today. Thus it can be seen that as time goes by, most of what is collected by the tax is not available for PECO projects, but instead must be paid as interest on the outstanding bonds. This also means that since the state sells the maximum amount of bonds it can each year, the ability to sell additional bonds the following year is dependent on there being an increase in the tax collections. When the tax collections increase, there is additional money available to pay the interest on new bonds. If tax collections were to stay constant, there could be no new bond sales. Since most of the PECO appropriation is derived from the sale of new bonds, it is easy to see that the tax source must grow if there is to be significant funding for the PECO program.

The loss of natural gas sales from the gross receipts tax base has reduced the amount of growth in the tax source, and reduced the amount revenue available to fund new school construction. The estimated lost gross receipts tax revenue could have supported an additional \$167 million in PECO appropriations from FY 1990-91 through FY 2000-01. The increased bonding capacity from collecting tax on the value of untaxed delivered gas today is approximately \$300 million.

Related Issues

Purchases of natural gas from out-of-state third-party suppliers or marketers, and potential deregulation of retail electricity markets, may erode local government revenue as well as revenue that accrues to the state. The public service tax (commonly referred to as the “municipal utility tax”) is based on utility purchases in a municipality or charter county, and franchise fees are traditionally negotiated as a percentage of a company’s gross receipts.

Municipalities and charter counties are authorized under s. 166.231, F.S., to levy a public service tax on the purchase of electricity, metered natural gas, liquefied petroleum gas either metered or bottled, manufactured gas either metered or bottled, and water service. This tax may be at a rate up to 10 percent, and is limited to purchases to purchases in the municipality or charter county. This tax does not include a use tax provision, and out-of-state marketers or third-party providers have been able to avoid collecting the tax.

Franchise fees are generally negotiated between a local government and a utility operating within its boundaries as compensation for use of public rights-of-way. The traditional rate for electric utilities has been 6 percent, but franchise fees have been negotiated above and below that rate.¹⁰ Franchise fees are usually negotiated

¹⁰ *State and Local Tax Considerations in Electric Utility Restructuring, Final Report,*

as a percentage of the gross receipts of the company. Franchise fees can represent up to 25 percent of a jurisdiction's general revenue and can be pledged.

Deregulation in the natural gas industry and potential deregulation of the electricity market allow consumers to buy from suppliers outside the state or jurisdiction without creating generating franchise fees, since the seller is not utilizing local government rights-of-way and those transportation and transmission facilities that use the rights-of-way are not receiving revenue for the electricity or natural gas being delivered.

Conclusions and Recommendations

Taxing natural gas purchased out-of-state differently from in-state purchases leads to three undesirable results: Florida companies that sell natural gas are placed at a competitive disadvantage because their sales are taxed; consumers who buy from Florida companies pay higher prices for natural gas; and funding for public education capital outlay is reduced when Florida consumers purchase untaxed natural gas.

This unequal taxation of natural gas purchases can be remedied by extending the existing gross receipts tax to the cost price of imported gas (generally known as a use tax) or by adding a per-unit tax on the distribution of natural gas. This committee is drafting legislation that would maintain the current gross receipts tax on natural gas sold by in-state companies. Gas transported by these companies would be subject to a per-unit tax, with the tax rate adjusted periodically for the market price, to maintain comparable taxation of gas purchased from in-state and out-of-state suppliers. Gas purchased from out-of-state suppliers that is not transported by Florida companies would be subject to tax on its cost-price, including transportation costs.

The draft legislation also includes parallel taxation of electricity. If Florida's electric industry is deregulated, the law will be in place to maintain a level playing field with respect to taxes.

Appendix

Appendix A – Natural Gas Transportation: Quantity and Revenue

	Investor-Owned Transported (therms)	Municipal and District Transported (therms)	Total Transported (therms)	Investor- Owned Transport Revenues	Municipal and District Transport Revenues	Total Transport Revenues
1990	55,028,426		55,028,426	\$4,127,159		\$4,127,159
1991	283,302,501	12,674,903	295,977,404	\$13,574,145		\$13,574,145
1992	387,008,574	16,063,889	403,072,463	\$20,721,232	\$741,410	\$21,462,642
1993	445,427,177	20,614,212	466,041,389	\$22,364,771	\$1,014,852	\$23,379,623
1994	600,391,334	20,709,101	621,100,435	\$30,169,203	\$984,755	\$31,153,958
1995	749,309,105	21,517,491	770,826,596	\$26,798,633	\$707,012	\$27,505,645
1996	645,301,087	21,126,360	666,427,447	\$26,460,180	\$750,270	\$27,210,450
1997	750,775,926	23,312,840	774,088,766	\$34,716,357	\$776,045	\$35,492,402
1998	745,550,218	21,498,440	767,048,658	\$36,244,265	\$585,278	\$36,829,543
1999	932,746,443	18,617,500	951,363,943	\$49,506,696	\$478,471	\$49,985,167
2000	1,004,985,842	33,529,990	1,038,515,832	\$45,991,927	\$1,110,492	\$47,102,419
2001	1,016,761,423	35,977,923	1,052,739,346	\$81,173,998	\$1,575,083	\$82,749,081

Source: FL PSC and Survey of members of Florida Municipal Natural Gas Association