

Testimony of

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Max Baucus, Chairman

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Good morning Mr. Chairman. My name is Terry Holzer, and I am the General Manager of Yellowstone Valley Electric Co-op in Huntley, Montana. I greatly appreciate the opportunity to appear before you today to discuss tax law changes that are needed to facilitate fair competition for all electric utilities in the move toward a more competitive marketplace.

Let me begin by thanking you for sponsoring, along with Senators Lincoln, Thompson, and Grassley, S. 794 – The Rural Electric Tax Equity Act. This legislation is a top priority for Montana co-op's attempting to survive in this new competitive marketplace. Senator Baucus, you have been a strong supporter of electric cooperatives, especially those cooperatives providing cost-based power in Montana. On behalf of all electric cooperatives, I want to say thank you for being the champion that you are of consumer-owned, cost-based electric cooperatives. Equally important to Montana co-ops, as you grapple with energy related tax changes, is the need to provide rural electric cooperatives with equal access to energy incentive programs. Co-ops should be given tradable tax credits equal to the benefits given to investor owned utilities (IOUs) when developing renewable generation and/or clean coal technologies.

Just last month, the United States House of Representatives passed H.R. 4, Securing America's Future Energy Act, which failed to adequately address rural electric co-op concerns associated with competitiveness and parity in the electric utility industry. It is our hope that when the Senate moves similar legislation that it provide a better balance and distribution of tax related flexibility and incentives.

Before I address our interest in tax policy changes, let me first give you some background about Yellowstone Valley Electric Co-op and the rest of Montana's electric cooperatives. Yellowstone Valley Electric Co-op serves 14,000 meters in Montana. Our electric cooperative provides service in six counties, with most of our customer growth occurring around the city of Billings as it expands into our service territory. We are one of 26 Montana electric cooperatives serving nearly 400,000 customers in the state. Co-ops employ approximately 625 people statewide, with a total annual payroll of approximately \$13 million. Our average total residential delivered cost of electricity for co-op customers in Montana is 8.47 cents per Kwh. We average approximately 2.44 co-op customers per mile of line, compared to 12 customers for Montana's largest IOU.

Nationally, there are nearly 1,000 electric cooperatives serving over 35 million consumers in 46 states. The table in Addendum A shows an overview of the electric industry, and illustrates that one of the co-op industry's greatest challenges is the lack of customer density. Nationally, electric cooperatives serve 6 consumers and generate \$7,000 per mile of line; whereas investor-owned utilities (IOUs) have 35 consumers and generate \$60,000 per mile of line.

As you are aware, under Section 501 © (12) of the Internal Revenue Code, electric cooperatives are exempt from federal income tax so long as 85 percent of their income

comes directly from their members. In Montana, electric cooperatives are assessed a 12 percent property tax levy, the same tax rate as an IOU, on all property located within a city or town with a population of 3,500 citizens or greater. There is, of course, a place in the market for all types of utilities. It is particularly important that, in an era of restructuring, tax policy be adjusted to keep the consumer-owned cooperative form of business structure viable.

ENSURE COMPETITIVE PARITY IN TAX RELIEF

As you may know, 24 states have passed legislation to restructure parts of the electric utility industry; others states have similar proposals or are studying the issue. In Montana, the restructuring of the electric utility industry began in 1997 with the passage of S.B. 390, The Electric Utility Industry Restructuring and Customer Choice Act. Under this legislation, Montana Power Company residential and small commercial customers will move to customer choice on July 1, 2002. The legislation allowed electric cooperatives to “opt out” of customer choice if it was not in their customer’s best interest. All but two electric cooperatives in Montana have opted to stay out of competition at this time. There are several localized reasons for Montana’s electric cooperatives to not open their systems to competition – the foremost reasons being the potential tax consequences to their cooperative and the uncertainties surrounding electric deregulation.

The business environment for electric utilities is changing rapidly due to federal and state legislative and regulatory actions. It is imperative that tax provisions, advanced in any national energy or utility restructuring legislation should provide for a smooth transition for electric cooperatives to ensure that all electric consumers can benefit.

All sectors of the utility industry – the investor-owned utilities (IOUs), the publicly-owned municipal utilities (munis) and the consumer-owned cooperative utilities (co-ops) – agree that legislative “tax fixes” are needed to keep pace with the changes occurring in the electric utility industry.

TAX TREATMENT OF ELECTRIC CO-OPS – 85/15 MEMBER INCOME TEST

As mentioned above, an electric cooperative is tax-exempt so long as 85 percent or more of its annual income comes from members. Substantially all of the approximately 1000 electric distribution cooperatives throughout the nation annually pass the 85 percent member income test and thus qualify for tax-exempt status. An electric cooperative which does not pass the annual 85 percent member income test is treated as a taxable entity.

Nationally, most of the largest electric generating cooperatives (G&Ts) – as opposed to distribution cooperatives – throughout the nation derive more than 15 percent of their income from non-members and are taxable entities. As a consequence, over 80 percent of the electricity generated by the cooperative segment of the electric utility industry was

produced and sold by taxable electric cooperatives. Of these taxable cooperatives, a large majority have little or no federal income liability.

The 85/15 test was enacted in 1924 and with a few limited exceptions has not been substantially altered in 75 years. Given today's electric industry and given the fact that most other kinds of cooperatives do not have a 85/15 test comparable to the one for rural electric cooperatives, I believe that changes are in order.

PROBLEMS WITH THE 85/15 TEST

The 85/15 test posed few problems for cooperatives prior to retail competition, mainly because cooperatives (like all electricity providers) had exclusive service territories. But with retail competition, the very nature of the business is changing. Let me provide some examples where Montana co-ops are placed at a disadvantage because of the 85/15 test.

For example, the 85/15 test is affecting the ability of Montana cooperatives to compete under Montana's electric industry restructuring law. Under this law, Montana cooperatives must form a for-profit subsidiary company in order to sell power outside their distribution system territories. Customers buying power from this subsidiary cannot become members of the parent cooperative, leaving cooperatives to be faced with a major disincentive to competition due to the non-member revenue issue under the 85/15 test.

The limitations of the 85/15 test also create a significant impediment to Montana electric cooperatives' participation in regional transmission organizations (RTOs). Involvement of cooperatives in RTOs is discouraged by the non-member revenue restrictions of 85/15 because RTO participation likely means cooperatives will be required to wheel or transport non-member power across their transmission systems. This impediment exists at a time when RTO development and participation is being strongly encouraged by the Federal Energy Regulatory Commission.

Another example of potential harm to Montana cooperatives under the 85/15 test stems from the recent sharp increase in market prices for electricity. This higher priced market has given rise to strong interest in the development of new generation facilities in Montana, including proposed development of alternative energy resources such as wind power. Electric cooperatives may well be obligated to wheel power produced by these facilities when they are located within the cooperative's service territory. This could result in the receipt of substantial non-member revenues that could affect the cooperatives non-profit tax exemption. Providing greater flexibility as outlined under S.794, would make it easier to participate in the competitive marketplace without losing our tax-exempt status and increasing the electricity rates of our members.

S. 794 – THE RURAL ELECTRIC TAX EQUITY ACT

Montana cooperatives strongly support S. 794, the Rural Electric Tax Equity Act because this legislation updates the tax laws to reflect the changes that have occurred in the

deregulation of the electric utility industry over the past few years, as well as anticipated changes. To compute a co-op's income, the Tax Code currently ignores two types of revenue from the 85/15 income test. S. 794 proposes additional exclusions from the income test. For example, the bill excludes income derived from the buyout of Rural Utility Service debt, condemnation income when a municipal annexes a cooperative's service territory, and gains on sales of the cooperative's assets. In addition, cooperatives need tax provisions allowing them to waive capital credits to certain larger customers that are demanding lower electric rates and to offer electric rates on bases that vary from fully embedded cost.

In addition to the exclusions from member income described above, S. 794 deems other types of income to be member income from the 85/15 test. In general, the items deemed to be member income are those which were member income or patronage sourced income prior to changes required from any electric restructuring law. Finally, the bill also provides generally the same level of relief for taxable cooperatives. By defining these similar types of income as patronage-sourced income, taxable electric cooperatives are able to participate in the open competitive market without increased tax liability.

TRADABLE TAX CREDITS TO INCREASE RENEWABLE ENERGY SUPPLY

In light of ongoing energy supply shortages and environmental challenges throughout the nation, Congress and the Administration should continue to pursue legislative options to promote the production of domestic, low-cost, efficient and clean energy supplies. However, tax benefits that create financial incentives for IOUs do not create incentives for rural electric or publicly owned electric utilities because these entities are not-for-profit, and do not generate federal income tax liability from which to deduct the credits.

In order to establish comparability and fairness with the IOUs, cooperatives and other not-for profit electric utilities must be provided with tradable tax credits. Furthermore, cooperatives must be permitted to sell, trade or transfer the tax credits to private entities that can utilize them. Proceeds from such sales provide comparable incentives for cooperatives' investment in new energy production similar to what is being proposed for the IOUs.

BENEFITS OF PROVIDING TRADABLE TAX CREDITS

A competitive electricity market rewards efficient energy production: Providing tax benefits to only one sector of the industry provides a competitive advantage for IOUs and a competitive disadvantage for the nearly 1000 consumer-owned electric cooperatives and 2000 publicly owned utilities that comprise 25 percent of the nation's electricity load. Offering incentives that are not usable by this significant segment of the market removes the opportunity to employ the existing capacity of cooperative and publicly owned utilities to deploy their expertise and resources in seeking solutions to the nation's energy challenges.

Because renewable energy sources and environmentally clean, advanced fossil fuel technologies usually are more expensive to operate than traditional sources, the federal government has made it a policy to provide investment incentives to encourage IOUs to build these facilities. The rewards are cleaner, more secure, independent, and diverse energy sources. Without comparable incentives, rural electric cooperatives and publicly owned electric utilities are not afforded the same opportunities to make these investments.

PARALLELS IN LAW SUPPORTING TRADABLE TAX CREDITS

There are several provisions in the Tax Code similar to the tradable tax proposal. The only way to benefit from nearly all of the tax credits in the IRC is to have tax liability equal to or in excess of the credits. Exempt organizations can qualify for tax credits by engaging in an unrelated trade or business; however their ability to benefit from the general business credit (the term used to include virtually all credits) is extremely limited. However, some of the credits are directed toward the economic event targeted in the law as opposed to taxpayer's investing in the property or activity generating the credit. For example,

- Section 41 Research credits are allowed for qualified research expenses paid to tax exempt universities;
- Section 38(b)(3) Alcohol fuel credits apply to the alcohol sold or used as fuel, regardless of the tax status of the producer or user;
- Section 47(a) credit addressing, in part, certified historic structures, allows the credit even though the structure may be used by a tax exempt entity; and
- Sections 613A and 619 provide for the depletion allowance for oil and gas and timber, regardless of the tax status of the owner of the property.

Each of these examples advance the public policy without penalizing any member of the economy that implements the public policy objective. In addition, while not a tax provision, an excellent and parallel example of the Tradable Tax Credit proposal is found in the tradable credits of 1990, 42 U.S.C. section 7651 et seq. The Clean Air Act Amendments of 1990 established a system to issue emission allowances for airborne pollutants, implemented by the Environmental Protection Agency. Electric utilities were issued emission allowances authorizing the emission of a specified amount of airborne pollutants by the utility during a specified calendar year or later period. Starting in 1993, unused allowances may be sold, traded or held in inventory for use against emissions in future years.

TAX PARITY TO BUILD NEW TRANSMISSION

Tax parity should also be provided to rural electric co-ops if Congress supports giving IOUs accelerated depreciation and other incentives to build new transmission facilities. There is a lack of available transmission throughout the nation and a need to provide some form of incentives to help spur new development. However, we would caution you against just throwing money at the problem, in the form of excessive tax breaks, and

compounding the error by giving the benefit only to the IOUs. We would support a more cautious and reasonable approach to providing incentives, with the understanding that co-ops would also be given access to these tax benefits, thereby preventing further monopolization of the transmission grid by IOUs.

In conclusion, all sectors of the electric industry have tax concerns due to restructuring and each sector should be provided with equal access to incentives that are designed to promote the cleaner more efficient generation and the building of new transmission facilities.

Thank you for the opportunity to appear before you today. I would be pleased to answer any questions that you may have.

Addendum A

Electric Utility Comparisons

	Investor Owned	Publicly Owned	Cooperatives*	Industry
Number of Organizations	190	2,000	930	3,120
Number of Total Customers.....	92 m	18 m.	14 m	125
Size (median number of customers)	230,000	1,800	10,600	
Customers, % of total	74%	15%	11%	
Revenues, % of total	76%	15%	9%	
kWh sales, % of total	75%	15%	9%	

Sales (billions kilowatt hours)

Residential	804	172	165	1,141
Commercial	767	155	52	974
Industrial	768	145	63	976
Other	64	27	6	97
Total	2,403	499	286	3,188

Density (consumers/mile of line)	35	39	6	32
Revenue/mile of line (dollars)	62,866	63,988	8,156	57,563
Distribution plant investment				
per consumer (dollars)	2,080	2,053	2,446	2,112
Assets (\$ billions)	606	126	70	802
Equity (\$ billions)	188	38	20	246

*870 Distribution, 60 Generation & Transmission cooperatives

kWh = kilowatt hours

sources: 1999 Dept. of Energy/Energy Information Agency, NRECA Strategic Planning & Analysis, Feb 2001

