FISCAL FOCUS

TOWARD DEREGULATION OF MICHIGAN'S ELECTRIC UTILITY INDUSTRY: WHAT SHOULD WE EXPECT?

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February 18, 1998

TO: The Members of the House of Representatives

Throughout the country, the electric utility industry is undergoing change as a result of state deregulation. This process is introducing competition into electric utility systems which, until recently, were exclusively state regulated and taxed as monopolies. Under deregulation, residential consumers as well as businesses will choose among various suppliers of electricity. Deregulation will tend to reduce the prices consumers pay for electricity, and market forces will supplant many of the government controls. It is also possible that states will need to redesign their tax systems to accommodate the revenue impact of deregulation.

This **Fiscal Focus**, "Deregulation of Michigan's Electric Utility Industry," examines issues surrounding the anticipated restructuring of Michigan's utility industry. It also provides an overall picture of the current status of deregulation of the utility industry in Michigan.

We appreciate the review and comments on the draft report which were provided by Mr. Robert B. Nelson, President, Michigan Electric and Gas Association; and Mr. Gerald Geml, Audit Supervisor, Electric Division, Public Service Commission.

This **Fiscal Focus** was prepared by Mitchell Bean, Senior Economist, and Marjorie Bilyeau, Tax Attorney. The report was formatted for publication by Jeanne Dee, Administrative Assistant.

Please call us should you have questions on this report.

James J. Haag, Director

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INTRODUCTION

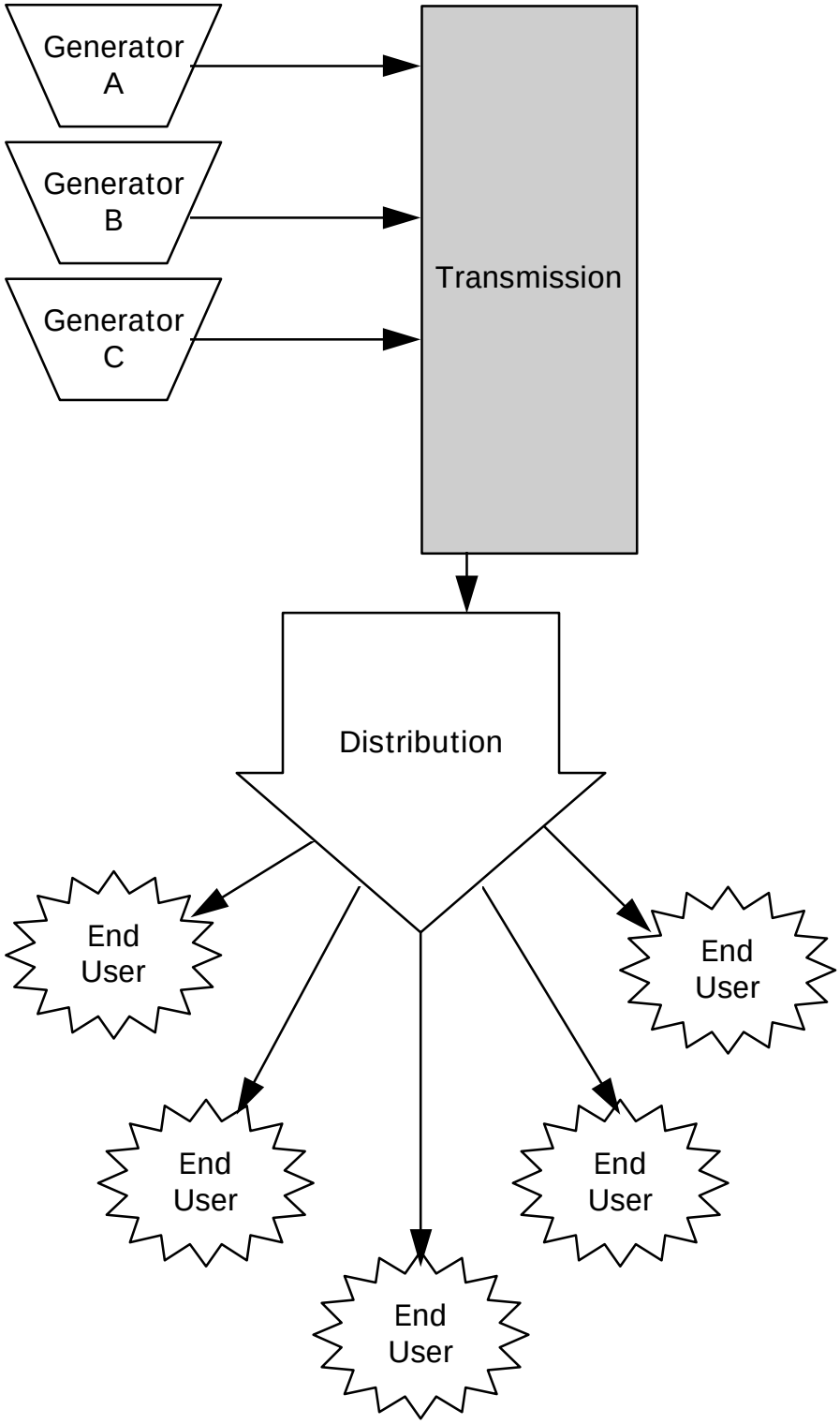
The electric utility industry in Michigan is in transition. Not only in Michigan, but throughout the country, deregulatory reforms are changing the electric utility industry from a traditionally regulated structure, to one that opens up new avenues for the generation, transmission and distribution of electricity. The changes are expected to have dramatic effects not only on the prices consumers pay for electricity, but also on the finances of state and local governments, utilities, and new competitors.

Under deregulation, residential customers as well as businesses are able to choose among various suppliers of electricity. Electric utility deregulation will restructure the industry by replacing control by government regulation with the market forces of competition. It is thought that by "unbundling" the separate and distinct functions of the electric utility industry, new suppliers can enter the market, leading to the creation of a more competitive market (i.e., lower prices) for electricity sales.

Where most electric utility companies in Michigan are now "vertically integrated," providing generation, transmission and distribution of electricity to customers, it is anticipated that new players will enter the market at many levels, making electricity cheaper and more abundant. Following are diagrams of the current industry structure and the way the structure of the electric utility industry is expected to evolve.

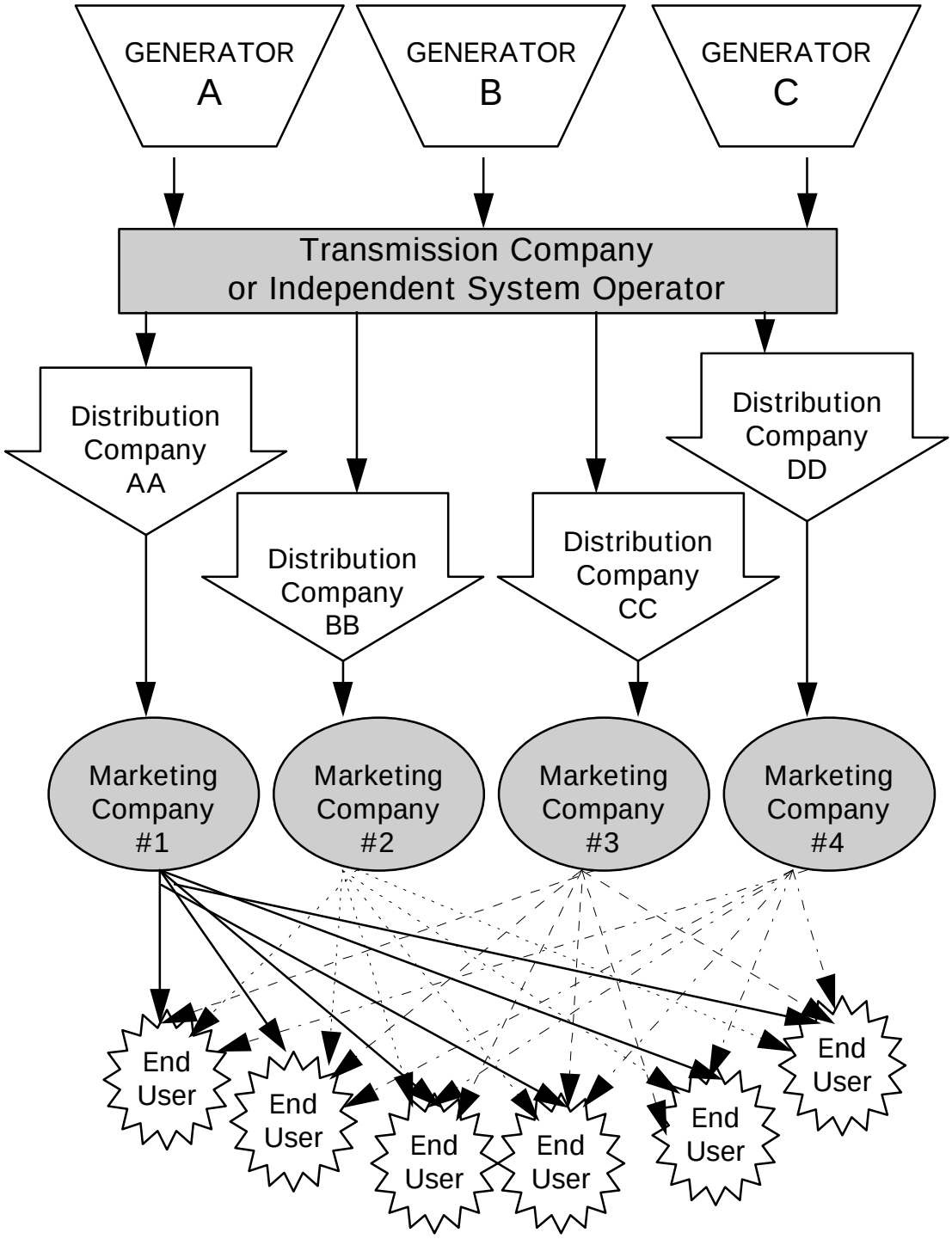
Because the deregulation of Michigan's electric utility industry is expected to have dramatic and long-range effects, it is important to understand several issues surrounding the anticipated restructuring. This **Fiscal Focus** will clarify some of the issues, while providing an overall picture of the current status of deregulation of Michigan's electric utility industry.

OLD ELECTRICITY INDUSTRY STRUCTURE



Adapted by House Fiscal Agency from *Energy Information Administration/Electricity Reform Abroad and U.S. Investment*.

RESTRUCTURED ELECTRICITY INDUSTRY



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A BRIEF HISTORY: THE DEREGULATION MOVEMENT IN MICHIGAN

In June 1997, the Michigan Public Service Commission issued an order opening up the state's retail electric market to competition.[1] This order phases in over time customer access to competitive electricity providers.

In addition, legislation was recently introduced in the Michigan House of Representatives that would restructure and deregulate Michigan's electric utility industry.[2]

These calls for deregulation mirror those being made across the nation, which arise from the Federal Regulatory Commission's (FERC) 1996 orders to implement "open access" to the nation's electric transmission lines.[3] Since that time, nearly every state in the nation has either proposed legislation for electric deregulation, or is now looking into such actions.

The original push for deregulation of the electric utility industry stemmed from the idea that such industries were no longer *natural monopolies* that required governmental regulation to keep consumer costs in check. A *natural monopoly* is one that supplies an area with virtually all of a product or service, because it possesses economic power to provide such goods or services at the lowest cost. A *natural monopoly*, in theory, leads to a situation whereby one existing supplier,

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[1] See Case no. U-11290 Electric Restructuring

[2] H.B. 5245.

[3] FERC Orders 888 and 889 were issued in April 1996 pursuant to the 1992 Energy Policy Act which mandated the deregulation of wholesale electricity sales, as well as interstate transmission of electricity. Retail electricity sales made within states are under state jurisdiction.

with costs going down as output increases, eventually lowers prices to such an extent that smaller competitors are eliminated. This can lead to a monopoly which is able to set the prices that all consumers will pay for the goods or services.

For necessities such as electricity, government regulation is a way to counterbalance the economic power of a natural monopoly, and to protect consumers from the high prices that could result. The view that an electric utility company is a natural monopoly has thus changed, and many economists now view competition in electric generation and distribution, as a desirable alternative to government regulation.[4]

[4] Peter Fox-Penner, ELECTRIC UTILITY RESTRUCTURING: A GUIDE TO THE COMPETITIVE ERA, Public Utilities Reports, Inc. Vienna, Virginia at 5.

MICHIGAN'S ELECTRIC UTILITY INDUSTRY: STRUCTURE AND SALES

Years ago, Michigan's electric utility industry was comprised of isolated plants providing power to localized areas. At that time, electricity could not be economically distributed over long distances. Gradually, technological developments allowed currents to be transmitted over longer distances. Among other factors, the great costs associated with the transmission over long distances, as well as the need to coordinate electric "loads" contributed to the *vertical integration* of electric utilities. A *vertically integrated* electric company is one that not only generates power, but also transmits and distributes it to retail customers. Most electric utilities in Michigan are *vertically integrated*, performing all three of these functions.

Today, the electric utility industry is divided into three major types: investor-owned, cooperatively-owned and municipally-owned. Most customers in Michigan are serviced by investor-owned companies such as Detroit Edison or Consumers Energy. In 1996, sales from investor-owned electric companies constituted 90.1% of total electric sales in Michigan, covering 88% of the state's customers.

Rural cooperatively-owned electric utilities supply electricity to 5.5% of Michigan electricity customers. There are currently 13 such systems in the state, serving about 226,000 customers. In 1996, Michigan sales from cooperatively owned electric systems were approximately $187 million.

Finally, 6.5% of Michigan consumers received electric power from public power systems owned by taxpayers of a city or district. Approximately $6.7 million in sales of electricity came from municipally owned systems in 1996.

Proponents of deregulation cite the current high costs of electricity in this state, compared to other Midwestern states. In 1996, average costs of electricity in Michigan were among the highest in Midwestern states. (See following table.)

Average Costs of Electricity in the Midwest for the 12 Months ending June 30, 1997

(Average cents/kWh)

	Residential		Commercial		Industrial		Total Retail Rates	
	1997	**1996**	**1997**	**1996**	**1997**	**1996**	**1997**	**1996**
Michigan	8.38	8.17	7.78	7.76	5.07	5.14	6.88	6.89
Illinois	11.02	10.80	8.20	8.01	5.69	5.57	7.78	7.67
Indiana	6.91	6.68	5.99	5.55	4.10	4.10	5.33	5.28
Ohio	8.96	8.77	7.78	7.72	4.65	4.76	6.70	6.74
Wisconsin	6.93	6.96	5.76	5.72	3.70	3.78	5.32	5.38
Midwest Average	8.74	8.58	7.39	7.24	4.67	4.71	6.60	6.59

Source: Edison Electric Institute

HOW MICHIGAN TAXES ITS ELECTRIC UTILITIES

There are three basic State-level taxes that are applied to electric companies in Michigan:[5] the single business tax,[6] the property tax,[7] and the sales[8] and use tax.[9] In fiscal year 1996, these state taxes raised $734.8 million, as shown on the following table. Michigan electric utilities had approximately $6.68 billion in sales during this time period, making the overall effective tax rate of 9.1% of sales.

FY 1995-96 Taxes from Electric Utilities Industry

Single Business Tax	$65.0 million
Property Taxes	$416.0 million
Sales/Use Taxes	$253.8 million

Source: Michigan Electric and Gas Association (MEGA)

[5] This does not include taxes related to personal income of electric utility industry employees, taxes on investment income generated by utilities securities, taxes for special funds such as unemployment taxes. This also excludes the Industrial Facilities Tax which is paid in lieu of the general property tax for up to 12 years after completion of facilities, located within plant rehabilitation or industrial development districts, that are granted exemption certificates. MCL 207.551, *et seq.*; MSA 7.800(1), *et seq.*; 1974 PA 198. It also excludes the Uniform City Utility Users tax, the basis of which is the privilege of consuming, among other things, electric services in a city of 1,000,000 or more. MCL 141.1151, *et seq.*; MSA 5.3188(251); 1990 PA 100.

[6] MCL 208.1, et seq.; MSA 7.558(1), et seq.; 1975 PA 228.

[7] MCL 2.11.1 et seq.; MSA 7.1 et seq.; 1893 PA 206; MICH. CONST. art. IX, §3, §6.

[8] MCL 205.51, *et seq.*; MSA 7.521 *et seq.*; 1933 PA 167; MICH. CONST. art. IX, §8.

[9] MCL 205.91, *et seq.;* MSA 7.555(1) *et seq.*; 1937 PA 94; MICH. CONST. art. IX, §8.

THE SALES TAX AND UNBUNDLING

Under deregulation, the sale of electricity would be *unbundled*. That is, various components of electricity production, delivery, and service would be separated and priced individually. The advent of electric utility degregulation raises two important issues:

How will these individual components be taxed?

Will there be an erosion of the State's sales tax base?

Under Michigan's General Sales Tax Act, the retail sale of electricity is taxed generally at 6%, or at 4% for residentially-used electricity. The retail sale of electricity is not statutorily defined, but includes a charge on the entire "bundle" of services such as generation, transmission, and distribution.

Deregulation could potentially erode the sales tax base because the sale of electricity itself would be separated from other charges for transmission and distribution that presently account for a large portion of the customers' bills. Deregulation potentially could exempt services[10] such as transmission and distribution from the sales tax; these services are now being taxed and included as the "retail sale of electricity." To prevent such a result, a legislative change to the Sales Tax Act would have to be made, permitting the sales tax to be applied to services such as transmission and distribution of electricity.

A second area of concern is the possible erosion of sales tax that may result from a significant price reduction in the sale of electricity. It is acknowledged that a drop in the price of electricity will be partly offset by a corresponding increase in the consumption of electricity, at least in the long run. Over time, as electricity gets cheaper, people and industries will purchase more electrical equipment and

[10] The sales tax is not imposed on most services under Michigan law.

will increase reliance on this form of energy. In the short run, however, demand for electricity will tend to be steady and consumption may not respond quickly to changes in price. Therefore, it is anticipated that the state may experience loss of sales tax revenues in the short run, based on Michigan's current sales tax laws. Proposals made in other states facing similar threats of lost revenues include taxing consumers of electricity according to how much electricity is used (rather than on the corresponding sales) or taxing all forms of energy consumption used in the state.

STRANDED INVESTMENT COSTS

A major stumbling block in the deregulation process is that of so-called *stranded costs* that could result from a move to a more competitive market. *Stranded costs* are expenses associated with utilities' past investments. These costs arise out of deregulation and are related either to the inability to recover prior investments in assets, or to deferred costs that become unrecoverable due to changes in the electric market. Examples include nuclear power plant assets and investments for updating plants and equipment made by utilities in reliance on the current rate structure. When customers are able to seek out lower-cost electricity suppliers, some existing utilities could be left with *stranded costs*.

Estimates for stranded costs in Michigan that would result from deregulation of the electric utility deregulation, range from $1 billion to $7.0 billion.[11] The Public Service Commission has estimated the stranded costs of the two largest suppliers to be $4.2 billion.[12] The issues are:

How should these expenses be allocated?
Who should bear the costs; ratepayers, utility shareholders, or taxpayers?

One suggestion has come from existing utilities and from some legislators. Known as "securitization," this option would sell bonds equal to the amount of the estimated stranded costs. Bondholders would then be repaid over time from a monthly charge that would be imposed on electric customers. Such a plan for recovering stranded costs would, among other things, allow either transition or transaction fees for stranded costs to be charged to customers over a certain period of time. Critics of these types of plans argue, however, that responsibility

[11] See Adam D. Thierer, *Consumers Should be Wary of "Securitization*," DETROIT FREE PRESS, October 16, 1997.

[12] Commission's Order, Case #11290, Jan. 14, 1998.

for stranded costs should be borne solely by utility shareholders rather than by utility consumers.[13] Some believe that the sale of bonds for stranded costs would provide utilities with a cash windfall at the outset of a plan that is designed to be market-driven.

[13] See Theirer at footnote 6.

FINANCIAL UNCERTAINTY FOR EXISTING UTILITIES

Related to stranded costs is the financial fallout that some utilities are expected to experience from deregulation and a more competitive market. Companies with existing high operating costs, long-term debt obligations and marginal returns may not be able to compete in a deregulated environment.

An example of how even the announcement of a deregulation plan can adversely affect a utility company can be found in New Hampshire, which conducted the nation's first pilot program for electric utility deregulation. This pilot program was deemed a success from a consumer's standpoint, because retail electricity rates were cut by 15% to 20%.[14] But the state's largest utility company, Public Service of New Hampshire, experienced dramatic drops in the utility's stock value after the deregulation plan was announced.[15] Public Service, which had previously filed for Chapter 11 bankruptcy protection and was committed under a reorganization plan to a certain level of revenues, obtained a temporary restraining order against deregulating, and New Hampshire's plans are now on hold.

[14] *Will Northeast Utilities Survive New Hampshire's Rate Cutting?*, THE NEW YORK TIMES, section D, Page 16 (October 16, 1997).

[15] According to an article in the New York Times, Public Service of New Hampshire's stock fell 17 percent in the two days following New Hampshire's order to deregulate. This amounted to a loss of $273 million in the company's market value.

EFFECTS ON LOCAL GOVERNMENTS

Electric generation plants have traditionally been important and stable sources of revenues for local communities. Not only are they typically large employers, but they generate significant local property tax revenues. If deregulation of the electric utility industry in Michigan were implemented, it is expected that some local communities would be "winners" while others would be "losers."

Some communities will reap benefits of new companies that are expected to form as the result of a competitive climate. In addition, some communities will benefit from certain existing utility plants that will thrive in a competitive market, such as those utilities that are able to minimize their stranded costs.

Although it is difficult to predict the precise outcome, it is anticipated that other communities may experience utility plant closings, loss of utility jobs, and the erosion of their tax base from decreased property values of certain utility plants. Because many communities rely on the taxes associated with, in particular, property valuations, the fiscal impact on some Michigan communities could be significant. New Hampshire, for instance, is facing a 30% reduction in local property tax revenues due to the decreased valuation of utility assets since electric deregulation was implemented.[16] With this in mind, it is understandable why many local communities in Michigan would like an electric utility restructuring plan that takes into account the serious fiscal consequences that deregulation will have on their communities.

[16] ELECTRIC UTILITY WEEK, December 22, 1997 at 13.

NEXUS

Another issue is that of *nexus* — whether a utility company has sufficient contacts with the state such that sales tax can be imposed, or use tax collection required, on behalf of a Michigan consumer. The idea behind *nexus* is that the responsibility for use tax collection can be imposed on out-of-state sellers only where certain constitutional requirements are met. In general, the issue is usually whether the seller has sufficient physical presence in the state.

Maintaining the requisite nexus with Michigan is important from the standpoint of sales and use tax collection. Deregulation and the change to a more competitive market means certain Michigan customers may obtain their electricity from out-of-state providers having no physical contact with the state.

A company that merely solicits customers by mail, for example, and delivers electricity from out-of-state generators, may not be considered to have nexus, and thus may not be required to collect use tax from Michigan customers. This could reduce electricity sales and use taxes collected by Michigan in a deregulated environment.

The lack of nexus with out-of-state suppliers also could reduce the Single Business Tax (SBT) collections. As mentioned above, the electric utilities have paid significant SBT to the state. In a competitive climate, out-of-state utilities would compete for Michigan customers, and in-state utilities would increase sales made to other states. For example, where electricity is generated by an out-of-state company having no nexus to Michigan, SBT would not be paid based on sales to Michigan customers.

Conversely, in-state utilities with sales out-of-state could apportion income away from the state; sales made to other states would *not* be *thrown back* based on current Michigan law, where the sales are made in a state with which the taxpayer has sufficient nexus. Where the target state either taxes the sales (because there

is sufficient nexus) or where the state doesn't tax sales but could have imposed an SBT-type tax[17] based on considerations of due process and the commerce clause, the sales are not *thrown back* to Michigan.[18]

[17] See MCL 208.42; MSA 7.558(42).

[18] See MagneTek Controls, Inc. v. Dept. of Treasury, 221 Mich App 400; 562 NW2d 219 (1997) citing Quill Corp. v. North Dakota, 504 US 298 (1992). In determining what portion of sales are attributed to Michigan for purposes of Michigan's formulary apportionment, a modified "sales destination" approach is used. Sales are "thrown back" and included in the numerator of the sales fraction of the apportionment formula where (1) the state where the goods were shipped did not subject the taxpayer to a business privilege tax, a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; and (2) the state where the goods were shipped would not have had jurisdiction to impose such taxes based on due process and commerce clause consideration.

CONCLUSION

Michigan's deregulation of its electric utilities will affect the price consumers pay for electricity, the revenues collected by the state, and the local government revenues. Structural changes will be brought about by deregulation, and many competing interests and policies will need to be reconciled.

One thing is clear: some deregulation and restructuring of Michigan's electric utility industry is occurring. How fast these changes proceed, and the precise course that will be taken, remain to be seen.

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