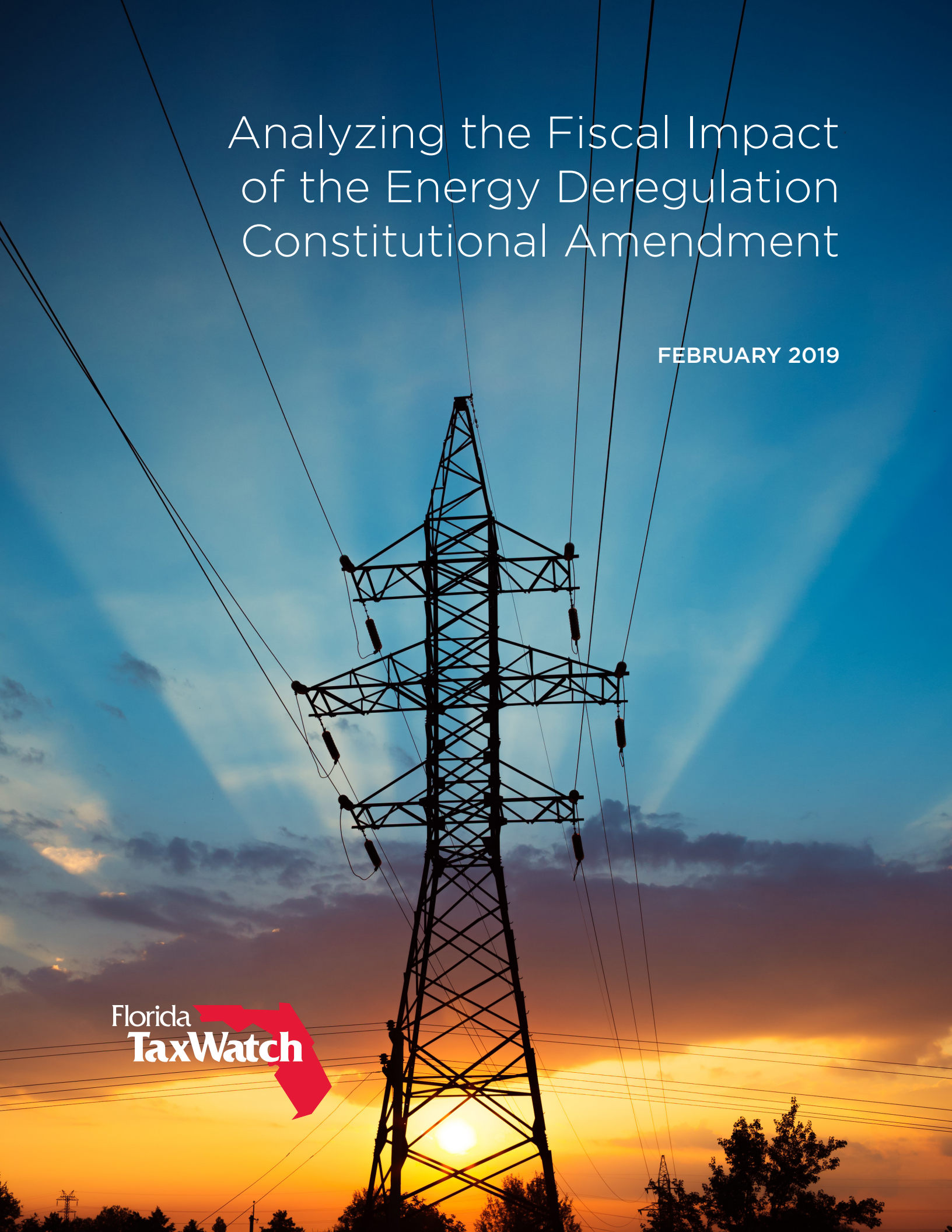
Analyzing the Fiscal Impact of the Energy Deregulation Constitutional Amendment

FEBRUARY 2019



Florida TaxWatch

Florida TaxWatch

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Senator Pat Neal
Chairman of the Board of Trustees

Dominic M. Calabro
President & Chief Executive Officer

Dear Fellow Taxpayer,

Electric power is vital for Florida's residents and businesses. We rely on electricity to power our modern lives and economy, and state and local governments generate significant revenue from the generation, distribution, and sale of electric power.

Currently, Florida electricity customers enjoy prices that are below the U.S. average for residential and commercial electricity. Yet, a proposed constitutional amendment initiative that would destructure Florida's energy market may appear on the November 2020 general election ballot that would (if approved) radically change Florida's energy market.

TaxWatch has undertaken this independent analysis to estimate the financial impacts of deregulation on tax revenues and to help Florida taxpayers better understand the effects of the proposed deregulation.

Discussions about improving such vital systems as Florida's energy market are healthy, and Florida TaxWatch is honored to offer this independent evaluation of this proposal; however, our long-held belief that the venue for considering such policy discussions should be the Legislature and not a constitutional amendment must be noted here.

TaxWatch is pleased to present this report and its findings and looks forward to engaging policymakers and taxpayers in informed discussion.

Sincerely,

Dominic M. Calabro

Dominic M. Calabro
President & CEO

Executive Summary

A proposed 2020 ballot initiative currently making its way through the process, if approved by 60 percent or more of the voters, would deregulate only the segment of Florida's energy market served by the investor-owned utilities (IOUs). Under the proposed language, IOUs would be limited to the construction, operation, and repair of electrical transmission and distribution systems, while municipal and cooperative utilities would have discretion whether to opt into competitive markets. The Florida Legislature would be required to create laws and regulations providing for competitive wholesale and retail markets for electricity generation and supply, and consumer protections, by June 1, 2023 and fully implement the new system by June 1, 2025.

There are a variety of significant tax and revenue implications of this amendment, and this Florida TaxWatch analysis finds that, unless very significant increases in the price of electricity for Floridians result, adoption of the proposed constitutional amendment will have a negative impact on state and local government revenues. These impacts have the potential to be relatively large. Of course, the Legislature and local governments can change the tax structure in an attempt to offset any revenue loss, but that road is fraught with peril.

This analysis provides estimates for both 2018 and 2026. The impacts were first estimated for 2018, the year of the latest tax data. Those estimates were then projected out to 2026—the expected first full year of implementation if the amendment were to pass. The estimates are as follows:

Potential Revenue Impacts by Source

	2018 Revenue Losses			2026 Revenue Losses		
	Low	Middle	High	Low	Middle	High
Electricity Franchise Fees (Local)						
Assumption 1	$171m	$341m	$512m	$190m	$380m	$568m
Property Tax (Local)						
Assumption 1	$18m	$27m	$35m	$26m	$71m	$50m
Assumption 2	$53m	$71m	$88m	$75m	$100m	$125m
Assumption 3	$68m	$95m	$122m	$97m	$135m	$174m
Assumption 4[A]	$105m	$151m[A]	$197m	$149m	$215m[A]	$280m
Gross Receipts Tax (State)						
Assumption 1	$14m	$24m	$33m	$16m	$26m	$37m
Assumption 2		$279m			$310m	
Public Service Tax (Local)						
Assumption 1	$43m	$86m	$129m	$48m	$96m	$144m
Sales Tax (State & Local)						
Assumption 1	$19m (State) $1m (Local) $20m (Total)	$37m (State) $2.5m (Local) $39.5m (Total)	$55m (State) $4m (Local) $59m (Total)	$21m (State) $2m (Local) $23m (Total)	$41m (State) $3.5m (Local) $44.5m (Total)	$61m (State) $5m (Local) $66m (Total)
State Total[B]	**$33m**	**$167m**	**$334m**	**$37m**	**$204m**	**$371m**
Local Total[C]	**$320m**	**$581m**	**$842m**	**$389m**	**$693m**	**$997m**
Potential Total	**$353m**	**$748m**	**$1,176m**	**$426m**	**$897m**	**$1,368m**

[A] Assumption 4 is a combination of the previous assumptions plus a loss of value from non-generation property, therefore the mid-point of assumption 4 represents the mid-point of the combination of the assumptions.

[B] State total includes the Gross Receipts Tax and State Sales Tax

[C] Local total includes the Franchise Fees, Property Taxes, Public Service Tax, and Local Sales Tax

Introduction

There are three major types of electric utility providers: municipal utilities, (rural) cooperative utilities, and investor-owned utilities. Municipal utility companies are "owned and/or operated by a municipality engaged in serving residential, commercial and/or industrial consumers, usually within the boundaries of the municipalities. The rates and revenues from the utilities are regulated by their city commission or an authority appointed by the city commission."[1] Cooperative utilities generally serve Florida's rural areas and are "joint ventures organized for the purpose of supplying electric energy to a specific area. The rates and revenues of rural electric cooperative utilities are regulated by their elected cooperative officers."[2] Investor-owned utilities, which collectively serve the majority of Floridians, are private companies that supply power directly to consumers in all areas not served by municipal or cooperative utilities while also generating power for their customers and to sell to the municipal and cooperative utilities at wholesale. "Investor-owned utility rates and revenues are regulated by the Florida Public Service Commission."[3, 4]

"There are three distinct components to the provision of electricity services: (1) generation (the actual production of electricity); (2) transmission (the transportation of large volumes of electricity at high voltage between the generating plant and the distribution system); and (3) distribution (the delivery of electricity to retail customers in a usable, low voltage form). Over the past century, Florida's electric industry has developed as a vertically-integrated industry, with electric utilities packaging the generation, transmission, and distribution of electricity and providing it to retail consumers in a single rate."[5]

Under Florida's current system, the retail price of electricity for consumers (Residential, Commercial, and Industrial) is below the national average. TaxWatch analysis of data compiled and provided by the U.S. Department of Energy's Information Administration (EIA) shows that Florida's residential rates are the lowest of the ten largest states in the country. Furthermore, the analysis shows that for the twenty years between 1997 and 2017, increases in retail electric prices in states with deregulated electricity markets and regulated states were about the same, and that the prices (per kilowatt-hour) for Residential, Commercial, and Industrial customers in regulated electricity markets (like Florida) are lower than the prices for Residential, Commercial, and Industrial customers in deregulated electricity markets.

"In November 2017, the Public Service Commission's *Review of the 2017 Ten-Year Site Plans* shows that the current supply of electricity in Florida is reliable, even during peak demand periods or unplanned plant outages. Moreover, either by statute or the PSC's approval of territorial agreements, all consumers in the state are assured electricity service regardless of their location or socio-economic status."[6]

1 CRC P51 Proposal Analysis, December 12, 2017.

2 CRC P51 Proposal Analysis, December 12, 2017.

3 CRC P51 Proposal Analysis, December 12, 2017.

4 The Florida Public Service Commission is a state body of appointed officials (with staff) that regulates rates, charges, territorial agreements, need for power plants, and much more regarding the generation, transmission, and sale of electricity. By law (Fla.Admin. Code R. ch. 25-6 (2000)), the Public Service Commission promotes "good utility practices and procedures, adequate and efficient service to the public at reasonable costs, and to establish the rights and responsibilities of both the utility and the customer."

5 CRC P51 Proposal Analysis, December 12, 2017 (page 4)

6 CRC P51 Proposal Analysis, December 12, 2017 (page 5, internal citations omitted from original)

While most states, 33 including Florida, have a regulated energy market, based on the general theory of electric power as an essential service for the well-being of society, buttressed by the industry's inherent propensity toward natural monopoly,[7] 17 states and the District of Columbia have since taken steps to destructure or deregulate[8] their retail markets for electricity since the early 1990s. Under a "deregulated" or "deconstructed" system, the price consumers pay for the transmission and distribution of electricity is generally still regulated but the price they pay for the actual electric power is not and customers choose their electricity provider from among any number of retail electricity suppliers available in their area.

An interest group named Citizens for Energy Choices is promoting a constitutional amendment initiative[9] that may appear on the November 2020 general election ballot. The proposed initiative, if approved by 60 percent or more of the voters, would deregulate only the segment of Florida's energy market served by the investor-owned utilities (IOUs); IOUs would be limited to the construction, operation, and repair of electrical transmission and distribution systems. Municipal and cooperative utilities would have discretion whether to opt into competitive markets. The Florida Legislature would be required to create laws and regulations providing for competitive wholesale and retail markets for electricity generation and supply, and consumer protections, by June 1, 2023 and fully implement the new system by June 1, 2025.[10]

The 2018 Florida Constitution Revision Commission considered a proposal (Proposal 51) similar to this proposed amendment. The Commission's "Proposal Analysis" found:

> *"The majority of states still follow the vertically integrated model that is currently used here in Florida. In those states that have experimented with restructuring their electricity markets, those efforts have typically occurred in states where electricity prices were disproportionately high and which had access to power supply sources from other states. Neither of those dynamics are present in Florida. As noted above, Florida's residential rates are below the national average and are the lowest of the ten largest states in the country. Moreover, Florida's peninsular geography constrains interties with other states and has 'resulted in an interstate interconnection system that has limited the state's competitive generation options (i.e., power sales to and power purchases from out-of-state utilities).'"*[11]

Proposal 51 was rejected by a 5-2 vote and died in the General Provisions Committee of the Constitutional Revision Commission in January 2018.

TaxWatch has undertaken this independent analysis to estimate the financial impacts of restructuring on public revenues, and to help Florida taxpayers better understand the effects of a competitive electric power market on their ability to secure reliable and reasonably-priced electricity.

7 See, e.g., Lazar, J. (2016), Electricity Regulation in the US: A Guide (second edition), Montpelier, VT, The Regulatory Assistance Project, Chapter 1: "The Purpose of Utility Regulation."

8 The terms "deregulate" and "restructure" mean essentially the same thing and are used interchangeably throughout this report.

9 Right to Competitive Energy Market for Customers of Investor-Owned Utilities; Allowing Energy Choice (Initiative Number 18-10).

10 Florida Division of Elections, "Right to Competitive Energy Market for Customers of Investor-Owned Utilities; Allowing Energy Choice (Initiative Number 18-10), retrieved from https://dos.elections.myflorida.com/initiatives/initdetail.asp?account=73832&seqnum=1, January 30, 2019.

11 CRC P51 Proposal Analysis, December 12, 2017 (page 5 internal citations omitted).

Effects of Restructuring Electricity on Tax Revenues

The energy market destructuring proposal would have significant and measurable impacts on the state and local tax revenues and likely even the structure of such taxes. While the impact could easily be measured after the fact, projecting those impacts, especially six years into the future (the proposal requires full implementation of the destructured system by June 1, 2025) is difficult.

The task is complicated by three main factors (in addition to Mr. Yogi Berra's astute observation that "predictions are hard, especially about the future"). First is the magnitude: in total, taxes and fees related to electricity generate nearly $4.5 billion for state and local governments. Second, many of the taxes are dependent on the price of electricity and/or the market value of real assets, both of which are difficult to forecast far into the future. Finally, there are some technical and legal issues that are unclear at this time – since the proposal does not specify the rules and regulations that will govern the destructured system but instead requires the Legislature to create them by June 1, 2023, the resulting revenue of the applicable tax laws and their application must be based on current law and assumptions of likely amendments thereto. It is likely some revenue sources will have to be restructured or new revenue sources implemented, but the response by future Florida Legislatures and local governments is unknown.

Changes in the price of electricity would impact revenues, since so much of the billions in taxes and fees paid by IOUs are based on the amount consumers pay or on the gross revenues of utilities, but the inconsistent outcomes across other states that have initiated deregulation and the probable allowance for recovering stranded costs further cloud the future. If electricity prices fall, so will government revenues and the cost of energy for public entities. Conversely, electricity price increases would boost revenue, offsetting some of the revenue loss that is due to other factors, but also increase the cost of energy for public entities. Since our extensive literature review finds little evidence that deregulation will significantly reduce Florida's electricity prices, TaxWatch does not attempt to quantify the impact electricity prices would have on government revenues.

An added degree of uncertainty results from Florida Constitutional Amendment 5,[12] approved by the voters in November 2018. The amendment requires that any state tax or fee increase be approved by at least a two-thirds vote of the membership of both the House and Senate, and that each increase be in a separate bill containing no other subject. Historically, tax increases in Florida that have been approved by majority vote have generally reached the two-thirds threshold;[13] however, with such a complicated and interrelated utility tax and fee structure, and so many competing interests, reaching a broad consensus may be difficult.

There are multiple factors resulting from a deregulated electricity market besides price that can impact revenues. These include the migration of energy generation outside of the state, the loss of property tax values of electricity assets, the need to distribute tax burden among more (and no longer similar) companies, tax and fee bases that might no longer be appropriate, and the revenues and profits of electricity providers. In addition to these factors, there are two issues that will significantly affect public revenues in a destructured system that must be addressed first. One is the stranded costs associated with the change from the current system; the second is the state's ability to exercise jurisdiction over new providers in the collection of taxes.

12 Article VII, s. 19, Florida Constitution.

13 Florida TaxWatch, 2018 Voter Guide to Florida's Constitutional Amendments. https://floridataxwatch.org/Research/Full-Library/ArtMID/34407/ArticleID/17819/2018-Voter-Guide.

Stranded Costs

Stranded costs represent the quantified losses that will be incurred by the IOUs as a direct result of the destructuring policy. If the proposed constitutional amendment were to pass, IOUs would be required to sell all generation assets within a fixed time period, which would likely lead to discounted prices for the assets, which are termed stranded costs. Essentially, stranded costs are the difference between book value to the current owner of an asset versus value of that asset sold at auction. Additionally, the costs of any legal obligations (such as breaking long-term purchase or service agreements) could count as stranded costs. Typically, IOU's are reimbursed for these costs.[14]

The market value of the generation asset cannot be known with certainty until a competitive auction has occurred; however, taxable values of real property are intended to represent the likely market value of that property. TaxWatch has examined the taxable value of Florida generation assets for IOUs[15] as well as the book value[16] and compared those values. That comparison shows as much as approximately $5.153 billion in potential stranded costs.

The U.S. Energy Information Administration reports that 2017 retail sales of electricity by Florida utilities was 233,154,549 MWh.[17] If the Florida PSC were to allow 100 percent recovery of this calculated difference, and charge it to ratepayers over a three year period, then the nominal charge per kilowatt-hour would be about $7.37 per 1,000 KWh. The average residential customer in Florida in 2017 is reported by EIA to have used an average of 1,089 KWh per month. If reimbursable stranded costs were to be larger, then this monthly charge to ratepayers would need to be larger. If instead asset auctions generated higher sale prices than implied by taxable valuations, then the stranded cost charge-off borne by ratepayers could be proportionately smaller.

Nexus

The introduction of competition is likely to attract new electricity suppliers, some of which may be located outside Florida. Whether these out-of-state suppliers may be held responsible for paying or collecting Florida taxes depends on whether "nexus" can be established. "Nexus" refers to the authority of a state to levy taxes on any out-of-state seller, historically based on physical presence (e.g., an out-of-state provider has sufficient physical property, employees or other assets in the state that would justify taxation).[18] "Physical presence" generally means there is a continuous and regular presence of employees or the presence of an office or other place of business within the taxing state.

Several taxes discussed below could be affected by nexus. Nexus issues arise when federal and state laws prohibit either taxing companies that have no physical presence (nexus) in the state or requiring them to collect taxes from purchasers on behalf of the government. This issue has received a lot of attention for many years in relation to the collection of sales and use taxes by remote sellers with no nexus in the state that sell products to residents of the state. Several U.S. Supreme Court decisions have held that companies with no nexus were not required to collect

14 Appendix A provides a detailed examination of stranded costs and their applicability.

15 Taxable values adjusted for recently completed construction.

16 Book values adjusted for accumulated reserves for depreciation.

17 U.S. EIA, "Florida Electricity Profile 2017, Table 1. 2017 Summary Statistics (Florida)". A MWh is 1,000 KWh.

18 Research Triangle Institute, "State and Local Tax Considerations in Electric Industry Restructuring, Volume 1-Task 3 Final Report, September 1998, retrieved from www.rti.org/sites/default/files/resources/7135-321.pdf, January 30, 2019.

and remit to the state any tax from purchasers. Mail order and phone sales have made this an issue for a very long time, but the explosion of Internet shopping has made this a serious revenue concern for many states, with Florida likely losing out on hundreds of millions of dollars of sales and use taxes annually. These taxes are legally due from the purchasers, but if the seller is not required to collect the tax, it is largely up to the purchaser to voluntarily pay the tax to the state.

A recent Supreme Court decision (*Wayfair vs. North Dakota*) threw out the physical presence requirement; however, the Court cautioned that complying with a state's tax law could not overburden an out-of-state seller. While this decision may pave the way for Florida to start collecting some of this missing sales and use tax revenue, the Legislature will have to take steps to facilitate such collections and Florida's resulting taxing scheme would have to pass constitutional muster. As this report discusses the various taxes on electricity, nexus will be a recurring issue. Since IOUs paid or remitted nearly $1.8 billion in these taxes in 2018, even a small percentage loss of these taxes due to nexus issues would constitute a significant negative fiscal impact for state and local governments.

Tax and Fee Tax Impacts

The electricity industry is a very important source of revenue for Florida's state and local governments. Multiple taxes and fees are levied against the sale of electricity and the operations of utilities. Providing electricity to Florida's citizens and businesses raises $4.4 billion[19] annually in taxes and fees for Florida governments (not including $2.8 billion from the sales of electricity by municipal-owned utilities).[20] Most of the tax and fee revenue is provided by private utilities. Florida's IOUs[21] pay or collect approximately $3.6 billion annually in franchise fees and public services, property, income, gross receipts, and sales and use taxes.

More than one-half of that revenue goes to local governments. This revenue is especially critical for municipalities where the public service tax on electricity is by far the largest municipal non-ad valorem tax source --- its nearly $800 million in annual revenues exceed discretionary sales tax and communications services tax revenue combined.

Charter counties collect an additional $260 million in public services taxes. Similarly, the nearly $600 million in electric franchise fees collected by municipalities represents their largest permit and fee revenue source, more than double that of all impact fees combined. Counties collect another $160 million in electricity franchise fees.

Schools are also big beneficiaries of utilities taxes. Approximately 40 percent of property taxes statewide go to school districts and the gross receipts tax funds construction, renovation, and maintenance of educational capital facilities.

19 Florida TaxWatch estimate from multiple sources, including utility companies, the Florida Legislature, the Revenue Estimating Conference and the Federal Energy Regulation Commission.

20 Florida Legislature, Office of Economic and Demographic Research, Municipal Revenue Account Totals, 2017. http://edr.state.fl.us/Content/local-government/data/revenues-expenditures/stwidefiscal.cfm.

21 Florida Power & Light, Tampa Electric Company, Duke Energy, Gulf Power, and Florida Public Utilities Company.

Franchise Fees

The taxing power of local governments is tightly restricted by the state constitution. Besides property taxes, which are authorized by the constitution,[22] local governments may only levy taxes authorized in law by the state Legislature. The constitution says: "No tax shall be levied except in pursuance of law… All other forms of taxation shall be preempted to the state except as provided by general law."[23] Under broad home rule authority granted by the constitution, however, local governments may levy fees. Fees are largely governed by case law; the guiding principle is that the fee is reasonable in relation to the government-provided privilege or service or that the fee-payer receives a special benefit.

Franchise fees are an example. These fees are negotiated between the municipal or county government and a utility. The adopted franchise agreement grants a utility a license to provide electric service to the residents and businesses within that city's limits or the unincorporated portion of a county. It also grants the privilege of using local government's rights-of-way to conduct the utility business (installing lines and poles and providing truck access). Franchise agreements also contain a promise that the local government will not provide competing utility services. Franchise fees are critical to local governments and they are the utility-related revenue source that carries the largest risk under the proposed amendment. Franchise fees are levied on other utilities, but the one on electricity is by far the most lucrative, bringing in $750 million annually to city and county governments. IOUs pay $682 million of that amount (Rural Electric Cooperatives also pay franchise fees). These fees are passed on to the purchasers of electricity as embedded costs (i.e., not identified by line-item as a source of public revenue).

Franchise agreements typically are long-term agreements, often 30 years. Deregulation would surely make the existing agreements obsolete. Typically, franchise fees are based on the gross revenues received by the utility from the customers in the local government's boundaries. With the loss of vertical integration, the revenue attributable to one company will be reduced. If IOUs no longer bill consumers for all costs (generation, transmission and distribution), the tax base will be greatly reduced. Many, including the Florida League of Cities, believe all franchise fee revenue could be at risk. It is likely the franchise fee agreements, as they exist now, would no longer be workable (or enforceable) after deregulation. A revised structure with new revenue source could be devised, but it would be a complex task, one that politics would make even more difficult.

Franchise fees could be restructured, such as being based on the value of energy distributed through a facility, but will franchises be as valuable as they are now? Surely not---while ostensibly payment of fair rent for the use of public rights of way, the true value to utilities is the granting of the right to be the exclusive seller. In a competitive marketplace, that value is lost. Even if franchise fees can be retained in some form, significant revenue losses are a distinct possibly. Moreover, since franchise fees can be included in the base for sales, gross receipts and public service tax levies, any reduction in franchise fees could impact those taxes as well.

22 Article VII, s. 9(a), Florida Constitution.

23 Article VII, s. 1(a), Florida Constitution.

Property Taxes

Property taxes are local governments' most important revenue source. Property taxes are reserved for local governments --- the state constitution prohibits the state from levying the tax.[24] Florida's cities, counties, school districts and special districts depend on the $31.4 billion this tax provides annually. Forty percent of the revenue ($12.6 billion) goes to schools. Counties collect 38 percent of the revenue ($11.9 billion; cities collect 15 percent ($4.8 billion); and independent special districts collect 7 percent ($2.1 billion).[25]

Property taxes are levied on both real and tangible personal property (TPP). Since household goods and personal effects are exempt, TTP taxes are generally paid only by businesses on their machinery, equipment, furniture, computers, signs, supplies, and other such property. The taxable value of real and tangible personal property is its fair market value minus any exclusion, differential, or exemption allowed by Florida laws. Millage rates (the tax rate) vary from jurisdiction to jurisdiction and are subject to various caps. The average millage rate paid by property owners in Florida is 17.46 mills ($17.46 per $1,000 of taxable value).[26]

Utilities are capital intensive and have significant real and tangible personal property tax obligations. Florida's IOUs paid $1.1 billion in property taxes in 2018. IOU generation sites accounted for $352 million of that amount. Many counties rely heavily on property tax revenue from utilities, especially small, rural counties where utility property can comprise a significant portion of the tax base. A sizable reduction in utility property value could have a profound impact on schools as well.

The proposed utility constitutional amendment would likely reduce property tax revenues. If deregulation and the required divestiture of generation property result in more out-of-state generation of electricity, there would likely be corresponding loss in in-state generation property, reducing Florida's property tax base. Factors including Florida's geography at the cost of interstate transportation of electricity will likely limit this impact.

A much more significant reduction in Florida's property tax base could result from the forced divestiture of generating facilities. This would be due in part to the IOUs stranded costs, which is largely the amounts by which the book values of utility generation assets exceed their market values. Sales of IOU property at below book value would reduce the appraised and taxable values of those properties. If the required divestitures were to result in "fire sale" prices, this will further reduce the selling price and thus the appraised and taxable values of IOU property.

It has been noted that the language of the proposed constitutional amendment is ambiguous as to whether the current IOUs would be able to own the transmission and distribution system.[27] The proposed amendment requires the Legislature to pass a law to "limit the activity of investor-owned electric utilities to the construction, operation, and repair of electrical transmission and distribution systems." It does not specify that the IOUs can own the systems. If this is interpreted as requiring the divestiture of ownership of the transmission and distribution system, then the value of these components of the IOUs' total tax base would be compromised.

24 Except for intangible personal property.

25 Florida Department of Revenue, Millage and Taxes Levied Report, 2017.

26 Florida Revenue Estimating Conference, 2018 Florida Tax Handbook. http://edr.state.fl.us/Content/revenues/reports/tax-handbook/taxhandbook2018.pdf.

27 Testimony and discussion at the Financial Impact Estimating Conference, February 11, 2019.

Public Service Tax

Municipalities and charter counties are authorized 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. Charter counties may only levy the tax on customers in the unincorporated area of the county. The tax cannot exceed 10 percent of the payments received by the utility from the sale of taxable items and the majority of governments levy the maximum. It is a tax on the consumer and the utility collects it and remits it to the local government.

The public service tax, sometimes called the municipal utility tax, is a critical revenue source for local governments, especially cities. It is by far their largest non-ad valorem tax source, supplying 13 percent of tax revenue (39 percent of non-ad valorem taxes). Of the $1.2 billion in public service taxes collected annually by cities and counties on all utilities, the sale of electricity contributes just over $1 billion.[28] Florida IOUs collect $856 million in public service taxes for cities and charter counties.

Since this is a tax on the consumer and utilities collect it, it could be impacted by nexus issues and be subject to an erosion of revenue collections. Due to the large amount of revenues collected, even if there is relatively small amount of electricity sales to Florida customers made by out-of-state companies with no nexus in Florida, and the sellers do not collect and remit the taxes, local governments could see significantly reduced revenues.

Gross Receipts Tax

The 2.5 percent gross receipts tax on electricity produces $634 million annually. The gross receipts tax is a state tax and is deposited into the Public Education Capital Outlay (PECO) Trust Fund to pay for construction and maintenance of Florida's educational facilities. Florida's IOUs pay $465 million annually in gross receipts taxes. All electric utilities must pay the gross receipts tax, including municipally-owned utilities and rural electric cooperatives.

Prior to 2014, the gross receipts tax was 2.5 percent and the sales tax on electricity used by commercial customers was 7 percent. In an effort to increase revenue for the PECO Trust Fund, the 2014 Legislature added a 2.6 percent gross receipt tax on the electricity sales tax base (commercial customers) and decreased the sales tax by 2.65 percent to 4.35 percent. This analysis considers the gross receipts tax as only the original 2.5 percent tax and the sales tax on electricity as 6.95 percent (4.35 percent plus 2.6 percent).

The state's gross receipts law will have to change under deregulation. A significant potential revenue impact arises because the gross receipts tax is levied on the receipts of electricity distribution companies.[29] Currently, since services are bundled under one company, tax is levied on both the charge for distribution and the charge for the electricity. Under the proposed amendment (and current statutory law) the distribution company would only be liable for the tax, while the receipts of the generators and the marketers would not be taxed. This would have to be addressed or a significant portion of the tax base (up to two-thirds)[30] could be compromised.

28 Florida Revenue Estimating Conference, 2018 Florida Tax Handbook.

29 Section 203.01(c)1., Florida Statutes

30 The cost of delivery electricity's compromises about 1/3 of the total price.

In 2005, the Legislature changed the gross receipts tax law in response to the deregulation of the natural gas market, which resulted in a significant increase in amount of gas provided from out-of-state. In addition to addressing the taxation of natural gas, the law changed the way an electricity transmission company is taxed if S. 203.01(c)1 does not apply. Presumably, this would be the case if the distribution company only receives payment for the delivery of electricity. Under this alternate provision[31], the tax would be based on the number of kilowatt-hours delivered multiplied by an "index" price: the average Florida price per kilowatt-hour for retail consumers in the previous calendar year.[32]

This has not been an issue for IOUs since both the charge for distribution and the charge for the electricity are included in the price. If this provision comes into play under the proposed amendment, generators and retailers would not be (directly) liable for the gross receipts tax and distribution companies would pay tax on the (estimated) total cost of electricity. The distribution companies might be able to recoup the cost through charges for the use of the system, but the effect on gross receipts revenues could be high. Florida TaxWatch performed a comparison of the index prices with the actual prices at various levels of usage and classification of services and found that index prices were between 3 percent and 7 percent below actual prices. In addition, since the index price is from the previous calendar year, the index price would lag behind the actual price, assuming actual electricity prices rise (after accounting for any effects of deregulation on price). It is likely that gross receipts tax collections would be less than it taxed at the actual price.

There is a use tax provision in the gross receipts tax law that requires a Florida purchaser of electricity that did not pay the tax to the seller to pay the tax directly to the Department of Revenue.[33] The provision also provides that if the purchaser paid a like tax to the seller, the amount of gross receipts tax owed to Florida is reduced by the amount of like tax paid. Even with the use tax language, as is the case with the sales tax, it may be difficult to collect the gross receipts tax on the sale of electricity by a company with no Florida nexus. Moreover, if the state in which the company is located levied a gross receipts tax which the Floridian paid in an amount at least equal to Florida's tax, no tax would be due to Florida. Under deregulation, therefore, the percentage of sales made by companies with no Florida nexus should result in a similar reduction in gross receipts tax revenue.

Sales Taxes

Florida has a state general sales tax rate of 6 percent, but electricity is taxed at 6.95 percent. Local option sales taxes also apply to electricity sales. The local rate varies from county to county, but it can add up to 2.5 percent. There is an exemption for residential electricity, which comprise a five-year average of 59 percent of total retail sales by IOUs[34]. Florida's IOUs collect $369 million in state sales taxes annually, and another $28 million in local sales taxes. Nexus has always been a problem for Florida's sales tax collections, and while the *Wayfair* decision may make future collections easier, the state is not there yet. If deregulation results in more sales by out-of-state companies, some loss in sales tax revenues should be expected.

31 Section 203.01(d)1., Florida Statutes

32 Florida Department of Revenue, Tax Information Publication No:18B06-01, Gross Receipts Tax Index Prices for the Period July 1, 2018 through June 30, 2019. https://revenuelaw.floridarevenue.com/LawLibraryDocuments/2018/05/TIP-121726_TIP%2018B06-01%20FINAL%20RLL.pdf

33 Section 203.01(f), Florida Statutes

34 Florida Public Service Commission, Statistics of the Florida Electricity Utility Industry, October 2018. http://www.psc.state.fl.us/Files/PDF/Publications/Reports/Electricgas/Statistics/2017.pdf.

Corporate Income Taxes

Corporations doing business in Florida must pay a tax of 5.5 percent on net income earned in Florida.[35] Florida "piggybacks" the federal income tax code in its determination of taxable income, annually adopting most federal changes. This makes federal taxable income the starting point for determining Florida taxable income. Any federal change Florida decides to "de-couple" from is then added or subtracted from federal income. Taxable income earned by corporations operating in more than one state is taxed in Florida on an apportioned basis using a formula that is based on the percentage of three factors that are located in Florida: 25 percent on property, 25 percent on payroll and 50 percent on sales. The first $50,000 of net income is exempt from taxation.

Reduced income of IOUs under a deregulated environment would decrease their income tax liability. Presumably, at least some of that lost liability would be offset by liability of the new companies that replaced IOU services; however, if some of the lost income moves to out-of-state companies, nexus issues would arise. Previous studies in Florida[36] and North Carolina[37] have estimated corporate income tax losses in a deregulated electricity market of 36.3 percent and 30.3 percent, respectively. Both estimates assume a decline in electricity prices and no recovery of stranded cost.

The Florida estimate assumed no significant entry into the market by out-of-state companies but noted that interstate transmission of electricity could raise questions as to how the apportionment formula will be applied for utility companies. The North Carolina study attributed approximately 19 percent of the reduction in corporate income tax revenue to lack of nexus.

As is often the case with corporate income taxes, tax payments vary considerably from year to year.[38] Coupled with the uncertainty created by the federal Tax Cuts and Jobs Act and how Florida will deal with the impacts, a base estimate of annual state income tax revenue by IOUs could not be produced.

Use Tax Paid by Utilities

Generally, utilities self-accrue sales taxes on their purchases. Instead of paying the tax to the vendor (regardless of where the vendor is located), they remit a use tax (same rate as the sales tax) directly to the state. Florida's IOUs' annual use tax payments exceed $100 million, the vast majority of which is due on distribution and transmission activities. Machinery and equipment used to generate electricity are exempt from the sales tax. Assuming purchases related to distribution and transmission activities remain in Florida, deregulation should not result in a significant loss of utility-paid use taxes.

Potential Revenue Impacts by Source

As discussed earlier, the complicated nature of utility taxation and the unknown manner in which the Legislature would implement the proposed amendment make reliable estimates of the proposed amendment's impacts unattainable. The purpose of this analysis is not to create a specific estimate of the revenue impact of electricity

35 The income tax applies to C corporations. S corporations, non-profit corporations, master limited partnerships and limited liability companies are exempt.

36 Florida Legislature, Office of Economic and Demographic Research, Potential Fiscal Impact of Electric Utility Deregulation on Florida's Public Education Capital Outlay (PECO) Program, December 1999.

37 Research Triangle Institute, State and Local Tax Considerations in Electric Industry Restructuring, Volume 1—Task 3 Final Report, September 1999.

38 Federal Energy Regulatory Commission, FERC Financial Report Form No. 1: Annual Report of Major Electric Utilities, Licensees and Others. Reports for each Florida IOU, multiple years.

deregulation, but to highlight potential impacts and magnitudes for the Financial Impact Estimating Conference, the Legislature, local governments, and other stakeholders to consider.

Florida TaxWatch analysis finds that, unless very significant increases in the price of electricity for Floridians result, adoption of the proposed constitutional amendment will have a negative impact on state and local government revenues. These impacts have the potential to be relatively large. Of course, the Legislature and local governments can change the tax structure in an attempt to offset any revenue loss, but that road is fraught with peril.

It should be noted that the way the Legislature chooses to handle stranded costs could impact revenues. If at least some of the stranded costs recovery is done through an assessment on customers' bills or through an artificially high retail rate imposed by law, and the Legislature chooses to make those consumer payments taxable, it could have a positive revenue impact on taxes such as the gross receipts tax, the sales tax, and the public service tax, and would reduce some of the potential negative impacts discussed below.

Estimates are given for both 2018 and 2026. The impacts were first estimated for 2018, the year of the latest tax data. Those estimates were then projected out to 2026—the expected first full year of implementation if the amendment were to pass. The estimates do not change drastically over time, as electricity prices are not expected to increase much in the next several years. Most estimates were grown using the future growth rates for electricity gross receipts taxes adopted by the Gross Receipts Tax Revenue Estimating Conference.[39] Property tax revenues were estimated using the future taxable value growth rates adopted by the Ad Valorem Assessment Revenue Estimating Conference,[40] reduced slightly due to the downward trend in average millage rates.[41]

Electricity Franchise Fees (Local)

Total Annual Revenue (Local): $750 million, with $682 million paid by IOUs

If deregulation rendered all current franchise agreements obsolete and unenforceable, the entire $682 million could be lost.

- Assumption 1: Local governments and utilities could agree on changes to salvage 25 percent to 75 percent of revenue. Franchises would be less valuable due to loss of monopoly.
  2018 Revenue Loss: $171 million to $512 million
  2026 Revenue Loss: $190 million to $568 million

Property Tax (Local)

Total Revenue from IOUs: $1.1 billion
Tax Revenue from IOUs Generation Sites: $352 million

- Assumption 1: Loss of 5 percent to 10 percent of the taxable amount of generation property due to movement out-of-state and plant closure for other economic reasons, including lack of profitability.
  2018 Revenue Loss: $18 million to $35 million
  2026 Revenue Loss: $26 million to $50 million

39 Revenue Estimating Conference, Gross Receipts Tax Conference Results, November 29, 2018. http://edr.state.fl.us/Content/conferences/grossreceipts/grossreceiptsresults.pdf

40 Revenue Estimating Conference, Ad Valorem Assessments Conference Package, December 11, 2018. http://edr.state.fl.us/Content/conferences/advalorem/adval_results.pdf

41 Florida Revenue Estimating Conference, 2018 Florida Tax Handbook. http://edr.state.fl.us/Content/revenues/reports/tax-handbook/taxhandbook2018.pdf.

- Assumption 2: 15 percent to 25 percent loss of generation property value due to forced sales at less than book value.
  2018 Revenue Loss: $53 million to $88 million
  2026 Revenue Loss: $75 million to $125 million

- Assumption 3: Assumptions 1 and 2 (15 percent loss from Assumption 2 applied to 90 percent of generation property).
  2018 Revenue Loss: $68 million to $122 million
  2026 Revenue Loss: $97 million to $174 million

- Assumption 4: Scenario 3 plus 5 percent to 10 percent loss of value of non-generation property.
  2018 Revenue Loss: $105 million to $197 million
  2026 Revenue Loss: $149 million to $280 million

Gross Receipts Tax (State)

Total GRT Collections on Electricity: $634 million
GRT paid by IOUs: $465 million

- Assumption 1: If Section 203.01(d)1., Florida Statutes applies, the difference between index prices and actual prices would reduce collections by 3 percent to 7 percent.
  2018 Revenue Loss: $14 million to $33 million
  2026 Revenue Loss: $16 million to $37 million

- Assumption 2 *(low probability)*: Since the tax is currently levied on distribution companies, if only distribution costs are taxed, only approximately 40 percent of the base would be taxed.
  2018 Revenue Loss: $279 million
  2026 Revenue Loss: $310 million

Public Service Tax (Local)

Total PST Revenue: $1.0 billion
Revenue Collected by IOUs: $860 million

- Assumption 1: 5 percent to 15 percent of sales are made by out-of-state companies and lack of nexus results in non-collection by seller and no use tax from purchaser.
  2018 Revenue Loss: $43 million to $129 million
  2026 Revenue Loss: $48 million to $144 million

Sales Tax (State and Local)

Revenue Collected by IOU: $369 million (state) and $28 million (local)

- Assumption 1: 5 percent to 15 percent of sales are made by out-of-state companies and lack of nexus results in non-collection by seller and no use tax from purchaser.
  2018 Revenue Loss: $18.5 million to $55 million (state) and $1.4 million to $4.2 million (local)
  2026 Revenue Loss: $21 million to $61 million (state) and $1.6 million to $4.7 million (local)

Corporate Income Taxes (State)

Reduced income of IOU's under a deregulated environment would decrease their income tax liability. Presumably, at least some of that lost liability would be offset by new companies; however, if some of the lost income moves to out-of-state companies, nexus issues would arise. CIT payments by IOUs fluctuate too greatly to estimate losses.

Potential Revenue Impacts by Source

	2018 Revenue Losses			2026 Revenue Losses		
	Low	Middle	High	Low	Middle	High
Electricity Franchise Fees (Local)						
Assumption 1	$171m	$341m	$512m	$190m	$380m	$568m
Property Tax (Local)						
Assumption 1	$18m	$27m	$35m	$26m	$71m	$50m
Assumption 2	$53m	$71m	$88m	$75m	$100m	$125m
Assumption 3	$68m	$95m	$122m	$97m	$135m	$174m
Assumption 4[A]	$105m	$151m[A]	$197m	$149m	$215m[A]	$280m
Gross Receipts Tax (State)						
Assumption 1	$14m	$24m	$33m	$16m	$26m	$37m
Assumption 2		$279m			$310m	
Public Service Tax (Local)						
Assumption 1	$43m	$86m	$129m	$48m	$96m	$144m
Sales Tax (State & Local)						
Assumption 1	$19m (State) $1m (Local) $20m (Total)	$37m (State) $2.5m (Local) $39.5m (Total)	$55m (State) $4m (Local) $59m (Total)	$21m (State) $2m (Local) $23m (Total)	$41m (State) $3.5m (Local) $44.5m (Total)	$61m (State) $5m (Local) $66m (Total)
State Total[B]	**$33m**	**$167m**	**$334m**	**$37m**	**$204m**	**$371m**
Local Total[C]	**$320m**	**$581m**	**$842m**	**$389m**	**$693m**	**$997m**
Potential Total	**$353m**	**$748m**	**$1,176m**	**$426m**	**$897m**	**$1,368m**

[A] Assumption 4 is a combination of the previous assumptions plus a loss of value from non-generation property, therefore the mid-point of assumption 4 represents the mid-point of the combination of the assumptions.

[B] State total includes the Gross Receipts Tax and State Sales Tax

[C] Local total includes the Franchise Fees, Property Taxes, Public Service Tax, and Local Sales Tax

Note: local estimates do not include any revenue from the state 6% sales tax (local government half-cent sales tax, county and municipal revenue sharing, and fiscally constrained counties).

Conclusion

Overall, this TaxWatch analysis clearly shows that deconstructing Florida's electricity market through the proposed constitutional amendment will likely have a significant negative impact on state and local revenues.

This analysis uses the best available evidence to estimate that this amendment has the potential to cause a loss of state and local revenue ranging from $426 million to $1.368 billion in 2026, the expected first full year of implementation.

Appendix A

Stranded costs fall into five main categories:[42]

- Unrecoverable costs of generation-related assets—in a competitive market, if electricity prices are lower than the level necessary to repay the investments and provide a fair return, and if the assets cannot be sold for use elsewhere, those costs will be stranded.
- Long-term contracts for power or fuel that would be money losers with lower market prices for power—long-term contracts that might have made good business sense in a regulated environment or that might have served some public purpose may become net liabilities in a competitive market. Two examples that may result in stranded costs are contracts that require utilities to buy power from other generators and contracts to buy fuel.
- Unrecoverable regulatory assets—in the electric power industry, a regulatory asset is essentially a promise from a public utility commission to let a regulated utility recover a cost it has already incurred (e.g., deferred income tax liability) by charging higher rates in the future than it would otherwise. If electricity rates are no longer regulated, the ability to recover that money may be impaired, and the regulatory asset becomes worthless.
- Unrecoverable investments in social programs—the costs of programs designed to encourage energy conservation and efficiency, assist low-income customers, etc., that have not been recovered by the time the retail electricity market is deregulated would not be recovered in a competitive market.
- Employment transition costs—employee-related expenses prompted by restructuring, such as the costs of offering early retirement, job training, etc., would not be recovered in a competitive market.

If restructuring occurs without provisions to compensate utilities for stranded costs, then the utilities will have to absorb all of these costs. How Florida treats these stranded costs may provide some relief; however, investors are likely to view the electricity generation market as riskier.

Consequently, the cost of capital would rise for new investment, thus raising the future cost of electricity.[43] Others claim that compensating utilities for stranded costs would slow the benefits of competition and keep electricity prices higher than otherwise. Permitting utilities to recover all stranded costs from ratepayers and taxpayers would reward utilities for making poor choices about electricity generation in the past and would not encourage them to make good choices in the future.[44]

42 Congressional Budget Office, "Electric Utilities: Deregulation and Stranded Costs," CBO Paper, October 1998, retrieved from www.cbo.gov/sites/default/files/105th-congress-1997-1998/reports/stranded.pdf, February 3, 2019.

43 A. Lawrence Kolbe and others, "Regulatory Risk: Economic Principles and Applications to Natural Gas Pipelines and Other Industries," (Boston, Mass.: Kluwer Academic Publishers, 1993).

44 Kenneth Rose, "An Economic and Legal Perspective on Electric Utility Transition Costs," NRRI 96-15, National Regulatory Research Institute, 1996.

Whether utilities should be compensated for all or some portion of their stranded costs is essentially a question of fairness. What is fair depends on how the following questions are answered:

- Does restructuring violate the regulatory compact between a utility and its regulators, under which a utility provides universal electricity service to all customers in a specified area at a price determined by the state in exchange for a guaranteed return and recovery of their costs?
- If implementation of state and federal laws led utilities to incur higher costs, should the utility be permitted to recover those costs?
- If restructuring does not permit a utility to recover its stranded costs, does that constitute a legal "taking" which is prohibited by the Fifth Amendment of the U.S. Constitution?
- If a regulated electricity market precluded a utility from earning a higher rate of return, should a competitive electricity market exempt a utility from earning abnormally low rates of return?[45]

The Federal Energy Regulatory Committee (FERC) in 1996 issued guidance via Rule 888 and subsequent determinations suggesting that IOUs generally should be able to recover stranded costs to the extent that the generation facilities in question were required by state regulatory authorities to be built and these costs incurred.[46] Some of the changes envisioned by Rule 888, however, have not been fully implemented.[47]

The Florida Energy 2020 Study Commission produced a report describing a comprehensive strategy for assuring that Florida would have an adequate, reliable and affordable supply of electricity.[48] This Commission advocated an approach called the "Discretionary Transfer Approach," which would have allowed IOUs to continue to own generating capacity and recommended allowing recovery of stranded costs over a six-year period.[49] The Commission advocated sharing any benefits from sales for existing generating assets with customers. Their report notes that "in virtually all states that have restructured, utilities were afforded the opportunity to recover costs associated with assets that would not be recoverable in a competitive environment."[50]

The Commission recognized that restructuring would have fiscal impacts to both state and local government, particularly with respect to existing local government property tax revenues.[51] No attempt was made to quantify what that impact might be, but there was a recommendation that policy makers consider what changes would be necessary to maintain a tax system that is fair to both producers and consumers while providing revenue neutrality for state and local governments.[52]

45 Congressional Budget Office, "Electric Utilities: Deregulation and Stranded Costs," CBO Paper, October 1998, retrieved from www.cbo.gov/sites/default/files/105th-congress-1997-1998/reports/stranded.pdf, February 3, 2019.

46 FERC, "Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Service by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities." Order No. 888, FERC Stats & Regs. 1996.

47 See discussion in Florida Energy 2020 Study Commission. "Florida...EnergyWise! A Strategy for Florida's Energy Future." December 2001. http://edocs.dlis.state.fl.us/fldocs/commissions/energy/2001report.pdf Last accessed February 15, 2019.

48 Florida Energy 2020 Study Commission. "Florida...EnergyWise! A Strategy for Florida's Energy Future." December 2001. http://edocs.dlis.state.fl.us/fldocs/commissions/energy/2001report.pdf Last accessed February 15, 2019.

49 Ibid.

50 Ibid.

51 Ibid.

52 Ibid.

ABOUT FLORIDA TAXWATCH

As an independent, nonpartisan, nonprofit taxpayer research institute and government watchdog, it is the mission of Florida TaxWatch to provide the citizens of Florida and public officials with high quality, independent research and analysis of issues related to state and local government taxation, expenditures, policies, and programs. Florida TaxWatch works to improve the productivity and accountability of Florida government. Its research recommends productivity enhancements and explains the statewide impact of fiscal and economic policies and practices on citizens and businesses.

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This Report and its findings are based on an independent analysis by Florida TaxWatch experts and renowned economist *Richard Harper, Ph.D.,* a senior member of the Florida Council of Economic Advisors at Florida TaxWatch.

The findings in this Report are based on the data and sources referenced. Florida TaxWatch research is conducted with every reasonable attempt to verify the accuracy and reliability of the data, and the calculations and assumptions made herein. Please feel free to contact us if you feel that this paper is factually inaccurate.

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