S. HRG. 106-435

FEDERAL TAX ISSUES RELATING TO RESTRUCTURING OF THE ELECTRIC POWER INDUSTRY

HEARING

BEFORE THE

SUBCOMMITTEE ON LONG-TERM GROWTH AND DEBT REDUCTION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

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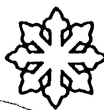

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FEDERAL TAX ISSUES RELATING TO RESTRUCTURING OF THE ELECTRIC POWER INDUSTRY

TUESDAY, OCTOBER 19, 1999

U.S. SENATE,
SUBCOMMITTEE ON LONG-TERM GROWTH
AND DEBT REDUCTION,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:30 a.m., in room 215, Dirksen Senate Office Building, Hon. Frank H. Murkowski (chairman of the subcommittee) presiding.

Also present: Senators Grassley, Nickles, Breaux, Conrad, Graham, and Kerrey.

OPENING STATEMENT OF HON. FRANK H. MURKOWSKI, A U.S. SENATOR FROM ALASKA, CHAIRMAN OF THE SUBCOMMITTEE

Senator MURKOWSKI. Good morning, ladies and gentlemen. Let me welcome you to the Senate Finance Committee, the Subcommittee on Long-Term Growth and Debt Reduction.

It is my understanding that this is the first time in 3 years this subcommittee has met, so hopefully we will not have to make up for it all at one time.

This will be a hearing on tax implications of electric deregulation.*

I, first of all, want to thank everybody for coming here on what many may believe is a long-overdue effort to address the tax implications of electric restructuring. In the Energy Committee, which I currently have the honor of chairing, we have held 18 days of hearings and heard testimony from some 160 witnesses on the issue of electric restructuring.

Although those 160 witnesses, I assure you, had about 160 different views, every witness agreed that the tax laws must be rewritten to reflect the new reality of a competitive electric market. Already, 24 States have implemented laws deregulating their electric markets, and the other 36 States are all considering deregulation schemes of one kind or another.

Faced with that reality, the Federal tax laws must be updated to ensure that tax subsidies, which made sense when electricity was a regulated monopoly, are not allowed to tilt the playing field in the new deregulated marketplace.

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* For more information on this subject, *see also*, Joint Committee on Taxation Staff Report of October 15, 1999 (JCX-72-99).

Today, we are going to hear testimony on many tax aspects of deregulation. The nuclear power industry will describe the problems that exist with regard to the nuclear decommissioning, fund tax rules that were written on the assumption that every State utility regulator would always set rates.

One of my constituents from Alaska, Eric Yould, will discuss the unique tax problems that electric cooperatives face in a deregulated environment. These are very important issues and I am sure that they can, and will, be resolved.

But the most difficult issue, in my view, is how we resolve the competitive issues between the investor-owned utilities who generate 76 percent of America's electricity and the second-biggest player, the municipals, who account for 15 percent of the market.

If we are going to have true competition in the electric market, then we must, at an absolute minimum, have a level playing field among the competitors. No one competitor should be afforded special subsidies that enhance its ability to expand market share.

When we deregulated the airline industry, all the airlines competed on an equal footing, whether it be Pan American, United, TWA, Eastern, and all the other carriers paid the same tax rates and utilized the same depreciation rules.

No single carrier was afforded special tax treatment. The government did not pick winners or losers, the marketplace picked the winners and losers. The same level playing field, with neutrality of taxation applied when we deregulated the telecommunications industry, is in order.

Why should the electric industry be treated any differently than airlines or telecommunications, or for that matter, any other American industry? Why should the government provide special tax advantages to one player in the market, thereby conferring competitive advantage over the other players?

Yet, that is the current reality that we have and see in the electric marketplace. Public power enjoys huge Federal subsidies in that they can issue tax-exempt bonds and they do not pay income taxes.

As the nonpartisan Joint Committee on Taxation noted in their recent analytical paper prepared for this hearing, municipal utilities enjoy a much lower cost of capital because of these tax advantages.

I would note that municipal utilities are taking advantage of these Federal subsidies to take market share from the investor-owned utilities. I have here an article from the May 21 issue of The Bond Buyer, where David Freeman, the general manager of the Los Angeles Department of Water and Power, tells how his agency is selling excess power, mostly Bonneville Power, throughout the State of California. This is the article. If you have not read it and you would like a copy of it, we will make sure you get one.

He noted, "We have made $80 million in net profits over the past 10 to 11 months just from those sales. Is this a profit that belongs to the government? It is certainly power from the government, subsidized PMA.

Ironically, Los Angeles has not opened, has not seen fit to open, its market to competition. Because of the profits Los Angeles is

making from selling outside its service area," and I think that is a very significant note.

"Freeman, however, says it may delay opening its markets to competitors in the near future." Delay opening its markets in the near future. "This is unfortunate because, if consumers and businesses are to maximize the full benefits of open competition and reduce rates, it will be necessary for all electricity providers to interconnect their facilities into the entire electric grid.

This system efficiently is significantly impaired because of the current tax law rules that effectively preclude public power entities from participating in State open-access restructuring plans without jeopardizing their exempt status of their bonds.

No one wants to see bonds issued to finance public power become retroactive taxable because a municipality chooses to participate in a State open-access plan. This would cause havoc in the financial markets and could undermine the financial stability of many of the municipalities. At the same time, however, public power should not have a competitive advantage in the marketplace based on Federal tax subsidies."

It is my hope that, through this hearing and perhaps others, we can begin to reach a consensus on how we can resolve these issues so that the consumer and business can gain the full benefits of competitive electric industry.

I look forward to the testimony. Let me advise you, as a consequence of the draft bill that we put in on the deregulation of the electric industry, it is my thought to proceed with that draft bill and address some of the issues that are more contentious, the PMAs, and the renewable mandate and others, perhaps, outside the parameters of that legislation. So, in the interest of full disclosure, I wanted you to know my thoughts.

Before we hear the witnesses, let me call on the Ranking Member, Senator Graham from the State of Florida. Good morning.

Senator GRAHAM. Thank you.

Senator MURKOWSKI. I look forward to your statement, along with Senator Breaux and Senator Kerrey.

OPENING STATEMENT OF HON. BOB GRAHAM, A U.S. SENATOR FROM FLORIDA

Senator GRAHAM. Thank you, Mr. Chairman. I appreciate your holding this hearing to examine the tax ramification of changes that are taking place in America's electric power industry.

I personally have been an advocate for State-led electric power restructuring. I believe the differences among the States, the history of State regulation, justify the States continuing to have the primary role.

I see the Federal role as being essentially to remove impediments to the States' ability to restructure the electric industry as the States consider it appropriate for their citizens.

One of those areas that is going to have to be dealt with is the buildup of Federal tax laws as it relates to the various types of electric utility companies, the investor-owned, the publicly owned, and electric cooperatives.

So, Mr. Chairman, I appreciate your holding this hearing today, which will get us started on understanding, what are the implica-

tions of the current tax law and what are the suggested changes that will be necessary in order to give to the States a level playing field upon which to make judgments that are in the best interests of their citizens relative to restructuring of this critical industry.

I look forward to hearing from our witnesses today.

Senator MURKOWSKI. Thank you very much, Senator.

Senator Breaux, it is nice to have you here this morning.

Senator BREAUX. I would have thought if you had had 16 days of hearings in that other committee, you would have solved all of these problems.

Senator MURKOWSKI. Well, that will give you some idea of what we are up against.

Senator BREAUX. Bring them over here now.

OPENING STATEMENT OF HON. JOHN BREAUX, A U.S. SENATOR FROM LOUISIANA

Senator BREAUX. I, like I guess all of our colleagues, have all of the various sources of power in our State. I mean, public utilities and investor-owned utilities and co-ops, and even independent power producers. So we are faced with trying to move into a new era.

I think the bottom line is, how do we make sure that there is, as we often the use the phrase, a level playing field? That necessarily takes into consideration the tax consequences and some things we have done in the past to encourage public power, and how do we level the playing field when they have a new era of deregulation and competition.

I strongly support competition. Those companies and providers of power that can do it for the least cost and do it in the most efficient manner possible will get the business, and I think that is what we should try to encourage. That is a very difficult thing to accomplish and I look forward to the suggestions.

Thank you.

Senator MURKOWSKI. Thank you very much, Senator Breaux.

Senator Kerrey, good morning.

Senator KERREY. Good morning, Mr. Chairman. It is a pleasure to be with you.

Senator MURKOWSKI. You really mean that?

Senator KERREY. No, I do not. [Laughter.]

Senator MURKOWSKI. Well, I am glad you are here anyway. Misery loves company, you have heard of that. [Laughter.] It shows the enthusiasm here. The Republicans did not do very well this morning, but that is all right.

OPENING STATEMENT OF HON. J. ROBERT KERREY, A U.S. SENATOR FROM NEBRASKA

Senator KERREY. Mr. Chairman, I want to thank you for holding the hearings. It is obviously an important issue to all of us. I hope, in the process of discussing both deregulation and tax policy of utilities that will heed both your statements and the statement that Senator Graham made, which is that every State is going to be different.

My State is unique. We have 154 not-for-profit community-based public power systems established by Senator George Norse. Ne-

braska is the only State in the Nation that is entirely public power, and that creates, suffice it to say, significant problems as we move into a deregulated environment.

It serves my State extremely well. Not only do we have low rates which we obviously think are important as we try to develop our economy, but citizens' participation in the decisionmaking is also an important aspect. They elect the boards. For both of those two reasons, public power enjoys broad bipartisan support in the State of Nebraska.

Before Senators Gorton, Jeffords, and I introduced S. 386 in February, there were 18 States that had moved toward permitting new competition in the electric industry at that time.

Since then, five additional States—Texas, Ohio, Arkansas, New Mexico, New Jersey—have followed with restructuring legislation. A number of other States, I have been told, we can expect to do the same during the next year.

The Federal tax rules governing municipal bond financing, however, did not anticipate this new era of electric utility restructuring when they were crafted more than a decade ago.

I fervently believe that, if Congress does not act to change the law, public power systems that open their transmission lines to privately owned utilities can jeopardize the standing and status of their outstanding tax-exempt bonds.

That is why the legislation Senator Gorton will speak about here in a few moments was 29 co-sponsors, and virtually everyone outside of Nebraska that has co-sponsored it has a mix of both public- and investor-owned utilities in their State or Congressional district. These colleagues share our view that the Bond Fairness and Protection Act is an equitable solution to this particular problem.

Now, let me say that this legislation does not grant special protection or special advantages to public power. Indeed, it does just the opposite, in my view, by providing a level playing field for all utilities in a new competitive environment.

Specifically, what the bill would do is provide them with an option. Now, you can either choose to operate under the limitations of the current so-called private use rules in our Tax Code, or if they prefer, they can choose to make a one-time irrevocable election that will allow them to build new power generation facilities, but only using fully taxable bonds instead of tax-exempt financing.

It is important to recognize that local governments may face unique situations in the financing of public power as the electricity market changes and we give them reasonable and fair choices.

Mr. Chairman, again, I appreciate your holding the hearing. It is probably not a pleasure for me to be anywhere this morning. I enjoy very much listening to your views on this matter.

I hope, again, as we move to sort of the final stage of this thing, that recognition will be granted to a very simple fact, and that is the needs of each individual State are apt to be considerably different.

I know that you recognize this, and it is has been a pleasure working with you on other issues where you have used that recognition to enable us to move the ball down the field, and I look forward to the testimony of the witnesses.

Senator MURKOWSKI. Thank you very much, Senator Kerrey. Well, your State is unique. As I gather, being a public power State, you would just as soon be left alone.

Senator KERREY. No, I would not say that. We are not advocating being left alone. We understand that change is necessary, although we are a little bit like the cartoon character, Dilbert, who said, "Change is good for you. You go first," because we have benefited enormously from public power.

But we are not advocating no change. We recognize that the marketplace is changing, the consumer needs are changing. What we are saying is, whatever the Federal Government does, try to do it in a fashion that allows each of the States to develop individual plans that suit their needs.

Senator MURKOWSKI. Thank you very much, Senator.

We have four panels, and I am going to request that, those presenting positions, try and keep within five to 7 minutes. I get a little edgy after 7 minutes.

Our first panel consists of Hon. Max Baucus, the Honorable Slade Gorton, Hon. Phil English. It is customary, of course, with the Finance Committee, to call on the Finance Committee members first. So I will enter into the record Max Baucus's 10-page statement and we will move to Senator Gorton from the State of Washington.

Senator you are lucky. Please proceed.

[The prepared statement of Senator Baucus appears in the appendix.]

STATEMENT OF HON. SLADE GORTON, A U.S. SENATOR FROM WASHINGTON

Senator GORTON. Well, that was a quick 7 minutes, Mr. Chairman.

Senator MURKOWSKI. You do not get the extra time, though. [Laughter.]

Senator GORTON. Mr. Chairman, you, and I think Senator Graham, are in particularly fortunate, or maybe unfortunate, circumstances as members both of the Finance Committee and of the Energy Committee.

As you have pointed out, over the course of the last 3 years or more, the number of hearings, and meetings, and the amount of public testimony on issues related to this issue is voluminous.

You have reflected the difficulty in dealing with these issues with your own outline of the bill at this point on the subject of retail competition and the restructuring of the electricity marketing field.

You are particularly fortunate because most of our members and most of our staffs deal either with energy issues or with tax issues, and not with both. What we are talking about here today, of course, deals very much with both.

The bill that I have introduced with Senator Kerrey and close to 30 other members for the second consecutive Congress is a tax bill, but it is a bill relating to taxes because of the dramatic restructuring of the way in which power is marketed in many States across the country and nationally on a wholesale level.

Public power, whether municipal or through public utility districts or otherwise, is subject to private use rules on its tax-exempt

financing. But these rules were developed at a time at which there really was no competition and which the geographical areas for public power entities was circumscribed, as was that of privately owned utilities. In a sense, they were competitive, but not in the sense of offering their services to the same customers.

As States move forward in allowing competition, regardless of any Federal action, or if the Federal action does, the current private-use rules provide public power with the unacceptable option either of violating present or past rules and incurring tremendous costs in refinancing their debt, or walling off customers, their own customers, from the kind of competition that I think all of us feel to be desirable.

These are not good choices as far as customers are concerned. They are, of course, at the same time especially expensive to the customers of public power entities.

The legislation that I have introduced with Senator Kerrey, for reasons that he outlined, I think, quite eloquently, is a compromise from the beginning. It does not simply allow public power to continue to issue tax-exempt financing without any limitation, but requires each one of them, each of the public power utilities, to make very, very real choices.

Particularly, existing private-use restrictions would be modified by this bill to not include the types of activities that pertain to opening a system to competition, such as FERC requirements to provide open access to transmission facilities, or a State requiring access to a utilities distribution system.

A utility could choose to continue to abide by existing private-use restrictions with these clarifications, but other utilities—and I think this would be a very large number of them—would have the option to the same certainty, the certainty created by grandfathering their existing tax-exempt debt incurred prior to the expectation of competition, but with the tradeoff of never using tax-exempt debt again for sources of generation, the area in which competition is becoming increasingly widespread.

These public utilities would still be able to use tax-exempt debt for the segments of the industry that are natural monopolies, distribution systems of wires through a community and large transmission systems that generally run between communities and power plants and throughout regions.

As I said, we have a dual challenge here, the challenge of either enabling, or at least not getting in the way, of retail competition. There is a debate between an administration and many others who feel that competition should be mandated at the Federal level, and those—and this is consistent with your own bill—who feel that this should be a decision made in each of the several States of the United States of America.

But even in the latter case, of course, at the present time, the Federal Government puts up real inhibitions that stand in the way of providing that competition, whatever State actions there are that take place.

What we seek to do with this compromise private-use situation is to be consistent with that local choice and to allow small utilities that do not want to get into this market to be unchanged, and to say that those that do want to get into the market in a competitive

fashion through generation facilities, that you have to operate by the same rules and the same standards that everyone else does.

Senator Kerrey has pointed out that this proposal has broad support in States and in communities with publicly owned utilities. But what we need to do, is create a system to enable a system that will benefit everyone and for which there can be broad support across the board, both in States and communities that are largely public power and those that are largely private power.

Senator MURKOWSKI. Thank you very much, Senator Gorton.

Congressman English, we welcome you over here and look forward to your statement. Please proceed.

[The prepared statement of Senator Gorton appears in the appendix.]

STATEMENT OF HON. PHIL ENGLISH, A U.S. REPRESENTATIVE FROM PENNSYLVANIA

Representative ENGLISH. Thank you, Mr. Chairman. It is a delight. If I might, I would like to enter my full statement for the objection so I can be brief.

Senator MURKOWSKI. No objection.

[The prepared statement of Representative English appears in the appendix.]

Representative ENGLISH. Mr. Chairman and members of the subcommittee, I want to thank you for the opportunity to testify before you today on an issue that is extremely important to my constituency.

As you are aware, the tax implication of electricity restructuring are significant. The Commonwealth of Pennsylvania and 22 other States are introducing competition into electricity markets. Decisions that Congress might make now will define electricity markets nationwide, will determine to what extent consumers will benefit from such competition.

I believe that, for electrical competition to work, the Federal Government needs to address the artificial competitive advantages of complete exemption from Federal income taxes and the use of tax-exempt financing by government-owned utilities when competing against other sellers of electricity.

These tax advantages may have had little practical impact when each electric utility, whether privately or governmentally owned, sold power within its own service territory. However, as the Joint Committee on Taxation has noted, if certain electric service providers were permitted to retain their ability to receive tax-exempt financing in a competitive marketplace, those providers might have a considerable cost advantage over other competitors in a deregulated market. I believe this would distort competition and grow government-owned utilities at the expense of their taxpaying competitors.

I became aware of this issue when a number of my constituent organizations, specifically, shareholder-owned and rural electric cooperative utilities, brought to my attention their concern about government-owned utilities using tax-exempt financing to lure away their existing customers.

All electricity providers understand that changes need to be made for moving from a monopolistic to a competitive environment,

changes in the Tax Code. The question is, what kind of change should be made?

The issue before us now is how to integrate municipal utilities into the competitive market in a way that advances, without distorting, competition. Tax-free financing and exemption from Federal and State income taxes pose no problem to electrical competition if, and only if, government-owned utilities limit the use of tax-free financing and exemptions to their traditional service areas.

On March 24, I introduced H.R. 1253, legislation which addresses competitive concerns by prohibiting tax-free bonds from being used to finance generation and transmission by government utilities if such utilities choose to compete in open electricity markets.

If such utilities elect to do so, any sales outside of their traditional service areas should be, like other commercial operations, subject to Federal income tax. This legislation will not affect government-owned utilities if they use tax-exempt financing and other subsidies to provide power in their historic service areas.

Moreover, this legislation will not affect municipal utilities that do not elect to sell generation or transmission in the new competitive marketplace. Since the vast majority of government utilities, of which there are more than 2,000, do not generate electricity, this bill will not affect them.

In addition, this legislation does not affect existing bonds or current bond holders, Federal authorities, such as the Bonneville Power Administration or rural electric cooperatives. I believe this is a balanced, fair approach to addressing tax and finance disparities in the context of deregulation.

As noted by the Congressional Research Service in a June 10, 1999 memorandum, Congress has engaged in an effort for 30 years to deny use of the Federal subsidy provided by tax-exempt bonds for goods and services that do not satisfy its conception of public services.

Some of these efforts have been directed specifically at public power. Concern regarding the spread of power subsidized with tax-exempt bonds caused Congress in the 1986 Tax Reform Act, to impose more severe restrictions on private use of bond proceeds for government-owned utility property than it did for other eligible private activities.

Congress' desire to further limit the spread of electricity subsidized by tax-exempt bonds has been demonstrated two times following the 1986 Act. First, the Omnibus Budget Reconciliation Act of 1987 adopted a provision that essentially treats as private activity, subject to the volume cap, any tax-exempt bond issue for which 5 percent or more of the proceeds are used to acquire output property owned by shareholder-owned utilities.

Second, the Omnibus Budget Reconciliation of 1996 further restricted shareholder or independent power producers' use of bonds for "local furnishing" to service territories that were using the bonds prior to January 1, 1997. Those providers using the bonds at that time were grandfathered. Additional local furnishers were prohibited.

It is clear, Mr. Chairman, that three decades of tax legislation has been directed to controlling the spread of the tax-exempt bond

subsidy to areas not served historically by public power. Why would we want to reverse course at this time?

That is exactly what will happen if provisions of Senate bill 386 or H.R. 721 are enacted into law. These bills specifically expand the ability of all government-owned utilities to issue new tax-exempt debt, to serve customers outside of their traditional service territory.

These bills, well-intentioned, would allow public power to use facilities financed with tax-exempt bonds to compete against private companies to sell power. It would enable government utilities to grab control over the electricity transmission system through the use of not-for-profit transmission control companies, a stated goal of public power.

What legitimate governmental purpose would be served under this type of financing arrangement? I, for one, cannot think of one.

Wrapping up, Mr. Chairman, what it would do, is provide special benefits to public power customers at the expense of all other taxpayers. As noted in a Congressional Research Service study, the exclusion from Federal income taxation of interest income on tax-exempt bonds for public power is a subsidy that obscures, rather than reveals, the true cost of electricity and redistributes income to public power customers from the 75 percent of the country that purchases its electric power through the private sector.

Allowing tax-exempt bonds to be used for new output facilities after deregulation of generation and retailing has been implemented would give public power a competitive advantage over IOUs. Congress should be concerned about this. I welcome the interest of this subcommittee in this difficult issue, and I very much appreciate the opportunity to testify today, Mr. Chairman. Senator Murkowski. Thank you very much, Congressman Phil English.

[The prepared statement of Representative English appears in the appendix.]

Senator MURKOWSKI. We have been joined by Senator Nickles. Senator Nickles, do you have any comments you would care to make?

OPENING STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM OKLAHOMA

Senator NICKLES. Thank you, Mr. Chairman. I want to thank you for having this hearing. I compliment our witnesses. I apologize to our colleague, Senator Gorton. I did not catch all of his statement. I did catch Congressman English's and I think it was an excellent statement. I happen to concur with most of what he said.

I think it would be a serious mistake for us to expand tax-exempt financing so entities can get into, and maybe have a competitive advantage, in a deregulated or competitive market. I am very much in favor of expanding competition in the utility field, and I would like for something to happen this Congress.

But I do think it is important that we address the tax inequities and make sure that, if we are talking about expansion and competition, that all players basically have no tax advantage. I think expansion of tax-exempts into a deregulated market beyond their

traditional areas would be a serious mistake, and I would compliment Congressman English for his excellent statement.

Senator MURKOWSKI. Thank you very much, Senator Nickles.

Senator KERREY. I wish you had been here to hear Senator Gorton's statement, because it was good, too. [Laughter.]

Senator NICKLES. I caught part of it.

Senator MURKOWSKI. Ordinarily, we do not eat our own. [Laughter.] But since Senator Gorton and Congressman English seem to be somewhat comfortable, if there are any brief questions from the members, this is an opportunity. I would call on the Ranking Member at this time, if you have any questions.

Senator GRAHAM. No questions at this time.

Senator MURKOWSKI. Senator Breaux?

Senator BREAUX. Just briefly, because you obviously differ on a number of key points. Can you give me both your explanations, Slade, and Congressman English, on the question of income taxes on sales outside of a territory?

I take it that, Slade, your bill would provide no income taxes on sales made by a public utility outside of their territory, and Phil, you say that if they go outside they should pay. What is the justification for your positions?

Representative ENGLISH. Mine is, simply, that there should be a level playing field and the differential provided by income taxes can be substantial. From my experience in Pennsylvania, where we have just deregulated, people have been making decisions based on minuscule differences in the cost of power and going with a power company that can provide them with just a few pennies' better rate.

In that context, I think there needs to be competition. I think public power should be able to compete. But the differential provided by that income tax difference can be enough to change decisions, and that is our biggest single concern.

Senator BREAUX. Slade, on the question I am looking for—thank you, Congressman English—is if they are allowed to compete with private companies and they make money off of it, why should there not be tax consequences?

Senator GORTON. Well, the answer to that, and both to Senator Nickles who was not here when I spoke, is that neither of these bill provide new tax exemptions. In fact, Senator Kerrey's bill and mine rather seriously limits the tax exempt debt of public utilities when they go into a competitive market.

By and large, publicly owned utilities purchase more power than they sell, and many of them are going to be selling outside of their own areas simply because competition is coming in from outside, competition for their own customers.

At the present time, as I say, they buy far more than they sell. But to say that privately owned utilities do not have tax advantages is just simply not the case. They currently have about $57 billion in accumulated deferred income tax benefits, $11 billion in unamortized investment-type tax credits, they get tax credits for pollution control equipment. The total of all of those is more than all of the tax-exempt bonds combined for publicly owned utilities.

So, you are never going to make the two get absolutely identical, but many of the types of tax- exemptions and tax credits that are

provided for privately owned utilities are never, under any circumstances, going to be available for publicly owned utilities.

In the area in which they can be competitive in the generation of power, which is some public and some private, we are saying, if you are going to get into that business on a competitive basis, you lose your tax-exempt bonds. You cannot build them.

For transmission facilities, for example, they are always going to be regulated. We are not going to have competitive transmission facilities built to parallel one another around the country. They are going to be FERC regulated. But one government does not impose income taxes on other governments, it is just as simple as that. We do not tax the cities, States, and counties of the United States of America, whatever the types of municipal services that they provide.

Senator BREAUX. Thank you, Mr. Chairman.

Senator MURKOWSKI. Senator Kerrey?

Senator KERREY. Well, let me just try to make it, Congressman English, in the form of a question rather than just a statement. I do think, if we are going to get legislation done, that all of us are going to have to both accommodate and make some effort to understand what each State is doing.

Pennsylvania is completely different than Nebraska. You heard in my testimony how different we are. To that end, I hope we do not have this debate go into a competitive analysis of subsidies. Investor-owned utilities get subsidies. They are not subsidy-free.

Any time I hear somebody say, I want a level playing field, it makes me nervous because it typically means they want something more than just a level playing field. If you are going to compete, it is oftentimes the case that your competitor may be better than you. It is difficult to tell whether they are better than you because they are just better than you, or are they getting some sort of advantage?

I mean, we are, in Nebraska, fully willing to make an effort to join this competitive environment, but what we face is, and I would just appreciate it if you could accommodate this question, if you were a Senator from Nebraska and you have got $2.2 billion in municipal debt that is out there tax-free, and you open up your lines for competition, you put that tax-exempt status at risk.

In that environment, would you put that tax-exempt status at risk or would you seek to change the Federal law to enable that municipality or that entity to be able to open up their lines without risking a significant increase in their cost of doing business?

Representative ENGLISH. I think that is an excellent question, Senator. I guess I would reframe it slightly. I think in a situation like——

Senator KERREY. I wish you would not. [Laughter.]

Representative ENGLISH. But I sympathize with your situation. My bill has tried to accommodate that concern by allowing existing debt to operate pretty much with its current status. But I do believe that, in Nebraska, if your municipal-owned utility were to go outside of the State and were to invest competitively, they should have some sort of an equitable tax situation.

I will concede to Senator Gorton that investor-owned utilities do take advantage of things like depreciation, as do manufacturers

and a variety of other enterprises. I am not sure that is the point. While the Tax Code may accommodate certain things that investor-owned utilities do, I am not sure you can put that on the same level as a tax exemption.

I think, Senator, what you have done is put your finger on the fact that this is a very, very difficult issue and we should try to find some way of establishing, as close as we reasonably can, a level playing field between different kinds of utilities.

I do not want to drive municipals out of business. At the same time, I do not want them to come into my area and under-price existing power providers.

Senator KERREY. Well, I would just say, in a competitive environment, if you and I are competing and you are my competition, I actually would like to put you out of business.

Representative ENGLISH. That is true.

Senator KERREY. You may not want to put us out of business.

Representative ENGLISH. But we should not be in the position of favoring one kind of utility over another.

Senator GORTON. Senator Kerrey, you have made a good point. Congressman English says he does not want to drive your people out of business, but he does not want someone coming into his district and offering his constituents lower priced electricity.

Representative ENGLISH. If it means a tax subsidy, no, I do not.

Senator GORTON. There was a third alternative to your question that you have not brought out. You could just say, we are not going to allow any competition and you can stay in the same situation that you are at the present time.

But I think you believe, and I believe, even in connection with my publicly owned power companies, we would welcome that competition. We think that it can benefit some of our customers as well. We simply do not want to lose the advantages that we have at the present time when we enable that competition to take place.

It is insufficient to say that, if we grandfather your existing debt, but all of your future debt no matter what you do it for, even your local distribution systems, is then going to be taxable. There is no incentive then for us, for your constituents and mine, to allow this competition in the first place.

Since we are saying in the bill that you and I have introduced that anything that we build in order to sell power elsewhere, generation facilities, is going to have exactly the same debt status that a privately owned utility does, I think that takes care of it.

We are not going to take advantage of these others. I think a tax-exemption is a tax-exemption, whatever you call it. There are widespread tax-exemptions for privately owned utilities that I think are justified, but they are subsidies. They make the cost of power to their customers lower than they would be if those rules did not exist.

Moreover, if we are going to get from here to there from where we are today to a truly competitive system in the United States, customers in Nebraska are going to have to feel that they at least have a potential advantage, customers in Washington are going to have to feel that way, customers in Pennsylvania are going to have to feel that way.

We have to come to an accommodation in which the vast majority of people, or all the people in the United States, feel advantaged by the new system and not that some of them are paying here so that someone else may receive elsewhere.

Senator KERREY. Thank you.

Senator MURKOWSKI. I am going to call the next panel and I want to move it along. But I think this is valuable, because we are getting right down to the crux of the argument between public- and investor-owned power.

Senator Conrad, good morning.

Senator CONRAD. Good morning. I am going to leave my speaking until the questioning time. I know you have an awful lot of witnesses here, Mr. Chairman. I was not here for the earlier testimony, so I am happy to pass on this round.

Senator MURKOWSKI. Senator Nickles?

Senator NICKLES. Mr. Chairman, thank you.

Let me see if I have learned a little bit. Both of you say that if you have a public power that expands out of their area, that that should not be tax-exempt, is that correct?

Senator GORTON. Should not be able to issue tax-exempt debt.

Senator NICKLES. Even, Senator Gorton, if they lose some customers in their own area? So the public power entity might say, well, I lost some to competition so I need to go outside so I can keep up the same level. You are still saying, if they go outside their area, they should not have tax-exempt financing?

Senator GORTON. They should not be able to build new generation facilities from which they are going to sell power outside of their own area and be able to build those generation facilities with tax-exempt dollars.

Senator NICKLES. All right. I agree with you.

Now, if they go outside and they are competing outside of their area, public power entities, should they pay income taxes on that additional service area?

Senator GORTON. No, Don, they should not. If we look at public power in the country today, it is a net importer. It is only going to be selling outside when someone else has taken away its customers inside.

It is still a municipal corporation or a State-owned corporation, and governments do not tax other governments. Nor will it be able to take advantage, because the overwhelming bulk of its sales will still be to its own customers of all of these various tax credits that are available to privately owned utilities at the present time.

Senator NICKLES. I agreed with your first part, I do not agree with the latter. I think if you are going outside, totally outside, that, one, it should not be tax-exempt, and two, it should be taxable and they should have, as you say, "tax advantages."

I do not think depreciation is a major tax advantage. I think you are entitled to write off your investment. But they should pay taxes on that if they are going to enter into a service area outside their market, at least that is my thought.

But I appreciate maybe kind of defining the two differences to some extent. There is some commonality as far as banning tax-exempt for outside of area, the different being primarily income tax

treatment outside the area. Is that correct, or at least one of the differences?

Representative ENGLISH. That is perhaps the most significant.

Senator NICKLES. All right.

Senator GORTON. Well, I think there are other differences as well, though I am not familiar with all of the elements of Congressman English's proposal.

Senator NICKLES. All right. Thank you.

Thank you, Mr. Chairman.

Senator MURKOWSKI. Let me just make a couple of comments here relative to the role of public power vis-a-vis investor-owned and the PMAs. It is my understanding that municipal public power, as a whole, buys more than they produce, as Senator Gorton stated.

However, we have a lot of small, small, municipally owned producers. On the other hand, TVA is the largest producer of power, Bonneville is the second. Both of those, of course, sell much, much more than they buy. So one of the difficulties here, obviously, is one size does not fit all.

Further, one of the problems I have in grasping the issue of a level playing field is the premise in Senator Gorton's bill, and Senator Kerrey's, that the generation would not be tax-exempt. However, he would exempt transmission facilities.

He would exempt repairs of generation units, which can be interpreted as tax-exempt generation, because one can make the case that, when you wear out your generation, you put in new generation facilities that do become tax-exempt.

So I think that is a correct interpretation. Is that correct, Senator Gorton?

Senator GORTON. Well, transmission facilities, I do not believe, Mr. Chairman, are likely to be competitive, and transmission costs and charges are going to be set by a Federal entity. Everyone is going to have them equally available to them. So to discourage the creation of new transmission facilities by imposing taxes on their debt that do not exist at the present time, seems to me, to be counter productive.

Senator MURKOWSKI. And repairs of generation?

Senator GORTON. Repairs of generation facilities. At the present time, these generation facilities, Mr. Chairman, are used for the existing customers of these utilities. As you pointed out, they now buy more power than they sell. They certainly ought to be able to repair those generation facilities under the same circumstances that they built them.

Senator MURKOWSKI. Well, it is my understanding that the municipal utility generation is not subject to FERC, which simply points out an inconsistency in the regulatory overview.

Senator GORTON. Generation. That is correct.

Senator MURKOWSKI. Now, my question, specifically—and it has been answered, but I would like to hear because I think it gets to the bottom of where we are going to ultimately in resolving this—is, again, some of the municipal utilities contend that, since investor-owned utilities are allowed to take accelerated depreciation, that this is a subsidy and it is a subsidy equal to and comparable

to the subsidy that municipal or public utilities receive by being allowed to issue tax-exempt bonds and now being subject to taxation.

Do you agree that there is total equity here, or that, indeed, one side or the other is incorrect in its interpretation?

Senator GORTON. Well, is it absolutely equal under each and every circumstance? Of course not, because some have more facilities in which rapid depreciation is taking place, and some have fewer. In some cases, it is a greater subsidy than the tax-exempt financing for municipal utilities, and in some cases it is less, but it is roughly comparable overall.

Senator MURKOWSKI. Phil, do you want to hit a home run on this one or not?

Representative ENGLISH. Well, I will try. But, Mr. Chairman, I do not think you could analogize the two. I would encourage the subcommittee to dig in and closely compare what we are dealing with here. I think it is apples and oranges. I have a real concern that you cannot compare the level of subsidy for public utilities versus investor-owned utilities the way it has been portrayed here.

I would also encourage the subcommittee to carefully examine the statement that Senator Gorton, who I agree with on many things, has made here today about transmission not being competitive.

I think there are situations where public/private partnerships could be extremely attractive to certain utilities that would partner with a municipal utility, taking advantage of the tax break that is provided in Senator Gorton's bill for transmission facilities. I think there are some situations where we might have some unintended consequences there.

Senator MURKOWSKI. Thank you both. Go ahead, Senator Gorton.

Senator GORTON. Mr. Chairman, one side has apples and the other side has oranges, I suppose we could say, but neither has both. The proposal by Mr. English wants to say one has one of them, the other has none.

Senator KERREY. The question I tried to ask earlier, we obviously have, from time to time, what seems to be a narrow difference, and sometimes a very broad difference between the two proposals. We can say that, in my case, when I talk to public power entities in Nebraska, Omaha Public Power, Nebraska Public Power, and simultaneously talk to Mid-America, which is an investor-owned utility headquartered in Iowa.

I can see where we can close the difference between the two. I hope, as we go through this thing, what I was trying to say is, we start off with rhetoric that says—and I do not mean to put a pejorative on it—you are being subsidized and I do not like it, your idea sucks and mine is terrific.

Senator MURKOWSKI. Please.

Senator KERREY. Pardon me?

Senator MURKOWSKI. I said, please.

Senator KERREY. Please. Your idea sucks, please, mine is terrific. [Laughter.]

Senator MURKOWSKI. He is hard to handle; that is all there is to it.

Senator KERREY. We are not likely, it seems to me, to get an agreement. I do think that it is vitally important for both sides

that we attempt to get the bill language, and I think we can. I do not think there are irreconcilable differences on the ground where people are doing business. I hope that we can put legislation together that enables all of us to say that we have done the best job of enabling everybody to be successful.

Senator MURKOWSKI. You may have lost us on your first few words, but we do appreciate your input.

Let me thank the panel. I think you have made a valuable contribution to the responsibility we have to finally resolve the issue of equity here. I would remind you that the objective here is to benefit the consumers. You benefit the consumers by reducing the rates, and you reduce the rates by increasing the efficiencies, not necessarily at the burden of the U.S. taxpayer.

So with that profound observation, and not allowing any further discussion from the members of the Senate, I will defer to panel two and panel one.

We are joined by Mr. Joseph Mikrut, Tax Legislative Counsel for the Department of the Treasury, Washington, D.C. We are fortunate to have two gentlemen with the wisdom of a moustache and a beard. I do not notice a pipe, but that is probably a good thing.

And the Honorable T.J. Glauthier, Deputy Secretary of the Department of Energy. Gentlemen, you have heard the witnesses. You have got a pretty good idea of the flavor of the place. We will run you five to 7 minutes and ask that you proceed in any order you so wish.

I guess, Mr. Mikrut, you are first on my list, but it is up to you gentlemen, between you. Do you want to go first? The secretary is first. Whatever.

STATEMENT OF HON. T.J. GLAUTHIER, DEPUTY SECRETARY, DEPARTMENT OF ENERGY, WASHINGTON, DC

Mr. GLAUTHIER. Thank you, Mr. Chairman. I think I will make a little broader statement, and Mr. Mikrut will make a more specific statement on some of the tax provisions.

Thank you for inviting us to testify today on the tax-related provisions included in the proposed electricity restructuring legislation.

On April 15, Secretary Richardson transmitted to the Congress the Comprehensive Electricity Competition Act, the administration's vision for the role the Federal Government should play in the transition to competition.

I want to thank you for introducing the two bills that we submitted, S. 1047 and S. 1048, S. 1048 containing the tax-related provisions of the administration proposal.

Twenty-four States, as you said earlier, have now adopted electricity restructuring proposals that provide for competition at the retail level, and almost every other State has the matter under active consideration.

The Clinton Administration believes this is a positive development. Competition, if structured properly, will be good for consumers, good for the economy, and good for the environment.

However, the full benefits promoted by competition can be realized only within an appropriate Federal statutory framework. What we do at the Federal level, and when we do it, will have a profound

impact on the success of State and local retail competition programs.

One of the primary functions of Federal restructuring legislation must be to remove the Federal impediments to wholesale and retail electric competition. Secretary Richardson has already testified before you in the Senate Energy and Natural Resources Committee about the administration's views on many of these impediments.

I would like, today, to outline the problems presented by the Tax Code. My colleague from the Treasury Department, Mr. Joe Mikrut, can provide greater emphasis on the specifics of the administration's tax proposals.

Publicly owned electric utilities are an important part of the Nation's power system. For instance, more than 25 percent of all the transmission facilities located in the State of California are owned by publicly owned utilities.

It is imperative that, as we transit to wholesale and retail competition, we enable the cities and towns served by publicly owned facilities to reap the same benefits that will be available to customers of investor-owned utilities.

The private-use restrictions in the Tax Code serve as a major deterrent to the development of competitive markets. Publicly owned utilities could very well endanger the tax-exempt status of their debt issued to finance generation, transmission, and distribution facilities if they, (1) voluntarily comply with FERC Order 888 by providing other utilities comparable access to their transmission facilities; (2) join an independent regional system operator; (3) enable other power marketers to use their distribution facilities as part of a retail competition program; or (4) mitigate their stranded costs associated with retail competition by selling excess power outside of their traditional service territory.

As a result, many publicly owned utilities to date have deferred taking action that would have the effect of promoting wholesale and retail competition.

As the industry moves toward a more efficient integrated structure, transmission and distribution facilities that may have been financed with tax-exempt debt need to be open to use by competing power marketers.

To achieve such a result, the administration proposes to amend the Internal Revenue Code to provide that private-use limitations are inapplicable to outstanding bonds for publicly owned generation, transmission, or distribution facilities if used in connection with retail competition or open-access transmission.

Two, tax-exempt financing would be unavailable for new generation or transmission facilities. Tax-exempt financing would continue to be available for distribution facilities subject to private use limitations, as under current law.

Interconnected distributed power and combined heat and power facilities are likely to be an important approach to meeting customer needs in restructured markets. In addition, these technologies provide important benefits to certain rural areas, such as parts of Alaska where high distribution costs inhibit growth.

While retail competition itself will provide an impetus to the development of both distributed power and combined heat and power

systems, a number of other significant barriers impede the effective deployment of these technologies.

Given the significant economic reliability and environment benefits of these technologies, a truly comprehensive plan for the electricity sector should include actions to reduce these barriers.

The present tax treatment of distributed power technologies may have the effect of discouraging their use in many types of applications. Depreciation lifetimes for particular pieces of equipment, such as turbined engines, may be much longer when the equipment is used as part of a building than when it is used in another application, such as airplane propulsion.

The administration's proposal attempts to clarify the depreciation schedule for distributed power equipment to ensure that our tax policies do not inhibit the development of this technology.

In addition, the administration has also included an investment tax credit for combined heat and power systems in its proposed restructuring legislation. This provision is intended to encourage increased energy efficiency by accelerating and introducing investments in such systems.

The increased demand for combined heat and power equipment should, in turn, reduce combined heat and power production costs and spur new technological innovation in such systems.

In the administration's view, existing nuclear power plants, which today supply one-fifth of the Nation's electricity needs, are an important part of our electricity future.

To avoid unintended adverse impacts on the economics of the nuclear power operations, changes in the structure of the electric power industry must not impede longstanding efforts to fund the eventual decommissioning of nuclear power plants.

Current law poses a significant barrier for the adequate funding of nuclear decommissioning funds. As a result, we have proposed an amendment to the Tax Code to allow owners of nuclear power plants that operate in a restructured environment to continue to make tax-deductible contributions to a qualified nuclear decommissioning fund.

Mr. Chairman, while the States are proceeding with their restructuring programs, all eyes are on the Congress to learn what signals the wholesale and retail markets will receive. As key members of the Senate's Finance Committee, and as the chairman of the Senate Energy and Natural Resources Committee, you are in a crucial position to address these issues in a comprehensive manner.

The administration believes that Congress should move forward on a comprehensive basis to enact legislation addressing all of the actual matters related to electricity restructuring, including tax issues.

Mr. Chairman, we cannot afford to wait until the 107th Congress to do what needs to be done now. Secretary Richardson and I, as well as our staff and experts from the Treasury Department, stand ready to assist you and the other members of this subcommittee in this vital endeavor. Only by working together can we take the steps that are necessary to provide consumers with the full benefits of competition. Thank you.

Senator MURKOWSKI. Thank you very much, Secretary Glauthier.

Our next witness is Mr. Mikrut, Tax Legislative Counsel for the Department of Treasury. Good morning. We welcome you to the committee and ask you to proceed.

[The prepared statement of Mr. Glauthier appears in the appendix.]

STATEMENT OF JOSEPH MIKRUT, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. MIKRUT. Thank you, Mr. Chairman.

Mr. Chairman, Senator Graham, members of the subcommittee and members of the full committee, thank you for inviting us here this morning to discuss provisions that may affect restructuring the electric power industry.

Secretary Glauthier has already discussed and described the administration's overall approach to restructuring and has briefly mentioned the need for certain tax legislation. I will focus my remarks this morning on the specifics of these tax initiatives.

Various Internal Revenue Code provisions may hinder certain transactions that may be undertaken pursuant to the restructuring of the electric power industry. In general, as was mentioned earlier, these provisions were drafted at a time when the electric power industry was subject to monopoly power, rate regulation, and electric service providers generally were locally found.

In light of restructuring, these provisions are somewhat antiquated. As described in detail in my written testimony, to address these situations the administration has proposed changes in the following rules: 1) those rules that govern tax-exempt financing for electric companies owned by State and local government entities; 2) a provision that would allow unregulated utilities to make deductible contributions to nuclear decommissioning funds; 3) finally, a provision to provide tax incentives for investments in distributed power and combined heat and power facilities.

With respect to tax-exempt financing, as you know, under current law, interest on debts incurred by State and local governments is excluded from income if the proceeds of such borrowings are used to carry out government functions and the amounts are repaid by the government.

Thus, facilities for electricity generation, transmission, and distribution may be financed with tax-exempt bonds if such facilities are used, and the debt service paid by, the State or local government.

A facility can satisfy this government-use requirement even when the electricity it generates or transmits is sold to private persons, so long as such persons are members of the general public.

Private use occurs, however, and the bonds would become taxable when electricity is sold under terms not available to the general public. Such change in status may imperil the status of the tax-exempt bonds on a retroactive basis.

Both the Internal Revenue Code and Treasury regulations provide certain de minimis or short-term tolerance, or exceptions, to these general rules. Specifically, temporary Treasury regulations issued in 1998 permit bonds outstanding on July 9, 1996, the date that the FERC issued an order to promote the open-access of transmission services, to retain their tax-exempt status when these

transmission facilities are used for private persons in connection with open access services.

In addition, similar rules were provided with respect to generation facilities. These temporary regulations will expire in January 2001. We have received several useful comments from interested parties with respect to these regulations and will soon begin the process of finalizing the regulations.

Regulations, however, will not go far enough to address the concerns of restructuring. These concerns are two. First, municipal utilities should not be discouraged from entering into open-access and competition for fear that such actions will render their previously issued tax-exempt bonds to become taxable.

Second, municipal utilities should not be granted a cost of capital advantage through taxes and financing with respect to new bonds when they compete with firms that may not issue such instruments.

Thus, the efficiency and equity of the restructured industry depends on the leveling of the playing field, a term that was used often this morning, with respect to capital costs, while at the same time ensuring that government-owned facilities are not discouraged from fully participating.

In order to meet this challenge, the administration proposes that no new facilities for electric generation or transmission should be financed with tax-exempt bonds. Because electricity distribution facilities are inherently local and often commingled with other public services, continued access to tax-exempt financing for such facilities would remain, as under present law.

Distribution facilities owned by for-profit providers will continue to be subject to rate regulation as natural monopolies and would not receive such tax advantages.

With respect to previously issued bonds used to finance transmission facilities, these would retain their tax-exempt status, notwithstanding private use resulting from actions pursuant to a FERC order requiring nondiscrimination, open access to those facilities.

To encourage municipal power systems to open their service areas to competition, pre-effective date bonds used to finance generation or distribution facilities also would be permitted to retain their tax-exempt status, notwithstanding private use resulting from the issuer's inclination of competition or from the issuer entering into a contract for the sale of electricity.

With respect to nuclear decommissioning, under present law, an accrual-basis taxpayer generally may not deduct an item until economic performance has occurred with respect to such item.

In general, with respect to decommissioning, economic performance occurs when the site is cleaned up. Current law provides two important benefits with respect to nuclear decommissioning costs. First, taxpayers that make contributions to qualified decommissioning funds may avail themselves of an exception from the economic performance rules and deduct such contributions as they are made.

Second, the income on such funds is subject to a reduced flat 20 percent rate. These rules prescribing favorable tax treatment for qualified nuclear decommissioning funds were adopted at a time

when all nuclear power plants were operated by regulated public utilities and a nuclear power plant and its decommissioning fund could not be transferred except between such entities.

Deregulation in restructuring of the industry has resulted in situations and transactions that were not contemplated when those rules were adopted. These novel circumstances have given rise to a number of questions, many of which we can answer administratively.

The questions that we can answer administratively through the ruling process are: may an unregulated taxpayer maintain a qualified nuclear decommissioning fund; does the transfer of a qualified fund to an unregulated taxpayer result in the recognition of gain or loss by the transferor, is the transferor of a nuclear power plant entitled to a reduction for decommissioning liabilities assumed by the transferee, and to what extent may the purchaser of a nuclear plant derive an immediate tax deduction from the assumption of the seller's decommissioning liabilities?

Unfortunately, the question that we cannot answer administratively and for which legislation is required is whether an unregulated taxpayer may make a deductible contribution to a qualified nuclear decommissioning fund.

Therefore, the administration proposes that the cost of service requirement in current law be eliminated and that all taxpayers, whether regulated or unrelated, be able to contribute to a fund based on the ruling amount. The ruling amount is essentially the amount determined on a look-back basis that gives you a level funding for the decommissioning liabilities.

Finally, the administration proposes two incentives with respect to certain types of power. With respect to distributed power facilities, which are generally, as Secretary Glauthier mentioned, turbine equipment used in commercial, industrial, and large residential properties. We proposed a 15-year depreciation period for such properties. This proposal will simplify current law, remove taxpayer uncertainty, reduce future tax controversies, and level the playing field for distributed power assets.

In addition, in the administration's budget there is a proposed 8 percent temporary investment tax credit for combined heat and power equipment. This credit will be available for large CHP systems that have a total energy efficiency exceeding 70 percent and in smaller systems that have a 60 percent energy efficiency. This credit would be available for investments made through the year 2002.

We urge the Congress to enact the tax proposals we have outlined in our testimony. Mr. Chairman, this concludes my prepared testimony and we would be pleased to answer any questions you, the members of the subcommittee, or the full committee may have.

[The prepared statement of Mr. Mikrut appears in the appendix.]

Senator MURKOWSKI. Thank you very much, Mr. Mikrut.

First, let me call on Secretary Glauthier. The administration's proposal, I think it is Section 402 of S. 1047, calls for a tax of up to 1 mill/kilowatt of electricity as part of deregulation. Why does the administration believe that this industry and its customers should be taxed at the time it is deregulated?

Mr. GLAUTHIER. Senator, you are referring to the public benefit fund fee, I believe, is that right?

Senator MURKOWSKI. That is correct.

Mr. GLAUTHIER. We think it is important that the benefits that are being provided currently by utilities in their regulated environment be maintained in a competitive environment and are concerned that not all States, as they move toward this, will do that, and not all utilities, as they operate in a competitive market, will feel that they are able to keep the benefits provided to support low income customers, to provide other benefits, some research and development funds, and some support for renewable energy sources. Those are benefits we think are important.

So the proposal is to maintain what we believe is already being provided there. It is not a new fee, but rather one that we estimate at approximately the level of the current funds that utilities now provide.

Senator MURKOWSKI. You used the terminology "it is not a new fee," and I call it a tax. Which is it?

Mr. GLAUTHIER. We think it is a fee. We believe it is estimated at about the same level that the industry now is providing these services from their customer base.

Senator MURKOWSKI. Why do you call it a fee?

Mr. GLAUTHIER. It is to supply services in the area, the service territories. The States will have the control of these funds and we see it as really continuation of the kind of services that these utilities now have.

Senator MURKOWSKI. Well, it might be construed as a tax by others. Is that a fair statement?

Mr. GLAUTHIER. I might defer to our Treasury expert, perhaps, on that definition. [Laughter.]

Senator MURKOWSKI. I was going to move over there next. What is it, Mr. Mikrut?

Mr. MIKRUT. I agree, Mr. Chairman, that it may be construed by some as a tax.

Senator MURKOWSKI. All right. It is nice to have definitions clarified.

Mr. MIKRUT. But it is something, of course, that the Congress may choose to structure as either a fee or a tax in the actual drafting of the legislation.

Senator MURKOWSKI. Mr. Mikrut, you note that the administration proposal calls for a 15-year life for distributed power property and favorable capital cost recovery for combined heat and power properties as well.

My question is, does the Secretary and the Treasury Department believe that the depreciation life of any other electric generation property is in need of change, particularly in a deregulated market? Second, will the Treasury be reviewing this issue as part of the depreciation study you will be delivering, I understand, to the Finance Committee this spring?

Mr. MIKRUT. Yes, Mr. Chairman. As you know, pursuant to legislation enacted in 1998, we are mandated to review the depreciation lives and methods used under present law and to make certain recommendations to the Congress on how those lives and methods should be changed.

One of the important aspects of this study, which we have outlined in the Notice of Public Comment that we put out, is just how changes in technology, changes in the marketplace affect depreciable lives, and change the use of equipment.

One thing we have identified specifically to date is the treatment of distributed power systems. It is unclear under present law whether those systems are an integral part to the building and, therefore, potentially subject to a 39-year straight-line life, or whether they should be treated as machinery and equipment, giving them more accelerated life. What we propose, is to clarify the law at this time to give a 15-year depreciable life on an accelerated basis to such equipment.

You are correct that there may be other types of assets that also raise these type of issues. We have asked for public comment on these, and these are things that we will be encompassing in a report to Congress next spring.

Senator MURKOWSKI. All right. I have five questions left and I am going to run through them, and I would appreciate brief answers. They are to you, Mr. Mikrut.

Treasury has proposed that a tax-exempt bond should not be issued for generation or transmission after deregulation becomes effective. The municipal utilities have been supporting Senator Gorton's bill that allows municipal utilities to continue to issue tax-exempt bonds for transmission facilities. Can you provide us with Treasury's view on why bonds should not be issued for transmission facilities?

Mr. MIKRUT. Well, we think the tax-exempt financing should be provided specifically for distribution facilities which are inherently local, which go strictly to the service territory traditionally and historically for public power, and we do not think tax-exempt bonds, in the new deregulated restructured environment, should go further than that.

Senator MURKOWSKI. Senator Gorton's bill also allows municipal utilities to issue tax-exempt bonds for repairing generating facilities. It strikes me that the repair exemption could be a giant loophole that could allow a utility to replace a turbine, extend the life of a plant indefinitely. We have discussed this with Senator Gorton and he gave us assurances to the contrary.

What is your view on the repair exception?

Mr. MIKRUT. Again, Mr. Chairman, the administration's proposal would not allow new taxes and financing for new generation facilities at all.

Senator MURKOWSKI. Now, Congressman English's bill would tax the profits of municipal utilities who make sales outside their service territory. What are the administration's views on the idea of taxing a municipal entity?

Mr. MIKRUT. This is somewhat of a brave new world.

Senator MURKOWSKI. It sure is.

Mr. MIKRUT. Traditionally, the Federal Government has not taxed the State and local governments. I understand the concerns behind Mr. English's bill. On the other hand, it would be difficult to discern why a municipality would be selling outside its service territory. It may be because some other competitor has come within

its service territory and, therefore, it has excess capacity for which it has to sell outside.

So I think this raises some difficult issues, not only of discerning why they were selling outside, but also overall issues of federalism.

Senator MURKOWSKI. I have asked this question of our previous panel, but I would like you to answer it as well. Some of the municipal utilities contend that, since investor-owned utilities are allowed to take accelerated depreciation, that that is a subsidy that is comparable to the subsidy that the public utilities themselves receive by being allowed to issue tax-exempt bonds and not being subject to taxation.

Do you agree with this contention?

Mr. MIKRUT. I think I agree with the prior panel that said it is really comparing an apple and an orange. They are both subsidies that attempt to limit the cost of capital for the electric producer. One is a direct subsidy in that they have taxes and financing, but indirect in that they get accelerated depreciation and investment tax credits in the past to lower their costs of capital. But I think it is very difficult to try to compare subsidies of two different taxpayers that traditionally have operated in two very different ways.

Senator MURKOWSKI. Thank you very much. That concludes my questions.

Are you on a time schedule?

Senator NICKLES. Yes, I am. I would like to follow up on on of your questions.

Senator MURKOWSKI. I am going to return to Senator Graham.

Senator GRAHAM. Go ahead.

Senator NICKLES. Senator Graham, thank you very much.

Mr. Chairman, I want to follow up on a couple of things you said.

First, let me ask you a question. You mentioned this tax, or Senator Murkowski did, and you called it possibly a fee. But this 1 mil/kilowatt hour, how much would that raise? You are going to have this on all electricity in the United States?

Mr. GLAUTHIER. Yes, that is right. It would raise about $3 billion a year.

Senator NICKLES. $3 billion a year? I can tell you, this is not going to pass. If you want to fantasize about it you can, and how you are going to spend it. Your comments were basically for welfare, for renewable, for approval, so we can take over some of the things that the States were doing or may not do. That is an absurd hidden tax that maybe you call a fee.

Now, I do not want to let you have any misunderstandings whatsoever: this is not going to happen.

Mr. GLAUTHIER. Well, we certainly are going to continue to support it. We think that the low-income features, for example, are important, and ultimately each State would make the decision as to whether they would participate in the fund or not.

Senator NICKLES. Well, States are doing this now, but do you think the Federal Government should take it over?

Mr. GLAUTHIER. We do. We do not think there is a consistent pattern of utilities following these same purposes as competition unfolds.

Senator NICKLES. And you kind of like the idea of having a big pool of funds that you could spend for renewable and for other things as well?

Mr. GLAUTHIER. The actual decisions would be made at the State level.

Senator NICKLES. Oh. I thought they were going to be made at the Federal level.

Mr. GLAUTHIER. The fund would be developed at the Federal level. The States would decide whether they were going to participate. The States then would make the decisions on the actual use of the funds at the State level. The eligibilities would be established federally, but they would not be all allocated.

Senator NICKLES. Mr. Glauthier, do not waste your time working on this. It is not going to happen, I will tell you that right now. [Laughter.]

Let me raise another issue that I saw, and Mr. Mikrut, you might touch on this. You did touch on it a little bit. That is, your tax credit. You were kind of comparing the two. You said, well, investor-owned utilities get accelerated depreciation. Do you not think that a company that pays taxes should be able to deduct their cost of capital equipment? Is that that much of a subsidy?

Mr. MIKRUT. The ability to deduct capital is not a subsidy, the ability to deduct it on an accelerated basis relative to the economic depreciable life is.

Senator NICKLES. Let me touch one subsidy that I think is, and that is an investment tax credit, and you just proposed one. Now, this combined heat and power, an 8 percent investment tax credit. You have stated that that would only be used up to, what, the year 2002?

Mr. MIKRUT. Yes, Senator.

Senator NICKLES. So these companies are going to rush forward in the next 2 years and make all kinds of decisions to spend hundreds of millions of dollars on the type of equipment that you have decided is only appropriate? What about, we have all kinds of combined cycled gas units that are recapturing heat, but those do not qualify, but what you have outlined here would qualify?

Mr. GLAUTHIER. Well, the reason for a temporary credit, Senator, is to encourage these investments in the short term, to encourage the research into these type of facilities and to get them a jump start on their usage.

Senator NICKLES. All right. I think that is, again, a serious mistake. It is a subsidy. Investment tax credits are a subsidy. It is basically, the Federal Government deciding, we think this is how you should spend your money, so we are going to give you that type of a payment. An 8-percent payment of whatever the costs would be, I think, is, again, very foolish tax policy, and probably very foolish energy policy.

Again, it is the government deciding, we think that money should be allocated in generation in this particular area, not some other area. That is imposing our wisdom just as if this 1 percent tax is, well, we are going to put this on all States, raise $3 billion a year, maybe call it a fee, and hope that the States will agree to spend it as we see fit, and if not, the tax still can be imposed. Is that correct?

Mr. GLAUTHIER. Yes, that is our proposal. That is right. The fee, however, would be adjusted every year based on the amount that is needed. If the States opted out of the program, then the fee would stop because there would not be any need to continue raising revenues for it.

Senator NICKLES. So this could be an opt-in. The States do not have to have this fee?

Mr. GLAUTHIER. The fee would be imposed on everyone, but the States do not have to participate in taking funds from the fund.

Senator NICKLES. Oh. This is a heck of a deal. We are going to have a fee, you are going to raise $3 billion, and the States can opt in if they want to spend it but not if it is going to be taxed on their consumers. You need to help him a lot. [Laughter.]

Mr. GLAUTHIER. As I said a moment ago, the fee would be reduced if not all the States are participating. A fee is really geared to a full participation nationwide.

Senator NICKLES. But you think, if we get this $3 billion pool out there, there might be some people saying, I would offer to have it spent in my State so that probably would not be a problem.

Mr. GLAUTHIER. There is a requirement that the States match the fund, and that is to try to guarantee that the States are serious about trying to support these functions.

Senator NICKLES. And this fee is not optional.

Mr. GLAUTHIER. That is correct.

Senator NICKLES. So that is kind of what most of us call a tax. It is not a voluntary situation. All right. I have made my point.

Mr. Chairman, thank you very much.

Senator MURKOWSKI. Thank you very much.

Senator Graham?

Senator GRAHAM. Thank you, Mr. Chairman. When we started this hearing, I thought the purpose of this was to look at those areas of the Tax Code as, in the Energy Committee, we are looking at other regulatory issues which might distort the ground upon which States can then legislate for utility deregulation.

It seems to me as if there have been some issues injected in here that either go beyond that objective or are in some cases maybe even in competition with that objective.

One of the questions that the Chairman asked was the issue of the tax-exempt debt for new transmission facilities. As I understand it, under S. 386 there would be a continuation of the tax-exempt debt for the financing of new transmission facilities, whereas the administration's bill would terminate that tax-exempt financing for transmission.

As I understand it, the proposal is that transmission will continue to be a regulated activity under FERC. If that is the case, assumedly all of the participants, all of the users of the transmission facility, whether they were investor-owned, municipal, or otherwise cooperative, would be charged a fee that would be a competitive fee without regard to the nature of the user of the transmission facilities.

If that is correct, then what is the theory behind eliminating the future tax-exempt status for transmission lines?

Mr. GLAUTHIER. If I may, the answer that Mr. Mikrut gave a little while ago, I think, gets to the essence of it, which is that the

two extremes, the distribution assets and the generation assets, are clear in their use in competition. The distribution assets, being local, are really to serve the local users and are not a part of the competitive environment. Therefore, we would continue to allow tax-exempt financing for those under the new program.

The generation assets at the other end are, indeed, what would be used competitively, and so tax-exempt financing would not be allowed for those. The transmission assets you ask about are in the middle, and our proposal is to not allow tax-exempt financing for those because they are going to be used for competition. They are used to, in fact, interconnect various regions and utilities.

But I think we are open to further discussion about the topic. Our feeling is that the proposal in the Gorton and Kerrey bill is a serious proposal that has a lot in common with our proposal, and we think that we could actually work to some agreement on these specific differences.

Senator GRAHAM. Obviously, your comment was so enlightening to Senator Kerrey, that he left at that high note of this hearing.

Another question which raises the same issue, and that is, if the purpose of considering these tax measures is to eliminate anomalies that would interfere with a State's ability to establish a competitive deregulated utility industry, the issue of tax-exempt debt for those activities for which there is a continued private-use restriction.

The administration's bill, as I understand it, does not give municipal utilities the option of continuing to live with under the private use restraint, whereas, S. 386 would allow a utility to continue to issue tax-exempt debt for both generation and transmission facilities if that publicly owned utility does not ask for relief from the private use restriction.

If the utility is going to continue to operate in the same restrained manner that it does today, why should the publicly owned utility not be able to continue to secure tax-exempt financing for its generation and transmission facilities?

Mr. GLAUTHIER. Your characterization of our proposal is accurate. We do propose that all generation and transmission investments after enactment of this bill would be taxable, or the bonds would be taxable.

The reason, is a couple of parts. One, is for most municipal systems, the vast majority of them, their investments are in just the distribution system. So they are going to be buying power from other sources and will not be directly impacted by the proposal.

For those systems who are investing in generation assets, we do not want to set up a disincentive to enter into competition. We are concerned that we want the marketplace to be open and to have a level playing field, have all the new generation assets invested in the same way.

Over time, our expectation is that the market will increasingly be open and competitive and all of these assets should be acquired on the same basis.

Senator GRAHAM. So, in summary, you feel that if the publicly owned utility continued to have the option of operating under the private-use restraints, that that would be an inhibition to that utility's capability or incentives to be a competitor.

Mr. GLAUTHIER. We do think it sets up an incentive not to go into competition, not to enter into this.

Senator GRAHAM. Thank you, Mr. Chairman.

Senator MURKOWSKI. Senator Breaux?

Senator BREAUX. Thank you, Mr. Chairman. Thank both of our witnesses.

Following up where Senator Graham left off about municipal utilities that do make a decision to go out and compete. Say that utility does not have anybody cherry picking any of their customers and they made a decision, because they have got an efficient, effective power plant, that they want to go out and compete in other markets outside of their jurisdiction, and no one has come into their jurisdiction yet.

What about the proposal of the taxation system of them competing with the private sector companies who pay tax and their being exempt from income tax, does that not create a level playing field?

Mr. GLAUTHIER. Well, the income tax proposal, I think, is more complex. As we described earlier, the combination of tax provisions on both sides of investor-owned utilities and municipals are a pattern that is embedded in the industry. We would not propose to subject municipal entities of local governments to Federal taxation.

Senator BREAUX. I understand that. But what do we do to create a level playing field? If we let a municipal who has used tax-exempt bonds to build their facilities, and no one is coming after them and they have their unit of distribution, no one is coming in and cherry picking it, they have used tax-exempt bonds to build their facility, and then they go outside of their territory and compete against investor-owned companies who do pay taxes and who have not used tax-exempt bonds. Is there not a big inequity there?

Mr. MIKRUT. Senator, that presumes, though, that when they built the facility they built too much, so they have over capacity so they have the ability to go outside their service territory.

I think the fact that most municipals are net buyers of power as opposed to net sellers seems to indicate that the facilities that they built were built with respect to their own service territory. So the fact pattern that you have set up, I am not sure, will exist in the restructuring world.

Senator BREAUX. Well, I suppose it does. I mean, I do not want to be hypothetical with the thing, but I just want to make a level playing field. I mean, I have got all of them in Louisiana. I have got municipals, I have got private investor owned, I have got co-ops, I have got everything.

Mr. GLAUTHIER. One provision of our bill also restricts any utility from going out to compete outside its territory unless it is opting into the program, willing to have other utilities market into its territory. So you could not have a situation at least where it is restricting other entrants into its own market.

Senator BREAUX. So the administration's position is that your proposal has a level, equitable taxation playing field as far as what investors would have to do with municipally owned power companies?

Mr. MIKRUT. Yes, that is right, going forward. And it grandfathers people's financing or capital structure at the outset.

Senator BREAUX. Well, I am not sure how we get there, whether we get there in this Congress. But, I mean, I think the main thing is to look at how we create a level playing field, where everybody can complete and no one has a government advantage over anyone else. I ma not sure we are there yet, but I think the administration's proposal is moving in the right direction. Thank you all very much.

Thank you, Mr. Chairman.

Senator MURKOWSKI. Thank you very much.

Senator Grassley, we appreciate your being with us. Please proceed.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. I would like time, Mr. Chairman, just to make a short statement. First of all, to thank you for holding a hearing and to inform you what might happen in Iowa, like what probably has already happened in almost half of the States, that we had legislation introduced last year, and probably worked out with all segments of the industry, to make sure that it is likely to pass the legislature next year.

I realize, Mr. Chairman, that you hope to move through the Energy Committee comprehensive legislation. Current tax law that has worked for the electric industry when it was a monopoly must be changed to reflect the new marketplace to develop a free market solution for rural electric cooperatives, municipals, and investor-owned utilities.

We have the ability to achieve this outcome. By encouraging competition in the marketplace, we will be enhancing services and quite likely lowering costs. The legislative vehicle developed to bring change to the marketplace, though, should not force the reorganization and modification of consumer-owned businesses.

I have worked hard to develop and advocate legislation that will ensure rural constituencies will not be burdened with higher cost. It is for those reason that I plan to work with Senator Baucus to introduce the 8515 amendment that I have advocated in the past as a freestanding bill.

Hopefully, this will draw more attention to this issue so that we may guarantee the benefits of competition without excessive cost.

In addition to rural cooperatives, municipal utilities should also be provided in an avenue to participate in a restructured environment while maintaining their traditional role in the marketplace.

For example, the tax provision of the Court-Jeffords-Kerrey-Bond Fairness and Protection Act dictate that any public power entity will willfully choose to participate in a competitive electric market must irrevocably forego their ability to issue tax-exempt bonds for electricity generation capacity.

Each public utility should have the option of competition based on what is best for their municipality. Private use restrictions were formulated at a time when deregulation was not contemplated. Private-use restrictions on municipal utility tax-exempt bonds remain a problematic remnant of an outdated regulatory scheme.

I support the Bond Fairness and Protection Act and the goals of the tax title. So, Mr. Chairman, I feel that the needs of rural co-

operatives, municipal utilities, and investor-owned utilities should be addressed as a whole in a comprehensive fashion so that all are treated equally in the environment of deregulation. So, consequently, I thank you for holding this hearing.

Senator MURKOWSKI. Thank you very much, Senator Grassley. As I listened to the witnesses and the members talk about equity, I am reminded that justice is blind. And the balance here is going to be tough to come by, but nevertheless we seem to be committed to it as an objective.

Two very brief questions, and I want to excuse this panel. Mr. Mikrut, as I understand it, if a nuclear utility with funds in a decommissioning fund is sold to a regulated entity, the transaction is tax free. But if it is sold to a non-regulated utility, the transfer is taxable. In a deregulated world, I wonder, does that really make sense?

Mr. MIKRUT. These are issues, Mr. Chairman, that we are currently addressing through the ruling process and that we really want to treat the same.

Senator MURKOWSKI. You want to give more thought to it?

Mr. MIKRUT. Yes.

Senator MURKOWSKI. That is encouraging.

Which leaves me my last question. Some purchasers of nuclear plants have demanded as a condition of sale that the seller fully fund the decommissioning fund. However, under current tax law, that is not permitted.

Can you give me a view, or is this under study as well? That is the answer I would like to have.

Mr. MIKRUT. I believe that is true. When Congress enacted these provisions in 1984, they did not allow the full funding of the 384 liability. So, by statute, there cannot be full funding of these funds.

Senator MURKOWSKI. Thank you very much. Oops. Almost got away with it. Yes, Senator Breaux?

Senator BREAUX. One brief question to Mr. Mikrut. As I understand, there is no prohibition now for a municipal power company to sell surplus power outside of their jurisdiction from facilities that were built with tax-exempt bonds. That's the current law. He is trying to record that like this.

Mr. MIKRUT. Yes, sir.

Senator BREAUX. Yes. All right. Thank you very much.

Senator MURKOWSKI. Is that satisfactory, Senator Breaux?

Senator BREAUX. Yes.

Senator MURKOWSKI. All right.

I want to thank you gentlemen very much. I think your testimony and your statements have added a great deal to the record and clarified some of the anticipated decisionmaking that is going on down in Treasury.

So, Mr. Mikrut and Mr. Glauthier, thank you very much.

I am going to put the balance together, so we are going to need a couple of more chairs. I would ask whoever is working the chairs around here to add a couple of more. We will be joined now by Mr. Tom Kuhn, president of Edison Electric, from Washington, DC; the Honorable Scott Maddox, mayor of the city of Tallahassee, FL; Mr. Joseph R. Ronan, Jr., vice president of the Calpine Power Service,

San Jose, California; Mr. William Mayben, president and CEO of the Nebraska Power Company, Columbus, NB.

And we have got two other gentlemen here, Eric Yould, executive director of the Alaska Rural Electric Co-Op Association from Anchorage; Mr. Corbin A. McNeill, chairman, CEO, and president of PECO Energy, Philadelphia, PA; Mr. William Carlson, chairman of the Renewable Committee of the Electric Power Supply Association, and vice president of Wheelabrator Environmental Services in Anderson, CA.

In the interest of time, I am going to limit your statements to 5 minutes. We will adhere to that. I see my colleagues have temporarily departed, to be seen again soon.

Tom Kuhn, president of Edison Electric, would you like to go first?

STATEMENT OF THOMAS KUHN, PRESIDENT, EDISON ELECTRIC INSTITUTE, WASHINGTON, DC

Mr. KUHN. Mr. Chairman, thank you very much. I commend your leadership for holding this very, very important hearing on what I think is one of the most critically important issues in electricity restructuring and one that, again, only the Federal Government can address.

I would like to address your earlier question, perhaps, on the subsidy issues with respect to taxes and tax-exempt financing, because I think that is an important issue. I know a lot of people talk about it in terms of apples and oranges, but perhaps I could put it into the context of a baseball analogy.

If you look at the Federal tax situation, the electric utilities are paying now $10 billion annually in Federal income taxes, and public power entities now do not pay anything. So in terms of that ball game analogy, we are paying $10 billion, the other side is not paying anything, and on the tax-exempt financing side, of course, is a 25 percent tax advantage on tax-exempt financing.

As the chairman indicated, really, in the current situation, almost half of the States in the country are now moving toward retail electric competition. Yet I know of only one municipally owned utility which has opened its service territory to retail competition. Indeed, many municipals are making millions of dollars selling electricity into neighboring competitive markets.

But I think the future situation is far more important. What we are here to address is the future situation. Competitive electric markets are expected to have very low profit margins. Electric facilities are very capital intensive. Since investment will flow to the lowest cost of capital, the availability of tax-exempt financing and tax-free sales to a limited group of utilities will distort the competitive market.

I used to work on Wall Street, and investors will always seek the lowest cost of capital. There is a 25 percent cost advantage with tax-exempt financing, and tax-exempt financing in competitive markets will expand greatly and further distort competitive markets.

For the past 2 years, we have held several meetings between CEOs from EEI members and public power utilities to discuss policies to fairly integrate public power in the competitive markets.

We have narrowed the differences between us, but let me discuss the basic principles first that our members advocate. First, in the future, all participants in competitive markets should be treated the same by Federal tax policy. The administration's bill heads in that direction by eliminating new tax-exempt bonds for generation and transmission facilities.

Representative English's bill takes a related approach by eliminating tax-exempt financing for new facilities that choose to sell power in competitive markets, but preserving it for municipals which choose not to go outside their service territories. The English bill also imposes income taxes on all sales in competitive markets outside of municipals' traditional boundaries.

Both approaches preserve preferential tax treatment for sales to a municipal's own constituents. We think that both of these legislative approaches are fair. Second, municipals which seek private use relief to compete outside their boundaries must open up their own territories to competition. This reciprocity is only fair.

Third, municipals operating in competitive markets should not be able to issue tax-exempt bonds for new generation facilities. This ensures that the success of new competitive generations is based on economic factors, not the availability of subsidies.

Fourth, we recognize that municipals which open up to competition need relief from private-use rules to sell electricity from existing generation facilities. The Treasury's temporary rule provides much of this relief. The administration bill provides permanent relief, but only if municipals open up to retail competition.

In many ways, providing relief for lost load, traditional customers which are lost to new competitors is like stranded cost recovery because it permits a fair transition to the competitive market for existing facilities. However, such relief should be subject to the same kinds of conditions as stranded cost recovery, including a duty to mitigate.

Fifth, public power says that existing transmission facilities should receive private-use relief so they can be used for open access by all electric suppliers. We agree with public power on this.

However, new tax-exempt financing for transmission and distribution facilities outside a municipal's service territory—I repeat, outside a municipal's service territory—is very different. Many new independent transmission organizations are now being formed.

We firmly believe that the choice of public or private ownership of these facilities should not be biased by the availability of preferential subsidized financing for only one class of owners, or you will further grow government.

None of these principles would compel municipalities to refund existing bonds. We have many, many problems with Senator Gorton's bill because it does not satisfy any of these principles.

It expands Federal tax treatment for municipalities, it does not require them to offer retail competition as a condition for receiving private use relief, it allows municipalities to issue new tax-exempt bonds for new transmission and distribution facilities, even outside their service territories.

It does not impose a duty to mitigate stranded costs. It does not require income taxes on profits from sales outside of municipals'

traditional territory, and it is not a part of a comprehensive electricity approach.

Mr. Chairman, our CEO's group is continuing to talk with our private power colleagues, our public power colleagues, to seek a real compromise on this very difficult issue. I remain optimistic that we can resolve our differences.

Thank you very much.

Senator MURKOWSKI. Thank you very, Mr. Kuhn.

[The prepared statement of Mr. Kuhn appears in the appendix.]

Senator MURKOWSKI. The next witness will be the Honorable Scott Maddox, Mayor of the city of Tulsa. Of Tallahassee, I am sorry.

Senator GRAHAM. Mr. Chairman, both to put the right geography for mayor, and also a little background, Scott Maddox has been a good friend of mine for a number of years, as has his father.

In 1993, when he was elected to the city commission of the city of Tallahassee, he was the youngest person to have been so elected. He was then elected by his colleagues to be the mayor of the city of Tallahassee. After a change in the charter to create what is described as a leadership mayor, he became the first person elected to that position. So he has been recognized repeatedly, both by the citizens and by his colleagues, for his leadership position.

I might say, Mr. Chairman, I was interested to note that his hobbies include rodeo riding and riding a Harley-Davidson, which seemed to be two appropriate hobbies for the task that he has undertaken, and maybe will give us some insight in how to deal with electric deregulation as well.

STATEMENT OF HON. SCOTT MADDOX, MAYOR, CITY OF TALLAHASSEE, FL

Mayor MADDOX. Thank you, Senator. Thank you, Mr. Chairman. It is my great pleasure to bid you greetings and welcome on behalf of the city of Tallahassee, the northern gate of the Sunshine State, where thousands live and millions wish they could.

I appreciate the opportunity to speak to you here today. As mayor of the city of Tallahassee, we have about 150,000 residents within our city limits, about a quarter of a million within the county. Our electric utility is owned and operated by the city of Tallahassee and has been since the early 1900's.

I also speak on behalf of the Florida League of Cities, where I am president-elect, and on behalf of the 400 cities in Florida which have passed a resolution in support of the Bond Fairness and Protection Act.

We have issued in Tallahassee over $297 million in tax-exempt bonds that may become retroactively taxable because of energy policy changes. We have 92,000 customers. We are the fourth-largest community-owned utility in Florida. Our top 10 customers represent 25 percent of the city's revenues.

Florida has 34 community-owned utilities serving more than 2 million Floridians. Our utilities are diverse. We have large systems, including Jacksonville, Orlando, Lakeland, Tallahassee, and Gainesville, and small utilities such as Bushnell and Havana, which serve about 1,000 residents each.

The implications for community-owned utilities in Florida are huge, since they hold $6.5 billion in tax-exempt debt. Tallahassee, in particular, has over $297 million in outstanding tax-exempt bonds.

My sole purpose here today is to help explain a conflict between Federal tax policy and energy policy and how it affects Tallahassee. The private use problem is about a conflict between Federal energy policy and Federal tax policy, and only Congress can fix it.

It grew out of passage of the Energy Policy Act of 1992, which allowed for wholesale competition and was pushed forward by the Federal Energy Regulatory Commission Order 888 mandating open access to the transmission grid to enable the wholesale competition envisioned by EPACT.

Twenty-three States have passed retail competition bills and a handful more are moving forward shortly. The private use problem is analogous to the private utilities' stranded cost problem. It deals with infrastructure investments made before the rules changed. Since we have moved from the geographically regulated system that we all operated under prior to 1992, these investments become economically unrecoverable if you lose customers due to competition.

It is different from stranded costs in one very important way, however. The stranded cost issue can, and is most appropriately deal with on the State level. The private use problem is a Federal Tax Code problem and can only be fixed by this committee. State legislatures and public utility commissions can assess justifiable price for stranded costs, but States cannot change the Federal Tax Code.

How this is resolved is vital to all State and local governments, not just public power communities. There are nearly $80 billion in tax-exempt bonds outstanding for public power investments, yet this represents only a small fraction of the nearly $1 trillion in outstanding bonds that State and local governments have issued for all purposes, schools, roads, bridges, waste water treatment facilities, and the like.

These private use rules impose two significant restrictions on community-owned utilities as we move toward deregulation. First, the private-use rules prevent community-owned utilities from permitting private businesses, including investor-owned utilities and power marketers, to use their transmission or distribution lines.

Second, the private-use rules prevent community-owned electric systems from selling power from tax-exempt financed generation facilities to individual customers on negotiated terms. These problems and the need for flexibility from the private-use restrictions make it impossible for community-owned utilities to compete for their own existing customers or open up their transmission lines.

The purpose of S. 386 is to prevent existing tax-exempt bonds from becoming retroactively taxable and keeping rates low, not to permit community-owned utilities to sell power into distant markets, and aggressively pick off large industrial customers from the private sector, and/or build the country's national transmission network.

What we think is the solution to the problem is the Bond Fairness and Protection Act. What it does, specifically, is to use the pri-

vate-use test on outstanding bonds, i.e., grandfather existing bonds, but only if the utility agrees to never again issue tax-exempt bonds to build new generation facilities, so an irrevocable election once the utility decides to do that. Or, if no private-use relief is needed, the utility can continue to issue tax-exempt debt under the existing private use rules. That is what it boils down to.

If you want to compete, like we have heard some testimony today about public utility systems that are competing in other areas, they make that election and they give away their tax-exempt financing.

If you are like Tallahassee, however, and you might not want to compete, you can keep your tax-exempt financing and keep doing what you have been doing since the early 1900's.

There was a lot of testimony today about there being an unlevel playing field and that the advantage was toward the public power systems. In Florida, I simply do not see that. I simply do not see that.

In transmission owned by Florida community-owned utilities, we have less than 2,000 miles of transmission. The Florida IOUs or investor-owneds have over 12,000. In Florida, we have less than 8,000 megawatts of capacity and the IOUs have over 30,000. In Florida, there is no danger of the gnat eating the elephant.

We also have to abide by public records laws, government and the sunshine, and all the different things that a community-owned system has to abide by. I do not think it is a level playing field, but I think it is tilted in the other direction.

In conclusion, Tallahassee is a community-run system. We do not have a profit. Our profit are police officers, fire fighters, and bus systems. We provide services to our community based on the revenue that comes out of the electric utility. Fifty-five percent of our property is off the tax rolls. We make decisions like tree trimming, where we trim our trees three times as much as the IOUs because we value our trees.

Senator MURKOWSKI. In the interest of time, I am going to call you on 5 minutes. Go ahead and wind up.

Mayor MADDOX. All right. Thank you, Mr. Chairman.

Senator MURKOWSKI. Thank you very much, Mayor Maddox.

[The prepared statement of Mayor Maddox appears in the appendix.]

Senator MURKOWSKI. Our next witness is Joseph R. Ronan, vice president of Calpine Power Services, San Jose. Please proceed.

STATEMENT OF JOSEPH R. RONAN, JR., VICE PRESIDENT, GOVERNMENT AND REGULATORY AFFAIRS, CALPINE POWER SERVICES, SAN JOSE, CA

Mr. RONAN. Thank you, Mr. Chairman and Senator Graham. My name is Joe Ronan. I am vice president of Calpine Corporation, based in San Jose, California. We are the fastest-growing independent power company in the United States. We have been in existence since 1984. We are a true independent. We are traded on the New York Stock Exchange. There is no investor-owned utility interest in Calpine.

Senator MURKOWSKI. I have got the Secretary of Energy in the back room. I need to speak to him for a moment, so Senator Graham will be here.

Mr. RONAN. Sure.

Senator MURKOWSKI. Please proceed.

Mr. RONAN. We have 10,000 megawatts in operation, construction, or development, including, as we sit here today, 4,500 megawatts of clean, gas-fired merchant plants under construction in the United States. We have, including power plants in Averdale, FL, Sumas, WA, and soon in Pryor, OK.

We are also the largest renewable and geothermal company in the United States. I prospectively endorse the remarks of my colleague, Mr. Carlson, who will talk about that shortly.

We have expanded, although we are based in San Jose, CA. We have expanded in States that have encouraged deregulation or have deregulated. The bulk of our assets are in California, the State of Texas, and in New England. Obviously, the reason why we go there, is because the market is developing and competition is encouraged.

Twenty-one years ago, the Congress passed a law which created the independent power industry, and it has been successful beyond, I believe, anybody's expectations. We now have a very close to a true competitive market in the United States.

I think we have now grown to the point that we do not need Federal regulation to force the independent power industry, but we need, now, Federal deregulation to remove barriers for development and for competition in this country.

We believe that only comprehensive Federal legislation with a date certain can ensure that benefits of competition would be felt by all throughout the country. As we have talked about, 24 States have passed certain forms of restructuring, and there are 26 States that have not. That checkerboard pattern, I do not think, is good for increasing competition in the industry.

Turning to the question of the day, and municipal and cooperative taxation, we have entered into a number of public/private partnerships, which some people have mentioned earlier today, with the Sacramento Municipal Utility District. We are building a 730 megawatt plant for the Magic Valley Cooperative in Edinburgh, TX.

We are building a plant as a partner with the lower Colorado river authority in Texas. We see great opportunities to work with municipals.

Now, to fuel our tremendous growth, we have had to go to the capital and equity markets. We have raised $6 billion over the last few years to fuel the expansion of our power plants and competition in other States.

None of this money is tax-exempt, of course. To that extent, I join with Mr. Kuhn and the administration in opposing any bill that would allow tax-exempt financing for municipalities or cooperatives to build new generation to compete in the market.

But, having said that, I do think that there are certain things in Senator Gorton's bill and in some of the other proposals here that would be beneficial for competition.

I think any kind of legislation, tax legislation or whatever, that encourages or incentives for the municipals to enter into the competitive market is good. In your deliberations, if you can come up

with something that would help the municipalities get into the market and compete.

In California, we know there are a number of municipalities up in northern California that own geothermal power plants. They would very much like to participate in the independent system operator. They are making attempts to get into that, but yet they have not made decisions to open up their markets to competition.

So to the extent that legislation would enable it or make it easier for the municipalities to somehow get into the market, open up that marketplace, and compete, I think that would be a very good thing.

In California, we just went through two to 3 years of divestiture of utility power plants, and that has gone very successfully. We are on the verge of divesting up to 3,800 megawatts of hydroplants that Pacific Gas Electric is divesting. I think, in many cases, these would be very attractive to the municipalities, but they probably will also need private partners to help fund and operate these facilities.

So, again, in any kind of legislation that you are considering, in any ways that you can facilitate or help the municipals move into a competitive market, open up their service territories to full competition and bring them into full partnership with the rest of the competitive world, Calpine would support.

Thank you, Mr. Chairman.

Senator MURKOWSKI. Thank you. I apologize for the distraction. But I have your statement and I have reviewed it, and want to thank you.

[The prepared statement of Mr. Ronan appears in the appendix.]

Senator GRAHAM. Mr. Chairman, I regret that I am going to have to leave at 11:45, and I wish to express my appreciation to all of the members of the panel who are making such a valuable contribution to our understanding of the complexities and nuances of this issue. We look forward to continuing this dialog until we can hopefully reach the goal that Mr. Kuhn—and you are not related to Bowie, are you?

Mr. KUHN. Unfortunately not. Senator Graham. Has suggested is our mutually held hope of a destination of a common agreement among all of the interests who are represented in this complex industry and issue.

Mr. KUHN. Thank you, Senator.

Senator MURKOWSKI. Thank you very, Senator Graham. I hope we can accomplish that. But I want to remind the panel that some might suggest only a magician could satisfy everybody, but we will try. Hope springs eternal.

Senator GRAHAM. Where is Ozzie Smith when you need him?

Senator MURKOWSKI. I do not know.

Our next witness is Mr. William Mayben, president and CEO of Nebraska Public Power, well represented by a friend who is not here but wishes he could be, Senator Kerrey. Please proceed.

STATEMENT OF WILLIAM MAYBEN, PRESIDENT & CEO, NEBRASKA PUBLIC POWER, COLUMBUS, NE

Mr. MAYBEN. Thank you, Mr. Chairman, for the opportunity to appear before the subcommittee today and tell you a little bit about what is of interest to us in public power.

You had plenty of people tell you what the problem is, and from listening to all of you, I get the impression you understand it just about as well as we do. I represent at this testimony the large public power council which is comprised of 21 of the largest public power, that is, government-owned, municipally owned electric utilities throughout the United States.

The 21 utilities provide electric service to approximately 6.5 million customers. We have been working quite hard these last 3 years as we got serious about what the Energy Policy Act of 1992 really meant to us. We have come down square one on the side of competition. We believe that we do need a very robust transmission system throughout the United States for there to be fair competition, for there to be a good, competitive market.

However, we have found that there are some tensions between laws that were passed many years before the Energy Policy Act of 1992, and before FERC 888 and 889 rules were passed upon us. We are finding that, in fact, those old rules are preventing us from making our contributions to the rich, robust transmission system.

At the present time, if we put our systems into regional transmission organization and relinquish control over the operations of those facilities, which we think is probably ultimately necessary for independence, we automatically violate the private-use rules.

Similarly, if, in fact, the movement in 24 of the States encompasses the entire United States, we think that retail competition is going to give us a lot of problems under the private-use rules.

As a for instance, at the present time we are prohibited from matching competition with specific term contracts for given industrial customers or large regional companies.

As a result of being unable to have a non-tariff type of an agreement with those kind of customers, we again find ourselves violating the private-use rules. What is at stake under these circumstances is either extinguishing our tax-exempt debt and replacing it with taxable debt, or not playing in the game, staying out of the marketplace, and we do not think that that fits within the assorted policies of the large Public Power Council. We think there ought to be an open competitive market and we want to be able to play in that transmission portion of it.

Now, with regard to the concerns that people have about public power becoming a juggernaut and taking everybody's load away from them, I can only speak to my own system, the Nebraska Public Power District. We are short on capacity.

In fact, during the summer months we are buying energy during the on-peak hours. Now, we do have some energy capability during the off-peak hours and we sell it back into the market.

But, as we all know, the price of energy during the on-peak periods are quite high compared to what we can sell our excesses during the off-peak periods.

So we strongly support the idea of a competitive market, but we do not think we represent as any kind of a threat to any of our in-

vestor-owned brethren. Now, Mr. Kuhn made mention of the discussions that have been taking place within EEI and certain members of the public power community.

I am one of those individuals that has been participating in those discussions. I am encouraged. There are certain conditions that the investor-owned utilities are asking for that we just cannot abide by, one of them being taxing any revenues that we might derive from sales off-system. We do believe that we will lose customers whenever retail competition arrives in Nebraska, and when we lose those customers we are going to have excess capacity.

Now, it may be that we do not have so much that we do not have to buy any longer at the time of system peak, but we are concerned that, at some point in time, we may have to be selling outside of our territory that power that was reserved for those customers that we lost.

In finishing, I would like to just say that we support the idea of regional transmission organizations. We think it is absolutely vital to a competitive market. We are finding certain issues and participating in the regional transmission organizations that would cause us to violate the private use rules and have to do something fairly drastic with regard to either our bond holders or with regard to our own debt, which in turn increases the cost of electricity.

We know that Congress has gone forward with deregulation, contemplating that large portions of the customers in the United States are going to experience increased cost.

Finally, we support S. 386 completely, but the large Public Power Council stands ready to engage in further discussions on that as the Senate works its way through this very complex issue.

Thank you very much.

Senator MURKOWSKI. Thank you very much, sir.

[The prepared statement of Mr. Mayben appears in the appendix.]

Senator MURKOWSKI. Next, Mr. Eric Yould, executive director of the Alaska Rural Electric Coop Association.

STATEMENT OF ERIC YOULD, EXECUTIVE DIRECTOR, ALASKA RURAL ELECTRIC CO-OP ASSOCIATION, INCORPORATED, ANCHORAGE, AK

Mr. YOULD. Thank you, Mr. Chairman, members of the committee. My name is Eric Yould. I am the executive director of the Alaska Rural Electric Cooperative Association. I greatly appreciate the opportunity to speak with you today about the implications of restructuring on the U.S. Tax Code.

My organization is a State-wide trade association of Alaska's electric utilities, which collectively serves some 600,000 throughout the State. That does not sound like much, but as a matter of fact, that is some 90 percent of the population up there.

My members reside all the way from Barrel on the north slope, down to Metlacatla at the extreme southern portion of the State. The make-up of the State is different than the lower 48, in that 16 of my member utilities are cooperatives, roughly 70 percent of the State, 5 are municipal systems, and 2 are investor-owned utilities.

However, nationally, I am also representing the National Rural Electric Cooperative Association. There are nearly 1,000 electric cooperatives serving some 31 million consumers in 46 States.

As everybody has noted, there have been 24 States which have passed some form of utility restructuring. The State of Alaska is looking at it very hard now as well. I am sure that the recent draft legislation that has been put forward by Senator Murkowski will enter into our ultimate decision on what to do with restructuring.

Nevertheless, restructuring will have an impact on the tax-exempt status, very possibly, of the electric co-ops throughout the United States, and I am here today to urge changes to the U.S. Tax Code to protect the tax-exempt status of co-ops which are otherwise possibly at risk of losing that tax status.

Electric co-ops are in a uniquely different situation than the investor-owneds and the municipals in that we serve a very sparse population in a very geographically large area.

If you will take a look in my testimony in Table 1, Appendix 1, it shows sort of an overview of the electric utility industry and illustrates the problem that we have.

On the average, electric cooperatives serve six customers per line mile of transmission line or distribution line, and generates only $7,000 per line mile. Compare that to the investor-owned utilities, who have 35 customers per mile and generate $60,000 per mile.

It illustrates precisely why the investor-owneds are in the economically flush areas, and rightfully so. That is the way the American system is. But at the same time, the cooperatives were put into rural America for a purpose and they are serving their constituents well.

Nationally, co-ops are the smallest of the utility sector, and yet we deal with some of the highest costs. As a matter of fact, in my State of Alaska, the cost of electricity in rural Alaska is roughly 50 cents a kilowatt hour. That is roughly six times what it is on the national average throughout the United States.

In addition to that, Appendix 2 of my testimony shows that co-ops serve a disproportionately large share of residential consumers, consumers that do not have the large load that allows economic returns to investor-owned utilities.

As you are aware, electric cooperatives have a different tax status because cooperatives are not-for-profit businesses that are owned and operated for benefit of consumer owners. There is, of course, a place in the market for all types of utilities, as evidenced by membership in our own State-wide association.

It is particularly important that, in an era of restructuring, that the tax policy adjust to keep the cooperative business structure viable. Who else would serve rural America?

An electric cooperative is tax exempt as long as 85 percent or more of its annual income comes from members. Income derived from non-member businesses is still generally taxed under the Unrelated Business Income Tax, UBIT.

An electric cooperative which does not pass an 85 percent member income test is treated as a taxable entity. As a matter of fact, most of large electric generating cooperatives in the United States, that is, 80 percent of them, as opposed to the little distribution co-

operatives throughout the Nation, derive more than 15 percent of their income from non-members and, hence, are taxable entities.

The 85/15 test posed few problems for cooperatives prior to the retail competition, mainly because cooperatives, like all providers, had exclusive service territories. But with retail competition, our tax status is at risk.

For example, cooperatives will be collecting wire charges when competitors sell power to cooperative customers over cooperative-owned power lines. Furthermore, cooperatives may also sell power to non-cooperative members. All of these will test the 85 percent test and, hence, may obviate their access to their tax-exempt status.

GNTs aside, substantially all of the approximately 900 electric distribution cooperatives throughout the United States passed the 85 percent member income test and, thus, qualified for tax-exempt status.

The 85/15 test was enacted in 1924. Given today's electric industry and given the fact that most other kinds of cooperatives do not have the 85/15 test comparable to that of the electric cooperatives, I believe that change is in order.

Mr. Chairman, your own Joint Committee on Taxation, in its October 1997 pamphlet on taxes, issued related restructuring concerns about cooperatives being able to maintain their tax-exempt status in a competitive environment.

Cooperatives do, in fact, pay taxes, however. In calendar year 1996, electric cooperatives in my State paid State and local taxes of $3.7 million. Nationally, the figure was over $700 million.

The only tax we are exempt from is Federal income tax because, as earlier stated, we are not-for-profit entities and because any revenues in excess of expenses, which are called margins, are reimbursed to members. Generally, those members then pay taxes on that patronage.

In wrapping up, there are a number of issues that will threaten the tax-exempt nature of cooperatives under a deregulated market: retail wheeling, non-member sales, asset sales, unbundled activities, sales below cost, diversified business.

In conclusion, all sectors of the electric industry have tax concerns due to restructuring, and we have certainly heard that today. When the 85/15 test was imposed 75 years ago, it was never contemplated the vast changes the industry is posed to undergo today.

We respectfully request that Congress recognize the changing market and revise the 85/15 test to ensure that cooperatives are part of the future competitive landscape of the electric industry.

Thank you, Mr. Chairman.

Senator MURKOWSKI. Thank you very much, Mr. Yould.

[The prepared statement of Mr. Yould appears in the appendix.]

Senator MURKOWSKI. Our next witness is Mr. Corbin A. McNeill, Jr., chairman and CEO of PECO. Good morning.

STATEMENT OF CORBIN A. McNEILL, JR., CHAIRMAN, CEO & PRESIDENT, PEPCO ENERGY, PHILADELPHIA, PA

Mr. MCNEILL. Thank you very much, Mr. Chairman. I do appreciate the opportunity to appear before you today.

As you mentioned, I am Corbin McNeill, chairman, president, and chief executive officer of PECO Energy Company, the regional utility in Philadelphia.

In addition, or in the context of the deregulated industry, PECO Energy has established AmerGen Energy, in partnership with British Energy, to acquire nuclear power plants in the United States. To date, AmerGen has announced agreements to acquire six nuclear reactors at five different plant sites.

My testimony today is presented on behalf of the Edison Electric Institute, the Nuclear Energy Institute, and the Utility Decommissioning Tax Group.

I will provide you with a short overview of the problems that the electric restructuring activities in the United States pose for nuclear decommissioning trust funds, and my written statement provides a more complete explanation of these issues.

As you have heard today, the electric industry is undergoing a profound change as a result of both Federal and State actions to deregulate both the wholesale and retail electricity markets. These actions have led to a fundamental change in the nature of the electric power industry. And perhaps the most astonishing element of this change is, in fact, the speed with which these changes are occurring.

Unfortunately, the Federal tax laws have not kept pace with the rapid changes which are taking place. It is important to emphasize the speed with which the marketplace is reacting to these developments.

As companies seek to respond to these rapidly changing market conditions, however, that task is complicated and, in many ways frustrated, by the lack of certainty regarding the Federal tax consequences of the new transactions which are being considered.

By way of example, I would note that, while AmerGen has announced five acquisition agreements to date, none of those sales is closed. While some of these agreements were only recently announced, AmerGen's purchase of the Three Mile Island Unit One in Pennsylvania is awaiting final action by the Internal Revenue Service and the appropriate rulings prior to closing.

The TMI transaction has received all other Federal approvals necessary to complete the transaction, except for the IRS ruling. Until Congress provides the IRS with guidance to provide a predictable set of regulations applicable to the new marketplace, I fear that other transactions could be similarly delayed.

Thus, if there is a single message that I can leave with you today, it would be this. Congress cannot afford to wait for the passage of comprehensive electric restructuring legislation to address many of the tax issues raised by deregulation.

The development of a mature competitive electric market will be hampered, and the continued operation of low-cost, competitive, reliable nuclear generation assets may be placed at risk if Congress does not act quickly to address the unintended tax consequences of the transition to a deregulated electric utility industry.

The problems raised by electric restructuring with regard to nuclear decommissioning trust funds really fall into two categories. First, are the cases in which similarly situated taxpayers will be treated differently depending upon whether they operate in a State

in which deregulation has occurred, and second, are the cases in which State and Federal legislation or regulatory requirements will conflict with the intent of existing Federal tax law.

There are three instances in which similarly situated taxpayers are to be treated differently as a result of restructuring. The first relates to what is commonly referred to as the cost of service issue. Current tax law limits contributions to a qualified trust fund to the lesser of an amount approved by a State public service commission, or an amount referred to as the level funding amount, which is determined by the Treasury Department.

As a result, nuclear plant owners in States that have deregulated conditions may be prohibited from contributing any money to qualified funds, since their rates are no longer approved by the State public service commissions.

The second case relates to license transfers and plant sales. This is an example you cited earlier, where current law permits the tax-free transfer of qualified funds in connection with the sale of nuclear plants from one regulated entity to another. Thus, if two traditionally regulated utilities were involved in the sale of a nuclear plant, the transfer of the qualified fund would not be taxed.

If, however, a regulated utility sold the plant to a buyer that is no longer regulated, which will be typical in a deregulated environment, the IRS has indicated the transfer could be considered a taxable event and such a ruling could effectively prevent the sale from taking place.

The final case in which similarly situated taxpayers would be treated differently relates to a disparity that is already written in the Tax Code but which will be exacerbated by deregulation, and that is that Section 461(a) provides more favorable tax treatment for funds collected to decommission those portions of nuclear plants and service since 1984. Thus, newer plants receive more favorable tax treatment than older plants. This artificial and arbitrary distinction should be eliminated.

There are two areas in which State and Federal regulations or legislation will conflict with the intent of existing Federal tax law. These issues arise where States have directed nuclear plant owners to accelerate the collection of decommissioning funds as part of the restructuring orders, or where agencies such as the Nuclear Regulatory Commission have required prepayment of decommissioning funds.

Mr. Chairman, without your legislation, electric customers in deregulated States will have to pay more in taxes, offsetting the benefits of competition. We would encourage you to consider these as you move forward with your legislation. Thank you.

Senator MURKOWSKI. Thank you very much, Mr. McNeill.

[The prepared statement of Mr. McNeill appears in the appendix.]

Senator MURKOWSKI. Mr. Carlson, chairman of the Renewable Committee of the Electric Power Supply Association, Anderson, CA. Good morning. It is still morning, but you are the last morning speaker. You have 1 minute.

STATEMENT OF WILLIAM CARLSON, CHAIRMAN, RENEWABLE COMMITTEE OF THE ELECTRIC POWER SUPPLY ASSOCIATION AND VICE PRESIDENT, WHEELABRATOR ENVIRONMENT SYSTEMS, ANDERSON, CA

Mr. CARLSON. I appreciate you saving that coveted last spot for Renewable Power.

Senator MURKOWSKI. That is fine.

Mr. CARLSON. I welcome the opportunity to participate today. Providing a place for renewable was one of the driving forces behind the passage of PURPA in the late 1970's.

Coupled with high electric prices at the time, this spawned a modest-sized, but important, renewable power industry in the U.S. consisting of wind, geothermal, biomass, municipal solid waste, landfill gas, solar, and hydro-generating resources.

Over 20 years, a multitude of innovations in all technologies have lowered costs and increased reliability. Our biomass plants, for instance, produce power much cheaper than a decade ago, despite 10 years of inflation.

All renewable technologies displace fossil fuels and their emissions. All provide fuel diversity as a hedge against the next oil/gas price shock. Some also provide superior disposal methods for agriculture, forestry, and solid waste industries, saving valuable land fill space and eliminating open burning. The prospect of State-by-State piecemeal electric restructuring is, at best, a mixed blessing for renewable.

I want to comment now on the difference between wholesale and retail markets. Wholesale only restructuring creates a market in which renewable cannot successfully compete, at least in this time of cheap gas.

Retail competition, on the other hand, holds real promise for our industry. Long term, customer choice of renewable must provide any premium the industry requires. This is the correct long-term solution to our survival.

In reality, though, there will be a long transition to national retail choice. By that, I mean choice after repayment of utility stranded costs. Even recent Federal initiatives focus on wholesale competition, leaving retail decisions to the States. Much renewable capacity will not survive a likely 10-year transition to national retail markets, and the benefits will consequently be lost.

These benefits are not trivial. A recent DOE study of the biomass power industry shows the non-electric, environmental, and economic benefits to total over 11 cents per kilowatt hour, over 6 times the market premium needed to sustain the industry through this transition period.

So how does Congress, if it chooses to, assist renewable through this transition so that the benefits and the fossil fuel hedge are not lost without breaking the bank?

One way is a renewable portfolio standard, or RPS, creating a second wholesale market that is competition driven, easily administered, perfect for renewable whose small size, short lead time, and easy sighting minimize barriers to entry and, thus, any opportunity for market power, and is easily sunsetted when the premium disappears due to competition or a national retail market develops.

Targeted tax credits are a second method, and one, of course, more appropriate to this panel. These credits remove any necessary premium from the electric system. When structured as production tax credits, they force plants to run generating public benefits in order to collect.

They can be targeted by technology to reward public benefits or to recognize the stage of development. Again, they can be easily sunsetted when no longer necessary. A textbook case of the value of tax credits is provided by Section 45, Wind and Closed-Loop Biomass Credit passed in 1992 as part of the Energy Policy Act.

Wind has used this credit, along with technical innovation, to restart a technology that had languished since 1987. Wind now projects that, by 2000, there will be nearly two-thirds more wind capacity than in 1992. Clearly, Congress accomplished its goal with this credit.

Regarding biomass, the bill language missed the mark, however, and described a fuel situation that does not exist. Consequently, the biomass industry has been unable to collect one dime of this tax credit since its passage.

Predictably, the biomass industry has then languished, losing nearly one-third of its capacity in restructured markets such as California and Maine. We are typical in our company. Of five biomass plants, three operate at part load, as wholesale markets do not support even the fuel prices for a large percentage of the day.

With every biomass kilowatt hour not produced, the Nation loses the 11 cents of benefits calculated by DOE, while access to the tax credit is by itself enough incentive to run all plants at full load.

If you would like one near-term action item, renew the Wind and Biomass Tax Credit, changing the definition and the in-service date of biomass.

On a larger basis, it is our hope that you will shorten our transition period by mandating full retail competition nationally, and during the transition, you will support the renewable industry with a modest RPS or a targeted Federal tax credit.

The Nation simply cannot afford to place in jeopardy the environmental, fuel diversity, and technological gains of the renewable power industry during this transition period. Thank you.

Senator MURKOWSKI. Thank you very much, Mr. Carlson.

[The prepared statement of Mr. Carlson appears in the appendix.]

Senator MURKOWSKI. I am going to be very brief with my questions, and we may have questions that we will submit to you in writing.

But, Mr. McNeill, I want to talk a little bit about nuclear utilities. If the rules on selling nuclear utilities are not changed so that they are tax-free transactions, do you think they are going to be nuclear plants that are just shut down?

If that happens, what is that going to do to our energy security? I do not understand the logic of treating decommissioning costs differently for plants prior to 1984, or the difference between the two. Is there a rationale?

Mr. MCNEILL. Let me address the first issue.

Senator MURKOWSKI. Fine.

Mr. McNEILL. That is that, clearly, as we have gone through negotiating the purchase of some of the plants, it is clear that the original owners did not want to continue to operate them.

If a sale transaction was not facilitated in some manner by the appropriate taxability of the decommissioning trust funds, then there is a risk that those plants could have been shut down at some point in the fairly near future as we enter a competitive market, because the scale of the organization that we will have allows us to operate these things more efficiently, more effectively, and therefore be competitive in the marketplace.

So there is the risk of that. Then, therefore, you will have a change in the mix and less energy security because nuclear fuel is an indigenous fuel source.

With respect to 1984, that was an arbitrary date that occurred when we shifted from unqualified to qualified trust funds. It was arbitrary and I cannot defend the differences that exist right now.

Senator MURKOWSKI. Fair enough.

Mr. Yould, I think it is fair to say that the co-ops in Alaska have done a very commendable job in meeting the needs as a consequence of difficult conditions, the topography, and so forth.

Things are different in the lower 48, of course. Some of the co-ops are gigantic. They are bigger than their IOU neighbors. I do not think that our situation in Alaska mirrors that of the lower 48, and I think you would agree with that.

But we have got down here the 85 percent rule which limits a co-op's ability to sell power to anything else beyond its service area. I do not assume we have got that problem in our State to any extent, is that right?

Mr. YOULD. We do not have the problem that the majority of utilities in the State are co-ops. That is not to say, however, that an independent utility such as Aurora Power or a large IOU from the lower 48 could not come up there and start to compete in such a fashion that the utilities would then have to retaliate or protect their service territory or their customers.

Senator MURKOWSKI. Well, would our co-ops benefit if the rule were loosened up?

Mr. YOULD. Yes, they would.

Senator MURKOWSKI. And you would propose that?

Mr. YOULD. Yes, sir.

Senator MURKOWSKI. All right.

And the benefits, specifically, would be?

Mr. YOULD. That we would maintain our tax-exempt status.

Senator MURKOWSKI. And obviously you are not moving outside your traditional marketplace in this sense because you are not hooked up to an interstate grid.

Mr. YOULD. We are not interconnected with Canada or the lower 48. Frankly, we would like the same advantages as any investor-owned that would come to the State. Should PUCA, for instance, be repealed? We would like to be able to get into other businesses so that we could compete with them equally, but we would like to maintain the 85/15 rule to do so, sir.

Senator MURKOWSKI. So you would like to maintain your tax-exempt status and compete with them. Then, of course, the question is, can they compete with you in that kind of an environment?

Mr. YOULD. In that we have a non-profit motive and, hence, are not cash flush, I suspect that we would be very vulnerable to any large investor-owned utility that would want to come up and compete with us, irregardless of any kind of tax break that we would have from the Federal Government.

Senator MURKOWSKI. Yes. But you also have to wonder if the market is big enough to attract an investor-owned to come in there and try and compete.

Mr. YOULD. Mr. Murkowski, I certainly agree with you. But at the same time, we have already seen competitors that are chomping at the bit to go after even the small market that we have up there.

Senator MURKOWSKI. Well, who is coming up that wants to come after your small market?

Mr. YOULD. Aurora Power, for one, a small aggregator. But we have also had interest from INRON.

Senator MURKOWSKI. Yes. Well, some of the folks are obviously looking at various areas. But it would seem to me that the lack of any interstate with Canada leads us to recognize that we are a little bit of an island, like Hawaii, in that sense.

You are doing a pretty good job and we do not want to rattle the cage too much, but we want to ensure that, ultimately, there are efficiencies because the co-ops can construct a nice little world if there is no incentive for efficiencies, and the rate payer pays the brunt of it. That is why a competitive marketplace is certainly desirous, but, nevertheless, we have got significant difference here in the structure and we are well aware of what that is.

Do you have anything to add?

Mr. YOULD. The only thing I would like to add is on a more general term, and that is that we do serve rural America. As a matter of fact, the line density in rural America is such that, as I mentioned earlier, we only have six customers per mile and only $7,000 per mile. The investor-owneds have 35 customers per mile and $60,000 per mile.

So, we are performing in a very difficult environment, and I think that there is a place for cooperatives, I think that they have done a tremendous thing for rural America and the bread basket of America.

Senator MURKOWSKI. Thank you.

I think most of these questions have been touched on. Either Mr. Kuhn or Mr. Ronan, relative to the competitive environment, what will be the negative impacts of Federal subsidies provided to government-owned utilities, briefly?

Mr. RONAN. The negative impact of Federal subsidies to government-owned utilities? You mean, by enacting some tax incentive?

Senator MURKOWSKI. Right.

Mr. RONAN. Well, I do not know how serious municipals really are in getting into new generation, as many people have said here. They, in fact, are a net buyer of power. But I believe, in certain circumstances, because of the cost of capital differences, it would make the municipals more competitive, or the non-municipals less competitive. I would think that would be the obvious answer, but I am not sure that is a real concern from our viewpoint around the country.

Mr. KUHN. Mr. Chairman, there is a 25 percent advantage in the use of tax-exempt financing. Very simply, Wall Street will go where there is lower-cost capital.

A lot of projects will be undertaken with lower cost capital, and they might be done in combination with regular tax-paying enterprises that see that hooking up with a municipality might be an advantage for them to use that cost of capital that can be enjoyed out there, and in marketplaces where margins were very, very low, they are going to go out and take advantage of that.

I might repeat, and that is why we think that S. 386 is definitely not a compromise, because it does allow the continuation of tax-exempt financing for new transmission and it does allow tax-exempt financing for generation in a number of circumstances.

I think that that, going forward, we would agree with the administration bill, and that which is in Representative English's bill that says, prospectively, going forward, we need to eliminate this.

That is, Mayor Maddox indicated that he was concerned about his existing debt, and we are very, very sympathetic to that and we are not interested at all in affecting any of that existing debt. We are very sympathetic to the situation.

As we have said, we have had conversations with the LPPC and addressing Mr. Mayben's issues. As long as they stick within their own territory and do not want to use tax-exempt financing in new generation markets or for new transmission, then we are very, very comfortable with that.

Senator MURKOWSKI. Thank you, Mr. Kuhn.

I have two questions, and Mayor Maddox and Mr. Mayben can take them. But S. 386 allows government-owned utilities to sell unlimited amounts of power from facilities financed with tax-exempt bonds anywhere it may construct power lines in the future.

Do you support that position?

Mayor MADDOX. That is not my understanding of the bill, Mr. Chairman.

Senator Murkowski. What is your understanding?

Mayor MADDOX. Well, my understanding is, you still have the private-use restrictions. They do not go away with this legislation.

Senator MURKOWSKI. Well, transmission and repair does.

Mayor MADDOX. Well, repair is only if the generation capacity of the project is not enhanced. So if you repair——

Senator MURKOWSKI. Well, you can certainly equalize it and bring it back to what it was before.

Mayor MADDOX. Or what it is today.

Senator MURKOWSKI. All right. Either one.

Mayor MADDOX. But, sooner or later, technology catches up with that. I can tell you, with the city of Tallahassee, we have got 1950's technology at one place, 1970's in another.

We are just now looking at modernizing and are in the process of doing that in our plants. If we were going to make repairs there, there are only so many repairs you can do on a 1950's car and it is not going to be as efficient as today's car.

And the private-use restrictions do not go away under this legislation. If we decide to compete outside our service area, we pay taxes. Our ability for tax-exempt financing goes away. We either

have to abide by the private-use restrictions or make the one-time, irrevocable election and give away the tax-exempt financing.

Senator MURKOWSKI. Mr. Mayben, should any relief from the private business use rules be dependent on a government-owned utility operating both its transmission and its distribution system to competition?

Mr. MAYBEN. Well, I believe it should. The problem we have today is that the transmission system of government-owned electric utilities have been financed from tax-exempt debt, and they are authorized to exercise in that domain in their service territory and to build those facilities.

I see no reason why consumers that are already receiving service over a transmission system or distribution system would expect to have to pay a higher per-unit cost just because of the transition to competition.

Both transmission and distribution will be regulated. We expect, as a part of a regional organization, that we may find public power and private power in some kind of alignment and alliances to build certain facilities to relieve constraints on the system. I would not be interested in our portion being taxable debt.

Senator MURKOWSKI. I am going to conclude the hearing with just a couple of general comments. I would refer the public power panel to the statement of Edison Electric Institute relative to the portion covering tax subsidies in a competitive market where the allegation is that the shareholder- or investor-owned utilities contribute about $9.88 billion annually in tax revenue and the government-owned or municipal, in effect, receive a $6.2 billion annual subsidy based on Federal preference on cost of capital, Federal income tax exemption, and other taxes.

I would appreciate, for the record, your analysis of that and the recognition that it is no secret here, where you have got investor-owned controlling about 79 percent of the power generation, and municipals 21 percent, but municipals are much more numerous and, therefore, have significant political clout and they are doing obviously a creditable job.

But the objective here of electric deregulation, which is a part but not necessarily the purpose of this hearing because we are talking about taxation, is to recognize the changes that are being made in the industry, the efficiencies that are being made in the industry under deregulation, the rapid rate under which the States are showing the initiative through their own recognition of what they think is best for them, and we want to encourage that.

But we also want a reduction to the rate payers as much as possible. In rural America, that creates an additional problem and obligation. There is new technology, fuel cells, and others that may be able to be addressed down the line.

You run the 20 miles in to serve somebody in rural America and it costs a lot of money. You put a fuel cell in, if it is efficient, and you can justify the cost. That may be some relief in the future.

But, in any event, as this committee tries to address and resolve this difference, we are either going to have to dictate a solution, which I would rather not do, or encourage you folks to come together and recognize the realities associated with your differences.

It would seem to me that one way is to recognize that, if public power is going to go out and compete, they are going to have to be treated the same way. That is one way of doing it.

Other people disagree with that concept and say, no, public power still has to have the benefits. But if it goes in competition with the private sector that is paying taxes, clearly, there is an inequity here and, indeed, if the investor-owned can meet the market demand in those general areas.

I am a little concerned with some of the gimmicks that I see in some of this legislation, where it seems like there is a possibility of getting the foot in the door, whether it be on the issue of continued tax-exempt status for transmission facilities and the recognition that the industry is changing, people are getting out of power generation, they are focusing into sales, they are focusing into transmission and the ability to get tax- exempt status for repairs to put your plant back into an equal operating capability are also concerns.

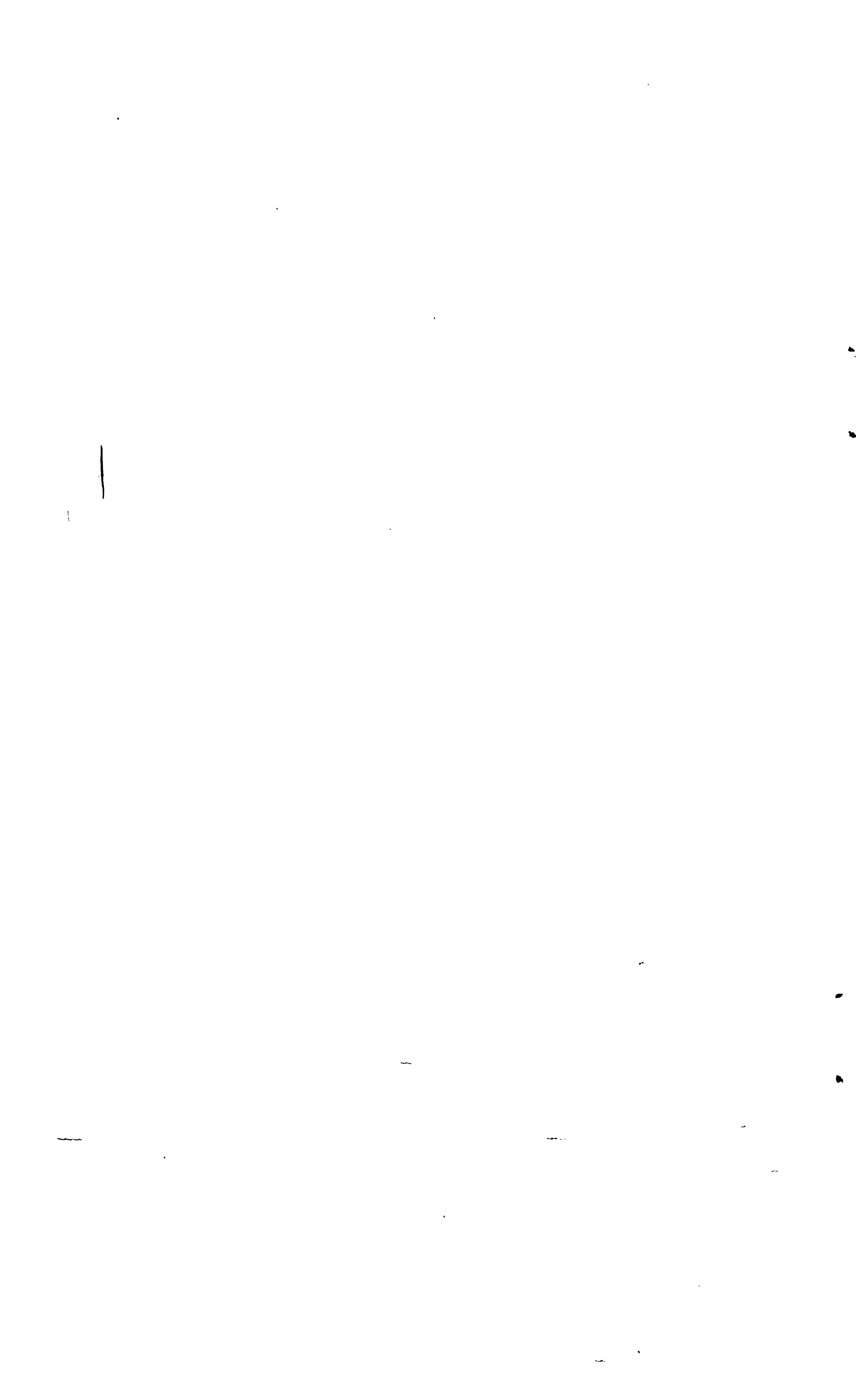
So I am going to do a little wishful thinking and encourage you folks to come together if you can. If you cannot, why, clearly you are going to have to be faced with the reality that, at some point, at some time, some Congress is going to resolve this with deregulation and you are going to get what they dictate or what your lobbyists are able to basically prevail on.

I would hope that, in the next Congress, we will get an opportunity to address with resolve the electric deregulation issue, and the topics we have discussed today are going to be very real, and concluding that in a meaningful way.

So if there is any possibility that you can find a common ground, it would certainly expedite things. It would cut your overhead. You would not have to pay your lobbyists for as long as you do, or your lawyers.

So, with that profound observation, let me thank you for contributing very meaningfully to the record, and I wish you a good day.

[Whereupon, at 12:22 p.m., the hearing was concluded.]



APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF HON. MAX BAUCUS

Mr. Chairman, thank you for holding this important hearing on the tax issues that surround restructuring of the electric utility industry.

Montana recently enacted legislation that will allow consumers to choose their retail supplier of electricity. The onset of competition for electricity in Montana has already set off significant change.

- The Montana Power Company responded to competition in the state by selling its generating assets—coal-fired power plants and hydroelectric facilities—to Pennsylvania Power and Light.
- Industrial customers are exercising their right to choose power suppliers. At last count, 80 percent of Montana Power's industrial customers have chosen to buy their power from a new power supplier.
- Flathead Electric Cooperative responded to competition by purchasing the service territory of PacificCorp in Northwestern Montana, adding more than 30,000 consumers to the 15,000 Montanans that they traditionally serve.

Many more changes are on the horizon as Montana continues its transition to competition.

As more states embrace retail competition, Congress has an important responsibility. We must act to remove the Federal roadblocks that stand in the way of states moving forward effectively with retail competition.

Mr. Chairman, I think we share the same philosophy on this issue. Throughout the Senate Energy Committee's inquiry into restructuring you have repeatedly said that Congress's goal should be to "deregulate what we can, streamline what we cannot deregulate and allow States to promote retail competition."

And that is what we are here to talk about today—how the U.S. Tax Code can help or hinder various segments of the electric utility industry as they respond to retail competition.

Montana and Alaska are alike in many ways. Both are noted for their rugged and remote country. You have more caribou than people, while we have more cattle than people. And like Alaska, the folks who live in small communities or on a farm or ranch in Montana are for the most part served by rural electric cooperatives.

Just as cooperatives are the dominant energy supplier in Alaska, electric cooperatives serve more consumers than any other power supplier in Montana. All told, co-ops provide electricity to nearly 400,000 Montanans who live in communities like Glasgow, Seeley Lake, Big Sandy and Red Lodge.

As the electric industry continues to change, we need to ensure that the Federal Tax Code does not hinder the transition to an open marketplace. In states like Nebraska that are predominately public power, that may mean private use relief. In states that rely on nuclear power, that may mean nuclear decommissioning. You feel strongly about that and have included the provision in your recently released comprehensive restructuring proposal.

In states like Montana and Alaska that are rural and have a significant cooperative presence, that means changes to the 85/15 rule.

The 85/15 rule is a federal law that requires electric cooperatives to earn at least 85 percent of their annual income from members of the cooperative.

If more than 15 percent of a cooperative's income is from non-member activity in a given year, then that cooperative loses its tax exempt status. This limitation made sense when the electric industry operated as a regulated monopoly, but it makes little sense in a competitive marketplace.

For example, Glacier Electric Cooperative in Northern Montana has opted into competition. A substantial number of their consumers could choose alternative power suppliers. If this happens, Glacier Electric will collect wheeling revenue—a

wires charge—from a number of power suppliers who are obviously not their members. This income is counted as non-member income. If it exceeds 15 percent of Glacier's revenue in a given year, then Glacier Electric loses its tax-exempt status.

Glacier's consumers will then see a rate increase on their electricity bill. This is clearly not a fair or intended result.

As a second example, Park Electric provides power to the Stillwater Mine, a platinum and palladium mine in the Beartooth Mountains. Stillwater Mine is Park Electric's largest customer. Park Electric owns and maintains wires and substations in order to serve the mine. Let's say that Stillwater Mine chooses a new power supplier. Park Electric may want to sell the assets that serve the mine. If they do this and the sale total exceed 15 percent of their annual revenue, then they lose their tax exempt status for the year.

Once again, the tax code punishes a cooperative who is engaged in competition by raising rates on its consumers.

The amendment I intended to offer this summer during markup of the tax bill with Senator Grassley and others would narrowly amend the 85/15 test, so that cooperatives are not punished by retail competition.

My proposal is straightforward. It simply says that revenue received by a cooperative as a result of their efforts to conform to a state law providing for retail customer choice is not counted against a cooperative on the 85/15 test.

It is also a proposal with a modest price tag. When it was included in the Democratic substitute to the tax bill earlier this year, the Joint Tax Committee scored it at less than $300 million—the smallest price tag of any of the measures being discussed here today.

This is not a downstream problem that Congress can address at our leisure. In states like Montana, where deregulation is already in progress, it is a problem that needs a solution now. My proposal does not create an "unlevel playing field" for any segment of the electric utility industry. It simply prevents the tax code from hurting electric consumers in my state and many other states.

Without this fix, Montanans in many rural communities are vulnerable to electricity rate increases. Rural consumers are also at risk in Iowa, Oklahoma, Nevada and Virginia. And could soon be at risk in Alaska, North Dakota and every other state represented in this Committee.

In closing, I appreciate that the Chairman is leading the electric restructuring debate in the Energy Committee. I am supportive of your efforts and offer any assistance that I can to help to further your goals.

But we must recognize that the tax changes are an integral part of that debate and are warranted whether or not federal restructuring passes in this Congress.

Just as you are a leading advocate of addressing nuclear decommissioning tax relief for investor owned utilities, I hope that you will also support a change in the 85/15 rule for electric cooperatives.

Thank You.

PREPARED STATEMENT OF WILLIAM CARLSON

Mr. Chairman and Members of the Subcommittee, my name is Bill Carlson and I am Vice President of Wheelabrator Environmental Systems. Wheelabrator Environmental System is a moderate size independent power company utilizing primarily renewable sources of energy. We operate nearly thirty independent power facilities throughout the United States, nearly all of which are fueled by renewable sources. The Renewable Energy Industry appreciates this opportunity to provide input to Congress as to how Federal tax policy may impact renewable energy generators in a restructured electric marketplace and, conversely, how a deregulated electricity market may restructure certain provisions of federal tax policy.

As you know, providing opportunities for independent renewable producers was one of the key driving forces behind the passage of the Public Utility Regulatory Policy Act (PURPA) in the early 1980's and the subsequent tax incentives passed by Congress to encourage and sustain renewable energy production.

As a consequence of PURPA, and in response to the high electricity prices across the nation at the time of its passage, a modest-sized but important renewables industry has grown up consisting of wind, geothermal, biomass, municipal solid waste, landfill gas, solar and small hydro energy producers. Over this 20-year period there have been a multitude of innovations in all of these technologies that have lowered their cost and increased their reliability. For example, at our company's largest biomass plant, we are now producing power for only 80% of the actual cost that we did in 1988, despite inflation of about 35% during this same period.

Another outgrowth of the proliferation of renewable projects has been the integration of the power generation facilities with other industries. Again, in the case of biomass, the use of waste materials as fuels (at a consumption rate of 20 million tons per year) has made these plants indispensable to proper forest management, for disposal of agricultural wastes and to the solid waste industry. In the case of every renewable energy technology, the environment has been the winner, with each technology displacing fossil fuel use and some also avoiding the open burning of waste materials and the use of valuable landfill space.

The piecemeal electric industry restructuring that has taken place to date in some states has clearly been a mixed blessing for the renewable energy industry. Wholesale-only restructuring, coupled with the current low natural gas prices, clearly makes it difficult for many renewables to compete in a "price-only" wholesale market. In many instances, "price-only" competition unreasonably fails to attribute fair value to the demonstrable, non-electric benefits enjoyed by the public as an inherent component of many renewable energy technologies. It should not be an option to simply give up the environmental and technological gains that have been made by the renewables industry by creating a partially deregulated market.

Conversely, the prospect of retail competition holds real promise for the renewables industry. In the long term, it is the hope of all of us that consumers, given a choice, will choose renewables for their environmental and fuel diversity benefits despite having to pay a small premium if measured against today's low gas prices. This clearly is the right long term solution for renewables.

The serious and most immediate problem is that a potentially long transition period is required to arrive at a time when all consumers have retail choice, and choice not distorted by repayment of utility stranded costs. The uncertainty and instability in the marketplace that is an unavoidable byproduct of the transition period, although it may be an unintended consequence, will have measurable negative impacts on the renewable energy sector. Current initiatives in Congress also appear to focus on wholesale competition, leaving retail competition, if any, up to the individual states. If retail choice must arrive in piecemeal fashion, and not until the end of stranded cost repayment, many renewables will not survive the transition.

If the conclusion is drawn that we are placing all our eggs today in the retail competition basket, then we should expect the following to happen during the transition period:

1. Erosion of renewable energy production capacity in the U.S.
2. Virtual halt to technological innovation during the transition period.
3. Loss of support for these technologies within the investment community.
4. Loss of the current crop of management and technical talent.
5. Loss of substantial environmental and economic benefits, including high levels of rural employment provided by renewables, particularly in areas that host many of these technologies.

The environmental and economic benefits referred to above are by no means trivial. For example, a soon-to-be released DOE study of the biomass industry estimates that the non-electric benefits (air quality improvements, reduction in the risk and severity of forest fires, etc.) of biomass power are worth 11.4 cents per kilowatt hour of electricity produced, a figure that is more than six times greater than the size of a tax credit or market premium needed to sustain the industry during the transition period.

If you accept that the benefits of renewables are real and that fuel diversity is a prudent hedge against future oil/gas price shocks, then how should Congress assist renewables through the perhaps decade-long transition to full national retail choice? A renewable portfolio standard (RPS) that establishes a second wholesale market for renewables will clearly keep renewables in the generation mix during the transition. It may also diminish the need for production tax credits in the future. This should give the lowest cost mix of renewables to meet any modest renewable objective established by Congress.

An RPS should work particularly well for renewables, since the small size, short lead time and easy siting of renewable facilities makes for very low barriers to entry into the market. Any RPS could sunset when full retail choice is available or when a combination of technological innovation or changes in prices of fossil fuels makes the premium between the two markets very small or non-existent. The only problem with a RPS is that it may become dominated by one or two technologies.

A second method to assist renewables in the transition, and one perhaps more appropriate to this panel, is the use of targeted federal tax credits. This removes the initial complexity of a required premium within the electricity marketplace while still preserving the public benefits previously described. When done in the form of a production tax credit, the credit also assures the plant is at work displacing fossil fuels and providing air quality benefits, not simply sitting idle collecting a subsidy.

The credits can also be targeted at specific technologies on the basis of public benefits provided, stage of development, etc. and can be eliminated when no longer necessary.

A textbook case of the value of this tax credit approach is provided by the example of the Section 45 tax credit passed in 1992 to provide 1.5 cents per kilowatt hour support to wind and biomass technologies. On the wind side, the credit was used by wind generators to restart the growth of an industry that had been virtually stagnant since 1987–88. By 1994 the effect of the credit and further technical innovation had again restarted wind development and the industry, by 2000, is expected to be nearly 2/3 larger than when the credit was passed. While the wind energy industry continues to need a production tax credit to reach its full potential, it is clear that Congressional support is having a desirable effect.

In the case of biomass, however, the definition of "closed loop biomass" chosen was so restrictive that it excluded all waste forestry, agricultural and urban fuels now used by the industry. As a consequence, no biomass energy generator has ever been able to collect a dime of the closed loop biomass tax credit. The existing biomass industry has been unsupported by federal tax incentives during this period.

The impact of this oversight on the biomass industry has been predictable. Instead of the steady growth shown by wind, biomass has languished, losing as much as 1/3 of the industry capacity in restructured states such as California and Maine. Of the five biomass plants that my company operates, three are curtailed during major portions of the year as the restructured market does not even yield energy prices high enough to cover the cost of purchasing our waste fuel. With every kilowatt hour not produced, the nation loses those 11.4 cents of environmental and economic benefits referred to earlier from the DOE study. Access to the biomass tax credit, by itself, would allow all plants to operate at full load.

Federal tax policy, additionally, can stimulate new and desirable industrial development related to the use of biomass materials. Three examples come to mind. First, biomass materials (especially agricultural and forestry-related residues), can be converted into a variety of chemical products. Second, new markets for the nation's hard-pressed agricultural sector can be created by growing specialty crops, such as switchgrass, for use as fuel in energy production facilities. Finally, biomass materials can be co-fired with coal in existing facilities to lessen air emission impacts of future operations.

Clearly, if this panel wants one suggestion for the very near term, extension of the wind and biomass tax credit with an expanded biomass definition to make it available to existing plants is that suggestion.

In conclusion, it is the hope that at the end of an electric restructuring transition period the preference of customers at retail for renewables will provide the needed market.

During the transition, however, either a RPS or access to federal tax credits will be needed to maintain the industry. We would ask you to look favorably on both of these as you continue your deliberations.

I have appreciated the opportunity to appear before the Subcommittee today and we look forward to working with you as you address these very important issues.

PREPARED STATEMENT OF HON. PHIL ENGLISH

Mr. Chairman and Members of the subcommittee, I want to thank you for the opportunity to testify before you today on an issue that is extremely important to me as a member of Congress and as a consumer. As you are aware, the tax implication of electricity restructuring are significant. The Commonwealth of Pennsylvania and 22 other states are introducing competition into electricity markets. Decisions Congress make now will define electricity markets nationwide and will determine to what extent consumers will benefit from such competition.

I believe that for electricity competition to work, the federal government needs to address the artificial competitive advantages of complete exemption from federal income taxes and the use of tax-exempt financing by government-owned utilities when competing against other sellers of electricity. These tax advantages may have had little practical impact when each electric utility, whether privately or governmentally-owned, sold power within its own service territory. However, as the Joint Committee on Taxation (JCS–20–97) noted, "if certain electric service providers were permitted to retain their ability to receive tax-exempt financing in a competitive marketplace, those providers might have a considerable cost advantage over other competitors in a deregulated market." This would distort competition and grow government-owned utilities at the expense of their taxpaying competitors.

I became interested in this issue when my constituents—specifically shareholder-owned and rural electric cooperative utilities—brought to my attention their concern about government-owned utilities using tax-exempt financing to lure away their existing customers. All electric providers understand that changes need to be made from moving from a monopolistic to a competitive environment. The question is what kind of change should be made.

The issue before us now is how to integrate municipal utilities into the competitive market in a way that advances—not distorts—competition. Tax-free financing and exemption from Federal and state income taxes pose no problem to electric competition if, and only if, government-owned utilities limit the use of tax-free financing and exemptions to their traditional service areas.

On March 24th, I introduced The Private Sector Enhancement and Taxpayer Protection Act of 1999, H.R. 1253, which addresses competitive concerns by prohibiting tax-free bonds from being used to finance generation and transmission by government utilities if such utilities choose to compete in open electricity markets. If such utilities elect to do so, any sales outside of their traditional service areas should be, like other commercial operations, subject to federal income tax.

This legislation will not affect government-owned utilities if they use tax-exempt financing and other subsidies to provide power in their historic service areas. Moreover, the legislation will not affect municipal utilities that do not elect to sell generation or transmission in the new competitive marketplace. Since the vast majority of government utilities, of which there are more than 2,000, do not generate electricity, this bill will not affect them. In addition, this legislation does not affect existing bonds or current bondholders, federal authorities such as the Bonneville Power Administration or rural electric cooperatives. The Pennsylvania Rural Electric Association and the Edison Electric Institute have endorsed my bill. Copies of their endorsements follow my testimony.

As noted by the Congressional Research Service in a June 10, 1999 memorandum, Congress has engaged in an effort for 30 years to deny use of the federal subsidy provided by tax-exempt bonds for goods and services that do not satisfy its conception of public services. Some of these efforts have been directed specifically at public power. Concern regarding the spread of power subsidized with tax-exempt bonds caused Congress, in the 1986 Tax Reform Act, to impose more severe restrictions on private use of bond proceeds for government-owned utility property than it did for all other eligible private activities. Congress' desire to further limit the spread of electricity subsidized by tax-exempt bonds has been demonstrated two times following the 1986 Act. First, the Omnibus Budget Reconciliation Act of 1987 adopted a provision that essentially treats as private-activity subject to the volume cap, any tax-exempt bond issue for which 5% or more of the proceeds are used to acquire output property owned by shareholder-owned utilities.

Second, the Omnibus Budget Reconciliation of 1996 further restricted shareholder or independent power producers' use of bonds for "local furnishing" to service territories that were using the bonds prior to January 1, 1997. Those providers using the bonds at that time were grandfathered; additional "local furnishers" were prohibited.

It is clear that three decades of tax legislation has been directed to controlling the spread of the tax-exempt bond subsidy to areas not served historically by public power. Why would we want to reverse course at this time? That's exactly what will happen if provisions of S. 386/H.R. 721 are enacted into law. These bills expand the ability of all government-owned utilities to issue new tax-exempt debt to serve customers outside their traditional service territory. These bills would allow public power to use facilities financed with tax-exempt bonds to compete against private companies to sell power. It would enable government utilities to grab control over the electricity transmission system through the use of "not-for-profit" transmission control companies—a stated goal of public power. What legitimate governmental purpose would be served under this type of financing arrangement? I can't think of one. What it would do is provide special benefits to public power customers at the expense of all other taxpayers. As noted in a Congressional Research Service study (98–528 E): "the exclusion from federal income taxation of interest income on tax-exempt bonds for public power is a subsidy that obscures rather than reveals the true cost of electricity and redistributes income to public power customers from the 75% of the country that purchases its electric power through the private sector. . .Allowing tax-exempt bonds to be used for new output facilities after deregulation of generation and retailing has been implemented would give public power a competitive advantage over IOUs."

Congress should have deep public policy concerns with the direction H.R. 721 and S. 386 would take the electricity marketplace. Electric generation and transmission is such a capital intensive industry that control will naturally flow to those with

the lowest cost of capital—in this case, tax-exempt financing. Thus, by reducing private use restrictions, these bills would increase government ownership of the nation's power grid at a time when electricity markets throughout the world are being privatized. In fact, the expansion of public power into competitive markets is already underway as a result of temporary IRS regulations. Some examples:

"The Bond Buyer" on May 21, 1999 reported that the general manager of the Los Angeles Department of Water and Power stated that LADWP has been the "primary beneficiary" from California's competition and that it has "made $80 million in net profits over the last 10 or 11 months selling in the power exchange." They are able to do this because of a loophole in the regulations that provide that short-term sales do not result in private business use.

The Energy Authority (TEA) (jointly owned by Jacksonville, Santee Cooper, Municipal Authority of Georgia and Nebraska Public Power District (NPPD) has operated a 24-hour trading floor since August 1997. This operation is advantaged over other traders in that it does not have to pay Federal income tax. Moreover, NPPD has stated that it joined The Energy Authority because it has "excess capacity for sale" (NPPD Web page). Just last week "The Bond Buyer" reported that The Energy Authority is "apparently generating handsome profits for its four [municipal] owners. The article reported that one official stated "Let me just say that we have exceeded all our expectations in terms of what we thought this organization could do. It has generated numbers many times larger that our estimated net revenues when we went into this business. . .in fiscal 1999, which ended June 30, the agency sold about $6 million worth of energy outside its ordinary territory—as compared to $35 million in sales to its members. The profit margin on the off-system trading was in excess of 8% of sales."

These examples speak for themselves: the IRS regulations and pending tax legislation (H.R. 721/S.386) are about public power entities using tax exemptions to make profits when competing head-to-head with taxpaying businesses. That clearly is not in our nation's public policy interest. Enactment of H.R. 721/S. 386 would further exacerbate what already is an egregious and lucrative misuse of the tax system.

I would ask the Senate Finance Committee to address this issue, and encourage the adoption of legislation that moves competition forward, not backward. Thank you for the opportunity to address you today.

Attachment.

Pennsylvania Rural Electric Association

[illegible] STREET • P.O. BOX [illegible] • HARRISBURG, PA • [illegible]
TELEPHONE 717 [illegible] • FAX 717 [illegible]

July 27, 1999

Honorable Phil English
Room 1410
Longworth House Office Building
Washington, DC 20515

Dear Congressman English:

On Wednesday, July 14, the Board of Directors of the Pennsylvania Rural Electric Association (PREA) approved the attached resolution in support of your legislation, H.R. 1253, "The Private Sector Enhancement and Taxpayer Protection Act of 1999." The PREA Board of Directors consists of a representative from each of PREA's thirteen member-cooperatives, including Northwestern Rural Electric Cooperative Association, which serves a majority of your congressional district.

As you well know, Pennsylvania's electric cooperatives are in somewhat of a unique situation, since we are currently the only cooperatives in the country to be fully engaged in electric competition. Because of our unique situation, we understand first-hand the tremendous complexities involved with the deregulation of the electric utility industry. One such complexity is determining how to keep a truly level playing field for all utilities and all segments of the electric utility industry.

While it is true that rural electric cooperatives are non-profit, consumer-owned and tax-exempt entities, they operate in the marketplace just like any other private sector business. Rural electric cooperatives are not "government-owned" utilities. And, even though rural electric cooperatives can borrow low-cost capital from the Rural Utilities Service, an agency within the U.S. Department of Agriculture, cooperatives can only use those funds for capital projects to better serve their core membership. None of the funds borrowed from the RUS can be used by a cooperative in a competitive marketplace to attract and serve customers outside of their existing membership base.

Because cooperatives are fundamentally different from municipal utilities (the segment of the utility industry your legislation targets) and investor-owned utilities, we believe it is important that, when moving to a competitive marketplace, safeguards be put in place to ensure that one sector of the industry not be given a competitive advantage over another In this new competitive utility marketplace, it would not be fair for municipal utilities to be able to utilize tax-exempt financing to compete for customers

against cooperatives and investor-owned utilities that do not have that same privilege. That is why we support the provisions of H.R. 1253.

I certainly applaud your interest in this issue that is so very important to the electric utility industry. And, I want to congratulate you for having the foresight to address such a problem before it could have significant negative impacts on not only the electric utility industry, but also the nation's taxpayers as well.

As always, I look forward to working with you in the future on this issue and other matters of mutual concern. Please feel free to contact me if I can ever be of further assistance.

Sincerely,

David F. Bonsick
Manager, Government and Regulatory Affairs

Enclosure

Pennsylvania Rural Electric Association

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99-7-F1
Private Use Restrictions

WHEREAS, for decades, public power utilities (municipal utilities) have issued tax-exempt bonds to finance generation, transmission and distribution facilities; and

WHEREAS, for the past thirty years, these bonds have been issued within the framework of a "private use" test, which is intended to ensure that federal tax-exempt benefits go to facilities serving the general public, not individual private entities;

WHEREAS, the new competitive utility marketplace that is developing across the country eliminates the obligation to serve and seeks to replace regulation with competition, thereby placing into conflict the appropriateness of the private use rules; and

WHEREAS, no sector of the electric utility industry should be given a competitive advantage in the drafting of the rules that will govern the new competitive marketplace; and

WHEREAS, if public power utilities were allowed to utilize tax-exempt bonds to assist them in competing outside of their traditional service areas, they would be provided with a significant competitive advantage; and

WHEREAS, several pieces of legislation with the goal of clarifying the private use rules have been introduced in the 106th Congress, including legislation introduced by Representative Phil English of Pennsylvania (H.R. 1253) that, among other things, severely limits the ability of public power utilities to use tax-exempt financing to compete outside of their traditional service areas; and

WHEREAS, Congressman English has personally requested the assistance of the Pennsylvania Rural Electric Association (PREA) in obtaining electric cooperative support for H.R. 1253.

THEREFORE BE IT RESOLVED, that the Board of Directors of the Pennsylvania Rural Electric Association supports the provisions of H.R. 1253 and urges the United States Congress to enact "The Private Sector Enhancement and Taxpayer Protection Act" during this the 106th Congress; and

THEREFORE BE IT FURTHER RESOLVED, that the Board of Directors of the Pennsylvania Rural Electric Association authorizes PREA staff to solicit support for H.R. 1253 from other rural electric statewide organizations and take appropriate steps to publicly express such support.

EDISON ELECTRIC
INSTITUTE

THOMAS R. KUHN
President

April 13, 1999

Dear Representative:

Representative Phil English recently introduced H.R.1253, "The Private Sector Enhancement and Taxpayer Protection Act of 1999," which would promote fair competition in electricity markets. The Edison Electric Institute (EEI) strongly supports this legislation, and urges your support and cosponsorship.

The electricity industry is in the transition from regulation to the use of open, competitive markets to sell power and related services and products. For competition to work, the federal government needs to address the artificial competitive advantages of complete exemption from federal income taxes and the use of tax-exempt financing by government-owned utilities when *competing* against other sellers of electricity. Government-owned and shareholder-owned utilities must participate in open markets under the same set of tax and finance rules. H.R.1253 accomplishes this objective.

Under this legislation, government-owned utilities are allowed to compete, but if they do, they can't use new tax-free bonds to finance their power plants and transmission lines; and they will be taxed on revenues from sales made outside of their service area. Importantly, this bill allows government-owned utilities to retain and use their tax-exemptions, tax-free financing and preferences when serving their own communities. It is only when a government-owned utility *elects* to act as a commercial entity and compete in open markets *outside its community* that it would it be treated like any other taxpaying, commercial entity.

The bill in no way affects bonds issued by state and local governments for legitimate governmental purposes (such as fire, police, hospitals and other services). In addition, the bill has no effect on approximately 2200 municipal utilities nationwide. Only the 30 plus large, aggressive municipal utilities with excess electric generation capacity would be affected by the bill. Also, the bill does not affect, (1) existing bonds or current bondholders; (2) federal authorities such as the Bonneville Power Administration; or (3) rural electric cooperatives.

Support for H.R.1253 would promote the development of healthy competition by requiring government-owned utilities to compete under the same tax and financing rules as other entities in the electric marketplace. It would also safeguard the current uses of tax-exempt financing for legitimate government purposes. For these reasons, EEI strongly urges your cosponsorship of this legislation.

Sincerely,

Thomas R. Kuhn

PREPARED STATEMENT OF T.J. GLAUTHIER

INTRODUCTION

Mr. Chairman, thank you for inviting me and my colleague from the Treasury Department to describe the tax-related provisions of the Administration's proposal for Federal electricity restructuring legislation. On April 15, Secretary Richardson transmitted to Congress the Comprehensive Electricity Competition Act (CECA)[1]—the Administration's vision for the role the Federal government should play in the transition to competition. DOE, the Agency responsible for formulating and implementing the Clinton Administration's energy policies, has worked closely with the Treasury Department and other agencies to develop this comprehensive package.

Twenty-four states have now adopted electricity restructuring proposals that provide for competition at the retail level. Almost every other state has the matter under active consideration. The Clinton Administration believes that this is a positive development. Competition, if structured properly, will be good for consumers, the economy and the environment. Companies that had no incentive to offer lower prices, better service, or new products will now compete for customers. Consumers will save money on their electric bills. Lower electric rates will also make businesses more competitive by lowering their costs of production. By promoting energy conservation and the use of cleaner and more efficient technologies, greenhouse gas emissions will be reduced, as will emissions of conventional air pollutants. However, the full benefits promised by competition can be realized only within an appropriate Federal statutory framework. What we do at the Federal level, and when we do it, will have a profound impact on the success of state and local retail competition programs.

One of the primary functions of Federal restructuring legislation must be to remove the Federal impediments to wholesale and retail electric competition. The Administration believes that certain provisions of the Internal Revenue Code may act as impediments and require clarification and modification to promote the efficient transition to competition. The growing interest in federal electricity restructuring legislation in both houses of Congress make this hearing on related tax issues especially timely. Our testimony today will focus on the amendments to the Code included in the Administration's comprehensive electricity restructuring proposal.

TAX PROVISIONS IN CECA

Tax-Exempt Bonds Used to Finance Publicly-owned Electric Facilities

Publicly-owned electric facilities are an important part of the nation's power system. For instance, more than 25 percent of all of the transmission facilities located in the State of California are owned by publicly-owned utilities. It is imperative that, as we transition to wholesale and retail competition, we enable the cities and towns served by publicly-owned utilities to reap the same benefits that will be available to customers of investor-owned utilities.

The private use restrictions in the Code serve as a major deterrent to the development of competitive markets. Publicly-owned utilities could very well endanger the tax-exempt status of their debt issued to finance generation, transmission and distribution facilities if they: (1) voluntarily comply with FERC Order No. 888 by providing other utilities comparable access to their transmission facilities; (2) join an independent regional system operator; (3) enable other power marketers to use their distribution facilities as part of a retail competition program; or (4) mitigate their stranded costs associated with retail competition by selling excess power outside of their traditional service territory.[2] As a result, many publicly-owned utilities, to date, have deferred taking actions that would have the effect of promoting wholesale and retail competition. The current statutory framework was established to fit an era when individual electric systems, whether privately or publicly-owned, operated within clearly defined service territories and the wheeling of power was not widely practiced. As the industry moves toward a more efficient, integrated structure, transmission and distribution facilities that may have been financed with tax-exempt debt need to be open to use by competing power marketers.

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[1] The Administration transmitted CECA to Congress in two separate parts. Both parts were introduced by Senators Murkowski and Bingaman (upon request)—S. 1047 and S. 1048—on May 13, 1999. S. 1048 contains the tax-related provisions of the Administration proposal.

[2] While the Internal Revenue Service has issued temporary regulations to address some of these issues, these regulations are set to expire in January, 2001. The Administration believes that it is preferable that Congress permanently resolve these matters pursuant to comprehensive electricity restructuring legislation.

To achieve such a result, the Administration proposes to amend the Internal Revenue Code to provide that (1) private use limitations are inapplicable to outstanding bonds for publicly-owned generation, transmission or distribution facilities if used in connection with retail competition or open access transmission and (2) tax-exempt financing is unavailable for new generation or transmission facilities. Tax-exempt financing would continue to be available for distribution facilities subject to private use limitations as under current law.

Tax Treatment of Distributed Power and Combined Heat and Power

Interconnected distributed power (DP) and combined heat and power (CHP) facilities are likely to be an important approach to meeting customer needs in restructured electricity markets. In addition, these technologies provide important benefits to certain rural areas, such as parts of Alaska, where high distribution costs inhibit growth. While retail competition itself will provide an impetus to the development of both DP and CHP systems, a number of other significant barriers impede the effective deployment of these technologies. Given the significant economic, reliability, and environmental benefits of these technologies, a truly comprehensive plan for the electricity sector should include actions to reduce these barriers.

The present Federal tax treatment of DP technologies may have the effect of discouraging their use in many types of applications. Depreciation lifetimes for particular pieces of equipment, such as turbine engines, may be much longer when the equipment is used as part of a DP facility than when it is used in another application, such as airplane propulsion. For example, when DP technologies are used in commercial industrial buildings, such assets may be treated as structural components and are therefore subject to straight-line depreciation over a 39-year lifetime. This treatment can have the unintended effect of discouraging the use of DP in applications where it would actually be more cost-effective than other technologies. In the view of the Administration, the treatment of DP technologies should be clarified by allowing a depreciation schedule for all DP equipment of 15 years.[3]

The Administration has also included an investment tax credit for CHP systems in its proposed restructuring legislation. The proposal would establish an 8 percent investment credit for qualified CHP systems placed in service in calendar years 2000 through 2002. The measure would apply to large CHP systems that have a total energy efficiency exceeding 70 percent and in smaller systems that have a total energy efficiency exceeding 60 percent. These energy efficiencies are well above the levels for conventional fossil fueled power plants.

An investment tax credit for CHP assets is expected to encourage increased energy efficiency by accelerating and inducing investments such systems. The increased demand for CHP equipment should, in turn, reduce CHP production costs and spur additional technological innovation in improved CHP systems. Given the significant economic and environmental benefits expected from this proposal, the Administration encourages Congress to enact an investment tax credit for CHP systems that would be effective during the critical transition to competitive retail markets that is now underway in many states.

Nuclear Decommissioning Costs

In the Administration's view, existing nuclear power plants, which today supply one-fifth of the nation's electricity needs, are an important part of our electricity future. To avoid unintended adverse impacts on the economics of the nuclear power operations, changes in the structure of the electric power industry must not impede longstanding efforts to fund the eventual decommissioning of nuclear power plants.

Under current law, the amount of contributions to a qualified nuclear decommissioning fund a utility is entitled to deduct under section 468A of the IRC is the lesser of the "cost-of-service" amount or the "ruling amount." In a restructured market, if a nuclear power plant is no longer subject to cost-of-service ratemaking, it could be determined that the amount of decommissioning costs included in cost-of-service would be zero. Because the amount qualified for the tax deduction is the lesser of the amount included in the cost of service or the ruling amount, the allowable tax deduction would then be limited to zero. This would pose a significant barrier to the adequate funding of nuclear decommissioning funds. To address this problem, section 468A needs to be amended. To address this problem, the Administration has proposed to repeal the cost-of-service limitation to allow owners of nuclear plants

[3] CECA also proposes a favorable transition charge treatment for efficient CHP and DP systems for on-site generation, federal interconnection standards for DP and CHP, and joint efforts between the Department and the Environmental Protection Agency to reduce barriers to environmental permitting of DP and CHP facilities.

not subject to cost-of-service ratemaking to deduct contributions to a qualified nuclear decommissioning fund.

CONCLUSION

Mr. Chairman, while the states are proceeding with their restructuring programs, all eyes are looking towards the Congress to learn what signals the wholesale and retail markets will receive. As a key member of the Senate Finance Committee and Chairman of the Senate Energy and Natural Resources Committee, you are in a crucial position to address these issues in a comprehensive manner.

The Administration believes that the Congress should move forward on a comprehensive basis to enact legislation addressing all of the actual matters related to electricity restructuring, including tax issues. Mr. Chairman, we can't afford to wait until the 107th Congress to do what needs to be done now. Secretary Richardson and I, as well as our staff and experts from the Treasury Department, stand ready to assist you and the other members of this Subcommittee in this vital endeavor. Only by working together can we take the steps that are necessary to provide consumers with the full benefits of competition.

PREPARED STATEMENT OF HON. SLADE GORTON

Mr. Chairman, thank you for the opportunity to testify at today's hearing on electricity-related federal tax issues. I appreciate that you scheduled this hearing, not only to hear about the details of my proposal, S. 386, the Bond Fairness and Protection Act, but also because the other issues on the agenda should be considered and solved at the same time.

My bill is a compromise for the future of tax-exempt financing. Presently, Public Power utilities are subject to "private use" restrictions in the tax code that place strict limits on the use of facilities that are financed with tax-exempt debt. These limits were burdensome in another era, but are proving unworkable now.

We are in a new era of emerging competition in the electricity industry. Due to the changes in electricity policy made by Congress in 1992 and subsequent action by the Federal Energy Regulatory Commission (FERC), the wholesale electricity industry now has significant areas of competition. There is still a long way to go before we achieve a truly competitive market, but actual competition and the possibility of competition have resulted in fundamental changes in this industry. It is a very different industry than it was 10 years ago.

Increased competition in the wholesale market—just in these past few years—has led to lower prices and billions of dollars of savings to electricity consumers, although many do not realize it because the savings have flowed through wholesale prices that residential consumers don't see.

Now we have Public Power utilities that are caught in a bind due solely to outdated tax law. As states and FERC move to open transmission lines—and in some cases distribution lines—for new entrants to use under standard rates and conditions, Public Power is trapped by private use. Either they open their systems to competition and incur huge costs of refinancing existing debt, or they wall off their consumers from any choices of different suppliers.

These choices clearly raise costs and rates for the customers of Public Power utilities. And they are terribly inefficient for the market and the economy as a whole. In sum, the existing private use restrictions serve as a barrier to open markets and increased competition.

My bill makes changes to the existing restrictions and allows these utilities to make choices. Specifically the existing private use restrictions are modified to not include the types of activities that pertain to opening a system to competition, such as FERC requirements to provide "open access" to transmission facilities, or a state requiring access to a utility's distribution system. A utility could choose to continue to abide by existing private use restrictions with these clarifications.

Other utilities would have the option to obtain certainty of "grandfathering" existing tax-exempt debt (incurred prior to the expectation of competition) but at the tradeoff of electing to never use tax-exempt debt for sources of generation (the segment of the industry that is becoming competitive.) These utilities would still be able to use tax-exempt debt for the segments of the industry that are natural monopolies: distribution systems of wires through a community, and large transmission systems that generally run between communities and power plants and throughout regions.

Regarding the costs of this legislation, I contend the revenue estimation of S. 386 is wildly incorrect. I am convinced the existing private use restrictions serve as drag on the national economy. Incrementally the drag is small, but it has large aggregate

impacts. Consumers are paying more, and the network is less efficient solely due to these outdated laws. Rectifying this policy will create a more efficient electricity marketplace and the resulting economic gain should result in more general revenue, not less. Secondly, the estimates should be based on real world behavior, not hollow theoretical conjecture. The revenue estimate assumes that without a legislative fix, Public Power will reissue its debt as taxable. The reality—and the evidence to date—is that Public Power will never risk this, and will instead wall off its customer base from competition. This hurts the customers and the reliability of the larger interconnected grid. Failure to act costs money, clarifying the tax code does not.

Finally, I agree that fixes are needed for the issues surrounding the nuclear decommissioning funds and the rural electric cooperatives. Yet as I stated earlier, these three issues must be addressed at the same time to ensure fairness for all the customers of this industry.

PREPARED STATEMENT OF THOMAS R. KUHN

Mr. Chairman and members of the Subcommittee, I am Thomas R. Kuhn, President of the Edison Electric Institute (EEI). EEI is the association of U.S. shareholder-owned electric utilities, their affiliates and associates worldwide. EEI's members serve approximately 75% of the nation's electric customers.

I appreciate the opportunity to appear before this Subcommittee today to address one of the most important aspects of electric restructuring. Specifically, I refer to creating a level playing field where all providers of electricity in competitive markets would have equal tax and financing opportunities. We commend the Chairman for holding this hearing so that an adequate record can be made of this key component of the electric restructuring debate.

ELECTRIC RESTRUCTURING IN THE STATES

The pace of electricity restructuring in the states is far more intense than occurred in either the telecommunications or natural gas industries. Just three years ago the first state adopted a retail competition plan. Today, roughly 63 percent of all American electricity consumers live in the twenty-three states that have approved customer choice programs. The remaining states and the District of Columbia are considering reforms to retail electric service.

Significantly, Mr. Chairman, in those 23 states that have embraced electric restructuring, nearly all have permitted government-owned municipal utilities to "opt out" of compliance with the state law or "opt in" to competition. . .at their own discretion. To date, virtually all municipal electric utilities have chosen not to permit their customers to benefit from competition. However, many of these government-owned utilities are aggressively marketing to customers outside their service territory. Further, Mr. Chairman, their marketing activities are subsidized by the federal government through the use of tax-exempt financing and income tax exemptions. We believe there is no legitimate justification for the use of these tax benefits outside of a government-owned utilities' service territory.

I would submit to members of this subcommittee that these actions by government-owned utilities are unfair to their own customers, unfair to other electricity suppliers in the competitive marketplace and unfair to American taxpayers who are subsidizing this activity.

SCOPE OF REGULATION

It is important to remember what will be regulated and what will not be in competitive electricity markets. Electricity suppliers will compete to sell power and energy services to consumers. However, the "wires" side of the electricity business—the distribution lines that deliver power to homes and businesses will remain regulated for the foreseeable future.

One of the keys to competitive markets is the existence of competitors. Thousands of suppliers currently participate in electricity markets, including over 2,000 municipal electric utilities, more than 900 electric cooperatives, and roughly 200 shareholder-owned utilities. There also are more than 4,000 non-utility generation projects that currently sell their power to utilities, as well as 650 power marketers. Plans for the construction of new merchant generating facilities representing over 90,000 megawatts of capacity are underway in states from coast to coast. As electricity markets become more competitive, many of these suppliers will be competing head-to-head to provide electricity and a variety of services to consumers.

Most electricity suppliers will move power over distribution and transmission systems that remain regulated. FERC regulates the interstate high-voltage wires of

shareholder-owned utilities to ensure guaranteed open access for all suppliers and to set fair and reasonable charges for transmission services. In 1996, FERC, in its Order 888, ordered shareholder-owned utilities, which own about 75 percent of the country's transmission systems, to open up their transmission lines to all suppliers in the wholesale market. This means that any wholesale power supplier can use transmission lines owned by shareholder-owned utilities at the same price and terms that those utilities charge themselves to ship power.

Unlike shareholder-owned utilities, government-owned utilities (many of whom are municipalities) are not subject to any rate regulation, (or to the full panalopy of FERC's open access rules.) Admittedly, this issue is not within the jurisdiction of the Finance Committee. It must be addressed by the Energy and Natural Resources Committee, however, if true competition is to occur.

TAX SUBSIDIES IN A COMPETITIVE MARKET

As a frame of reference, I think it would be helpful to review the current state of the law as it relates to subsidies in a competitive environment. Mr. Chairman, I believe we can make this very simple . .shareholder-owned utilities pay large amounts of taxes each year (the highest effective tax rate of virtually any industry). Government-owned utilities pay no income tax, are permitted to use tax-exempt financing (a 2% interest rate differential in a competitive market where price margins are expected to be less than 1%), receive preferential access to low cost federally-produced hydro power and are exempt from numerous other federal and state taxes. Let me explain by example:

Under current law, the following is illustrative.

1) Shareholder-Owned Utilities Federal Income Taxes Paid (1995)	$9.88 billion (annual)
2) Government-Owned Municipals Federal Income Taxes Paid (1995)	$0 (annual)
3) Government-Owned (Municipals) Subsidies Received (1995)	
A. Federal Preference Power	$1.86 billion
B. Cost of Capital (Tax-Exempt Financing)	$1.32 billion
C. Federal Income Tax Exemption	$2.26 billion
D. Other Taxes	$0.79 billion
	$6.23 billion (annual)

BACKGROUND ON THE PRIVATE USE RULES

Mr. Chairman, the "private use" rules of current law have been the subject of much debate over the past 30 years. As we move forward in considering the appropriate tax rules for the electric restructuring debate, it may be useful to consider the Congressional rationale for imposing limitations on tax-exempt financing.

Since the late 1960s, and particularly since the Tax Reform Act of 1986 ("TRA"), Congress repeatedly has attempted to restrict the use of tax-exempt bonds to financing legitimate governmental purposes. In the General Explanation of the Tax Re-

form Act of 1986 (TRA), HR.3838, at 1151 (May 4, 1987), the Joint Committee on Taxation stated that "[t]o the extent possible, Congress desired to restrict tax-exempt financing for private activities without affecting the ability of State and local governments to issue bonds for traditional governmental purposes." The same types of impacts described by the Joint Committee on Taxation (too great a volume of tax-exempt debt, misallocation of societal resources and lost revenue to the Federal Treasury) will result if governmental utilities are allowed to compete with Federal subsidies in a competitive power market.

That Congress has specifically and repeatedly acted to limit the expansion of governmental utilities use of tax-exempt bonds. The TRA of 1986 contains special rules, particularly the $15 million limitation on private use, restricting the use of tax-exempt bonds by governmental utilities. Additional special restrictions on the growth of governmental utilities were imposed by the Omnibus Budget Reconciliation Act of 1987. These rules specifically limited the use of tax-exempt bonds to finance the expansion of governmental utilities. As the rationale for these new limitations, the House Ways and Means Committee stated that:

> "The committee is aware of recent actions taken by several State and local governments to acquire assets of or interests in existing electric and gas generating and transmission systems. Financing the purchase of such investor-owned facilities with tax-exempt bonds effectively substitutes tax-exempt securities for taxable securities. As such, any benefit that consumers may gain from using tax-exempt financing rather than taxable financing comes at the expense of reduced Federal Government revenues. Since such use of tax-exempt financing is undertaken at the discretion of the State or local government, it effectively removes control of Federal Government revenues from Congress. The cost to the Federal Government in terms of revenue foregone could be substantial if this activity were allowed to continue and grow. Therefore, consistent with its actions in recent years to limit the Federal revenue loss from tax-exempt bonds, the committee believes it is important to restrict the use of tax-exempt bonds for the purchase of privately-owned output facilities."

IRS REGULATIONS

As you know Mr. Chairman, California was the first state to enact electric restructuring legislation. Prior to that event, government-owned (municipal) utilities were active in communicating with the IRS and Treasury that they could not enter competitive markets without violating the "private use" rules of the Internal Revenue Code. To protect these government-owned utilities who wished to enter into competition, the IRS issued generous temporary regulations which exempted municipal utilities from violating the private use rules if:

—they joined an ISO or other aggregator of electric power;

—they made "short-term" sales (extending up to 180 days) outside their service territory, including to power aggregators like the California Power Exchange.

—they made sales for up to 3 years outside their service territory to replace "lost load" to competition.

As the Committee moves ahead in its consideration of appropriate tax and financing options available to the various market participants, I would urge you to keep in mind that the public power community has already been granted extensive regulatory relief from current law private use rules by the IRS.

I also urge the Committee to take note of the action taken by the municipal utilities in California after the IRS issued regulations to protect them if they entered into competition. Specifically, they "opted-out" (refused to join the California restructuring plan). The publication Bond Buyer reported on May 21, 1999 that David Freeman, general manager was:

> ". . . not sure whether LADWP will let competitors enter its market in the next 10 years, and added that so far his utility has been the 'primary beneficiary' from California's competition, making millions of dollars in profits by selling power to other utilities."

It quoted, Mr. Freeman as saying:

> "We have made $80 million in net profits (emphasis added) over the last 10 or 11 months selling into the power exchange. I go to bed every night and thank the Lord for competition because it is enriching us. . ."

Similarly, Seattle Light has entered the California competitive market by signing contracts for the sale of power to Nordstrom Department stores in California. Just like the situation with LADWP, no other competitor has the reciprocal right to sell into Seattle Light's service territory.

Currently, there are 31 large, aggressive government-owned utilities with over 13,000 MW of excess power to sell. That's more than the total capacity of any one of 28 individual states. It is reasonable to expect these government-owned utilities will continue making commercial sales outside their service territories, taking advantage of tax subsidies which were designed to help them serve customers within their service territories.

THE ROLE OF PUBLIC POWER

The public power community has been very direct in announcing its plans for expanding the role government-subsidized power in the electric restructuring debate. Specifically, they recommend a government-owned and controlled transmission system for the United States. This position was set forward by the Large Public Power Council (LPPC) in December 1998 when it published "Uncrossing the Wires—Transmission in a Restructured Market." The executive summary to this document states:

> "The clear conclusion is that the interests of all those concerned—FERC, participants in the generation market, members of the transmission grid and, most importantly, consumers-would be best served by a not-for-profit TransCo."

We disagree with the conclusion, but public power's objective is clear—government ownership of all transmission.

Legislation sponsored by Senator Gorton (S.386) would allow municipal utilities to finance new transmission facilities with tax-exempt debt. If public power is successful in its efforts, our transmission system in the future would become a governmental grid financed with tax-free dollars. The Federal Treasury would lose money as taxpaying entities are displaced by tax-exempt ones. The goal of deregulation is competition, not more governmental involvement in the electric business.

Mr. Chairman, it is the opinion of EEI that a government-owned and controlled transmission system is not consistent with the creation of a fair and equitable system for bringing competition to America's electric consumers. We urge you to reject public power's efforts in this area.

CURRENT LEGISLATION

I. As noted above, the public power community is already benefiting from electric restructuring in the states as well as the current IRS regulations on private use. To their credit, they have been successful in urging members of the Senate and House to support even more sweeping legislation (S.386, Gorton and H.R.721, Hayworth) to further enhance their tax and financing advantages over other market participants who pay taxes and are generally unable to issue tax-exempt debt. These identical bills, if enacted into law, would provide public power with a vast new ability to exploit their tax and financing advantages over tax-paying entities in the new competitive market. Their ability to use tax-exempt debt alone provides them with over a 25% financing advantage over tax-paying entities, an advantage unrelated to competitive efficiencies.

As we move forward with electric restructuring legislation, I believe our objective should be to enhance competition for all electric consumers, not just the few served by public power. S.386 would have the effect of growing government, contrary to the goal of creating a competitive marketplace. The bill would expand the ability of government-owned utilities to finance transmission facilities with tax exempt-bonds. S.386, contrary to its stated purpose, also expands the ability of many government-owned utilities to issue new tax-exempt bonds for generation and transmission facilities by providing new exceptions from the private business use rules. The bill allows government-owned utilities to sell for profit outside their existing boundaries while allowing these utilities to continue to issue new tax-exempt debt and not pay income tax on profits from sales in these markets. While we have no problem competing with public power on a fair and equitable basis, we believe that Federal subsidies intended to benefit a munis' own service territory customers should not be used outside their boundaries to create unfair economic distortions. Moreover this legislation broadens the role of government in the electric industry, contrary to the goal of movement to a more competitive marketplace.

Many claims have been made in support of S.386. Let me address just a few:

Claim: S.386 is a compromise.

Fact: The bill is not a compromise. It only serves the interests of public power by providing substantial loopholes allowing government-owned utilities to sell for profit in distant markets currently served by taxpaying, shareholder-owned electric utilities. The bill allows these government-owned utilities to continue to issue new tax-exempt debt and not pay income tax on profits from sales in distant markets.

Claim: Without passage of S.386, public power customers may be denied access to competitive services and prices, and government-owned utilities would be unable to replace lost customers.

Fact: This contention is simply wrong. IRS regulations issued last year specifically allow government-owned utilities to replace lost customers without losing tax-exempt financing.

Many government-owned utilities, which were established to serve their local communities, already are venturing beyond their boundaries to attract valuable commercial and industrial customers—and they are using their considerable tax advantages and other federal subsidies to do it. For example, The Energy Authority (owned by the city of Jacksonville, Florida, Santee Cooper in South Carolina and the Municipal Electric Authority of Georgia) has operated a 24-hour trading floor since August, 1997. The Nebraska Public Power District (NPPD) joined the Energy Authority to enhance their marketing capabilities. NPPD has publicly stated that their reason for joining was because "they have excess capacity for sale."

If government-owned utilities are concerned about replacing lost customers, why do they need to build new generating facilities? For example, Santee Cooper, which testified before Congress that public power needs to be able to replace lost customers, recently announced plans to construct a $275 million tax-free bond-financed power plant.

Claim: Government-owned utilities are more closely regulated than any other type of utility.

Fact: The fact is, however, that government-owned utilities regulate themselves—they are not regulated by independent agencies. In some cases they may be regulated by PUCs for environmental compliance and other federal or state statutes, but they set their own transmission and distribution rates, which are exempt from FERC and, generally, state PUC approval. Hence, they can erect barriers to their customers by charging high rates for transmission or distribution access by other suppliers of electricity.

Claim: S.386 is a reasonable approach because a government-owned utility will no longer be able to issue tax-exempt debt for new generation facilities if it does not abide by current law private use restrictions.

Fact: The bill contains numerous loopholes that would allow government-owned utilities to sell substantial power outside its service territory and still use new, tax-exempt bonds for generation facilities.

Mr. Chairman, I could go on about the inequities of S.386. Perhaps it would be more useful, however, if I summarize our concerns with this legislation.

—Government-owned utilities would be able to "cherry-pick" industrial customers of other generators of electricity. The bill would expand the current law exceptions to private business use for tax-exempt bonds without imposing requirements that the lines financed with the tax-exempt debt be located within the service territory of the government-owned utility.

—There is no requirement that the government-owned utility open its distribution system to competition to obtain the relief in the bill which enables it to compete outside it's boundaries.

—There is no requirement for government-owned utilities to submit to FERC jurisdiction. Thus, customers of the government-owned utility could be "walled-off" from competition through manipulation of transmission pricing or access rules (preventing other suppliers of electricity from competitively bidding for government-owned utility customers).

—New transmission and new distribution could be financed with tax-exempt debt without regard to location, enabling public power to take over all new transmission.

—Government-owned utilities could compete for new customers outside their service territory and avoid paying income tax. . .a large, unjustified competitive advantage.

II. More balanced proposals are available that integrate government-owned utilities into competitive electricity markets without distorting competition or growing government.

Government-owned utilities can best be integrated into competitive markets by applying to them the same tax and finance rules as applied to all other market participants. This principle is embodied in H.R.1253, introduced by Rep. Philip English (R–PA). H.R.1253 would require government-owned utilities that sell power in competitive markets to finance new generation and transmission facilities with taxable bonds, and to pay income taxes on profits from those sales, just like all other competitive suppliers. The bill would have no impact on existing tax-exempt bonds or current bondholders. In addition, the 2,200 plus

municipal electric utilities that continue to serve their traditional customers would not be impacted by the legislation.

Another approach is found in the Administration's electricity restructuring proposal embodied in S.1047 and the accompanying tax provisions of S.1048, which have been introduced by request by Chairman Murkowski (R–AK) and Senator Jeff Bingaman (D–NM). These proposals exempt municipally-owned utilities from private use rules for existing bonds while, at the same time, placing them on an equal footing with other electricity suppliers for issuing debt in the future, as long as they open their systems to competition. That is, current bonds would continue to remain tax-free, but government-owned utilities would not be able to issue tax-free bonds for the construction of generation or transmission facilities in the future.

The Administration's approach also offers a balance of interests and a compromise means of integrating government-owned utilities into competitive markets. It reduces distortion of competition caused by subsidies, allows municipals who wish to compete to do so using financing techniques comparable to those of other competitive suppliers, and allows competition to move forward for the benefit of real choice for customers.

CONCLUSION

Mr. Chairman, the expansion of municipal subsidies in the newly competitive electricity market is a difficult issue to address. I pledge to you that EEI is prepared to continue our discussions with the public power community to seek a reasonable compromise to this difficult issue. We believe such discussions are more beneficial to all electric consumers than passage of punitive legislation, such as S.386, which only benefits one stakeholder in the electricity debate.

There is a legitimate role for public power in the electricity marketplace. If legislation is needed to deal with the tax and financing elements of electric restructuring, it should not harm the 2,200 plus government-owned (municipal) utilities that want to serve their customers. Nor should it, however, provide unfair tax rules which only benefit large, aggressive government-owned utilities who want to sell excess power beyond their service territory. A reasonable compromise should be found. S.386 is not such a compromise.

PREPARED STATEMENT OF SCOTT MADDOX

Good morning, Mr. Chairman and members of the subcommittee. My name is Scott Maddox and I'm the Mayor of Tallahassee, Florida. I am testifying on behalf of the American Public Power Association. We appreciate the efforts of this committee to build a record on all tax-related electric restructuring issues. Today, I would like to comment specifically on a serious tax problem facing community owned electric utilities as they move to deregulation. If community owned utilities embrace competition, as many state laws are encouraging them to do, they can be placed in a situation where their existing tax-exempt bonds will become retroactively taxable. Congress needs to remove this serious barrier to open competition in order to promote consumer choice and lower electricity prices for all consumers.

The American Public Power Association (APPA) is the national service organization representing the interests of over 2,000 community owned and other state and local government-owned utilities throughout the U.S. While APPA member utilities include state public power agencies, and serve many of the nation's largest cities, the majority of our members are located in small and medium-sized communities in 49 states. In fact, 75 percent of APPA's members are located in cities with populations of 10,000 or less. APPA member utilities provide about 14 percent of all kilowatt-hour sales to ultimate consumers in the U.S. and collectively serve more than 40 million Americans.

Florida has 34 community owned utilities serving more than two million Floridians. Our utilities are diverse. We have large community owned utilities, including Jacksonville, Orlando, Lakeland, Tallahassee and Gainesville, and small utilities, such as Bushnell and Havana, which serve about 1,000 customers each. The subject of this hearing is the tax implications of electric industry deregulation. The implications for community owned utilities in Florida are huge since they hold $6.5 billion in tax-exempt debt. Tallahassee, in particular, has over $297 million in outstanding tax-exempt bonds.

My sole purpose today is to help explain a conflict between federal tax policy and energy policy and how it affects Tallahassee as well as the over 2,000 public power communities nationwide. I come to you not just bearing a problem, but also suggesting a reasonable solution. To that end, I ask you and the members of the sub-

committee to embrace with confidence and speed S. 386, The Bond Fairness and Protection Act. A companion bill, H.R. 721, has been introduced in the House. My personal objective today is to help you and your staff better understand a severe problem facing community owned utilities, and why those that have this "private use" problem are willing to give up our use of tax-exempt bonds to build new generation facilities in return for the relief we need. At the same time, it is not fair to penalize these communities that do not have a private use problem by denying them the right to issue tax-exempt municipal bonds for local infrastructure facilities, including electric facilities, in the future. I know there is a lot of misinformation and tension surrounding this issue, but I am confident that this hearing will help separate the facts from the fiction.

I. RECONCILING CONFLICTS BETWEEN EXISTING TAX LAWS AND CHANGES IN STATE AND FEDERAL ENERGY POLICY

Twenty-three states have now adopted deregulation legislation. Many other states will follow in the near future. These new laws, and the "open access" policies they seek to promote, have created an extremely serious problem for communities served by public power systems that have issued tax-exempt debt to finance their local electric utility infrastructure. If these community owned electric utilities take steps to conform their operations to these new state policies, they are immediately confronted with the nearly insurmountable obstacle of Federal tax code private use restrictions. In most cases, implementation of state restructuring plans—and even Federal Energy Regulatory Commission (FERC) policies designed to provide open transmission access for competitive wholesale markets—will jeopardize the financial standing of these public power communities and millions of bondholders across the U.S. Specifically, if community owned utilities participate in competitive markets and violate private use restrictions, their outstanding tax-exempt bonds could become retroactively taxable to the date of issuance.

Under current tax law, electric utilities owned and operated by units of state and local government issue tax-exempt bonds to finance their capital investments. These bonds are subject to the private use rules in the federal tax code designed to prevent private parties from benefiting from lower-cost tax-exempt financing. These private use rules impose two significant restrictions on community owned utilities with tax-exempt financed transmission and generation facilities:

- First, the rules severely restrict the use of community owned utilities' transmission facilities by private business, including investor owned utilities and power marketers, to use their transmission or distribution lines, and could prevent the transfer of control of these facilities to third party, independent grid management organizations.
- Second, the private use rules severely limit the ability of community owned electric systems from selling power (from tax-exempt financed generation facilities) to individual customers on negotiated terms.

Both problems discourage community owned utilities from embracing electricity deregulation and form a barrier to open and efficient electricity markets at both the wholesale and retail level. These problems, and the need for flexibility from the private use restrictions, make it impossible for community owned utilities to compete for their own EXISTING CUSTOMERS or open up their transmission lines. The purpose of S. 386 is to prevent existing tax-exempt bonds from becoming retroactively taxable and keeping rates low, not to permit community owned utilities to sell power into distant markets, and aggressively pick off large industrial customers from the private sector and/or build the country's national transmission network!

I am here today because as a Mayor I do not want to raise electric rates for the City of Tallahassee nor do I want to see our bondholders placed in a situation where their investments are not what they bargained for. Moreover, I would like to keep the decision making at the local level in my community, which is precisely what S. 386 does.

Below are some examples of what the private use rules mean in a competitive environment, which already exists in the wholesale market and which is becoming a reality in the retail markets affecting over half the nation's population. (See attachment A for a more detailed description of private use problems titled The Ties That Don't Bond, Private Use and Public Power, February 1999.)

II. REAL LIFE PROBLEMS (OPENING TRANSMISSION LINES, INDUSTRIAL CONTRACTS, LOST LOAD PROBLEMS, JOINT POWER AGENCIES AND THEIR CITIES ARE AT RISK)

a. Transmission

Severe problems exist for all community owned utilities that have transmission facilities. In its recent Notice of Proposed Rulemaking (NOPR) the FERC calls for

all utilities—including community owned utilities—to join Regional Transmission Organizations (RTOs) within the next two years. Community owned utilities support formation of RTOs. However, transferring ownership or operational control of transmission facilities to an RTO—and even providing for open access in accordance with policy expectations of the Energy Policy Act of 1992—can result in a retroactive determination that the underlying bonds are taxable.

b. Industrial Contracts

Passage of state electric deregulation legislation enables individual customers to choose from several alternative power suppliers. Private and cooperative utilities, as well as power marketers, are signing contracts with their largest customers in an effort to retain those customers once retail competition is an option. These utilities can provide a specially tailored contract in exchange for a long-term arrangement. Unfortunately, if a community owned utility executes a similar contract, it can count against the private use restrictions. Thus, community owned utilities are limited in the steps they can take to retain existing retail customers. These limitations increase the potential that the utility will lose customers and will compound the impact of the private use problem.

c. Lost Load

As explained above, in retail markets large customers will seek and obtain specially tailored contracts to meet their specific needs, just as they do in buying any other products. Because of outdated private use rules, a community owned utility may be unable to offer such a contract, even to customers in their own service territory that they have been successfully serving for decades. This could deny that customer the best choice in the market, and will lead to loss of customers by the utility for reasons that have absolutely nothing to do with price or quality of service.

If a community owned system loses a customer (and all utilities will lose customers) the public system may be unable to re-market the generating capacity it had built to serve that lost customer as a result of the private use rules. Thus, any excess capacity that a public system has may become idle and unproductive solely as a result of the private use tax rules. Inability to resell the capacity can lead to significant financial losses, and, in turn, higher costs for the remaining customers of that utility as well as a reduction in overall economic efficiency.

d. Joint Action Agencies and their Cities are also at Risk

Missouri River Energy Services (MRES) is the supplemental power supplier to 17 community owned electric utilities in western Iowa—providing about 40 percent of the energy needs of these communities. Currently, about half of the entire MRES sales to its Iowa members is for retail service to 6 large customers. Given experience in other industries and independent assessments of the electric utility industry it is likely that at least some of those customers—as well as other industrial customers, large commercial customers and customers with multiple facility locations—will be lost to other power providers. Under the current private use restrictions, the affected Iowa community owned utilities and MRES would be limited in the offsetting sales that could be made. While the energy can be sold on the short-term market, such sales neither covers the full cost of the energy nor services the underlying debt. The revenue shortfall can only be made up through higher rates in the remaining electricity MRES sells to its Iowa members and members in other states. This situation could lead to further load lost and threaten the financial health of the Iowa community owned utilities and MRES. (Note: there are 68 Joint Action Agencies nationwide)

III. IRS TEMPORARY AND PROPOSED REGULATIONS DO NOT FIX THE PROBLEM

The Department of Treasury issued "proposed and temporary" regulations in January 1998, and while the regulations are helpful, they did not resolve all of the issues. First, the regulations are "proposed and temporary" lasting three years. They expire in January 2001. Community owned utilities are reluctant to make long-term decisions with substantial financial implications on the basis of temporary regulations. Second, the Joint Committee on Taxation (JCT) has issued a report questioning the legal authority of the regulations. While we believe Treasury acted properly, the JCT report makes us more reluctant to base critical financial decisions on these regulations. Finally, and most importantly, generation private use problems are not adequately addressed in the regulations and future transmission private use problems are not addressed at all. Clearly, the Treasury doesn't have that statutory authority to resolve all of the critical issues facing community owned utilities as we move to electric deregulation. Only Congress can provide permanent transition relief.

IV. FINANCIAL IMPLICATIONS (BAD FOR CONSUMER, BONDHOLDERS AND LOCAL GOVERNMENTS)

As the aforementioned conflicts arise, most utilities have two options: defease, or call, their existing tax-exempt debt and replace it with taxable debt, or forgo the sale of capacity from transmission or generating facilities, leaving fixed costs of those facilities to be borne by the remaining ratepayers on the systems and close their transmission and distribution facilities from competition.

The first option—refinancing existing debt with taxable debt—would in itself lead to significant turmoil in the bond markets. Community owned utilities and their customers would pay significantly higher rates since bonds would now be taxable. This would be, in effect, a new retroactive tax on consumers, something I know this Committee does not want to embrace. Certainly this situation, and the degree of uncertainty suddenly injected into the equation would, impact all municipal markets and investor confidence if more than $75 billion in tax-exempt debt were suddenly recalled or rendered taxable as a result of incompatibility of the tax laws with state deregulation initiatives.

The second option—leaving unproductive facilities idle simply because of arcane tax rules—is woefully inefficient, both economically and environmentally. This option would leave the remaining customers saddled with potentially high costs and would make the electricity market far less efficient by removing competitively priced electricity from the marketplace.

Both of these options would raise electric rates considerably—possibly by hundreds of millions of dollars—and in the worst case could lead to a death spiral as customers faced with higher electric costs leave the system for other suppliers. If Congress does not address this problem soon, the outcome of the introduction of electricity competition will be higher electric rates for millions of Americans served by community owned utilities.

V. LEGISLATIVE PROPOSALS

1. S. 386—The Bond Fairness and Protection Act

APPA supports a solution spearheaded by Senators Slade Gorton and Bob Kerrey—the Bond Fairness and Protection Act (S. 386/H.R. 721)—that would preserve local decision making about how to use tax-exempt bonding authority. It would allow each community owned electric system to "elect" to obtain relief from private use limits, but forego the right to issue tax-exempt bonds for new generation facilities in the future. In short, the bill provides two choices:

1) Lifts the private use test on outstanding bonds (i.e. grandfather existing bonds), but only if the utility agrees to never again issue tax-exempt bonds to build new generation facilities, or

2) If no private use relief is needed, the utility can continue to issue tax-exempt debt under a clarified version of the existing private use rules.

The bill's clarifications of the private use definition allow common sense activities envisioned by federal and state deregulation plans; providing open access transmission in compliance with FERC Order 888 or state laws; joining an ISO, Regional Transmission Group (RTG) or power exchange; or providing open retail access over your distribution.

If enacted, this legislation will accomplish two objectives: 1) clarify existing tax laws and regulations regarding the private use rules so that they will work in a new competitive marketplace and 2) provide encouragement for public power utilities to open their transmission or distribution systems, thereby providing a choice to more consumers.

This bipartisan bill has gained strong support in the Senate, where it has 30 cosponsors, seven of which are on this Committee—Senators Jeffords; Thompson; Grassley; Moynihan; Hatch; Robb; and Kerrey. Companion House legislation (H.R. 721) sponsored by Reps. J.D. Hayworth (R–AZ) and Bob Matsui (D–CA) has 87 cosponsors. In addition, the provisions of H.R. 721 were recently incorporated by Chairman Joe Barton (R–TX) in H.R. 2944, The Electricity Competition and Reliability Act, comprehensive electricity legislation expected to be considered next week by the Energy and Power Subcommittee of the House Commerce Committee. (See Attachment B for a complete list of co-sponsors of S. 386/H.R. 721, the Bond Fairness and Protection Act.)

Support for this legislation has grown considerably. Seniors, environmental groups, investor owned utilities, state and local organizations, as well as over 166 local governing organizations, ranging in size from as small as the City of Chattahoochee, Florida to as large as the San Antonio City Council, have publicly endorsed S. 386, the Bond Fairness and Protection Act. Moreover 57 Local Chambers of Commerce support the Gorton-Kerrey bill, because of ability for local communities

to make their own financial decision. Companies such as Alcoa, Praxair, Enron Corp. as well as many others have voiced support for S. 386. Over 1000 local elected officials throughout the country have also endorsed the Gorton-Kerrey approach. (See Attachment C for a complete list of organizations and resolutions endorsing the bill.)

Congressional action in this area is urgently needed—existing wholesale markets cannot function effectively, and state restructuring plans cannot be fully implemented, without public power's full participation. The private use restrictions not only hamstring the ability of public power utilities to ensure that their communities receive the benefits that effective competition can provide, but also negatively impact the underlying market. In conclusion, The Bond Fairness and Protection Act, assures a fair and reasonable resolution of this problem, and it provides a resolution that respects the inherent rights of the units of local government we represent.

Concerns Raised About S. 386 are Unfounded

a. Transmission: Some have argued that S. 386, The Bond Fairness and Protection Act, will promote the building of transmission lines on a tax-exempt basis and that community owned electricity systems will finance all transmission facilities nationwide. Nothing is farther from the truth. It is a fundamentally flawed assumption that if community owned utilities have access to tax-exempt financing they will then build the entire national grid. This assumption does not recognize the current reality of the transmission system in this country or the difficulty of siting new lines or how and why state and local governments issue tax-exempt bonds. If the use of tax-exempt financing drove transmission construction decisions, it should be doing so now. So why doesn't public power own more that 8 or 9 percent of the existing transmission lines, and why do we have so many transmission constraints all over the country? Because utilities can't put wires anywhere they want and you don't run multiple sets of wires from the same generation source!

Even more significant is the fact that community owned utilities focus on the needs of their communities. They do not exist to engage in activities far removed from those communities. As the Mayor of Tallahassee, I can assure you that neither I nor the city council would permit our community owned utility to issue tax-exempt debt to finance transmission facilities in distant parts of the state, much less in distant parts of the country. Even though such debt might be legally separated from debt our city issued for other purposes, the credit worthiness of our city is affected by the security of the debt issued by our utility. We would not allow our credit rating to be adversely affected by actions of our local utility, especially if their actions would not directly benefit our own community. I can assure you local elected officials throughout the country certainly share this view.

b. Public Power Systems Can Still Issue Tax-Exempt Bonds For Future Generation Facilities: Not all community owned utilities have or expect to have a private use problem—and many will not take the "election" made available by the Gorton-Kerrey bill. Requiring all utilities to forego future tax-exempt financing would force many municipal systems—including systems in Florida, Alaska, Iowa and Delaware to name a few—to give up an essential tool of municipal government for no reason. In addition, a wide array of local government groups would strongly oppose the mandated denial of tax-exempt financing for what is a legitimate governmental function. The Gorton-Kerrey bill allows each local utility to determine which policy option is best for the community. In short, it promotes local control.

Moreover, the community owned utilities that issue tax-exempt bonds for new generation will still be subject to the stringent 10 percent private use test. This fact alone will inhibit, if not prohibit, them from building competitive generation facilities to sell power in the open market. Further, the construction of "new" merchant generation plants—plants constructed to sell power in the competitive generation market—is inherently risky. So as a local elected official, I would not want my community owned utility to take risks of this nature because in the end they could have an adverse effect on the overall credit rating and credit worthiness of my community. Opponents of the bill never highlight this fact.

c. Exceptions In The Bill Are Too Broad: It has been argued that this legislation provides large loopholes that make it unfair. One such area is the exemptions in the bill for electing utilities. It is correct that this legislation includes a limited number of minimal exceptions. However, they are targeted, narrow and necessary to transition into a competitive electricity marketplace. First, the bill allows for available refinancing of outstanding generation bonds—provided the term of the bond is not extended. Second, tax-exempt bonds can be issued for project renovations provided that the generation capacity of the project is not significantly increased. Third, the bill allows tax-exempt financing for environmental compliance—an "exception" insisted upon by the bill's sponsors. [Note: private utilities have used

tax-exempt pollution control bonds in the past and continue to refinance this debt; in addition, private utilities continue to have access to tax-exempt financing for fishery protection efforts at privately licensed hydropower projects.]

2. Clinton Administration's Legislation S. 1048

APPA would like to comment on the Clinton Administration's proposed private use solution. The Administration's proposal would eliminate all authority for state and localities to issue tax-exempt bonds in the future for generating and transmission facilities. Distribution facilities would still be eligible for bond financing. The Administration's proposal is commendable in that it eliminates the private use restrictions on outstanding tax-exempt electric utility debt and protects bondholders.

However, we oppose this proposal on two grounds. First, it provides no element of choice. All community owned electric systems would lose the ability to issue tax-exempt bonds regardless of whether they face private use problems. This approach represents a virtually unprecedented restriction on the ability of state and local governments to use tax-exempt financing for facilities that would not violate private use restrictions. APPA, along with other state and local organizations, oppose this aspect of the bill because of its federally intrusive approach.

Second, we find little justification for eliminating tax-exempt financing for transmission facilities. Transmission lines are not being deregulated; they are just becoming more open—for all to use. Transmission and distribution facilities are expected to continue as regulated monopoly functions—it is not expected that multiple parties will seek to build competing systems. However, under FERC rules and under many state deregulation plans, these facilities will be available on an open access, common-carrier basis. Thus, any reduction in system costs resulting from tax-exempt financing will be available equally to all users of the system. Community owned systems will not receive a "competitive advantage." Moreover, providing local "wires" is a basic function of community owned utilities, and we are not willing to relinquish this basic community owned authority.

3. H.R. 1253, The Private Sector Enhancement and Protection Act (Bad Policy)

The Private Sector Enhancement and Protection Act, H.R. 1253 would increase the rates of public power systems and eliminate them as competitors as the electric utility industry moves to a more competitive structure. H.R. 1253 does not provide relief on existing tax-exempt bonds, the primary reason legislation is needed.

Moreover, with a number of exceptions, H.R. 1253 would deny public power utilities that sell outside their "qualified governmental service area" the use of tax-exempt financing and would require them to give up their income tax-exemption on sales outside their qualified governmental service area. Rep. English, the author of the bill, says that his bill would impact "less than 30 large, aggressive utilities that want to sell electric generation outside of their service territory!!" Unfortunately, the bill captures over 752 community owned utilities, and 450 of them own no generation.

Specifically, the bill as introduced would apply to all "governmental electric output facilities," with exceptions for:

- local distribution facilities within a utility's service area;
- small utilities (defined as those that provide electricity to less than 5,000 consumers and that derive at least 30 percent of average gross income from sales to residential customers during any three-calendar year period);
- sales to another governmental utility for resale only to ultimate consumers located within the purchasing utility's territory;
- sales pursuant to a pooling or swap arrangement, to a regional transmission group, or for emergency transfers;
- sales pursuant to an existing contract or a renewal of an existing contract provided the renewal is at the sole option of the purchaser;
- and de minimus sales (less than 10 percent of the utility's average sales during the preceding three calendar years).

First and foremost, the bill does not lift the private use restrictions on outstanding tax-exempt debt or the problems associated with these restrictions.

This proposal has been constructed on an unsound foundation and is based on the faulty assumption that the "playing field" is tilted in favor of public power. The faulty assumption relies on incorrect information about the role public power plays in 2,000 communities across the country and lack of knowledge about community sovereignty over community owned bond issuance.

This sovereignty is based on our federalist system of government. In most countries, the central government exerts substantial if not total control over financial affairs of subordinate governments. In stark contrast, one of the distinguishing characteristics of our federalist system is the ability of state and local governments to

issue debt on their own behalf to finance local infrastructure needs without federal intervention. Public power systems are eligible to issue tax-exempt bonds because they are entities of state and local government, and are owned and operated by the communities they serve.

Moreover, the proposal subjects public power communities to federal income taxation on revenue from electric sales made outside their existing service territory. Proposals that suggest income or other federal taxes be imposed on any unit of state and local government is also contrary to our federalist system wherein one level of government does not tax another.

Lastly, the proposal prohibits public power systems from using tax-exempt bonds for generation facilities if they sell power outside of their traditional service territory. At a time when states are requiring electric utilities to open their service territories and offer consumers a choice, H.R. 1253 pushes publicly owned utilities to build a fence around their communities—or suffer a significant tax penalty. In essence, it raises rates on consumers and hinders competition.

VI. NUCLEAR DECOMMISSIONING FUND TAX DEDUCTION/ COOPERATIVES' 85/15 TAX-EXEMPTION ISSUE

APPA recognizes that certain provisions of the U.S. Tax Code affecting all electric utilities conflict with changes in the electric utility industry brought about by state restructuring initiatives. These provisions include: 1.) contributions to nuclear decommissioning funds; 2.) the 85/15 rules affecting rural electric cooperatives tax-exempt status, and 3.) the private use restrictions for public power. We believe it is imperative for Congress to provide tax equity between all sectors of the industry and urge Congress to address these issues simultaneously.

U.S. Tax Code provisions dealing with the tax treatment of contributions to nuclear decommissioning funds, and the tax-exempt status of rural electric coops who receive more that 15 percent of their electric revenue from non-members, are also affected by state restructuring legislation.

On the nuclear decommissioning tax issue, private investor-owned utility owners of nuclear power facilities may deduct authorized contributions to an approved decommissioning fund in calculating federal income taxes. The allowed amount of such deductions by law is the lesser of the state utility commission approved amount, or an amount approved by the Internal Revenue Service. Without this special provision, these contributions would not be deductible for income tax purposes until decommissioning expenses are actually incurred.

With state restructuring and deregulation, and the elimination of cost-of-service rates, the amount of state authorized contributions to decommissioning funds may be zero. And since federal law requires that deductions shall be the lesser of state or IRS allowed amounts, current contributions to such funds may no longer be deductible for federal income tax purposes.

With respect to the tax-exempt status of rural electric cooperative, we understand that if more than 15 percent of the revenue come from other than members, all income from that year becomes taxable. State restructuring activities may force coops to exceed this threshold with regard to revenues received for the use of their transmission facilities, or for the sales of energy and capacity from their generation facilities.

These provisions of the U.S. Tax Code dealing with all segments of the electric utility industry need to be reconciled with changes in state laws so that the public policy objectives of these Tax Code provisions do not conflict with or create obstacles to the realization of the public policy objectives of newly enacted state electricity deregulation efforts. And all of these Tax Code provisions should be dealt with comprehensively.

The Clinton Administration's comprehensive electricity bill (S. 1048) includes a provision allowing for nuclear decommissioning funds to continue to be tax deductible. However later in the year broader legislation was introduced in both the House and the Senate, which included provisions to eliminate any tax liability associated with the transfer of such nuclear decommission funds in the event that nuclear facilities are sold. This broader legislation, The Nuclear Decommissioning Funds Clarification Act, H.R. 2038/S. 1308 currently has two co-sponsors in the Senate and 17 in the House.

Neither the provisions of the Administration's nuclear decommissioning bill (S. 1048) nor the more generous provisions of H.R. 2038/S. 1308 were included in this year's large tax cut bill, H.R. 2488, the Taxpayer Refund and Relief Act of 1999. Instead, that bill contained a "middle ground" provision that dealt with the nuclear decommissioning issue without providing excessively generous tax breaks to private utilities. The Senate Finance Committee did not include this provision in its version

of the legislation, and instead agreed that all transactional electric utility tax issues should be considered simultaneously. APPA applauds the committee's decision.

The investor owned utilities, many of whom actively and aggressively oppose the enactment of the Bond Fairness and Protection Act, are now urging Congress to ignore the obvious fact that both the private use and nuclear decommissioning problems are the result of changes in the industry brought about by state restructuring legislation. They are urging Congress to enact the Nuclear Decommissioning Restructuring Act now, but to oppose the simultaneous enactment of the Bond Fairness and Protection Act. APPA endorses tax equity for all sectors of the industry.

VII. TRADABLE TAX CREDIT/RENEWABLE ENERGY PRODUCTION INCENTIVE (REPI)/ SECTION 45, RENEWABLE PRODUCTION TAX CREDIT

Our primary concern is the private use issue and the need for a fair and reasonable resolution to this problem; however, APPA would like to comment for the record on another matter under jurisdiction of this committee. As you may or may not know, public power has a long-standing position in favor of the development and pursuit of renewable energy. Through our membership and committee process, we have developed principles on renewable energy policy that Congress should consider as it develops legislation promoting the restructuring of the electric utility industry or as it pursues air quality measures. Below is a representative sampling of our renewable energy principles followed by a discussion of a new renewable energy incentive that we would like this committee to contemplate.

Principles

1. Public power recognizes the importance for the power generation sector to increase the use of renewable energy and other green technologies.
2. Such increased use can be best achieved through competitively neutral incentives that treat public power entities on an equivalent basis as non-public power entities.
3. Incentives should be structured to assist power generator entities to overcome existing barriers to increased renewable energy use and deployment of other green technologies.
4. Incentives should be structured to provide comparable benefits to each region of the country and allow power generator entities to be most responsive to the needs and preferences of their customers and the competitive market.
5. The incentive should be easy to administer and provide sufficient documentation for easy verification.

Elements of a Renewable Incentive Available to Not-for-Profit Entities

APPA advocates the creation of tradable or refundable tax credits for use by energy producing entities unable to take advantage of existing renewable energy tax credits.

The option would make such credits available under the Treasury Department. Not-for-profit entities would be eligible to claim a tax credit similar to the Section 45 credit. Specifically, the amount of credit is not effected by the amount of federal tax liability, rather, it would be calculated along the same guidelines as Section 45 projects. A participant would be given a refund based on a 1.5 cents (adjusted for inflation) per kWh of electricity generated from renewable energy projects.

Such a proposal would require an amendment to the Internal Revenue Code to provide a refundable credit against Federal taxes for tax-exempt, as well as taxable electric utilities that produce electricity from eligible renewable energy projects. A new Section 34 would be added to allow for-profit taxable utilities to claim a refund income tax credit while not-for-profit entities could claim a refund payment by the Secretary of the Treasury in new Section 6431.

Refunds would be based on the number of kilowatt hours of electric energy generated by the facility through the use of solar, wind, geothermal and biomass as defined by the Public Utility Regulatory Policies Act (PURPA). The amount of such payments would be 1.5 cents per kilowatt hour, adjusted for inflation.

Entities eligible for this refund would be prohibited against "double dipping," that is, taking the benefits of this program together with any other tax or appropriated incentive program designed to promote renewables.

VIII. CONCLUSION

Federal tax policy must be reconciled with current energy policy. These changes must be done by Congress and are needed today. State and federal deregulation laws cannot be fully implemented without transitional tax relief, and the temporary

IRS regulations do not address the entire problem nor do they do so on a permanent basis. In closing, I urge this committee to address these transitional tax issues simultaneously. I also urge you to do so expeditiously. The Bond Fairness and Protection Act is a fair bill and deserves this Committee's support. Thank you for your time.

Attachment A

The Ties That Don't Bond, Private Use and Public Power, February 1999

The Ties That Don't Bond

Private Use and Public Power

February 1999

A report by

The American Public Power Association

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Washington, DC 20037-1484

FOREWORD

The nation's nearly 2,000 community owned public power systems are not just another kind of electric utility. They are units of state or local government created to provide an essential service subject to local control. Their historic and current-day focus is on providing their citizens the best possible electric service at the lowest possible cost. They have financed their electric utility infrastructure (generation, transmission and distribution facilities) just as they have financed other municipal activities, through the issuance of tax-exempt bonds. For more than 100 years, either for constitutional reasons (as some would argue), or for reasons of comity and respect extended by governmental entities to each other, the interest on municipal bonds issued to finance facilities that are owned, controlled and operated by the governmental issuer has not been subject to federal taxes.

Municipal bond financing has traditionally come with a number of "strings" attached to prevent the extension of public credit for strictly private purposes. This is the public policy behind the "private use" limits that apply to all tax-exempt financed facilities. But as the electric utility industry (particularly power generation) goes through the transition from regulation to competition, private use threatens to strangle many community owned electric utilities. In addition, the continued application of these private use rules to outstanding debt -- debt issued years or decades ago in an entirely different utility environment -- is an impediment to the more competitive future that both state and federal legislators are seeking to achieve.

Collectively, community owned electric utilities have more than $70 billion in outstanding tax-exempt bonds. The private use limits control the sales from or the use of generation and transmission facilities financed by these bonds in a restructured environment. As a practical matter, private use limits will result in "stranded investment" for these community owned utilities because they will not be able to use these facilities to meet the needs of their own customers, or the public at large. The application of these "old" private use laws to the "new" dynamics of the more competitive electric utility environment is unfair to the communities that issued these bonds, unfair to the citizens they serve, and unfair to those who have invested in these bonds. Only Congress can address this situation.

The accompanying report, "The Ties that Don't Bond: Private Use and Public Power", contains a number of examples demonstrating how this private use problem hurts the citizens and communities served by the nation's 2,000 public power systems and frustrates the move to greater competition in the electric utility industry. This report refers to such entities as the "Municipal Power Agency" or the "City Utility", but, despite their anonymity, these are "real life" examples. Providing specific examples by name can have unintended consequences. So, as is the case with private letter rulings

issued by the Internal Revenue Service, the identities of the specific community owned utilities in these cases are not given.

The American Public Power Association, representing the interests of nearly 2,000 community owned electric utilities, is asking for a fair resolution of this serious problem. Those utilities -- for the most part the largest of the nation's public power systems -- that have financed transmission and generation facilities with tax-exempt bonds are asking Congress to give them the opportunity to erase the private use limits on their existing tax-exempt financed facilities. (They are not asking for the elimination of private use rules for any new bonds.) In return for this relief, they are willing to pay the high price of giving up their right to issue tax-exempt bonds for new generation facilities.

For decades, investor-owned utilities have complained about public power's use of municipal bonds because, in their eyes, it provides a competitive advantage. Today, to get relief from these private use limitations, public power systems are willing to make a trade -- relief from the "old" private use rules in return for an irrevocable commitment not to use this form of financing for new generation. This is the underlying principle of the recently introduced Gorton-Kerrey bill in the U.S. Senate. It respects the rights of state and local governments. It preserves local control. And it addresses the concerns of private power companies. It is a fair deal. We ask the Congress to enact it.

Alan H. Richardson
Executive Director
American Public Power Association

"Private Use" Thwarts Competition

In the emerging world of electricity deregulation, customers are free to shop for an electricity supplier who offers the most appealing package of prices and services. However, because of some outdated laws -- known as the "private use" regulations – established long before restructuring was contemplated, many of the 35 million public power customers could be deprived of the benefits of deregulation and end up paying higher rates – the exact opposite of what deregulators intend.

In more than 2,000 communities across the United States, consumers are served by municipal and state-owned utilities, which were established to provide a viable alternative to investor-owned utilities. These community owned utilities operate as non-profits, offering reasonable rates and allowing customers to participate in local control and decision-making. When they were established, these community utilities financed their facilities with tax-exempt bonds, never imagining they might be forced to take actions which would make the interest on these bonds taxable. Now, in a deregulated market, these communities are faced with two equally inadequate options -- participate in competition with significantly higher costs or completely wall themselves off from competition.

Under current law, facilities financed by municipal bonds must be dedicated to public use. Anything more than very limited "private use" could cause $70 billion worth of bonds to become taxable, including retroactive taxation of interest paid. So, at the same time the restructured market is opening up numerous options which are reshaping the way electricity is bought, sold and supplied, community owned utilities are bound by the promise to their bondholders not to violate the private use rules and to keep their bonds tax-exempt.

To help underscore the significant private use problems facing municipal and state-owned utilities, several examples are outlined in this paper. While not exhaustive, they all point out one basic fact – unless relief is provided, the citizens of these communities will be faced with additional costs, creating a potential "death" spiral of increasing costs and decreasing sales. The temporary regulations issued by the Internal Revenue Service.(IRS) in January, 1998 provide relief in some cases, but as they expire in 2001, the rules are a short-term band-aid approach to a problem that demands a solution that only Congress can provide.

Problem One: Difficulty Complying With FERC-mandated Wheeling

Municipal Power Agency (MPA) is a joint action agency with 30 relatively small member municipalities that provide electric services to residents in multiple counties. MPA owns generation and transmission facilities financed entirely with outstanding tax-exempt bonds. To comply with Federal Energy Regulatory Commission (FERC) Order 888, MPA has filed transmission tariffs with FERC to provide for wheeling over its transmission lines, with the understanding that MPA would not participate in any wheeling agreement which would violate private use.

WattSell, a power marketer, asks MPA to wheel power over its transmission lines for three years beginning in January, 1999, but MPA must decline. If it agrees to WattSell's request, the IRS Temporary Regulations (IRS-TR) would prohibit MPA from issuing additional tax-exempt bonds. Naturally the inability to use tax-exempt debt would increase MPA's costs, forcing an increase in customers' rates. MPA would have liked to participate in a system which opens all transmission lines for general public use, but is prevented by a tax code not in sync with electricity deregulation.

Problem Two: Inability to Join Independent System Operator

City Utility (CU) is a municipally owned utility serving customers in California. With the possibilities opened up by the state's deregulation, CU wishes to join the California independent system operator (ISO) and transfer control of its transmission facilities to the ISO. Under the IRS-TR, CU can do this without causing its outstanding bonds to become taxable; however, if CU joins the ISO it will be unable to refinance a significant portion of these bonds and won't be able to finance future improvements to the transmission system on a tax-exempt basis. Adding to the problem, if there is no legislation to resolve private use by the time the IRS-TR expire, participation in the ISO could prevent CU from issuing tax-exempt bonds for any purpose.

What is CU to do? Considering all of the above, CU judges it can't join the ISO because it would result in significantly increased costs. This shows how current private use limitations inhibit a public power system from joining in the deregulation of the industry and offering its customers retail choice. In addition, the ISO has one less member, which means there will be less transmission capacity available for general use, making the transmission market less efficient.

Problem Three: Inability to Enter into Power Marketer Ventures

MidCity is a medium-sized city that provides electric services to its residents. It owns transmission and distribution facilities and interests in two electric generating plants, all of which were acquired using the proceeds of tax-exempt bonds. Each year, MidCity purchases small amounts of electricity for its peak periods and sells modest

amounts of power during non-peak periods. Prior to deregulation, it could do this effectively. Now, because of the complex environment and the dramatically increased risks introduced by power marketers, MidCity needs to find a more efficient way to handle these sales and purchases.

ElectriMarket, a private power marketer, approaches MidCity with a proposal similar to the 10-year agreements ElectriMarket has with a number of small investor-owned utilities and cooperatives. Under the contract, ElectriMarket would receive a fixed annual fee plus an incentive fee calculated as a percent of savings or profits below or above a set baseline.

The contract appeals to MidCity because it could effectively minimize the risks associated with purchasing and selling electricity and at the same time reduce overhead. However, agreeing to this contract raises potential private use concerns related to the 10-year term, ElectriMarket's exclusive role, and the method of compensating ElectriMarket. MidCity must reject the contract, knowing all the while that neighboring cooperative and small investor-owned utilities have entered into similar arrangements to reduce their risks, lower their costs, and more effectively purchase and sell electricity.

Problem Four: Limitations on Long-Term Contracts

The State Power Authority (SPA) serves customers in a portion of its home state and owns interests in three electric generating units purchased with tax-exempt bonds.

Scenario A: Municipal utilities are less competitive and have trouble retaining customers.

Several of SPA's major retail customers, who collectively account for 20 percent of SPA's sales, have requested special, long-term contracts. These customers have informed SPA that if their demands aren't met, they will look for other suppliers when deregulation is enacted. Because of the private use limits, SPA is unable to agree to these contracts.

Under the IRS-TR, SPA can only offer these customers "requirements contracts," defined as contracts under which the customers agree to purchase all of the electricity needed from SPA and under which there may be no minimum guaranteed payments by the customer or penalties imposed if the customer leaves SPA's system. If these requirements contracts last beyond the expiration of the current IRS rules, SPA might not be able to issue any additional tax-exempt bonds. Even if SPA risks signing a contract which lasts beyond January, 2001, it is still at a dramatic competitive disadvantage. Competitors who are not restricted by the private use rules are able to offer customers better contracts. If SPA loses customers to suppliers who can offer more appealing terms, SPA's revenues will decrease, and it will have to raise electric rates.

Scenario B: Municipal utilities lose customers because they cannot amend special contracts.

SPA has a large industrial customer who purchases 40 percent of SPA's electricity under a long-term requirements contract containing a penalty if the customer leaves SPA. The contract began in 1982 and was approved by the IRS. Under this contract, which will expire in 2005, the customer purchases power on the basis of SPA's production cost for electricity. The industrial customer now wants to amend the contract so it pays a fixed cost for the electricity and has threatened to find a new supplier if SPA does not agree.

Under the IRS-TR, making this change would cause SPA to violate private use rules. The IRS-TR do contain a special rule grandfathering this type of requirements contract, but only if the contract is not amended. So, SPA is left with the alternatives of losing this big customer -- which would be financially devastating -- or paying off all of the affected tax-exempt bonds as soon as possible using taxable bonds or equity.

Problem Five: Difficulty in Replacing Lost Load

SmallCity provides water, sewer and electric services to its 20,000 residents and owns a small share in an electric generating unit, which it financed with tax-exempt bonds. The state in which SmallCity is located has passed legislation for retail choice. As a result, a national company which once purchased 12 percent of SmallCity's load has found a different supplier to sell power to all its factories. To avoid raising rates for remaining customers, SmallCity must find a buyer for this "lost load". If SmallCity can't find long-term purchasers for the electricity (while adhering to the private use rules), it will have to resort to selling electricity short-term on the spot market, which SmallCity believes will also ultimately require raising its rates.

SmallCity has negotiated with several possible purchasers, all of whom want a 5 to 10 year contract. Under private use restrictions, however, SmallCity has only two options to replace lost load: a) sell it on a requirements contracts basis (with no minimum payments), or b) sell it under a special rule for lost load, which has numerous limitations, including contract terms of no more than three years. SmallCity realizes, however, that a three-year contract probably won't be very profitable, and knows it might have to raise rates to cover losses.

If SmallCity is still selling the lost load when the IRS-TR expire, it will be unable to issue additional tax-exempt bonds or refinance existing ones. Even if the IRS-TR were to become permanent, SmallCity would still be limited to 30-day spot sales, requirements contracts, and sales of up to three years under the very limited and complex lost load rule.

Problem Six: New Facilities

The Southern Power District (SPD), a small municipal utility, issued tax-exempt bonds in 1998 to finance a new transmission line and to purchase a small share of an electric generating unit. Because the bonds were issued after 1997, SPD is not eligible for any of the relief provided in the IRS-TR. SPD may not join an independent system operator or similar entity, may not wheel pursuant to FERC Order 888, and may not use the special lost load rule to sell excess generation without causing its bonds to become taxable. SPD and its customers are therefore unable to take part in some of the innovative and beneficial options available in the competitive electricity marketplace.

Conclusion

The above scenarios clearly illustrate the difficulties faced by state and municipally owned utilities -- and their tens of millions of customers -- in a deregulated electric utility environment because of the severe restrictions imposed by the private use regulations. These utilities are presented with the untenable alternatives of violating the restrictions and suffering financial penalties or of not participating in a competitive market. Clearly there is a need for comprehensive private use relief, so that customers of community owned utilities have the same opportunity to benefit from lower rates and enhanced service as do their counterparts currently served by co-ops or investor-owned utilities in deregulated states.

Attachment B

Co- Sponsors of S. 386/H.R. 721, the Bond Fairness and Protection Act

Co-Sponsors of S. 386
October 8, 1999

Republicans

1. Gorton (WA)
2. *Jeffords (VT)*
3. Smith (OR)
4. Bennett (UT)
5. Hagel (NE)
6. Thurmond (SC)
7. Bunning (KY)
8. McConnell (KY)
9. *Thompson (TN)*
10. Frist (TN)
11. *Grassley (IA)*
12. *Hatch (UT)*
13. Warner (VA)

Democrats

1. *Kerrey (NE)*
2. Daschle (SD)
3. Hollings (SC)
4. Leahy (VT)
5. Harkin (IA)
6. Murray (WA)
7. Johnson (SD)
8. Wyden (OR)
9. Bayh (IN)
10. Kerry (MA)
11. Boxer (CA)
12. Feinstein (CA)
13. Feingold (WI)
14. *Moynihan (NY)*
15. Kohl (WI)
16. Lieberman (CT)
17. *Robb (VA)*

Total: 30

Names in italics are members of the Senate Committee on Finance (7).

Co-Sponsors of H. R. 721
October 8, 1999

Republicans

1. *Hayworth (AZ)*
2. Bereuter (NE)
3. *Houghton (NY)*
4. Terry (NE)
5. Barrett (NE)
6. Cook (UT)
7. Nethercutt (WA)
8. Pombo (CA)
9. Hostetler (IN)
10. Horn (CA)
11. Hilleary (TN)
12. Latham (IA)
13. Callahan (AL)
14. *Herger (CA)*
15. Cannon (UT)
16. Gilchrest (MD)
17. *R. Lewis (KY)*
18. Radanovich (CA)
19. Emerson (MO)
20. Cox (CA)
21. Petri (WI)
22. Riley (AL)
23. Royce (CA)
24. Jenkins (TN)
25. Whitfield (KY)
26. Ose (CA)
27. Hastings (WA)
28. Calvert (CA)
29. Walden (OR)
30. DeMint (SC)
31. LoBiondo (NJ)
32. Thune (SD)
33. Wolf (VA)
34. Spence (SC)
35. King (NY)
36. Graham (SC)
37. Hefley (CO)
38. LaHood (IL)
39. Cubin (WY)
40. Watts (OK)
41. Smith, N (MI)
42. Goodlatte (VA)
43. Brady (TX)

Democrats

1. *Matsui (CA)*
2. Gejdenson (CT)
3. Martinez (CA)
4. Kucinich (OH)
5. *Tanner (TN)*
6. Eshoo (CA)
7. *Neal (MA)*
8. *McDermott (WA)*
9. Boucher (VA)
10. Rodriguez (TX)
11. Gonzales (TX)
12. Tierney (MA)
13. Lee (CA)
14. Goode (VA)
15. Inslee (WA)
16. Moakley (MA)
17. *McNulty (NY)*
18. C. McCarthy (NY)
19. Danner (MO)
20. Faleomavaega (AS)
21. Clement (TN)
22. Weygand (RI)
23. DeFazio (OR)
24. *J. Lewis (GA)*
25. C. Peterson (MN)
26. Baldwin (WI)
27. T. Barrett (WI)
28. K. McCarthy (MO)
29. Sisisky (VA)
30. Spratt (SC)
31. Phelps (IL)
32. Olver (MA)
33. Clyburn (SC)
34. Evans (IL)
35. Hooley (OR)
36. Blumenauer (OR)
37. Wu (OR)
38. Capuano (MA)
39. Thompson, Mike (CA)
40. Condit (CA)
41. Baird (WA)
42. Meek (FL)
43. Capps (CA)
44. Udall (CO)

Total: 87

Names in italics are members of the House Committee on Ways and Means (10).

Attachment C

Organizations and Resolutions Endorsing the Bill

Organizations Supporting
S. 386/H.R. 721
The Bond Fairness and Protection Act

American Public Power Association
Large Public Power Council
Government Finance Officers Association
Governors Public Power Alliance
Enron Corp.
International City/County Managers Association
Madison Gas and Electric
National League of Cities
National Association of Counties
Natural Resources Defense Council
Public Citizen
National Consumers League
Avista Corp.
National Conference of State Legislatures
Education Finance Council
Municipal Treasurers' Association
American Public Works Association
Association of Metropolitan Water Agencies
American Public Gas Association
Association of Metropolitan Sewerage Agencies
International Bridge, Tunnel and Turnpike Association
Council of Infrastructure Financing Authorities
American Association of Port Authorities
Massachusetts Municipal Association
Wisconsin Alliance of Cities
Central Washington Hospital, Wenatchee, Washington
The Seniors Coalition
International Brotherhood of Electrical Workers (IBEW)
Consumer Federation of American (CFA)
Praxair, Inc.
Aluminum Company of America (ALCOA)
American Federation of State, County and Municipal Employees (AFSCME)

Organizations Supporting
S. 386/H.R. 721
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SUN DAY Campaign
Solar Energy Industries Association
National Bioenergy Industries Association
Global Biorefineries, Inc.
Clean Fuels Foundation
BOC Gases
Wallaston Alloys, Inc.
Miltons, Inc.
Symmons Industries, Inc.
Public Utilities Risk Management Association (PURMA)
Hyatt Key West (Florida)
Florida Keys Community Center
The Galleon Resort (Florida)
Holiday Inn Beachside Key West (Florida)

63-236 00 - 4

Resolutions Passed in Support of
S. 386/H.R. 721
The Bond Fairness and Protection Act

Massachusetts Municipal Association
Wisconsin Alliance of Cities
Ocala City Council (Florida)
Chillicothe City Council (Missouri)
Marshall Board of Public Works (Missouri)
Municipal Electric Power Association of Kentucky
Nebraska Public Power District
Kansas Municipal Utilities
Southern Minnesota Municipal Power Agency
Healdsburg City Council (California)
Sioux Center City Council (Iowa)
Pella City Council (Iowa)
Independence City Council (Iowa)
Municipal Energy Association of Nebraska (MEAN)
City of Fairmont Public Utilities Commission (Minnesota)
Utah Municipal Power Agency (UMPA)
Austin Board of Water, Electric, Gas and Power Commissioners (Minnesota)
International Union of Operating Engineers (IUOE), Local 266
American Municipal Power-Ohio/Ohio Municipal Electric Association
Edgerton Village Council (Ohio)
Princeton Utility Commission (Minnesota)
Princeton City Council (Minnesota)
Osage City (Kansas)
Missouri River Energy Services Board of Directors
Philippi City Council (West Virginia)
Franklin City Council (Virginia)
Springfield Board of Public Utilities (Missouri)
Salem City Council (Virginia)
Opelika City Council (Alabama)
Florida Municipal Power Agency (FMPA)
City of Clewiston (Florida)
Missouri Association of Municipal Utilities
Missouri Joint Municipal Electric Commission
Missouri Public Utility Alliance

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Oberlin Public Utilities Commission (Ohio)
Newport-Cocke County Chamber of Commerce (Tennessee)
Opelika Chamber of Commerce (Alabama)
Jackson City Council (Minnesota)
Oberlin City Council (Ohio)
Chillicothe Chamber of Commerce (Missouri)
Willmar Municipal Utilities Commission (Minnesota)
Lafayette City-Parish Council (Louisiana)
Lafayette Public Utilities Authority (Louisiana)
Oregon People's Utility District Association (OPUDA)
Traverse City Light and Power Board (Michigan)
Traverse City Commission (Michigan)
Maquoketa Municipal Electric Utility Board of Trustees (Iowa)
Ephrata Borough Council (Pennsylvania)
Rocky Mount City Council (North Carolina)
Coldwater City Council (Michigan)
Coldwater Board of Public Utilities (Michigan)
Conway Area Chamber of Commerce (Arkansas)
Owatonna Utility Commission (Minnesota)
City of Bethany (Missouri)
Alabama Municipal Electric Authority
Altus City Council (Oklahoma)
Grand River Dam Authority
Vermillion City Council (South Dakota)
Oberlin Area Chamber of Commerce (Ohio)
City of Columbus Water & Light Commission (Wisconsin)
Greenville City Council/Board of Trustees, Greenville Electric Utility System (Texas)
Blackstone Town Council (Virginia)
Bedford Town Council (Virginia)
Kissimmee Utility Authority Board of Directors (Florida)
Pocahontas City Council (Iowa)

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Zelienople Borough Council (Pennsylvania)
Brainerd Public Utilities Commission (Minnesota)
Gainesville City Commission (Florida)
Intermountain Power Agency (IPA)
Auburn City Council (Nebraska)
Auburn Board of Public Works (Nebraska)
Municipal Electric Utilities of Wisconsin (MEUW)
Roseville City Council (California)
Detroit Lakes City Council (Minnesota)
Elk River Municipal Utilities Commission (Minnesota)
Worthington Water and Light Commission (Minnesota)
Kirkwood City Council Resolution (Missouri)
Harlan Municipal Utilities Board/Harlan City Council (Iowa)
Sallisaw Town Council (Oklahoma)
Spiro Town Council (Oklahoma)
Beresford City Council (South Dakota)
Orrville City Council and Public Utilities Board (Ohio)
Oklahoma Municipal Power Authority
Michigan South Central Power Agency
Sturgis City Commission (Michigan)
Martinsville Chamber of Commerce (Virginia)
Louisiana Energy and Power Authority Board of Directors (LEPA)
Geneseo Municipal Utility Board (Illinois)
Geneseo City Council (Illinois)
Fort Pierre Common Council (South Dakota)
Kingfisher City Council (Oklahoma)
Pawhuska City Council (Oklahoma)
Cushing Municipal Authority (Oklahoma)
Vandalia Board of Alderman (Missouri)
Newport City Council (Tennessee)
Marshall City Council (Michigan)
Heart of the Valley Chamber of Commerce (Wisconsin)

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Mangum Utility Authority (Oklahoma)
Florida Municipal Electric Association (FMEA)
Moorhead Public Service Commission (Minnesota)
Public Power Association of New Jersey
Stillwater City Council (Oklahoma)
Watertown Municipal Utilities Board (South Dakota)
Columbus Area Chamber of Commerce (Wisconsin)
Board of Directors, Northern Wasco County PUD (Oregon)
East Grand Forks Water, Light, Power and Building Commission (Minnesota)
Rockville Centre Board of Trustees (New York)
City of Wells Utility Commission (Minnesota)
Luverne City Council (Minnesota)
Pawnee City Council (Oklahoma)
Danville Utility Commission (Virginia)
Thief River Falls City Council (Minnesota)
Richmond Common Council (Indiana)
Purcell City Council (Oklahoma)
Perry Municipal Authority (Oklahoma)
Southwestern Auglaize County Chamber of Commerce (Ohio)
Geary City Council (Oklahoma)
Braman City Council (Oklahoma)
Mooreland City Council (Oklahoma)
Vinton Municipal Electric Utility Board of Trustees (Iowa)
Edmond City Council (Oklahoma)
Key West Utility Board (Florida)
Quincy City Commission (Florida)
Burlington Electric Commission (Vermont)
Wyoming Municipal Power Agency (WMPA)
Anadarko City Council (Oklahoma)
Goltry Public Works Authority Board of Trustees (Oklahoma)
Frederick City Council (Oklahoma)

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San Antonio City Council (Texas)
Mayor Kenneth Johnson (Carthage, Missouri)
Carthage Water & Electric Plant (Missouri)
North Little Rock City Council (Arkansas)
Waupun Area Chamber of Commerce (Wisconsin)
Public Utilities Risk Management Association Board of Directors (PURMA)
Willmar City Council (Minnesota)
The Greater New Braunfels Chamber of Commerce (Texas)
Boerne City Council (Texas)
Northern Municipal Power Agency
City of Chattahoochee (Florida)
Board of Directors, Blue Ridge Power Agency (Virginia)
Watonga City Council (Oklahoma)
Blackwell City Council (Oklahoma)
Collinsville City Council (Oklahoma)
Municipal Electric Systems of Oklahoma, Inc. (MESO)
Virginia Municipal Electric Association (VMEA)
Copan City Council (Oklahoma)
Laverne City Council (Oklahoma)
Pryor City Council (Oklahoma)
Fort Pierce Utilities Authority (Florida)
Fort Pierce City Commission (Florida)
Cordell City Council (Oklahoma)
Comanche City Council (Oklahoma)
Wynnewood City Council (Oklahoma)
Green Cove Springs City Council (Florida)

PREPARED STATEMENT OF WILLIAM MAYBEN

INTRODUCTION

My name is William Mayben and I am President and CEO of the Nebraska Public Power District. I am testifying today on behalf of the Large Public Power Council (the "LPPC"). We appreciate the opportunity to participate in today's hearing on the tax issues involved in electricity deregulation, a process that will have a direct impact on virtually everyone in America.

The LPPC is an association of 21 of the largest state and locally-owned electric utilities in the United States. LPPC's members directly and indirectly provide reliable, high-quality, low-cost electricity to approximately 6.5 million customers in both urban and rural settings. Like their approximately 2000 smaller public power counterparts throughout the country, LPPC's members are not-for-profit entities committed to the people and communities they serve.

Today I would like to discuss some issues that arise in moving from a regulated to a deregulated market that we believe need to be addressed to treat public power fairly in the deregulating electricity market.

PRIVATE USE RELIEF

Public power systems, like other businesses, need access to capital to make the investments necessary to continue providing efficient dependable service to their customers. However, unlike our investor-owned utility counterparts, public entities cannot issue stock. Therefore, like every other State or local government entity, public power utilities have no practical source of external financing other than the municipal bond markets.

In exchange for the right to issue tax-exempt bonds to investors, public power systems must operate under a strict regime of Federal tax rules governing their ability to issue such debt. These rules generally limit private business use of tax-exempt bond financed facilities ("private use rules"). The principal test for private use under the present law provides that no more than the lesser of 10 percent of the bond proceeds or $15 million per facility may be used by a private business. Public power companies have relied on the tax-exempt bond market for capital and fully complied with the private use rules at the time bonds were issued and continue to do so throughout the terms of those bonds.

In the regulated electricity market of the past, the private use rules were cumbersome but manageable. However, with the Energy Policy Act of 1992, Congress began to significantly alter the regulated monopoly by introducing the element of competition into the wholesale marketplace. The 1992 legislation along with the Federal Energy Regulatory Commission (FERC) Orders 888 and 889 have promoted an open transmission network allowing greater choice of wholesale power supply. While open transmission continues to evolve through developments in the marketplace and legislative and regulatory initiatives, the private-use restrictions are a factor impeding attainment of fully open transmission. This stifles a competitive wholesale marketplace as contemplated by Congress in 1992.

In California approximately 30% of the transmission is owned by public power entities. Federal private-use restrictions are in direct conflict with federal energy policy and limit use of the public power transmission. This leaves a major void in the California Independent System Operator (ISO).

In addition to wholesale deregulation many states are implementing retail choice. With greater competition, publicly-owned utilities face some difficult choices under today's private use rules. In a deregulated competitive environment, large private business customers will seek and obtain specially tailored contracts to meet their special electricity needs, just as they do in buying any product.[1] If the private use rules in effect today remain intact, a public power utility may be prevented from offering its customers such a contract, even to private businesses in its own service territory that it has been serving for decades. If a public power system loses customers in a competitive marketplace, as a result of the private use rules, the utility may be unable to re-market the generating capacity it had built to serve those lost customers. That excess capacity may become idle and unproductive for the economy as a result of the private use rules. The inability to sell the excess capacity will result in higher costs for the remaining customers, precipitating a further erosion of the public utility's customer base.

Investors in public power tax-exempt bonds may face significant penalties if public power systems seek to retain existing customers by negotiating contracts and marketing excess capacity. Such actions could constitute a violation of the private use rules, and thus render the interest on the utility's outstanding bonds taxable. More than $70 billion of tax-exempt debt has been issued to finance generation, transmission and distribution facilities. Investors rely on the ability of public power systems to repay them through the sale of power from the assets they financed and to maintain the tax-exempt status of those bonds. Failure to address private use issues places these investments in jeopardy. A downgrading of public power bonds could impact other segments of the municipal bond market upon which states, cities, and towns rely to finance essential infrastructure. Uncertainty in these markets could lead to higher borrowing costs, which will ultimately be passed on to citizens and customers. The only alternative for public power systems is compliance with the IRS change of use rules, which will also result in significantly higher costs to customers.

In effect, publicly-owned utilities face the prospect of violating the private use rules and consequently higher costs, or walling off their customers from competition: in each case consumers would experience higher rates—the precise opposite of what deregulation is supposed to achieve. The consumer can only lose when this happens.

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[1] In the state of Florida, for example, nearly half of the total electricity sales of the state's 32 municipal utilities come from only about 10% of their customers.

UPDATING THE PRIVATE USE RULES

For the reasons that I have just outlined, the LPPC believes that the private use rules urgently need to be updated to adapt to the emerging deregulated electricity marketplace.

Our suggested modifications are best embodied in legislation introduced by Senators Slade Gorton and Bob Kerrey—S. 386 the Bond Fairness and Protection Act of 1999. This legislation has attracted the bipartisan support of 29 cosponsors to date. The bill's cosponsors include six members of the Finance Committee: Senators Jeffords; Thompson; Grassley; Moynihan; Hatch; and Robb. Congressmen J.D. Hayworth of Arizona and Robert Matsui of California have introduced a companion bill (H.R. 721) in the House that enjoys bipartisan support as well.

The Gorton/Kerrey legislation would provide publicly-owned utilities with an option: they can continue to issue tax-exempt bonds for generation, transmission and distribution facilities under a set of private-use rules clarified to provide a modest set of changes to deal with deregulation; or they can elect to generally forego the ability to issue tax-exempt debt for new generation facilities, but with a grandfather of their existing tax-exempt bonds from the adverse application of the private use rules.

The clarifications to the private use rules proposed in the legislation are intended to accommodate the reality of operating in a deregulated market. Specifically, private use would not include certain "permitted open access transactions." The bill lists the following activities as permitted open access transactions: (1) providing open access transmission service consistent with FERC Order No. 888 or with state open transmission access rules'; (2) joining a FERC-approved Independent System Operator (ISO), Regional Transmission Organization (RTO), power exchange, or providing service in accordance with an ISO, RTO, or power exchange tariff; (3) providing open access distribution services to competing retail sellers of electricity; or (4) if open transmission or distribution services are offered, contracting for sales of power at non-tariff rates with on-system purchasers or existing off-system purchasers.

Only the last of these clarifications is new and would merely permit publicly-owned utilities to enter into long-term contracts with existing customers, a change that is essential if these utilities are to compete with other electric providers for these customers. In fact, this change would merely give publicly-owned utilities the same ability to contract with their customers as the investor-owned "two county" utilities that benefit from tax-exempt bonds have. Moreover, given the changing nature of how electricity is being sold, a publicly-owned utility should not have to give up the ability to issue tax-exempt bonds merely in order to contract or to provide service to its historic customers.

The Bond Fairness and Protection Act of 1999 has attracted the support of a diverse group of organizations including the Independent Energy Producers and the National League of Cities. Similarly, the Government Finance Officers Association has endorsed the need for private use relief of the type contained in S. 386. While the LPPC believes that the Gorton/Kerrey legislation represents a reasonable solution to the obstacles public power faces in the deregulation process, we are by no means precluding negotiated changes to the specifics of the legislation in order to arrive at a consensus. The LPPC would be a willing and enthusiastic participant in any such effort.

Attached to this testimony are letters of support for the Gorton/Kerrey bill from various industry participants.

ADMINISTRATION EFFORTS AT PRIVATE USE RELIEF

The Administration has recognized the need for private use relief and has taken some steps to provide it. In January 1998, the Treasury and the Internal Revenue Service ("IRS") issued temporary and proposed regulations relating to the private use rules for generation, transmission, and distribution of electricity with facilities financed with tax-exempt bonds. These rules provide limited relief, within the context of present law, from the application of the private use rules in a deregulated environment. Because these regulations are temporary, they will expire three years after publication unless the IRS finalizes or reissues them.

The Administration also included revisions to the tax rules governing private use of tax-exempt bond-financed electric facilities in its FY 2000 Budget submission. Limited private use relief provisions were also included in the Administration's comprehensive deregulation plan submitted to Congress in April.

The Administration proposal would bar the use of tax-exempt bonds for new facilities for electric generation and transmission. Distribution facilities could continue to be financed with tax-exempt bonds subject to the existing private use rules. Sec-

ond, the Administration proposal would grandfather existing tax-exempt bonds from private use rules if the bonds were used to finance: (1) transmission facilities the private use of which results from a FERC order requiring non-discretionary open access to those facilities; or (2) generation or distribution facilities the private use of which results from retail competition or a contract effective after implementation of retail competition. The proposal would permit current, but not advance, refunding of bonds issued before date of enactment of the Administration's Comprehensive Electricity Competition Plan.

The LPPC applauds the Administration's recognition of the need to address private use rule problems and its efforts to afford publicly-owned utilities some opportunity to participate in a deregulated market. However, neither the temporary regulations nor the proposals contained in the Administration's deregulation plan address some other serious problems associated with private use rules or offers the flexibility that S. 386 provides which would allow public power to continue to be viable in the future. Further, as noted above, the temporary regulations, unless finalized, will expire in January of 2001.

COMPREHENSIVE DEREGULATION LEGISLATION

In this testimony I have tried to summarize the changes to present tax law that the LPPC believes are necessary as part of a deregulated environment. We also are acutely aware that we are not the only stakeholders involved in the deregulation debate. Current providers of electricity to America include not only public power systems but also investor-owned utilities and electric cooperatives. Each of these groups has specific requests that they deem imperative to ensure their viability in a deregulated environment.

For example, in the investor-owned sector, the tax consequence of nuclear decommissioning is a troublesome problem for various utilities with nuclear facilities throughout the nation. These nuclear plants were constructed during an era of regulated service areas when the customer base was established and cost-effectiveness was less relevant. Now, as various states enter into an open electricity market, these facilities are being purchased or taken offline. The costs and other tax issues associated with this decommissioning are substantial. The utilities that own the nuclear plants in question have requested help in the form of tax relief with respect to the costs of decommissioning these units as well as the tax effects of transferring funds for nuclear decommissioning.

Both the private use and nuclear decommissioning problems grow from the move toward deregulation. Clearly, all sectors of the industry require some measure of relief because of the move to a more competitive marketplace. Further, addressing the problems of any one segment of the market while ignoring the others could provide an unfair advantage for one type of entity over the others. Therefore, the consideration of the menu of problems caused by the transition to a deregulated electricity market should be done simultaneously to prevent granting one segment of the market a competitive edge over the others. In fact, the Administration has recognized the essential nature of this "linkage" by including both limited private use relief and nuclear decommissioning proposals in its deregulation plan.

This linkage however was broken with the passage of The Taxpayer Refund and Relief Act of 1999, (H.R. 2488) this summer that included only nuclear decommissioning relief. While the veto of the tax bill has rendered the issue moot for now, there are certain to be other attempts to legislate in this area in the future.

We believe it is essential that the private use rule modifications for public power systems move simultaneously with nuclear decommissioning tax relief for investor-owned utilities and other transition relief for coops. This would help ensure fairness for everyone that is essential to achieving the goals of electricity deregulation: affordable and reliable electricity for all.

CONCLUSION

Again, Mr. Chairman we appreciate this opportunity to present our views on the tax issues involved in electricity deregulation. We urge Congress to provide much needed relief from the clear conflict between application of private use restrictions of the Internal Revenue Code to publicly-owned utilities and the federal deregulation of wholesale energy supply. As you know, the marketplace is not waiting for Federal legislation to further deregulate at the retail level; it is happening now in numerous states and localities around the country. But only Congress can fix the Federal tax rules that are in conflict with federal energy policy and increasingly with state energy policy.

We stand ready to offer our assistance and cooperation to the Committee in any way possible as you consider the tax issues related to electricity deregulation.

Thomas D. Flanigan
Director, Government Relations

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Washington, DC 20004
Tel (202) 393-0962

The Honorable Bill Archer
Chairman
Ways & Means Committee
1102 House Office Building
U.S. House of Representatives
Washington, D.C. 20515

May 25, 1999

Dear Chairman Archer:

As states begin to allow retail electricity competition we have become aware of a tax problem that pertains to the "private use" rules. Under these rules many public power communities are now threatened with significant financial penalties as they adjust to the changing marketplace. As you know, these are rules that limit the amount of electricity that publicly-owned utilities may sell to private entities through facilities that are financed with tax-exempt bonds. Publicly-owned utilities now are faced with violating these rules or keeping their customers from competition.

As North America's largest industrial gases company, Praxair has four major plants and over 700 hundred employees throughout Texas, including Houston. We require huge amounts of electricity to make our products such as oxygen, nitrogen and argon. Electricity can be as much as 70% of our operating cost. Being an enthusiastic supporter of competition, we are nevertheless greatly concerned that unless the tax law is changed our electricity costs -- and in particular the costs of those public power suppliers who currently provide their customers with competitively-priced electricity -- could escalate.

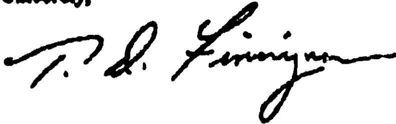
Praxair urges the Ways & Means Committee to incorporate into tax legislation *The Bond Fairness and Protection Act of 1999* (H.R. 721, S. 386), which protects consumers by grandfathering outstanding tax-exempt bonds, but only if the issuing municipality or state utility elects to terminate permanently its ability to issue tax-exempt debt to build new generating facilities. This is a fair compromise between publicly-owned utilities and investor-owned utilities. It provides an option for publicly-owned utilities to address the problem of how to comply with private use restriction in a restructured marketplace.

Another approach that purports to address this is Congressman English's H.R. 1253. However, it not only will not solve the "private use" problem associated with existing

debt, it would preempt state and local decision-making authority. It would also subject certain state and local revenues to the federal income tax. The result would be new barriers to competition and customer choice resulting in higher electric rates.

The Internal Revenue Code is already an obstacle to the full realization of wholesale competition. Without H.R. 721 the Code will became an even greater obstacle to retail competition. We hope you and your Committee will take action to favorably report this Bill and help public power become a vigorous player in the new competitive market.

Sincerely,



BOC GASES

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E. John Occhipinti

July 13, 1999

The Honorable Bill Archer
Chairman
House Ways and Means Committee
1102 Cannon House Office Building
Washington, DC 20515

Dear Mr. Chairman:

The goal of competition should be lower costs for all classes of customers and a fair regulatory environment so a multiple number of diverse competitors might participate in the marketplace. As the States move forward with electric utility restructuring, the "private use" rules for public power electric utilities are presenting a real barrier to realizing competition goal. Under these rules many communities served by public power are now threatened with significant financial penalties as they adjust to the changing marketplace.

As an industrial customer of a public power utility BOC Gases is writing to urge the Ways and Means Committee to incorporate into tax legislation the Bond Fairness and Protection Act (H.R. 721) authored by Congressman J.D. Hayworth (R-AZ) and cosponsored by thirty-six Members of the House of Representatives.

BOC Gases is the industrial gases business of The BOC Group, the worldwide industrial gases, vacuum technologies and distribution services company operating in some 50 countries with sales last year of $5.7 billion. In Aiken, South Carolina, we are served by Santee Cooper, the state owned electric and water utility which serves nearly 500,000 customers throughout the state. Along with our Aiken, South Carolina facility, BOC Gases has 60 other major facilities in 25 states from Maine to California. In the production of industrial gases, electricity comprises nearly 65% of our production costs and, consequently, electricity prices play a significant role in our siting decisions and ultimately impact our bottom line and the generally favorable business climate we seek.

Competition is a good thing and we support it, but the "private use" rules actually prevent public power from providing the benefits of competition to their customers. Without private use relief, public power is faced with the untenable predicament of entering competition and immediately having to increase prices because of the rules which would require the restructuring of its current debt (nearly $70 billion outstanding) which was issued during the noncompetitive regime of the past. H.R. 721 is a reasonable and balanced compromise. It allows public power utilities to grandfather existing debt, but would require them to elect to obtain future debt for expansion by taxable means. Simply put, it allows public power to transition to a significantly different competitive environment without having to pay restitution for past years of acceptable practice.

At the same time, H.R. 721 ensures that when public power competes with other investor-owned entities, it will do so without the financing advantage of tax exempt debt. Specifically, the bill requires that a utility elect to permanently terminate the issuing of tax exempt debt in the future if it plans to compete outside of its traditional service territory with new load.

Mr. Chairman, we also wish to express our reservations about H.R. 1253, a bill sponsored by Congressman English. Rather than solve the private use problem, this legislation is intended to shackle public power with even greater costs and burdens by making, for the first time ever, public power sales subject to federal taxation.

State and local governments have never been subject to such taxation and increasing the ratepayer's costs through taxation of nonprofit entities seems the wrong way to go.

As the States continue to move toward restructuring - your home state of Texas most recently - it is imperative that the private use rules be addressed. We hope you and your committee will take action to favorably report this bill and help public power become a vigorous and reliable player in the new competitive market.

Sincerely,

E. John Occhipinti

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Paul G. Campbell, Jr.
Executive Vice President

June 17, 1999

The Honorable Strom Thurmond
United States Senate
217 Russell Senate Office Bldg.
Washington, DC 20510

Dear Senator Thurmond:

I am writing to you about S.386, known as the Bond Fairness and Protection Act. Alcoa supports the passage of this Act as shown in the attached paper. Locally, this legislation deals with the tax treatment of Santee Cooper's electric utility bonds and outdated federal restrictions on how facilities financed with these bonds can be used to serve us as a business customer.

Alcoa employs about 600 people at our Mt. Holly primary aluminum reduction plant, which has been a mainstay of the local economy since we built it in 1979. Our business depends upon low cost electricity, and Santee Cooper has served us well.

Rapid changes are occurring in the electricity industry. I understand that federal "private use" tax laws could restrict Santee Cooper's ability to negotiate power rates to meet our future needs. Under certain conditions, if Santee Cooper were to develop a method of meeting our individual requirements, they could risk triggering provisions in the federal tax code that would make their outstanding utility bonds retroactively taxable. Restricting Santee Cooper from serving our electrical load in the best manner does not make sense, and could have a material impact on our operations.

I urge you to co-sponsor the Bond Fairness and Protection Act and vote for this important legislation to support our local community and our ability to remain competitive.

Sincerely yours,

Paul

Paul G. Campbell, Jr.
Executive Vice President

cc: T. Graham Edwards, Santee Cooper

Alcoa Supports Bond Fairness and Protection Act

Alcoa is the world's leading producer of primary aluminum, fabricated aluminum and alumina. We are active in all major segments of the industry including mining, refining, smelting, fabricating and recycling. In 1998 we had 103,500 employees at 215 operating locations in 31 countries, and about 57% of our $15.3 billion in revenues came from business within the United States.

Electricity is a key component in many of our manufacturing processes, and we depend upon economical power supplied by a number of investor-owned and consumer-owned utilities to keep our US operations competitive.

Changes are occurring in the electricity industry that require utilities to change the way they operate. Under existing federal "private use" tax laws, consumer-owned utilities that serve our plants could risk triggering provisions in the federal tax code that would make their outstanding utility bonds retroactively taxable if they attempt to meet our changing needs. This is an effective disincentive for a utility to provide the service we need to remain competitive, and should be changed.

The Bond Fairness and Protection Act (S. 386/H.R. 721) would allow consumer-owned utilities to utilize their transmission and distribution systems to meet all of their customers' needs without jeopardizing the status of existing tax-exempt debt. It would also provide assurance that these utilities would not be penalized for allowing private use of their systems associated with recent Federal Energy Regulatory Commission open-access policies. It is a reasonable compromise between a number of parties in that it would not allow expanded use of new tax-exempt debt and would in some circumstances prohibit the use of new tax-exempt debt to build new generation facilities. The Bond Fairness and Protection Act is important for the continued reliable and economical service we need, and we urge its passage.

PREPARED STATEMENT OF CORBIN A. MCNEILL, JR.

Chairman Murkowski and Members of the Subcommittee: I am Corbin McNeill, Chairman, President, and Chief Executive Officer of PECO Energy Company. PECO Energy, headquartered in Philadelphia, is a diversified energy company providing retail electric service throughout southeastern Pennsylvania and retail gas service in suburban Philadelphia. PECO Energy is also engaged in retail and wholesale electricity markets throughout the United States. The company's retail electric affiliate, Exelon Energy, is currently the largest non-utility supplier of retail electricity in the nation in terms of customers served, and PECO's Power Team is engaged in wholesale electric and gas sales in 47 states and Canada.

PECO Energy is also a partner with British Energy in AmerGen Energy Company, a limited liability corporation established in 1997 to acquire nuclear power plants in the United States. To date, AmerGen has announced agreements to acquire six nuclear reactors: Three Mile Island Unit 1 in Pennsylvania, the Clinton Generating Station in Illinois, Nine Mile Point 1 and 59 percent of Nine Mile Point 2 in New York, Oyster Creek in New Jersey, and Vermont Yankee.

My testimony today is on behalf of the Edison Electric Institute (EEI), the Nuclear Energy Institute (NEI), and the Utility Decommissioning Tax Group.

EEI is the national association of U.S. shareholder-owned electric utilities, their affiliates and associates worldwide. EEI's members serve approximately 75 percent of the nation's electric customers.

NEI is the national association of companies involved in the commercial nuclear power industry. NEI's members include all utilities licensed to operate commercial nuclear power plants in the United States, nuclear plant designers, major architect-engineering firms, fuel fabrication facilities, materials licensees, and other organizations and individuals involved in the nuclear energy industry.

The Utility Decommissioning Tax Group is composed of more than 60 nuclear utilities, investment advisory companies and trust companies. The Group is currently pursuing legislative and regulatory amendments to the tax laws as nuclear utilities disaggregate and transition to competition.

Mr. Chairman, the electric power industry in the United States is undergoing a profound change as a result of Federal and state actions to deregulate both the wholesale and retail electricity markets. In 1992, Congress passed the Energy Policy Act in an effort to promote increased competition in the nation's wholesale electric power market. More recently, 24 states have acted through legislation or regulation to deregulate electric sales at the retail level. These 24 states include 17 states with nuclear power plants, representing 60 of the nation's 103 operating reactors.

These actions have led to a fundamental change in the nature of the electric power industry in general and in the shape of the electric utility industry in particular: traditional, vertically-integrated utilities are being forced to rethink the way in which they do business in a newly-deregulated environment, new players are entering the market every day, and creative partnerships are being formed to compete in the new energy marketplace.

Perhaps the most astonishing element of this restructuring of the industry is the dramatic speed with which these changes are occurring. Unfortunately, Federal tax law has not kept pace with the rapid changes taking place.

It is important to emphasize the speed with which the marketplace is reacting to the changes caused by restructuring. As companies seek to respond to the changing market, however, that task is complicated, and in many instances frustrated, by the lack of certainty regarding the Federal tax consequences of various transactions being considered.

By way of example, I would note that while AmerGen has announced five acquisition agreements to date, none of those sales has closed. While some of these agreements were just announced recently, AmerGen's purchase of Three Mile Island Unit One is awaiting final action by the Internal Revenue Service prior to closing. The TMI deal has received all Federal approvals necessary to complete the transaction except for the IRS ruling. Until Congress provides the IRS with guidance to provide a predictable set of regulations, I fear that other transactions could be similarly delayed in the future.

Thus, if there is a single message that I can leave with you today, it would be this: Congress can not afford to wait for the passage of comprehensive electric restructuring legislation to address some of the tax issues raised by deregulation. The market is moving forward, but the development of a mature competitive electric market will be hampered and the continued operation of low-cost, competitive, reliable nuclear generating assets may be placed at risk if Congress does not act quickly to address the unintended tax consequences of the transition to a deregulated electric industry.

While restructuring of the industry has raised many tax-related issues, I will limit my comments today to the implications of electric restructuring for the Federal tax treatment of nuclear decommissioning trust funds.

BACKGROUND

Decommissioning nuclear power plants after they no longer produce electricity is a public health and safety imperative. The companies that own and operate nuclear power plants have a responsibility under Nuclear Regulatory Commission regulations to ensure that the necessary decommissioning funds are available when needed.

Similarly, state and federal policymakers have a long-held interest in ensuring there is adequate decommissioning funding for two important reasons: accumulating funds over 40 years saves electricity consumers money in the long run; and having adequate decommissioning funding assures that nuclear power plants will not be subject to Superfund-type cleanup issues.

Decommissioning a nuclear power plant requires that nuclear power plant owners accumulate $400–500 million per plant over the plants' 40-year operating period. These trust funds are segregated from a company's other assets, dedicated exclu-

sively to decommissioning, cannot be spent for any other purpose, and can only be spent with the express approval of the Nuclear Regulatory Commission.

Since 1984, U.S. tax policy has recognized that decommissioning represents a unique financial undertaking and thus qualifies for specialized treatment under the tax laws. Specifically, the Internal Revenue Code and Internal Revenue Service regulations treat annual contributions to decommissioning funds as a deductible expense. This policy was appropriate for utilities in the regulated cost-of-service environment, but the Code must be updated to reflect the competitive electricity market.

ISSUES RAISED BY ELECTRIC RESTRUCTURING

The problems raised by electric restructuring with regard to nuclear decommissioning trust funds fall into two categories: first, cases in which similarly-situated taxpayers will be treated differently depending upon whether they operate in a state in which deregulation has occurred, and second, cases in which state and Federal legislation or regulatory requirements will conflict with the intent of existing Federal tax law.

Let me provide a brief—and somewhat simplified—summary of current tax law before elaborating on each of these issues.

Section 468A of the Internal Revenue Code of 1986, as amended, allows an electric utility company which owns or leases a nuclear power plant to deduct contributions made to a Qualified Nuclear Decommissioning Reserve Fund, subject to limitations.

Contributions are limited to the lesser of: (1) the amount that a state commission allows to be collected for decommissioning (the cost of service amount), or (2) an amount approved by the Treasury Department (the ruling amount) as consistent with the concept of level funding.

Under level funding, the amount a plant owner is permitted to contribute is based on the projected decommissioning costs yet to be collected and the estimated remaining operating life of the plant. For example, if decommissioning costs were expected to be $200 million above what has been collected and the remaining life of the plant is 20 years, the owner can contribute $10 million annually to a Qualified Fund.

These limitations on deductible contributions were put in place to prevent nuclear power plant owners from arbitrarily managing their contributions in order to take excessive deductions in any single year. Under current law, the level funding amount acts as a ceiling on the amount a power plant owner can contribute to a Qualified Fund in any single year.

Let me now elaborate on each of the issues I identified earlier.

There are three instances in which similarly-situated taxpayers are likely to be treated differently as a result of restructuring.

COST OF SERVICE REQUIREMENT

The first relates to what is commonly called the "cost of service" issue. As I said, current tax law limits contributions to a Qualified Trust Fund to the lesser of an amount approved by a state public service commission or to the level funding amount.

Since in a restructured environment, many state commissions now have no rate-making authority over generating plants, the cost of service amount is zero. As a result, nuclear plant owners whose plants are no longer regulated under cost of service regulation will be prohibited from making contributions to a Qualified Fund.

Section 468A was written at a time when all nuclear plants were regulated by state public utility commissions. The failure of the Code to envision nuclear plants operating in a deregulated environment may lead to the unintended consequence of plant owners being unable to make contributions to a Qualified Fund.

While the IRS has issued some Private Letter Rulings to address this issue, Congress should act to address this now-antiquated provision in the Code and provide uniform rules for the new deregulated marketplace. Failure to address this issue would result in one set of rules for power plant owners in states that have deregulated and another set of rules for those in states that have not deregulated.

Since the level funding method serves as a ceiling for contributions under current law, the industry supports amending Section 468A to permit contributions to a Qualified Fund using the level funding method.

The Clinton Administration has also expressed support for this solution both as part of its budget proposal for fiscal year 2000 and as part of its proposed electric restructuring proposal, the Comprehensive Electricity Competition Act.

LICENSE TRANSFERS

A second case relates to license transfers and plant sales. Current law permits the tax-free transfer of Qualified Funds in connection with the sale of a nuclear plant from one regulated entity to another. Thus, if two traditionally-regulated utilities were involved in the sale of a nuclear plant, the transfer of the Qualified Fund would not be taxed. If, however, a regulated utility sold the plant to a buyer that is no longer regulated by a public service commission, the IRS has indicated that the transfer could be considered a taxable event. Such a ruling could effectively prevent a sale from taking place and, in some cases, could lead to the closure of plants.

As a result of state laws to restructure the electric power industry, some nuclear plant owners have chosen (and in some cases been required) to sell their generating plants. Because of the decommissioning liabilities associated with nuclear plants, the buyers of these plants are requiring current plant owners to fully fund the projected cost of decommissioning as part of the sales agreement. Under current law, only a portion of the fully-funded amount could be contributed to a Qualified Fund.

There are important public policy reasons to address this particular issue. With the transition to a deregulated environment, companies which own a single nuclear plant are often finding that it is uneconomic to operate these plants in a competitive marketplace. The overhead costs associated with the operation of a single unit plant make it inefficient to operate in isolation. In some instances, plant owners have announced that they will either sell the plants or close them.

Closing nuclear power plants before the end of their useful lives has important public health and safety, energy security, electric reliability, environmental, and economic consequences. In the two nuclear plant sales approved to date, the Nuclear Regulatory Commission has recognized the public health and safety implications of closing plants prematurely and has required full funding of decommissioning trust funds as a condition of license transfers that they have approved to date.

From an energy security perspective, nuclear power provides 20 percent of the electricity generated in the United States each year, second only to coal. Since the oil crisis of the 1970s, nuclear power has significantly decreased the dependence of the United States on imported oil. Closing nuclear plants prematurely will decrease the diversity of our energy mix.

From an electric reliability standpoint, nuclear power contributes large amounts of electricity in those areas of the country most prone to lapses in electric reliability as a result of transmission and power supply constraints. For example, in the summer of 1998, the Midwest experienced unprecedented price spikes in wholesale electricity markets because of the unavailability of several power plants—nuclear and fossil. During the summer of 1999, however, the power supply in the Midwest was much more stable, due largely to the fact that all of the region's nuclear power plants operated throughout the summer.

Nuclear power also provides significant environmental benefits since it generates electricity without burning fuel. As a result, nuclear power does not emit any greenhouse gases or air pollutants that contribute to acid rain or smog. In many cases, nuclear plants are located in precisely those regions that benefit the most from its clean air profile, such as the Northeast. If plants were forced to close unnecessarily, they would have to be replaced with plants that would worsen the region's strained air quality.

Finally, from an economic perspective, the unnecessary closure of nuclear plants would result in significant job loses and could have serious impacts, both direct and indirect, on local and regional economies.

Failure to address this issue could lead to the closure of some marginal nuclear plants since potential purchasers of nuclear plants have shown an unwillingness to purchase plants where sellers refuse to fully fund nuclear decommissioning trust funds as a condition of the sale.

Section 468A should be amended to allow power plant owners to contribute to a Qualified Fund where, in connection with the transfer of a nuclear power plant, the transferor or transferee (or both) is required to contribute a greater amount for nuclear decommissioning costs as part of the transfer of the plant.

UNEQUAL TREATMENT OF PLANTS DUE TO AGE

The final case in which similarly-situated taxpayers will be treated differently relates to a disparity that is already written into the tax code but which will be exacerbated by deregulation. Section 468A provides more favorable tax treatment for funds collected to decommission those portions of nuclear plants in service since 1984. Thus, newer plants receive more favorable tax treatment than older plants.

When Section 468A was enacted in 1984, Congress drew a distinction between amounts contributed to decommissioning funds for plants in service prior to 1984

and plants in service after 1983. Specifically, contributions to Qualified Funds are limited in the aggregate to the portion of total decommissioning costs allocable to the portion of the post-1983 operating life of the plant. Amounts collected to pay decommissioning costs for the portion of the plant prior through 1984 are not deductible and must be placed in a Non-Qualified Fund.

The distinction between pre- and post-1984 contributions is completely arbitrary and is not based on any substantive policy rationale. The distinction treats taxpayers with identical decommissioning expenses differently based solely upon the age of the plant. This produces inequitable results, particularly in the new competitive marketplace for power supply, and the provision should be abandoned.

Congress should act to eliminate the distinction between plants based on their age by allowing all future contributions to be made to Qualified Funds. This would prevent different treatment of similarly-situated taxpayers and would place all nuclear plants on the same footing in the competitive marketplace for energy.

CONFLICTS BETWEEN STATE AND FEDERAL LAW AND THE FEDERAL TAX CODE

There are two areas in which state and Federal regulations or legislation will conflict with the intent of existing Federal tax law. These issues arise where states have directed nuclear plant owners to accelerate the collection of decommissioning funds as part of restructuring orders, or where agencies such as the Nuclear Regulatory Commission have required pre-payment of decommissioning funds as a condition of a plant sale.

As part of some state restructuring proceedings in conjunction with deregulation, many nuclear power plant owners have been directed to accelerate their collection of decommissioning costs to assure that the plants will have adequate funds to decommission the plants at the end of their operating lives. As noted above, under current law, the Internal Revenue Service could reject the accelerated funding as exceeding the more traditional level funding amount, thus barring the plant owner from contributing the total amount collected to a Qualified Fund and denying the owner the corresponding deduction associated with such a contribution.

From a public policy perspective, nuclear plant owners should be encouraged to fund their decommissioning trusts earlier rather than later. The Department of Energy and the Nuclear Regulatory Commission have both expressed concerns about decommissioning trust funds being under-funded. Permitting accelerated contributions to trust funds where required by state or Federal orders would serve a strong public policy interest.

The industry believes that Section 468A should be amended to permit power plant owners to contribute the full amount collected to a Qualified Fund where Federal or State law or regulation requires or permits the accelerated collection of decommissioning funds. This would allow plant owners to comply with applicable Federal or state laws without being penalized for exceeding the level funding amount. Such accelerated funding would only be permitted as required by Federal or state law, thus preventing a plant owner from arbitrarily increasing contributions in an effort to increase deductions.

S. 1308: NUCLEAR DECOMMISSIONING TRUST FUND CLARIFICATION ACT

Mr. Chairman, let me thank you for your personal leadership in trying to address these critical issues. Your legislation, cosponsored by Senator Breaux, seeks to deal with the unintended tax consequences of electric restructuring by ensuring that electric consumers are not unnecessarily penalized by the transition to a deregulated electric market.

Companion legislation, H.R. 2038, has been introduced in the House by Congressmen Jerry Weller and Ben Cardin and enjoys strong bipartisan support among members of the House Ways and Means Committee.

As you know, many of the core provisions of the Nuclear Decommissioning Trust Fund Clarification Act were included in H.R. 2488, the Financial Freedom Act of 1999. Although that bill was vetoed by President Clinton, Congress should be commended for recognizing the need to deal with this issue expeditiously.

CONCLUSION

Mr. Chairman, without the Nuclear Decommissioning Trust Fund Clarification Act, similarly situated taxpayers will be treated differently depending on whether they are in states that have deregulated their electric markets. The benefits of lower energy prices in those state with retail competition could be offset by increased taxes that consumers in those same states may have to pay if current law is not changed. Clearly, Congress did not intend, or even envision, such a result.

I urge the committee to act quickly to avoid such unintended consequences.

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

PREPARED STATEMENT OF JOSEPH MIKRUT

Mr. Chairman, Ranking Member, and Members of the Subcommittee: It is a pleasure to speak with you today about the current-law tax provisions that may affect transactions undertaken with respect to the restructuring of the electric power industry.

The Administration supports restructuring of the electric power industry. Deregulation and increased competition, as envisioned by the Administration's Comprehensive Electricity Competition Plan, will encourage more efficient production and delivery of electricity resulting in savings for consumers, a more competitive American economy, and reduced greenhouse gas emissions. Almost all States have either adopted restructuring proposals that allow consumers to choose among competing power suppliers or are considering such proposals. Federal action is necessary, however, if State programs are to realize their full potential.

In April, the Administration delivered the Comprehensive Electricity Competition Plan to Congress. As Secretary Richardson noted when the Plan was delivered, the legislation it proposes will provide the tools needed to ensure that electricity markets operate as competitively and reliably as possible. The Administration estimates that creating a competitive electric industry will save consumers $20 billion per year.

Deputy Secretary Glauthier of the Department of Energy and I are here this morning to discuss the tax initiatives in the Administration's electricity restructuring proposals.

Certain Internal Revenue Code provisions may hinder certain transactions that may be undertaken pursuant to the restructuring of the electric power industry. In general, these provisions were drafted at a time when the electric power industry was subject to rate regulation and electric service generally was supplied by a local provider—whether the provider was a taxable investor-owned utility or a tax-exempt government-owned facility or cooperative. To address these situations, the Administration has proposed changes in the rules governing tax-exempt financing for electric companies owned by a State or local governmental entity, a provision that would allow unregulated utilities to make deductible contributions to nuclear decommissioning funds, and tax incentives for investments in distributed power and combined heat and power facilities.

TAX-EXEMPT FINANCING

Current Law

Under current law, interest on debts incurred by State or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions and the debt is repaid with governmental funds. If a bond is nominally issued by a State or local government, but the proceeds are used (directly or indirectly) by a private person and interest payments are derived from the funds of such a private person, interest on the bond is taxable unless the borrowing is for a purpose specifically permitted under the Code and certain other conditions are met.

Facilities for electricity generation, transmission, and distribution may be financed with tax-exempt bonds if the financed facilities are used by and debt service is paid by a State or local governmental entity. A facility can satisfy the governmental use requirement even when the electricity it generates or transmits is sold to private persons so long as those persons are treated as members of the general public. The general public for this purpose may include customers, such as large industrial users, that are charged lower rates than others, such as residential customers, under a reasonable and customary rate schedule. Private use occurs, however, when electricity is sold under terms, such as low-rate, take-or-pay contracts, not available to the general public or when facilities are operated by private persons (other than under certain permitted management contracts) or the benefits and burdens of ownership are otherwise transferred to private persons. Such private use of a facility (including, under the change-in-use rules, private use that begins after an initial period of governmental use) may render the interest on bonds that financed the facility taxable.

Both the Code and Treasury regulations provide certain short term and de minimis exceptions to these general rules. For example, in some cases, up to ten percent of the bond proceeds of an issue may be used for certain private business uses with-

out the entire issuance being treated as a private activity bond. In addition, temporary Treasury regulations issued in 1998 permit bonds outstanding on July 9, 1996 (the date of Federal Energy Regulatory Commission (FERC) action to promote the creation of nondiscriminatory, open-access transmission services) to retain their tax-exempt status when the transmission facilities financed with those bonds are used by private persons in connection with the provision of such open-access services. Those temporary regulations also provide that bonds outstanding on July 9, 1996, may retain their tax-exempt status notwithstanding certain private use of the generation facility financed by the bonds. The private use must occur in connection with the sale of excess capacity resulting from opening the issuer's power system to competition. The regulations further require that the length of the sales contracts cannot exceed three years, that the issuer issue no further tax-exempt bonds to finance increased generation capacity during the term of the contract, and that any stranded costs recovered by such sales be used to redeem outstanding tax-exempt bonds.

The temporary regulations expire in January of 2001, about 14 months from now. We have received useful comments from interested parties regarding these regulations and will soon begin the process of developing permanent regulations. Regulations, however, are incapable of fully addressing the issues raised by restructuring.

Issues Raised by Deregulation and Restructuring

The rules prescribing favorable tax treatment for bonds issued to finance public power facilities were adopted at a time when such facilities generally were operated to serve a limited, local geographic area. The restructuring of the electric power industry may result in situations and transactions that were not contemplated when those rules were adopted, raising issues that require a re-examination of such rules. Specifically, achieving a restructured electricity industry is hampered by the following three issues that arise with respect to the tax-exempt bond rules:

First, municipal utilities may be reluctant to open up their service territories to competition due to concerns regarding private use of their bond-financed transmission facilities.

Second, some municipal utilities may be unable to compete effectively in a deregulated environment because their bond-financed generation facilities are subject to private-use limitations.

Third, because municipal utilities may finance output facilities on a tax-exempt basis, they have a cost of capital advantage over private, for-profit providers of electricity.

The efficiency and equity of a restructured industry depend on leveling the playing field with respect to capital costs while at the same time ensuring that government-owned facilities are not discouraged from fully participating.

To achieve efficient, nondiscriminatory transmission, it may be necessary to turn the operation of government-owned transmission facilities over to independent regional systems operators or in other ways use those facilities in a manner that may violate the private use rules. As traditional service areas of both investor-owned and government-owned systems are opened to retail competition, the latter may find it necessary to enter into long-term contracts with private users of electricity in order to prevent their generation facilities from becoming stranded costs. Without relief from the change-in-use rules, government-owned systems may be unwilling to open their service areas to competition or allow their transmission facilities to be operated by a private party.

To maintain fair competition between government-owned and investor-owned electric companies in a restructured industry, and to avoid unwarranted indirect federal subsidies in this restructured environment, no new facilities for electric generation or transmission should be financed with tax-exempt bonds. Because electric distribution facilities are inherently local and often commingled with other public services, continued access to tax-exempt financing of such facilities by government-owned electric systems will not distort competitive balance in the industry. Moreover, these distribution facilities will continue to serve customers as members of the general public. Distribution facilities owned by for-profit providers will continue to be subject to rate regulation as natural monopolies. Continued tax-exempt financing of distribution facilities does, however, require a bright-line standard for the distinction between transmission and distribution facilities.

Administration Proposal

The Administration's Comprehensive Electricity Competition Plan proposes the following changes to the tax-exempt bond rules to resolve issues under current law and assure that restructuring of the electric power industry will deliver real savings for all Americans.

To address the change-in-use issue, pre-effective date bonds (i.e., bonds issued before the date the proposal is enacted) used to finance transmission facilities would be permitted to retain their tax-exempt status notwithstanding private use resulting from actions pursuant to a FERC order requiring nondiscriminatory open access to those facilities. Under the Administration's broader plan for encouraging industry restructuring, FERC would be given the power to require governmental electric utilities to provide such open access.

To encourage municipal power systems to open their service areas to competition, pre-effective date bonds used to finance generation or distribution facilities would be permitted to retain their tax-exempt status notwithstanding private use resulting from the issuer's implementation of retail competition or from the issuer entering into a contract for the sale of electricity or use of its distribution property that will become effective after implementation of retail competition.

These changes will not affect the treatment of a sale to a private entity of a facility financed with tax-exempt bonds. Such a sale will continue to constitute a change in use.

To establish fair competition in a restructured industry, interest on bonds (other than pre-effective date bonds) that finance electric generation or transmission facilities would not be exempt. Distribution facilities, defined as those operating at 69 kilovolts or less (including functionally related and subordinate property), could continue to be financed with tax-exempt bonds under the change-in-use rules of current law. In addition, tax-exempt bonds could be issued to refund bonds issued before the enactment of our proposal, but advance refunding would not be permitted.

NUCLEAR DECOMMISSIONING

Current Law

Under current law, an accrual basis taxpayer generally may not deduct an item until economic performance has occurred with respect to that item. This economic performance requirement defers deductions for costs incurred in decommissioning a nuclear power plant until decommissioning occurs. A taxpayer that is liable for the decommissioning of a nuclear power plant may, however, deduct contributions to a qualified nuclear decommissioning fund that will be used to pay the decommissioning costs.

A qualified nuclear decommissioning fund is a segregated fund that accepts only contributions for which a deduction is allowable and that is used exclusively for the payment of decommissioning costs, taxes on fund income, payment of management costs of the fund, and making investments. The taxpayer establishing or maintaining the fund must have a direct ownership interest or, subject to certain restrictions, a leasehold interest in a nuclear power plant and must be liable for decommissioning the plant. A nuclear power plant is defined for this purpose as a nuclear plant used predominantly in the trade or business of furnishing or selling electricity at rates that have been established or approved by a public utility commission. The fund is prohibited from dealing with the taxpayer that established the fund. The fund is subject to tax at a flat 20-percent rate. In general, tax is imposed on the fund's net investment income after the deduction of management costs.

The taxpayer maintaining a qualified nuclear decommissioning fund generally must include in income any amount distributed by the fund, other than for payment of management costs. Thus, amounts withdrawn by the taxpayer to pay nuclear decommissioning costs are included in income when the withdrawal occurs. At that time, however, the taxpayer will be allowed a deduction for decommissioning costs with respect to which economic performance has occurred.

Except to the extent provided in regulations, a taxpayer is also required to include in gross income any amounts that are properly includible when (1) the disqualification of a qualified fund results in a deemed distribution of its assets, (2) the taxpayer is required to terminate a qualified fund because decommissioning of the nuclear power plant to which the fund relates is substantially complete, or (3) the taxpayer disposes of the nuclear power plant to which a qualified fund relates.

The regulations provide rules that apply when a taxpayer disposes of a nuclear power plant and, in connection with the disposition, transfers its interest in a qualified fund relating to that plant. If the transferee is eligible to maintain a qualified fund and continues to maintain the fund after the transfer while satisfying certain other conditions, the transfer of the fund is treated as a nontaxable transaction. The transferor does not recognize any gain or loss on the transfer and the transfer is not treated as a distribution of fund assets with respect to which an inclusion in gross income is required. The transferee also does not recognize any gain or loss on the transfer and takes the transferor's basis in the fund. Under the regulations, the IRS may, if necessary and appropriate to carry out the purposes of the statutory

and regulatory provisions relating to qualified funds, apply these rules (and permit continued qualification of the fund) even in cases in which the transferee would not otherwise be permitted to maintain a qualified fund.

The amount that may be contributed to a qualified nuclear decommissioning fund for a taxable year is limited to the lesser of the cost of service amount or the ruling amount. The cost of service amount is the amount of nuclear decommissioning costs included in the taxpayer's cost of service for ratemaking purposes for the taxable year. The ruling amount is the amount that the IRS determines to be necessary to provide for level funding of an amount equal to a specified percentage of the nuclear decommissioning costs of the taxpayer. The percentage of nuclear decommissioning costs that can be funded through a qualified fund is determined by dividing the period during which the fund is in effect by the useful life of the nuclear power plant. In general, the effect of this limitation is that qualified funds cannot be used to fund nuclear decommissioning liabilities that relate to taxable years beginning before the enactment in 1984 of the provision permitting taxpayers to establish such funds. The IRS specifies a schedule of ruling amounts in a ruling issued to the taxpayer. If circumstances change, a taxpayer may request a revised schedule of ruling amounts. In addition, the schedule is reviewed at intervals of no more than 10 years (5 years if, instead of a schedule prescribing a dollar amount for each taxable year, the IRS has approved a formula or method for determining the schedule of ruling amounts).

Taxpayers may set aside funds for nuclear decommissioning in addition to the amounts they contribute to qualified funds. In some instances, State or Federal regulators require such additional funding. In addition, some taxpayers maintained segregated nuclear decommissioning funds prior to the effective date of the qualified decommissioning fund rules. In the case of amounts irrevocably set aside for nuclear decommissioning before July 19, 1984 (the effective date of the economic performance requirement), taxpayers may have taken the position that a deduction was allowable at the time the funds were set aside. Alternatively, taxpayers may have taken the position in taxable years ending before that date that such amounts, if set aside to comply with State or Federal regulatory requirements, were not includible in gross income. Since 1984, no deduction or exclusion from gross income has been allowable with respect to contributions to, or segregation of amounts in, nonqualified funds and the income of a nonqualified fund is taxed to the taxpayer at the taxpayer's marginal rate.

Issues Raised by Deregulation and Restructuring

The rules prescribing favorable tax treatment for qualified nuclear decommissioning funds were adopted at a time when almost all nuclear power plants were operated by regulated public utilities and a nuclear power plant and decommissioning fund would not be transferred except between regulated public utilities. Deregulation and restructuring of the electric power industry have resulted in situations and transactions that were not contemplated when those rules were adopted. These novel circumstances have given rise to a number of questions, including the following:

May an unregulated taxpayer maintain a qualified nuclear decommissioning fund? This issue may arise when, as part of deregulation, a nuclear power plant and the related decommissioning fund are transferred from a taxpayer subject to rate regulation to an unregulated taxpayer. Alternatively, a taxpayer that was previously subject to rate regulation with respect to electricity produced at a nuclear power plant may, because of deregulation, no longer be subject to such regulation.

Does the transfer of a qualified nuclear decommissioning fund to an unregulated taxpayer result in recognition of gain or loss by the transferor or the fund? Is such a transfer treated as a distribution of fund assets required to be included in the gross income of the transferor?

Is the transferor of a nuclear power plant entitled to a deduction for decommissioning liabilities assumed by the transferee?

To what extent may the purchaser of a nuclear power plant derive an immediate tax benefit from assumption of the seller's decommissioning liabilities?

May an unregulated taxpayer make deductible contributions to a qualified nuclear decommissioning fund? This issue also arises with respect to both previously regulated taxpayers and unregulated transferees.

Guidance under Current Law

Under current law, the IRS may permit the transfer, without disqualification, of a qualified nuclear decommissioning fund, together with the nuclear power plant to which it relates, to a taxpayer that is not a regulated public utility. In addition, the

IRS may permit the unregulated transferee to maintain the qualified fund after the transfer. In the cases that have been brought to our attention, it is our view that such treatment is both necessary and appropriate to carry out the purposes of the statutory and regulatory provisions relating to qualified funds. Similarly, a regulated taxpayer that becomes unregulated should also be permitted, in appropriate cases, to continue maintaining a qualified fund.

The IRS may similarly permit the transfer of a qualified nuclear decommissioning fund from a regulated taxpayer to an unregulated taxpayer to qualify as a nontaxable transaction that (1) does not result in recognition of gain or loss by either the transferor or the fund and (2) is not treated as a distribution of fund assets required to be included in the gross income of the transferor. If the transaction is nontaxable, the basis of fund assets will not change and the transferee will take the transferor's basis in the fund. Again, in the cases that have been brought to our attention, it is our view that such treatment is necessary and appropriate under current law.

Under current law, the seller of a nuclear power plant will be allowed a current deduction for any amount treated as realized or otherwise recognized as income as a result of the purchaser's assumption of the seller's decommissioning liability. The economic performance rules would ordinarily defer the seller's deduction until decommissioning occurs. However, regulations provide that, if a trade or business is sold and the purchaser assumes one of its liabilities, economic performance occurs with respect to the liability when the amount of the liability is included in the amount realized by the seller.

Under current law, a liability is not treated as incurred until economic performance occurs with respect to the liability. Thus, the purchaser of a trade or business is not allowed a deduction for liabilities assumed in connection with the purchase until economic performance occurs with respect to the liabilities. The regulations clarify, in the case of nondeductible items, that the economic performance requirement also defers the tax benefit of an increase in basis. The regulations state, "an amount a taxpayer expends or will expend for capital improvements to property must be incurred [i.e., economic performance must occur] before the taxpayer may take the amount into account in computing its basis in the property." In the case of decommissioning liabilities assumed in connection with the purchase of a nuclear power plant, the regulations suggest that the liabilities may not be taken into account in determining the basis of the acquired assets until decommissioning occurs.

Deregulation will generally eliminate traditional cost of service determinations for ratemaking purposes. Because the amount of the deductible contribution to a qualified nuclear decommissioning fund is limited to the amount of nuclear decommissioning costs included in the taxpayer's cost of service for ratemaking purposes, deregulation may result in complete loss of the deduction for contributions to the fund. In many cases, a line charge or other fee will be imposed by a State or local government or a public utility commission to ensure that adequate funds will be available for decommissioning. This charge or fee could be viewed as the equivalent of an amount included in cost of service for nuclear decommissioning, but there is no assurance that all State deregulation plans will provide for such a funding mechanism.

Administration Proposal

The favorable tax treatment of contributions to nuclear decommissioning funds recognizes the national importance of the establishment of segregated reserve funds for paying nuclear decommissioning costs. Although the favorable tax treatment was adopted at a time when nuclear power plants were operated by regulated public utilities, deregulation will not reduce the need for such funds. Accordingly, the Administration's Comprehensive Electricity Competition Plan proposes to repeal the cost of service limitation on deductible contributions to nuclear decommissioning funds. Under the Administration proposal, unregulated taxpayers would be allowed a deduction for amounts contributed to a qualified nuclear decommissioning fund. As under current law, the maximum contribution and deduction for a taxable year could not exceed the ruling amount for that year. The new rules would apply in taxable years beginning after December 31, 1999.

DISTRIBUTED POWER AND COMBINED HEAT AND POWER PROPERTY

The Administration's Plan also includes two tax proposals intended to reduce current barriers to the development of distributed power and combined heat and power technologies.

Distributed Power Property

Newly developed distributed-power technologies have made it possible to place electricity generation assets in or adjacent to commercial and residential establishments, as well as in industrial settings. The current depreciable property classification system, however, does not adequately account for these assets, particularly when they are used to produce both electricity or mechanical power and usable heat. Also, under current law, distributed power assets used to produce electricity in a commercial or residential setting are likely to be depreciated over much longer lives than are similar, or identical, assets used to produce process energy in an industrial setting.

The Administration's Plan proposes to clarify that distributed power property has a 15-year depreciation recovery period. Such property would include assets used to produce electricity that is primarily used in a building owned or leased by the taxpayer. Such assets may also be used to produce usable thermal energy. To avoid abuse, at least 40 percent of the total energy produced would have to consist of electrical power, and no more than 50 percent of the electricity produced could be sold to, or used by, unrelated persons.

This proposal will simplify current law by clarifying the assignment of recovery periods to distributed power property. It will remove taxpayer uncertainty, reduce future tax litigation, and level the playing field for distributed power assets. It should also encourage the use and development of more energy-efficient and less polluting electrical generation technologies.

CHP Investment Tax Credit

Combined heat and power (CHP) systems utilize thermal energy that is otherwise wasted in producing electricity by more conventional methods. Such systems achieve a greater level of overall energy efficiency, and thereby lessen the consumption of primary fossil fuels, lower total energy expenditures, and reduce carbon emissions. The Administration's Plan proposes a temporary tax credit for investments in CHP equipment. The eight-percent credit would be available for investments in large CHP systems that have a total energy efficiency exceeding 70 percent and in smaller systems that have a total energy efficiency exceeding 60 percent. It would be available for qualifying investments made through 2002. To prevent abuses, a qualifying CHP system would be required to produce at least 20 percent of its total useful energy in the form of thermal energy and at least 20 percent of its total useful energy in the form of electrical or mechanical power.

The CHP investment tax credit is expected to accelerate planned investments and induce additional investments in such systems. The increased demand for CHP equipment should, in turn, reduce production costs and spur additional technological innovation in improved CHP systems.

We urge Congress to enact the tax proposals I have outlined in my testimony. These proposed changes are needed to encourage restructuring plans that are being developed by individual States and to permit those plans to realize their full potential.

Mr. Chairman, this concludes my prepared testimony. I will be pleased to answer any questions you or other members of the Subcommittee may have.

PREPARED STATEMENT OF ERIC P. YOULD

Good morning Mr. Chairman and Members of the Committee. My name is Eric Yould and I am Executive Director of the Alaska Rural Electric Cooperative Association, officially known as ARECA. I greatly appreciate the opportunity to appear before you today to discuss the effects of electricity restructuring on electric cooperatives as they relate to the tax code.

My organization is the statewide trade association for Alaska's electric utilities, which collectively serve more than 556,000 Alaskans from Barrow on the North Slope to Metlakatla in the extreme southern panhandle. Our member systems include 16 cooperatives, five municipal systems, two IOUs and a number of very small village systems. Nationally, there are nearly 1,000 electric cooperatives serving over 31 million consumers in 46 states.

As the committee members know, 23 states have passed electric restructuring. As in an increasing number of other states, electric utility restructuring is a major issue in Alaska. Our State Legislature last year commissioned a third-party study on restructuring, and is exploring this highly complex issue through a House Special Committee on Utility Restructuring whose membership includes the speaker, minority leader and several committee chairs. Chairman Murkowski's newly released

draft legislation on electric market competition is also certain to figure prominently in our state legislative deliberations during next year's session.

The table in Appendix 1 shows an overview of the electric industry, and illustrates that one of co-op industry's greatest challenges nationally is the lack of customer density. On average, electric cooperatives serve 6 customers and generate $7,000 per mile of line whereas IOUs have 35 customers and generate $60,000 per mile of line. Nationally, co-ops are the smallest sector of the utility industry but are burdened with some of the highest costs. I might point out that, in my state, power rates exceed 50 cents per kwh in some our remote communities, which is six times the national average of 8.5 cents per kwh. Additionally, as Appendix 2 illustrates, our industry nationally serves a disproportionate number of residential consumers.

As you are aware, electric cooperatives have a different tax status because cooperatives are not-for-profit businesses that are owned and operated for the benefit of consumer-owners. There is, of course, a place in the market for all types of utilities, as evidenced by membership in our own statewide association. It is particularly important that in an era of restructuring, that tax policy adjust to keep the cooperative business structure viable.

In addition to electric energy, cooperatives serve many other sectors of our economy, such as agriculture, finance, retailing, telecommunications, housing and energy. The 45,000 member-owned co-ops nationwide provide $500 billion worth of goods and services annually in the United States.

The Single Tax Principle

In general, under Federal tax law, businesses organized as cooperatives are taxed according to the single tax principle. The single tax principle holds that income is subject to tax at either the business level or the owner level, but not both. The application of the single tax principle is not unique to cooperatives. Federal tax law applies the single tax principle in many types of business organizations, including partnerships, limited liability companies (LLCs), and S corporations.

Under Federal tax law, cooperatives in most industries are not taxed on income derived from business done with or for their members. Rather, this member-sourced income is generally retained by the cooperative as equity capital and is allocated to each of the cooperative's members, like partnership income is allocated to partners. The member, in turn, includes the allocated income as a part of his or her business taxable income.

Tax Treatment of Electric Cooperatives

An electric cooperative is tax-exempt so long as 85 percent or more of its annual income comes from members. Income derived from non-member business is still generally taxed under the unrelated business income tax (UBIT).

G&Ts aside, substantially all of the approximately 900 electric distribution cooperatives throughout the nation annually pass the 85 percent member income test and thus qualify for tax-exempt status. These distribution cooperatives are fully taxable on non-member unrelated business income.

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 in 1996, over 80 percent of the electricity generated by the cooperative segment of the electric utility industry was produced and sold by taxable electric cooperatives.

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. For example, cooperatives will be collecting "wire charges" when competitors sell power to cooperative customers over cooperative-owned power lines. As I will explain later, cooperatives may also sell power to non-cooperative members and there are other transactions in which cooperatives may become involved with non-members.

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.

The Joint Committee on Taxation, in its October 1997 pamphlet of tax issues related to restructuring, recognized the problem. It noted that:

"With electric power industry restructuring, it is not clear that a rural electric cooperative can be assured that it will receive 85 percent of its income from its mem-

bers because fees that the cooperative receives for wheeling electricity through its system and sales of surplus electricity will not be income from members."

The report goes on to state:

"If restructuring were accompanied by a loss of the tax-exempt status of electric cooperatives, the prices cooperative members face might rise as a result. . ."

Rural Electric Cooperatives Do Pay Taxes

In calendar year 1996, electric cooperatives in my state paid state and local taxes or their equivalents of about $3.7 million. Nationwide the figure was over $700 million. The only tax co-ops are exempt from is federal income tax because, as earlier stated, they are not-for-profit entities and because any revenues in excess of expenses—which we call margins—are returned to the members in the form of a patronage dividend. This is considered to be excess capital and is returned to our member-owners of this business.

EFFECT OF RESTRUCTURING ON COOPERATIVES' TAX STATUS

Retail Wheeling—If another utility or power marketer serves a co-op customer, that provider would have to pay the co-op a wires charge for using (or "wheeling" over) the co-op's distribution lines. Since this income to the co-op will be from a non-member, it will be counted as non-member income and could trigger disqualification of the co-op's tax-exempt status.

Non-Member Sales—Electric cooperatives, like other types of utilities, are capital intensive industries that plan for their customers' long-term needs, usually 35 years.

If a number of residential consumers or an even smaller number of industrial or commercial consumers leave the co-op, that co-op will have "stranded investments" which still must be paid for. If replacement sales to members are not available, existing non-member income could rise above 15%, violating the 85/15 test. Unaltered, the tax law would have the additional negative effect of raising costs to the remaining consumers.

Asset Sales—If other consumers cannot be found, a cooperative may have to sell some of its assets to non-members. Assets could include generation, transmission, distribution facilities as well as real estate and other property. Assets sales are generally high dollar items and could easily cause a system to violate its 85/15 test.

Unbundled Activities—As the industry evolves nationally, we are seeing the breakdown of vertical integration, which is generation, transmission, distribution, metering and billing from one provider. What can be expected is that a host of new providers will emerge to offer individual, or "unbundled," services. It is quite possible co-ops could be required to provide unbundled services to non-members. This could also lead to violation of the 85/15 test.

Sales Below Cost—As a cooperative, power rates are now the same for customers within a given class, such as commercial or industrial. In an environment of full competition, where that occurs, it may be necessary to offer a below-market rate on a temporary basis within a class to keep a current customer or attract a new one. Sales at below cost would currently be considered as non-member revenue. Should such sales occur, they should not contribute to violation of the 85/15 test.

Diversified Business—Even the threat of competition has brought significant changes to the electric marketplace. Consumers are asking for more efficient methods of delivery of not only electricity, but also related services.

We strongly believe if a co-op provides another service on a for-profit basis, then the co-op should be liable for all taxes on that service. If the co-op uses alternative forms of organization for non-utility services, UBIT should apply. However, if the co-op offers its member-owners on a not-for-profit basis other services that other utilities are permitted to offer, then cooperative tax law should apply.

Conclusion

All sectors of the electric industry have tax concerns due to restructuring. For the cooperative sector, it is clear that the 85/15 test, when imposed 75 years ago, never contemplated the vast changes the industry is poised to undergo today.

We respectfully request that Congress recognize the changing market and revise the 85/15 test to ensure that cooperatives are part of the future competitive landscape of the electric industry.

Thank you and I will be glad to answer any questions you might have.

Appendix 1

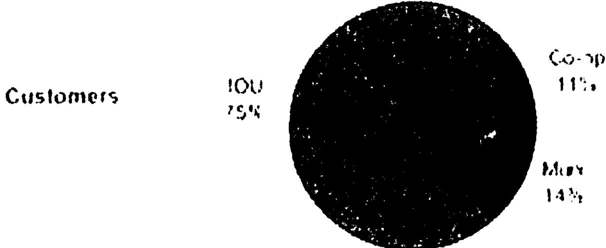
Table 1
Electric Utility Comparisons

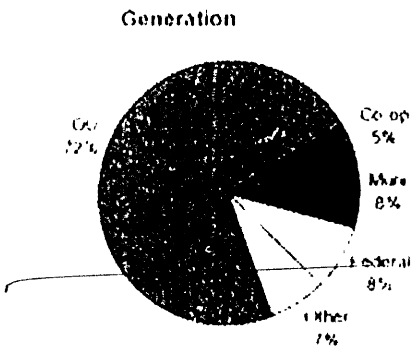
	Investor-Owned	Publicly Owned	Cooperatives	Industry Total
Number of Organizations	244	2,014	*960	3,218
Size (median number of customers)	315,000	1,700	9,400	
Customer, percent of Total	75 percent	14 percent	11 percent	
Revenues, percent of Total	79 percent	13 percent	8 percent	
Kwh Sales, percent of Total	76 percent	14 percent	8 percent	
Sales (billions kilowatt hours)				
Residential	751	149	142	1,042
Commercial	713	111	38	862
Industrial	766	148	54	968
Other	62	24	6	2,964
Total	2,292	432	240	2,964
Density (consumers/mile of line)	35	48	6	
Revenue(mile of line dollars)	60,000	73,000	7,000	
Distribution plant investment Per customer (dollars)	1,549	1,503	1,975	
Assets ($billions)	587	158	62	807
Equity ($billions)	193	36	18	247
Debt to capitalization ratio	47 percent	72 percent	71percent	

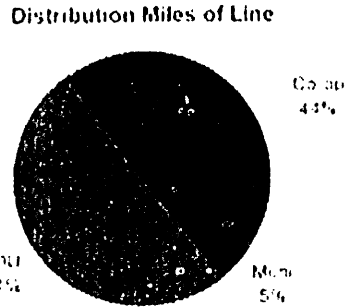
*900 Distribution, 60 Generation and Transmission cooperatives
Kwh = kilowatt hours
Sources: 1995 Dept of Energy/Energy Information Agency, Rural Utilities Service

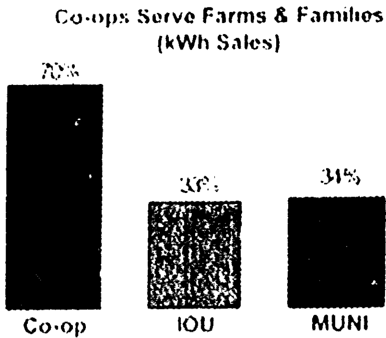
Appendix 2

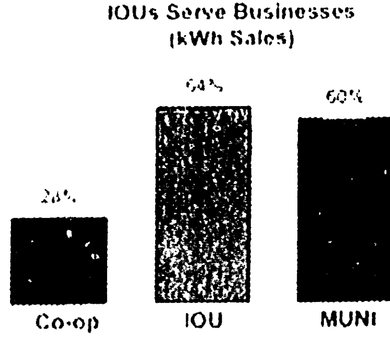
Total U.S. Electric Utility Comparisons, by Sector

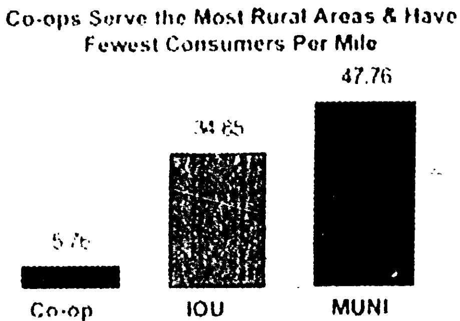


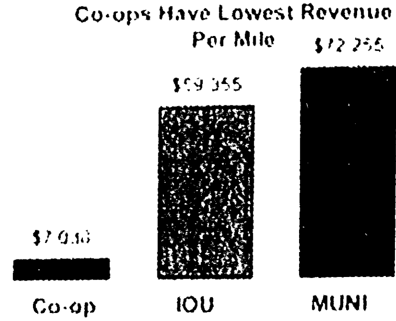












COMMUNICATIONS

STATEMENT OF THE COALITION FOR FAIR COMPETITION IN RURAL MARKETS

This statement is submitted by the Coalition for Fair Competition in Rural Markets (the "Coalition"), which is comprised primarily of taxable propane retailing companies and of national and state propane trade associations that, combined, account for approximately 85 percent of retail propane sales in this country.

This statement is presented to the Subcommittee because entities in one segment of the electricity industry—the tax exempt rural electric cooperatives—are beginning to compete with taxable, investor-owned propane retailing companies while maintaining the substantial competitive advantages of their income tax exemption as well as federal loan subsidies and related benefits. This situation and a recently-reported Internal Revenue Service ruling pose a significant threat to the viability of the taxable propane industry as well as several other industries which now pay federal income taxes on their earnings. In this context, Coalition members urge the Subcommittee to give careful attention to requests from RECs to expand their exempt status along with electricity restructuring.

The substance of this statement is summarized as follows:

- The tax exempt status granted to RECs, coupled with federally subsidized loans and loan forgiveness, addressed a clear public policy purpose for several decades. Continuing the RECs' tax exemption for that purpose—the electrification of rural America—is a policy decision on which the Coalition takes no position.
- Expanding the scope of the RECs' exempt status to cover other non-electricity business activities, such as propane retailing, creates an unwarranted and certainly an unfair subsidy for RECs as they compete with taxable companies in an already highly competitive industry. Of equal concern is the ability of RECs to maintain their exempt status when the benefits of their federal subsidies are available to their propane affiliates or subsidiaries.

A description of the propane retailing industry follows the "Conclusion."

A. THE RECS' PURPOSE AND EXEMPT STATUS

1. Rural Electrification

Rural electric cooperatives came into existence earlier this century when the vast majority of rural America did not have electric service. While the first tax exemption appears to have been granted to an REC in 1923 by the IRS's predecessor [1], it was not until after the Rural Electrification Act in 1936 that the numbers of RECs began to increase significantly and that they began to tackle their rural electrification objective with substantial effect. The availability of subsidized loans from federal agencies provided the capital needed to take on this objective. Rather than seeking to create subsidized competitors for investor-owned electric companies, the exemption and loan programs sought to encourage continuing electrification of rural regions of the country after the Great Depression had drained capital from those companies.

During the 75 years since the first tax exemption was granted, the RECs' mission to electrify the rural areas of the United States appears to have been fulfilled successfully. Now, the mission of RECs seems to be to generate, transmit and distribute electricity to customers in the service areas which were "electrified" many years earlier.

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[1] I.T. 1671, II–I CB 158 (1923).

2. RECs' Exempt Status Under Code Sec. 501(c)(12)

a. The statutory language

RECs are granted exempt status under sec. 501(c)(12) of the Internal Revenue Code of 1986. Specifically, the exemption is available to entities described in 501(c)(12)(A) as—

Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

The relevant description of entities in current law has not changed greatly since its predecessor was first enacted in 1916 as sec. 231(10), which allowed an exemption for—

Farmers' or other mutual hail, cyclone, or fire insurance company, mutual ditch or irrigation company, mutual or cooperative telephone company, or like organization of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting its expenses.

b. RECs' are deemed to be "like organizations"

Clearly, RECs are not listed in the statute. Instead, their exempt status is derived from the "like organizations" term that has been in the provision since 1916. While there is no useful statement of Congressional intent, Coalition members recognize that RECs are a reasonable class of entities to be deemed "like organizations." With the passing of more than 75 years since the 1923 exemption ruling, there is no serious question about the nature of the rural electrification activities being within the "like organizations" phrase. Indeed, Congress has, in effect, approved this status because the amendment in 1980 that removed pole rental income and prepaid REA loan income from the 85 percent member income test explicitly mentions mutual or cooperative electric companies in sec. 501(c)(12)(C).

Since the original 1923 ruling, the IRS has ruled that public utility-type services (electricity, natural gas, water and sewer) are business activities that can qualify as a "like organization." For this text, the IRS has considered the nature of the product or service being provided, regulatory/monopoly factors affecting the business, the type of delivery system used and whether it is regulated by a public utility commission (PUC). Rural electrification continues to be an exempt activity only because of this reasonable application of the "like organization" term in the context of the mutual and cooperative ditch, irrigation and telephone entities actually listed in the statute; it is not an activity that is mentioned in the statutory list of exempt activities.

3. Other REC benefits

In addition to their exemption from federal tax, RECs enjoy other significant advantages over their taxable, investor-owned competitors. These include the RECs' access to subsidized capital in the form of low-interest loans and 100 percent loan guarantees from the Rural Utilities Service ("RUS"—formerly the Rural Electrification Administration), a division of the U.S. Department of Agriculture. Another source of low-cost financing is the National Rural Utilities Cooperative Finance Corporation (CFC) which supplements RUS financing programs. These financing programs gives RECs a substantial cost of capital advantage over other entities. RECs also have access to their monopoly customer lists, credit histories, market research and energy use data that can be transferred to their non-utility-subsidiaries, often at no cost.

B. EXPANSION BY RECS INTO OTHER BUSINESSES

1. The General Situation

Having completed their mission with apparently tremendous success, RECs have begun actively and substantially expanding their business operations into a broad range of activities beyond rural electrification and even beyond continuing electricity services for rural areas. These new operations include home security, landscaping, cable and satellite television, Internet service, information and risk management services and propane retailing.[2]

The move by RECs into non-utility services was documented as early as 16 years ago by the General Accounting Office (GAO) in 1983 and again 10 years ago by the

[2] See, e.g., "This is Not Your Father's Oldsmobile: Electric Cooperatives Venture Into the Future," Electricity Journal, (November 1997) and "Touchstone Launchs Co-op Media Blitz," The Electricity Daily, April 6, 1998.

Small Business Administration (SBA) in 1989.[3] Both agencies addressed ways in which diversification brings RECs into direct—but subsidized—competition with taxable businesses which provide such services. Both reports recommended a more careful application of and substantial restructuring of the RECs' exemption as a result of changes in the RECs' operations and activities.

The Coalition believes that the competitive problems first outlined in the 1980s now are becoming serious realities. The legality of RECs entering other businesses generally is determined by state business statutes, but the availability of the federal income tax exemption (and other federal benefits) clearly is determined by federal law. If RECs choose to enter businesses for which there is no public policy basis for federal subsidies, they should be required to do so either at the expense of those subsidies or in a way which completely eliminates the cross subsidization of the new business venture by the electricity business.

2. The RECs' Move into Propane Retailing

Coalition members cannot state with certainty which REC was the first to enter the propane business. Available information suggests it was Coosa Valley Electric Cooperative in February 1996.[4] Since that date, at least 30 more RECs have entered the propane industry through August 1999. The National Rural Utility Cooperative Finance Corporation has reported that about 300 more ". . . have indicated a strong interest in entering the propane business."[5]

Competition from new entrants into the propane retailing business is neither new nor a source of concern to Coalition members. Indeed, the industry routinely sees new entrants. The serious issue here is that a new taxable propane company cannot undertake its new business with substantial valuable assets that it has built up over decades in a tax exempt and subsidized loan environment while maintaining exempt status and loan subsidies for its primary line of business; an REC does both. The significant economic value of an REC's federal tax exemption cannot be matched either by new entrants or by existing companies in the propane industry.

The Coalition recently commissioned a study by National Economic Research Associates ("NERA") to assess the ways in which RECs can leverage their federal tax and financing benefits—benefits presumably intended to promote their rural electrification objective—by using cross-subsidization and/or cost-shifting when entering the propane retailing industry. The report to the Coalition is entitled "Why Entry by Rural Electric Cooperatives into Propane Distribution is Anti-Competitive"[6] and, although RECs are relatively new to the propane industry, the report documents apparent use of subsidized benefits to compete with taxable companies by providing retail propane services at prices below the market for such non-subsidized companies.

The report is too long to be included here, but the Coalition has provided one to the Subcommittee for its files. The report's principal points are summarized as follows:

- RECs' cost-shifting reduces competition. Cost-shifting occurs if the costs incurred by an REC's propane affiliate migrate to the books of its core electricity business and are subsequently recouped in higher electricity prices paid by the RECs member and non-member customers. If this occurs, consumers are ultimately harmed in two ways: electricity prices are higher than they otherwise would be, and efficient independent propane distributors lose market share to the REC's propane affiliate, whose costs are artificially reduced by the cost-shifting. If the REC's propane affiliate then increases its share of the market significantly, the reduction in competition would provide it the opportunity to increase prices above competitive levels.
- RECs' cross subsidization distorts competition. Cross subsidization occurs when the REC's electricity business supplies services to its affiliate but the affiliate does not compensate the parent for the true costs of these services, if at all. The most apparent example of cross-subsidization arises if the propane affiliate obtains access to low-interest loans that would not be available but for the subsidized status of the parent REC. Also, the parent's ability to guarantee market loans with its exempt retained capital and/or subsidized loans reduces the market risk of the affiliate. These practices could significantly distort competition.

[3] Legislation Needed to Improve Administration of Tax Exemption Provisions for Electric Cooperatives, GAO/GGD–83–7 (1983); SVL Associates, "Competition Between Small Business and Rural Electric and Telephone Cooperatives in Non-Utility Businesses," (Final Report to the SBA, 1989).

[4] National Economic Research Associates ("NERA"), "Why Entry by Rural Electric Cooperatives into Propane Distribution is Anti-Competitive," September 1999, at "Alabama."

[5] Short Takes—Propane Push, http://www.nrucfc.org/solutions/Month/Aug/Aug.html.

[6] NERA report at footnote 4.

Cross-subsidization also occurs if the propane affiliate uses the REC's intangibles such as a corporate logo, trademark and customer lists—assets built up over many years with the benefit of tax-exempt status and federally subsidized loans. RECs also cross-subsidize their affiliate if the propane affiliate benefits from market intelligence that could only be obtained by the parent REC, such as co-op meter reader identifying which co-op customers have propane tanks on their property.

- RECs' co-marketing and joint branding are confusing and anti-competitive. Co-marketing and joint branding of electricity and propane by an REC and its propane affiliate may result in consumer confusion. Consumers may be falsely led to believe that propane services are regulated by state authorities; they might attribute a level of reliability or superior quality to the propane service; or they might question whether or not they are obliged to purchase their propane, as they are required to purchase their electricity, from the REC. To the extent consumers are misled on any of these issues, they may be willing to pay higher prices or accept lower quality for REC propane when, in fact, alternative suppliers provide propane at lower costs and/or higher quality services.

This is not a situation which should be sanctioned either by the IRS or the Congress. Regrettably, the IRS appears to be doing so, and Congress may be asked to do so.

3. The IRS's Position on RECs and Propane Sales

a. The Coalition's Substantive Case

On September 28, 1999, the Coalition submitted a memorandum and a background appendix to the IRS urging that a comprehensive set of guidelines be developed and published making clear that revocation of exempt status would occur if RECs undertook business activities—specifically propane retailing—not covered by sec. 501(c)(12). (A copy has been provided for the Subcommittee's files.) Prior to delivering those materials, the Coalition read the public release on the National Rural Utility Cooperative Finance Corporation's web site (www.nrucfc.org) of a September 9, 1999 memorandum by the Washington Utility Group ["WUG Memo"] reporting ". . . that the IRS had decided to rule favorably on [treating] propane service as a 'like activity' . . . for purposes of sec. 501(c)(12)." We submitted our memorandum to the IRS and then awaited the release of a redacted text of the ruling before making more detailed comments.

For purposes of this statement to the Subcommittee, the relevant substantive arguments in our memorandum to the IRS are summarized here:

- A general principle of statutory construction requires narrow application of tax exemptions because they run counter to the purpose of the income tax, namely raising general revenues. Congress can create whatever exemptions it pleases, as matters of legislative grace, but these exemptions cannot be expanded by the IRS and courts beyond what Congress clearly states is the purpose of exemption language.
- The IRS's traditional use of public utility-type services as the standard for being a "like organization" was reasonable, in the context of the listed activities of mutual or cooperative ditch, irrigation and telephone companies. This drew rational and discernible boundaries around the "like organizations" term without giving exempt entities a license to move into other businesses while under the protection of exempt status.
- Propane retailing does not come close to meeting a sec. 501(c)(12) standard, whether you are reading the actual statutory language or are applying the public utility-type service standard to the term "like organization."
- Other features of exempt organizations provisions—including UBIT generally and the 85 percent member income requirement—do not override the narrow application of exemption statutes and provide a shield for RECs to enter businesses beyond the scope of sec. 501(c)(12).

While recognizing that differences of opinion are possible on many topics, Coalition members are quite confident that this commentary on the relevant statute and interpretive judicial and administrative rulings is sound.

Then, in late October, we saw an October 22, 1999, "Electric Co-op TODAY—PSR" article which reported that the IRS issued as many as four private letter rulings in late September holding that the sale of propane is a "like activity" for purposes of sec. 501(c)(12). (A copy is provided for the files.) Now we understand that, if such rulings actually exist—and we must assume they do—none may be released at all. The Coalition is left to assess and to comment on the possible analysis by the IRS using only the WUG Memo and the October 22 article.

The Coalition sent another letter to the IRS on November 9, 1999 commenting as best we could on this unfortunate situation. Two substantive points of that letter relevant to this statement are summarized in points a and b below.

a. The IRS's reported conclusion that propane retailing is a "like activity" because it is an "energy source" is not based on the statute, case law, prior administrative rulings or the facts.

The analysis reportedly applied by the IRS is presented in the October 22 article and can be summarized in the following quotation reported to be from the IRS's letter ruling:

> [B]ecause propane is an energy source supplied to customers, similar to electricity or natural gas (although it is not supplied by pipeline to the customer end user), we rule that your distribution of propane gas by trucks to members on a coöperative basis is a 'like activity' contemplated under section 501(c)(12) of the Code. That propane is an energy source is certainly true.

That this fact is a basis for ruling that the retail sale and delivery of propane to customers ". . . is a 'like activity' contemplated under section 501(c)(12) . . ." is an assertion that is without support in the law, in court opinions or in rulings related to this Code section for these reasons:

- The statute says nothing directly about sales of "energy sources" being exempt activities. The listed activities—ditch, irrigation and telephone services—neither include nor imply an energy-related basis for the exemption.
- The public utility-type service standard, which has been the "like organization" standard for several decades, provides no basis for propane as an exempt activity. As discussed more fully below, propane retailing has none of the characteristics of a public utility—there is no monopoly service area, there is no single piping system that links all customers to one supplier in a service area, there is no monopoly pricing and there is no public utility commission that regulates any pricing or service area functions of the multiple companies in a given area.

"Energy source" is not an appropriate standard. The statutory language does not list an energy source activity, so there is no clear meaning on which to base such a ruling. The legislative history of sec. 501(c)(12) and of subsequent amendments to it provide no reference to energy sources as being a substantive standard, so there is no Congressional intent upon which to base the ruling. There is no body of court opinions which equate irrigation, ditch and telephone services with energy sources, so there is no judicial doctrine upon which to base the ruling. There are no administrative rulings which call attention to energy sources as "like organizations"

b. If the reported ruling position is allowed to stand, the range of business activities into which exempt RECs are allowed to move will have been expanded so greatly that there will be no clear limitations on the scope of the sec. 501(c)(12) exemption.

The reported ruling creates a basis for exemption under sec. 501(c)(12) which, if allowed to stand, will soon eliminate any distinguishable boundaries for the scope of exempt activities for RECs or any entity granted an exemption under that section. Six months ago, we would have appeared silly to suggest that the IRS was heading in a direction which would throw open the door to RECs to move into a wide range of business activities. Now, that is a virtual certainty. Beginning with "energy sources" as a standard, such businesses can include home heating oil, gasoline, diesel, kerosene, aviation fuel, landfill gas recovery, biomass gas production—none of which is a public utility business or even like a public utility business in any way, but each of which is an energy source.

Entry into these taxable business sectors will be a large step, but it will be only the first of many. Once a favorable ruling is obtained, further expansions will be possible based on the analysis underlying the electrical appliance ruling granted in 1980 to an REC.[7] There, the REC was allowed to maintain its exemption while selling electrical appliances because the latter promotes the expanded and efficient use of electricity sold by the REC. Is there any distinction between that situation and allowing an REC—

- first to sell gasoline or diesel fuel as an exempt activity and then to operate traditional service stations, to sell cars/trucks and to sell automotive parts, supplies, or
- first to sell aviation fuel and then to operate an airport and to sell planes, or
- first to sell recovered gas (primarily methane) from landfills and then to operate landfills and to operate garbage pickup services?

The "energy sources" standard is only the first of several that can be created. The propane analysis appears to be based on stretching to make the link between pro-

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[7] PLR 8109002 (October 31, 1980).

pane and natural gas, with natural gas as the link to the public utility-type service, which then is the old standard for "like organization" which actually is in the statute. A parallel analysis can occur with respect to other public utilities such as water services. Public water utilities provide a potable beverage just as electricity and natural gas utilities provide energy sources. The path from public water services to bottled water sales to beverage sales is just as clear—and just as inappropriate—as the path from public utility energy services to energy resources to propane sales. Sales of bottled water, sodas, juices, coffee, tea, milk, beer/wine/spirits companies are no less fanciful now than the energy items above. Once these are sanctioned, the grocery stores, restaurants, bars and other locations which normally sell them also become permissible under the electrical appliances precedent, just as service stations, airports and garbage pickups can flow from energy sources.

C. CONCLUSION

Federal tax exemptions address specific public policy objectives that have been identified and considered worthy of a tax exemption. Our purpose is to focus Congressional attention on the fact that the RECs' exemption is being pushed far beyond the rural electrification objective—and even beyond the continuing sale of electricity services to customers in rural areas—to justify competition with taxable business sectors.

With this in mind, Coalition members urge Congress to give careful attention to any requests from RECs for expanding their exemption. If the recent IRS ruling declaring propane sales to be a "like activity" is not reversed, the number of taxable business sectors into which exempt RECs will move will increase significantly and the taxes paid by investor-owned companies will be reduced accordingly. Even if the ruling is reversed, it is essential that RECs not be enable to enter such businesses indirectly through affiliates or subsidiaries which have the backing of the substantial tax and financial subsidies of the parent REC. If nothing else is possible, exempt RECs can forgo their exemption and revert to the general rules for taxable co-operatives which preceded current Subchapter T.

A DESCRIPTION OF THE PROPANE RETAILING BUSINESS

Propane retailing is a highly competitive business that has been in all parts of the country for most of the 20th century. A general description of the industry is provided below.

a. Propane is delivered by trucks to tanks at the customers' locations.

Propane is a product of both natural gas production and crude oil refining. Most propane retailers purchase it at the refinery or at the gas plant and then transport it to their own storage tanks. From this location, a local propane distributor delivers the product by "bobtail" truck to customers who lease the company's smaller storage tanks and place the tanks at their businesses and residences. When a customer wants to change suppliers, the old supplier picks up its tank and the new supplier puts its tank in place. (Distributors also sell propane in the familiar portable tanks.)

Distribution of propane directly to end-users by pipelines is technically feasible. But this is financially practical only when there is a large group of customers suitably concentrated so that the savings from making one large delivery to a central tank serving those customers is not exceeded by the capital cost of building the pipeline which ties them all together. Examples of candidates for propane distribution pipelines include mobile home parks and towns many miles from natural gas transmission lines. The very limited applicability of pipeline solutions is reflected in the fact that, in the fifty-plus years that the propane distribution business has been in existence, pipeline distribution systems have never had a significant presence.

b. Propane retailing is a large competitive business.

The propane retailing industry has a very large number of companies and is highly competitive. In 1994, there were approximately 8,000 independent marketers operating about 13,500 propane distribution centers around the nation. The 50 largest companies (based on gallons sold) accounted for less than 50 percent of nationwide sales that year, and the five largest companies accounted for less than 27 percent of nationwide sales.[8]

With so many companies in the business, local markets are served by many competitors. The number of competitors for any given customer base varies from region to region and from city to city. A minimum of five propane retailers generally serve

[8] Fitch Investors Service, L.P., Retail Propane Distribution Industry (July 3, 1995) (the "Fitch Report"), pp. 2 and 15. The 1994 data are the most recent on these percentages.

the same geographic area, but the average is eight to ten— possibly more— propane retailers in a city or a region. Of this larger number, three or four of the largest companies are likely to be there with four to six smaller retailers, too.

According to the Fitch report, retail propane distribution centers—

> . . . typically serve customers within a 25-square mile area. . . . Each center occupies one to three acres of land that accommodates an office/appliance showroom, above-ground storage tank capacity for 15,000–60,000 gallons of pressurized liquid propane, an inventory of storage tanks and portable cylinders usually leased to customers, and a fleet of bobtail delivery and rack trucks for periodically filling customers' stationary and portable on-site tanks. The average retail center markets about 685,000 gallons of propane annually. Depending on geographic location, size and type of markets served, and the number of competitors, a distribution center's volume can profitably range between 250,000–5,000,000 gallons. Market conditions permitting, national and regional retailers strive to reach the initial threshold for optimizing economies of scale and profitability by developing retail centers that individually deliver approximately one million gallons or more annually.

Fitch Report at 4.

Clearly, the propane retailing industry is not characterized by monopoly territories. With 8,000 companies nationwide and an average of eight to ten in most markets, propane companies engage in competition every day with no protection by monopoly service areas.

c. Propane retailing is not a regulated business.

The propane retailing industry is not subject to supervision or to regulation by any public board or utility commission with respect to pricing or restricted service areas. New entrants and existing companies in any given market area base their pricing on market forces and their own companies' financial needs. Pricing can be affected by competing energy resources for particular uses, by the season of the year, by refinery/wholesale costs and any number of other local market factors that affect businesses in the area.

Propane is not classified as a hazardous environmental substance by federal or state regulations, but its transportation is regulated under the hazardous materials rules that apply to a number of substances.

Attachments.

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November 9, 1999

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Mr. Steven T. Miller
Acting Assistant Commissioner
Employee Plans and Exempt Organizations Division
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Gentlemen:

This letter on behalf of the Coalition for Fair Competition in Rural Markets (the "Coalition") supplements our September 28, 1999 memorandum (the "Coalition Memorandum") regarding the exempt status under Code section 501(c)(12) of a rural electric cooperative (an "REC") that enters the propane retailing business.

Public reports from REC representatives state that the IRS recently issued at least one private letter ruling holding that propane sales are a "like activity" for purposes of sec. 501(c)(12). The adverse effects of this ruling on the taxable propane business sector will be substantial as RECs begin to compete directly with taxable companies without either the appearance of operating through arms length affiliates or the actual facts of similar costs of capital and tax burdens.

Coalition members believe that such a ruling is incorrect. We would like to present a comprehensive commentary on the specific analysis in such a ruling, but we are hindered by our inability to see a text. This letter presents the Coalition's best effort to comment on the substance of -- and likely effects of -- the reported rulings based on what has been reported publicly by REC representatives.

We renew our request that the IRS address the fundamental issue of the limitations on exempt status for RECs, and we add a request that the reported ruling(s) be revoked as quickly as possible to prevent an irreversible reduction in both the size and competitive capabilities of the taxable propane retailing sector.

PATTON BOGGS LLP

Mr. Marcus S. Owens
Mr. Steven T. Miller
November 9, 1999
Page 2

A. **The Current Situation**

The Coalition Memorandum presented the case for narrowly applying the "like organizations" exemption language in sec. 501(c)(12) to RECs. That case is based on the longstanding principle of statutory construction which requires narrow application of exemptions, and it is reinforced by court opinions and IRS rulings with respect to RECs and sec. 501(c)(12).

In my transmittal letter for the Coalition Memorandum, I acknowledged that we learned of the reported IRS private letter ruling just as we were preparing to deliver our materials to you. That letter stated the following regarding that ruling and our desire to comment on it:

> Research and initial drafting of the [Coalition] Memorandum were completed prior to the public release on the National Rural Utility Cooperative Finance Corporation's web site (www.nrucfc.org) of a September 9, 1999 memorandum by the Washington Utility Group reporting ". . . that the IRS had decided to rule favorably on [treating] propane service as a 'like activity' . . ." for purposes of sec. 501(c)(12). Actual issuance of a private letter ruling is expected when the case load permits. Until the redacted text of the expected PLR is publicly released, we cannot review and comment on the analysis and conclusion presented there.

The Washington Utility Group memo is in tab 4 of the Appendix to the Coalition Memorandum, and it is referred to in this letter as the "WUG Memo."

We were hopeful that the report was either premature, incomplete or wrong. We wanted the chain-building metaphor used in the Coalition Memorandum to be an excessive means of describing "exemption creep" and a metaphor that would not be confirmed by a propane exemption based on similarities to the last link created rather than an exemption rooted in the statutory language.

Then, we received a photocopy of an October 22, 1999, "Electric Co-op TODAY – PSR" article which provided summary commentary and one direct quotation from what the author identified as a September 28 private letter ruling on the propane issue. The article closed by reporting that ". . . the IRS issued three other substantially similar rulings . . ." along with the quoted ruling. A copy of the article is enclosed.

To date, we still have not seen any such text among those released from time to time by the IRS. Now we understand from IRS personnel that, if such rulings actually exist, they will not be released at all.

This is a very troubling situation for the taxable propane companies and their associations in the Coalition. We must assess and comment on the reported analysis by the IRS using only the WUG Memo and the October 22 article which reports to quote from one of the rulings. Presenting a reasoned commentary to you from this position leaves us vulnerable to the accurate criticism that we do not have all the information on which to base that commentary. But by *not* presenting a commentary, we would concede the argument on a controversy which, at the moment, is being addressed incorrectly by the IRS.

The controversy is much too important to Coalition members to be abandoned for lack of a redacted text of a private letter ruling. Prior to reports on the ruling, the taxable propane businesses were beginning to face competition from exempt RECs, primarily through affiliates that at least create the appearance of being completely separate entities even when the REC's retained capital, borrowing power and other intangible and tangible assets stand behind the affiliate. Coalition members believe that, absent effective "firewalls" which prohibit an REC from utilizing its assets to benefit the affiliate, such competition through such affiliates represents an inappropriate activity for an exempt REC for the reasons presented in the Coalition Memorandum. Now, assuming that the October 22 article accurately reports the IRS's position that propane sales are, themselves, an exempt activity, the legally separate entity is no longer necessary; RECs can undertake propane sales directly.

We are prepared to risk making comments that miss one or more points or that do not state accurately the entire IRS analysis because not challenging what we must assume is the new IRS position is not a viable option for the taxable propane business sector. The IRS apparently has sanctioned the entry of exempt RECs into this mature, highly competitive business which has none of the characteristics of the public utility-type services previously described as the standard for "like organizations." If that position is not reversed, Coalition members believe that the taxable propane sector will be steadily replaced by a non-taxable sector. In fact, if the position stated in the reported ruling(s) is not reversed, there will be no discernible boundary to the scope of the activities to which the sec. 501(c)(12) can be applied. This would be a gross distortion of the public policy purpose underlying sec. 501(c)(12).

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For these reasons, this letter presents the Coalition's commentary regarding what we must consider to be accurate reports of action that the IRS has taken. The following three points are discussed in detail below:

1. Propane retailing is a highly competitive business that has no characteristics which provide even an arguable basis for holding that it is a public utility-type service.

2. The IRS's reported conclusion that propane retailing is a "like activity" because it is an energy source is not based on the statute, case law, prior administrative rulings or the facts.

3. If the reported ruling position is allowed to stand, the range of business activities into which exempt RECs are allowed to move will have been expanded so greatly that there will be no clear boundaries to the sec. 501(c)(12) exemption.

B. The Case Against Propane as an Exempt Activity

The Coalition Memorandum presented in detail the case for describing limitations on the scope of the exemption for RECs under sec. 501(c)(12) generally and for holding that propane retailing is neither an exempt activity nor one in which an exempt REC should be allowed to engage even as a non-exempt activity. Some of that case is repeated or referred to below. Most of the following commentary emphasizes the issues that have been presented or highlighted by the public reports regarding one or more private letter rulings on this topic.

1. Propane retailing is a highly competitive business that has no characteristics which provide even an arguable basis for holding that it is a public utility-type service.

Propane retailing is a highly competitive business which has been in existence in the United States for most of the 20th century. Its natural customer base is primarily in rural areas and small towns where propane is used extensively for heating, cooking and a variety of energy-related purposes on farms and in other businesses. Propane is also used for certain vehicles and for recreational purposes such as outdoor barbecues in suburban and city areas.

Propane retailing is not now and never has been a public utility-type service. The common characteristics of public utility-type services include (i) a single system which "links" (via wire or pipe) one service provider to all customers in the area, (ii) an absence of competition in a service area, usually by law or administrative decision but also as a result of the prohibitive cost of building a parallel system to compete with an existing monopoly, (iii) monopoly pricing power and (iv) PUC regulation and oversight of prices, services and service areas. The propane retailing sector has none of these characteristics.

a. Propane is delivered by trucks to tanks at the customers' locations.

Propane is a product of both natural gas production and crude oil refining. Most propane retailers purchase it at the refinery or at the gas plant and then transport it to their own storage tanks. From this location, a local propane distributor delivers the product by "bobtail" truck to customers who lease the company's smaller storage tanks and place the tanks at their businesses and residences. When a customer wants to change suppliers, the old supplier picks up its tank and the new supplier puts its tank in place. (Distributors also sell propane in the familiar portable tanks.)

Distribution of propane directly to end-users by pipelines is technically feasible. But this is financially practical only when there is a large group of customers suitably concentrated so that the savings from making one large delivery to a central tank serving those customers is not exceeded by the capital cost of building the pipeline which ties them all together. Examples of candidates for propane distribution pipelines include mobile home parks and towns many miles from natural gas transmission lines. The very limited applicability of pipeline solutions is reflected in the fact that, in the fifty-plus years that the propane distribution business has been in existence, pipeline distribution systems have never had a significant presence.

b. Propane retailing is a large competitive business.

The propane retailing industry has a very large number of companies and is highly competitive. In 1994, there were approximately 8,000 independent marketers operating about 13,500 propane distribution centers around the nation. The 50 largest companies (based on gallons sold) accounted for less than 50 percent of nationwide sales that year, and the five largest companies accounted for less than 27 percent of nationwide sales.[1]

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1 Fitch Investors Service, L.P., *Retail Propane Distribution Industry* (July 3, 1995) (the "Fitch Report"), pp. 2 and 15. The 1994 data are the most recent on these percentages.

With so many companies in the business, local markets are served by many competitors. The number of competitors for any given customer base varies from region to region and from city to city. A minimum of five propane retailers generally serve the same geographic area, but the average is eight to ten -- possibly more -- propane retailers in a city or a region. Of this larger number, three or four of the largest companies are likely to be there with four to six smaller retailers, too.

According to the Fitch report, retail propane distribution centers --

> . . . typically serve customers within a 25-square mile area. . . . Each center occupies one to three acres of land that accommodates an office/appliance showroom, above-ground storage tank capacity for 15,000 – 60,000 gallons of pressurized liquid propane, an inventory of storage tanks and portable cylinders usually leased to customers, and a fleet of bobtail delivery and rack trucks for periodically filling customers' stationary and portable on-site tanks. The average retail center markets about 685,000 gallons of propane annually. Depending on geographic location, size and type of markets served, and the number of competitors, a distribution center's volume can profitably range between 250,000 – 5,000,000 gallons. Market conditions permitting, national and regional retailers strive to reach the initial threshold for optimizing economies of scale and profitability by developing retail centers that individually deliver approximately one million gallons or more annually.

Fitch Report at 4.

Clearly, the propane retailing industry is not characterized by monopoly territories. With 8,000 companies nationwide and an average of eight to ten in most markets, propane companies engage in competition every day with no protection by monopoly service areas.

c. Propane retailing is not a regulated business.

The propane retailing industry is not subject to supervision or to regulation by any public board or utility commission with respect to pricing or restricted service areas. New entrants and existing companies in any given market area base their pricing on market forces and their own companies' financial needs. Pricing can be affected by competing energy resources for particular uses, by the season of the year, by refinery/wholesale costs and any number of other local market factors that affect businesses in the area.

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Propane is not classified as a hazardous environmental substance by federal or state regulations, but its transportation is regulated under the hazardous materials rules that apply to a number of substances.

2. **The IRS's reported conclusion that propane retailing is a "like activity" because it is an energy source is not based on the statute, case law, prior administrative rulings or the facts.**

The analysis reportedly applied by the IRS in one or more private letter rulings is presented in the October 22 article and can be summarized in the following quotation reported to be from the IRS's letter ruling:

> [B]ecause propane is an energy source supplied to customers, similar to electricity or natural gas (although it is not supplied by pipeline to the customer end user), we rule that your distribution of propane gas by trucks to members on a cooperative basis is a 'like activity' contemplated under section 501(c)(12) of the Code.

This quotation and the article's accompanying description of IRS comments in the document referred to by the author make it clear that the analysis is based on propane's status as an energy source. That propane is an energy source is certainly true. That this fact is a basis for ruling that the retail sale and delivery of propane to customers is a "'like activity' contemplated under section 501(c)(12) . . ." is an assertion that is without support in the law, in court opinions or in rulings related to this Code section.

a. **There is no statutory basis for an "energy source" exemption.**

The relevant description of entities in the statutory language of sec. 501(c)(12) has not changed greatly since its predecessor was first enacted in 1916 as sec. 231(10), which allowed an exemption for --

> Farmers' or other mutual hail, cyclone, or fire insurance company, mutual ditch or irrigation company, mutual or cooperative telephone company, or like organization of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting its expenses."

Today, sec. 501(c)(12)(A) applies to --

> Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

The Coalition Memorandum acknowledged that RECs were a reasonable class of entities to be covered by the "like organizations" language that has been in this exemption provision from the beginning. With more than 75 years of history since 1923 when the first REC exemption ruling apparently was granted, there is no serious question about the nature of the rural electrification activities being within the "like organizations" phrase. Indeed, Congress has, in effect, approved this status with the amendment in 1980 that removes pole rental income and prepaid REA loan income from the 85 percent member income test for mutual or cooperative electric companies by explicitly mentioning the latter in sec. 501(c)(12)(C).

Nonetheless, rural electrification is recognized as an exempt activity only because it is a reasonable application of the "like organization" language in the context of the mutual and cooperative ditch, irrigation and telephone entities listed in the statute, not because there is any reference to "energy source" in the statute or because any listed entity is energy-related. The "energy source" term does not appear in sec. 501(c)(12) or its predecessors.

Therefore, basing a propane ruling on finding that it is an energy source is not supported by the statute. The ruling must arise from some other line of analysis.

b. The public utility-type service standard, which has been the "like organization" standard for several decades, provides no basis for propane as an exempt activity.

For several decades, the courts and the IRS routinely reaffirmed that the "like organization" exemption requires both a structural and substantive similarity to the listed organizations. Both court and IRS rulings refused exemptions when cooperatives argued only that their activities were related to the electricity purpose for which an REC could gain an exemption. This history is reviewed in detail on pages seven to nine of the Coalition Memorandum.

The IRS had developed a relatively clear position that substantive similarity required a finding of a public utility-type service. Interpretive rulings addressed the

characteristics that tend to identify such services. The Coalition Memorandum discusses these matters on pages nine to eleven. While this clearly is an interpretation of the statutory term "like organization," it is not unreasonable because the term certainly must have some workable meaning. In the context of the listed irrigation, ditch and telephone services and the implicit rural nature of the services for which a federal tax subsidy was being created, the public utility-type service standard had a rational basis and, we believe, imposed a relatively clear boundary on what activities could be undertaken by exempt RECs.

As discussed above, there is nothing about the propane retailing business that remotely resembles a public utility or even a public utility-*type* service. It does not have monopoly service areas or monopoly "links" to customers' locations. It does not have public board oversight or pricing regulations. Competition is open and aggressive all around the country.

Therefore, basing a propane ruling on finding that it is an energy source is not supported by the public utility-type service standard. The ruling must arise from yet another line of analysis.

c. "Energy sources" is not an appropriate standard.

Even though the published materials are not complete, Coalition members must take at face value that the IRS's new analysis is correctly described in the quoted material in the October 22 article and in the information provided in the WUG Memo. Both documents indicate that the IRS has moved beyond the public utility-type service standard and has begun to create new standards that significantly expand the scope of 501(c)(12), beginning with sales of energy sources as one new substantive standard.

We find no basis for such a substantive standard. The statutory language does not list an energy source activity, so there is no clear meaning on which to base such a ruling. The legislative history of the language and of subsequent amendments to it provide no reference to energy sources as being a substantive standard, so there is no Congressional intent upon which to base the ruling. There is no body of court opinions which equate irrigation, ditch and telephone services with energy sources, so there is no judicial doctrine upon which to base the ruling. There are no administrative rulings which call attention to energy sources as "like organization" characteristics -- much less emphasize energy sources -- so there is no good administrative precedent for ignoring the statute and case law and prior rulings when making the new ruling.

d. **The RECs' facts and representations fail to make a case that propane retailing is itself a "like activity."**

Our review of the October 22 article and the WUG memo leads only to the conclusion that the reported ruling is the result of a process of erosion of IRS views by worthy and persistent REC representatives. The WUG Memo reported a history of failed informal efforts to gain a favorable ruling with respect to propane sales as a "like activity." But the WUG Memo also noted a continuing effort to wear down the IRS's opposition. When the REC representatives determined that the IRS's problems seemed to be reduced to the delivery of propane by truck rather than by pipeline, a new ruling request was made with several well stated representations and facts. Among those were that a pipeline would be developed within five to ten years, that public utility companies routinely sell propane (by truck) and that natural gas companies use propane both to expand their delivery systems and to maintain BTU levels in their pipelines during peak periods. This request was then followed by another in which an REC proposed to install a pipeline system in large mobile home parks for purposes of delivering propane and proposing that the REC eventually would connect such systems to a natural gas pipeline.

Though interesting, none of the representations or facts noted in the WUG Memo are relevant to the proper analysis of the statute, the case law or prior IRS rulings related to RECs under section 501(c)(12). Consider the following :

- The ruling requests did not argue that propane retailing falls within the public utility-type service standard; they argued that some true public utility companies also sell propane and deliver it by truck.

- The requests did not argue that propane sales either are a public utility or that such activity is *like* the sales of natural gas by public utility companies; they argued that some natural gas utilities also use propane in their pipelines.

- They did not argue that propane delivery must be made through a single "link"/pipeline to the customers' locations by a monopoly seller which owns that pipeline; they argued that pipelines would be installed when economically feasible and then stated that they would install pipelines in large mobile home parks.

- They said nothing at all about pricing or other regulation and supervision of propane retailing services.

In summary, the facts and representations made no case at all that propane retailing is a "like activity" under either sec. 501(c)(12) itself or the judicial and administrative interpretations of that statute.

Instead, the WUG Memo makes it clear that, rather than arguing that propane sales are a like activity, the strategy was to make propane sales look as much "like" a "like activity" as possible. What they did was to make a case that propane is chemically similar to natural gas, that it *can* physically be delivered by pipeline like natural gas and that natural gas companies also use and sell propane. While not at all tied to the "like organization" language, these arguments regrettably obscured both the issue and the proper analysis and have led to one or more incorrect rulings.

3. **If the reported ruling position is allowed to stand, the range of business activities into which exempt RECs are allowed to move will have been expanded so greatly that there will be no clear limitations on the scope of the sec. 501(c)(12) exemption.**

The reported ruling creates a basis for exemption under sec. 501(c)(12) which, if allowed to stand, will soon eliminate any distinguishable boundaries on the scope of exempt activities for RECs or any entity granted an exemption under that section. The widely recognized principle of statutory construction which requires the narrow application of exemptions will have been reversed by a ruling which, as noted below, cuts a path for a substantial number of new and equally improper exempt activities.

Energy sources are not mentioned in the statute or subsequent court or IRS commentaries on the "like organization" language. But the reported ruling creates energy sources as a substantive standard for applying that term while no longer applying the public utility-type service as the standard. An abridged genealogy of this new standard would look something like this:

1916 Irrigation, ditch and telephone services and "like organizations" are specifically listed in the statute.

1923 Rural electrification services are deemed a "like activity" under the first REC ruling.

1967 Water service is a "like activity" under a revenue ruling.

1980 Electrical appliance sales in conjunction with electricity sales is shielded by the "like activity" term under a private letter ruling.

1997 Water, sewer and natural gas services by an REC are "like activities" under a private letter ruling.

1999 Sale of an energy source is a "like activity" under one or more private letter rulings, with propane as the first identified energy source.

As improbable as this would have seemed a few months ago, it is no longer ridiculous to assert that the list of "like activities" will lengthen just as quickly as RECs (or telephone cooperatives or others exempt under the actual statutory language) can identify opportunities to enter energy source businesses. Such businesses can include home heating oil, gasoline, diesel, kerosene, aviation fuel, landfill gas recovery, biomass gas production – none of which is a public utility business or even *like* a public utility business in any way except with respect to generic descriptions of goods and services sold. Entry into these taxable business sectors will be a large step, but it will be only the first of many.

Once a favorable ruling is obtained, further expansions will be possible based on the analysis underlying the electrical appliance ruling granted in 1980 to an REC.[2] There, the REC was allowed to maintain its exemption while selling electrical appliances because the latter promotes the expanded and efficient use of electricity sold by the REC. Is there any distinction between that situation and allowing an REC --

- first to sell gasoline or diesel fuel as an exempt activity and then to operate traditional service stations, to sell cars/trucks and to sell automotive parts, supplies, or
- first to sell aviation fuel and then to operate an airport and to sell planes, or
- first to sell recovered gas (primarily methane) from landfills and then to operate landfills and to operate garbage pickup services?

The energy sources standard is only the first of several that can be created, if the propane ruling(s) analysis is not reversed. The propane analysis appears to be based on stretching to make the link between propane and natural gas, with natural gas as the link to the public utility-type service, which then is the old standard for "like organization" which

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2 PLR 8109002 (October 31, 1980).

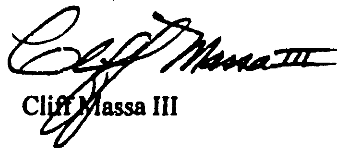
actually is in the statute. A parallel analysis can occur with respect to other public utilities such as water services. Public water utilities provide a potable beverage just as electricity and natural gas utilities provide energy sources. The path from public water services to bottled water sales to beverage sales is just as clear -- and just as inappropriate -- as the path from public utility energy services to energy resources to propane sales. Sales of bottled water, sodas, juices, coffee, tea, milk, beer/wine/spirits companies are no less fanciful now than the energy items above. Once these are sanctioned, the grocery stores, restaurants, bars and other locations which normally sell them also become permissible under the electrical appliances precedent, just as service stations, airports and garbage pickups can flow from energy sources.

C. Conclusion

Coalition members believe that the reported IRS ruling or rulings holding that propane is a "like activity" are incorrect. The linkage between propane and natural gas is tenuous at best, but even if it were strong, an exemption ruling must be based on a narrow application of the statute. The new "energy source" standard cannot be supported by this principle of statutory construction. If allowed to stand, the analysis will underwrite the virtually unrestrained expansion of an exempt business sector that is properly limited to rural electrification or at least to electricity services.

This is an improper result, and we renew our request that IRS develop and publish a clear set of guidelines based on the narrow application of sec. 501(c)(12). We also request that the IRS revoke any ruling which has held that propane is a "like activity."

Sincerely,



Cliff Massa III

Enclosure

cc: David Jones, Exempt Organizations Division
Robert C. Harper, Exempt Organizations Division
Jonathan Talisman, Department of the Treasury
Steven Arkin, Department of the Treasury

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September 28, 1999

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Director
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1111 Constitution Ave., NW, 6413 IR
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Mr. Steven T. Miller
Acting Assistant Commissioner
Employee Plans and Exempt Organizations Division
Internal Revenue Service
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Gentlemen:

On behalf of the Coalition for Fair Competition in Rural Markets (the "Coalition"), I am writing to ask that the Internal Revenue Service develop and publish guidelines for revoking an exemption under section 501(c)(12) of the Internal Revenue Code when a rural electric cooperative (an "REC") enters the propane retailing business. The retail sale of propane is an activity that clearly is not linked to the process of rural electrification or to continuing sales of electricity and is not in any way "like" the activities listed in sec. 501(c)(12) for which an exemption can be granted.

The Coalition is comprised primarily of taxable propane retailing companies and of national and state propane trade associations. A list of Coalition members as of this date is included at tab 1 of the Appendix to the enclosed Memorandum to the Internal Revenue Service (the "Memorandum").

The Coalition makes this unusual request in response to the expansion by RECs into competition with taxable propane companies which do not enjoy the economic benefits of substantial business assets that have been built up over several decades in the tax exempt environment of another line of business. The Coalition urges prompt attention to this request due to the accelerating pace at which the RECs are moving into the propane industry. Our request is made all-the-more urgent by a recent public announcement from REC representatives which reports that the IRS has decided to rule favorably on a request by an REC to treat propane distribution as a "like" activity under sec. 501(c)(12).

The accompanying Memorandum is divided into six sections. Section I provides an introduction and an overview of the tax exemption issues raised. Section II briefly describes the history of RECs and their movement into the propane industry. Section III sets forth the appropriate analytical framework within which tax exemptions in general -- and the RECs' tax exemption in particular -- should be viewed.

Sections IV and V present in detail the arguments that are briefly summarized as follows:

- There is no basis for providing an exemption to a propane cooperative under the "like organizations" provision of sec. 501(c)(12). Similarly, an REC should not be allowed to do in increments what no cooperative should be allowed to do as a sole or primary exempt business.
- The "insubstantiality" test is not appropriate, the 85 percent income test is not a safe haven and the UBIT provisions are not useful in the context of an activity for which an exemption should be denied. Even if applied. they are not effective in imposing on an REC the same economic factors faced by taxable companies in the propane retailing business.

Section VI of the Memorandum summarizes the arguments and our conclusion that clear and specific guidelines are needed for revoking the exemption of an REC which enters the propane business. whether that entry is undertaken directly, through a subsidiary, in a joint venture or by any other means.

The Appendix provides additional reference materials related to the propane industry and other information cited in the Memorandum.

Research and initial drafting of the Memorandum were completed prior to the public release on the National Rural Utility Cooperative Finance Corporation's web site (www.nrucfc.org) of a September 9. 1999 memorandum by the Washington Utility Group reporting ". . . that the IRS had decided to rule favorably on [treating] propane service as a 'like activity' . . ." for purposes of sec. 501(c)(12). Actual issuance of a private letter ruling is expected when the case load permits. Until the redacted text of the expected PLR is publicly released, we cannot review and comment on the analysis and conclusion presented there.

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Mr. Marcus S. Owens
Mr. Steven T. Miller
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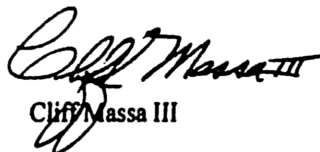
For these reasons, the Memorandum has been revised to refer to the analysis that is reported by the September 9 memo. Following the release of the expected PLR, we will draft and deliver any additional commentary that is necessary to complete our argument in the context of that PLR.

Coalition members and their representatives are willing to provide additional information and to meet with you and other IRS officials to discuss this issue further.

Sincerely,



Cliff Massa III

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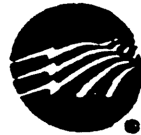

Power Supply Report

IRS: Propane Sales A 'Like Organization' Activity

By Ty Thompson

The Internal Revenue Service, in a Sept. 28 private letter ruling, said that selling or distributing propane gas by truck delivery to cooperative members on a co-op basis is a "like organization" activity under Internal Revenue Code Section 501(c)(12).

To qualify for exemption from federal income taxation under the code mentioned above, a co-op must be a "mutual or cooperative telephone company[y] or like organization."

A tax-exempt electric cooperative requested the ruling that proposed, among other things, providing propane gas to new and existing members. Because it was not economically viable to build a pipeline, the electric co-op proposed delivering the propane gas by truck.

The ruling applies only to the electric co-op that requested the ruling, indicating the current views of the national office of the IRS.

The IRS found that, similar to furnishing light and water, distributing propane gas is a type of public utility service similar to those enumerated in IRC section 501(c)(12). The IRS also found that distributing propane gas does not need to be regulated under state law to be a like organization activity under IRC section 501(c)(12).

As with natural gas, the IRS noted that the public commonly uses propane gas as an energy source. Similarly, gas-burning appliances using either natural or propane gas are virtually identical, and public utility companies also supply propane gas. Because propane gas can be stored as a liquid and transported by truck, rail car or barge, it allows a utility to provide energy services to customers located outside the territory of natural gas pipelines.

The IRS, therefore, concluded that "because propane is an energy source supplied to customers, similar to electricity or natural gas (although it is not supplied by pipeline to the customer end user), we rule that your distribution of propane gas by trucks to members on a cooperative basis is a 'like activity' contemplated under section 501(c)(12) of the Code."

Thomas Strait, with the Washington Utility Group, represented the electric co-op in obtaining this IRS ruling. Strait reported that the IRS issued three other substantially similar rulings at the same time this one came out. □

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MEMORANDUM TO THE INTERNAL REVENUE SERVICE

Re: Revocation of Section 501(c)(12) Tax Exempt Status for A Rural Electric Cooperative Entering the Propane Business

September 28, 1999

Patton Boggs LLP
Washington, DC

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3. An exempt REC should not be permitted to engage in the propane business, subject only to the unrelated business income tax rules inasmuch as they are neither relevant nor effective here. 23

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I. INTRODUCTION AND OVERVIEW

This Memorandum is submitted on behalf of the Coalition for Fair Competition in Rural Markets (the "Coalition"). The Coalition asks that the Internal Revenue Service ("IRS") develop and publish guidelines for revoking an exemption under section 501(c)(12) of the Internal Revenue Code (the "Code")[1] when a rural electric cooperative (an "REC") enters the propane retailing business. The retail sale of propane is an activity that clearly is not linked to the process of rural electrification or to continuing sales of electricity and is not in any way "like" the activities listed in sec. 501(c)(12) for which an exemption can be granted.

The Coalition is comprised primarily of taxable propane retailing companies and of national and state propane trade associations. A list of Coalition members as of this date is included at tab 1 of the attached Appendix. The individual member companies and those represented by the associations are estimated to account for approximately 85 percent of retail propane sales.

The Coalition makes this unusual request in response to the expansion by RECs into competition with taxable propane retailing companies all around the country. The propane industry routinely sees new entrants, but a new *taxable* propane company cannot undertake its new business with substantial valuable assets that it has built up over decades in a tax exempt environment while maintaining exempt status for its primary line of business; an REC does both. The significant economic value of an REC's federal tax exemption cannot be matched either by new entrants or by existing companies in the propane industry. This exempt status should not be allowed to provide any benefit beyond the electricity-related purpose for which it was granted under the "like organizations" wording of sec. 501(c)(12).

The Coalition urges prompt attention to this request due to the accelerating pace at which the RECs are moving into the propane industry.[2] As recently as February 1996, there appeared to have been only one REC that had actually entered the propane business. As of this date, Coalition members have identified more than 30 RECs which are in the business.[3] As rapid as this growth has been, it appears to be only the beginning. The IRS should undertake the timely development and publication of revocation guidelines to limit the number of taxable companies which will be adversely affected by the RECs' expansion into the propane business.

The Coalition's request is made all-the-more urgent by a September 9, 1999 memorandum from the Washington Utility Group (the "WUG memo") placed on the web site of the National Rural Utility Cooperative Finance Corporation (the "NRUCFC").[4] The WUG memo reports ". . . that the IRS had decided to rule favorably on [the request to treat] propane

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1 All Code references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

2 For a discussion of the propane industry see Appendix at tab 2.

3 Appendix at tab 3.

4 http://www.nrucfc.org.

service as a 'like activity' . . ." for purposes of sec. 501(c)(12). Actual issuance of a PLR will follow as the case load permits.[5] Until the redacted text of the expected PLR is publicly released, we cannot review and comment on the analysis and conclusion presented there. Therefore, this Memorandum will refer to the analysis that is reported by the WUG Memo. Following the release of the expected PLR, we will draft and deliver any additional commentary that is necessary to complete our argument in the context of that PLR.

This Memorandum is divided into six sections. Section I provides an introduction and an overview of the tax exemption issues raised. Section II briefly describes the history of RECs and their movement into the propane industry. Section III sets forth the appropriate analytical framework within which tax exemptions in general -- and the RECs' tax exemption in particular -- should be viewed. Sections IV and V present in detail the arguments that are briefly summarized as follows:

- There is no basis for providing an exemption to a propane cooperative under the "like organizations" provision of sec. 501(c)(12). Similarly, an REC should not be allowed to do in increments what no cooperative should be allowed to do as a sole or primary exempt business.

- The "insubstantiality" test is not appropriate, the 85 percent income test is not a safe haven and the UBIT provisions are not useful in the context of an activity for which an exemption should be denied. Even if applied, they are not effective in imposing on an REC the same economic factors faced by taxable companies in the propane retailing business.

Section VI summarizes the arguments and our conclusion that clear and specific guidelines are needed for revoking the exemption of an REC which enters the propane business, whether that entry is undertaken directly, through a subsidiary, in a joint venture or by any other means.

The Appendix provides additional reference materials related to the propane industry and other information cited in sections of this Memorandum.

[5] Washington Utility Group Memorandum to Interested Electric Cooperatives, September 9, 1999, as published on the NRUCFC web site; the text is in the Appendix at tab 4.

II. THE HISTORY AND EVOLUTION OF RECS

Rural electric cooperatives came into existence at a time when the vast majority of rural America was without electricity.[6] The first electric cooperative in the United States was formed in 1914, and by 1935 over 30 such cooperatives were in existence.[7] The IRS apparently granted the first exemption to an REC in 1923, but it was not until the Rural Electrification Act in 1936 that the numbers began to increase significantly as RECs took hold and gained access to the start-up capital needed to build electric distribution facilities.[8] Today, the National Rural Electric Cooperative Association ("NRECA") reports that there are 875 distribution RECs and 60 generation and transmission RECs.[9]

Over the past 75 years, the RECs' mission to electrify the rural areas of the United States has been completed.[10] With a successful record of accomplishment behind them, RECs began expanding their operations substantially. In recent years, RECs across the United States have expanded into a broad range of business activities that, in many cases, have no relationship to their original purpose of providing electric service in rural communities. These new operations include home security, landscaping, cable and satellite television, Internet service, information and risk management services, and propane retailing.[11]

The trend of RECs moving into non-utility services was documented more than 15 years ago by the General Accounting Office (GAO) in 1983[12] and again 10 years ago by the Small Business Administration in 1989.[13] Both agencies addressed ways in which diversification brings RECs into direct -- but subsidized -- competition with taxable businesses which provide

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6 *Legislation Needed to Improve Administration of Tax Exemption Provisions for Electric Cooperatives*, GAO/GGD-83-7 (1983) (the "GAO Report").

7 *Id.* at 3.

8 *Id.* at 3.

9 NRECA web page (http://nreca.org/coops/elecooop3.html), September 24, 1999.

10 *See e.g.*, GAO Report, at 9-33.

11 *See, e.g.*, "This is Not Your Father's Oldsmobile: Electric Cooperatives Venture Into the Future," *Electricity Journal*, (November 1997) and "Touchstone Launches Co-op Media Blitz," *The Electricity Daily*, April 6, 1998, quoting National Rural Electric Cooperative Association (NRECA) Vice President Martin Lowry about the "considerable activity" that RECs are engaged in as the expand into services such as natural gas, telecommunications, security, and propane; "Clearwater Power Electric Cooperative to Operate Propane Service Subsidiary," *Lewiston Morning Tribune*, Nov. 16, 1997. *See also* NRECA's web site at http://www.nreca.org which has described how some RECs have established subsidiaries "to engage in economic development activities (non-utility services)," July 20, 1998.

12 GAO Report, *supra* note 6.

13 SVL Associates, "Competition Between Small Business and Rural Electric and Telephone Cooperatives in Non-Utility Business," (Final Report to the Small Business Administration, 1989).

such services.[14] Both reports recommended that, as a result of changes in the RECs' operations and activities, a more careful application of and substantial restructuring of the RECs' tax exemption is in order.

The Coalition takes no position regarding the continuing need for an exemption based on rural electrification or, in the current context, on continuing sales of electricity to customers who are not in rural areas. Our argument is that, as RECs have expanded into other businesses, the scope of RECs' activities has been pushed far beyond any reasonable application of the statutory exemption language of sec. 501(c)(12). The RECs' motivations for such expansion pose important public policy issues that need to be debated, but those issues are not relevant here. The Coalition's request for development and publication of guidelines for revoking an REC's exemption is based solely on the need to limit a federal income tax exemption to its clearly intended purpose. This request is made with a growing sense of urgency because of the pace at which RECs are moving into businesses that are in no way linked to providing electricity, much less to their original rural electrification function. The urgency is further increased by the report in the WUG memo which indicates that the IRS is agreeing to rule that propane sales are a "like activity" for sec. 501(c)(12) purposes -- a ruling for which there is no sound basis.

We cannot state with certainty which REC was the first to enter the propane business and when it did so. Available information suggests that the first was Coosa Valley Electric Cooperative in February 1996.[15] Since that date, at least 30 more RECs have entered the propane industry through August 1999. A list of the RECs currently known to be in the propane industry appears in the Appendix at tab 3. The National Rural Utility Cooperative Finance Corporation has reported that about 300 more ". . . have indicated a strong interest in entering the propane business."[16]

This Memorandum presents only the Coalition's case with respect to RECs moving into the propane business. Coalition members believe that RECs' entry into other businesses listed above emphasizes the need for published IRS guidance in this area; however, we do not speak for companies in other business sectors.

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[14] The Coalition commissioned National Economic Research Associates to collect available information and then to prepare an analysis of the competitive impact of RECs moving into the propane business. Although undertaken for other purposes, the study (the "NERA Report") produced information that confirms the Coalition members' view that the RECs' federal income tax exemption (along with other governmental benefits) is being used to support their entry into the propane business. The NERA Report is contained in the Appendix at tab 5.

[15] *Id.* at "Alabama."

[16] *Short Takes – Propane Push*, http://www.nrucfc.org/solutions/Month/Aug/Aug.html.

III. CODE PROVISIONS WHICH REDUCE FEDERAL REVENUES BY EXEMPTING ENTIRE SECTORS OF THE ECONOMY ARE TO BE INTERPRETED NARROWLY.

As the federal government's general revenue tax, the income tax must apply broadly to produce the revenues which pay the government's bills. Given its substantial claim on private sector resources -- more than $1 trillion annually -- the income tax naturally is susceptible to efforts to enact provisions which reduce or eliminate tax liability. These provisions are numerous, and their aggregate effect is to limit substantially the income tax burden that would otherwise be borne by specific sectors of the economy. There may be continuing disagreements about the desirability of such provisions, and these disagreements are important topics for policy makers to debate. However, these are not topics for consideration here.

Instead, the point of departure for our argument is the essential purpose of the income tax -- *i.e.*, the raising of the government's general revenues. Although there are innumerable provisions that alter the application of tax rates to computed income, the income tax is more than a complex set of carrot-and-stick features which set out to encourage the private sector to take certain actions. Its purpose is to raise enormous amounts of general revenues. Exemptions, exclusions, deductions and credits are *exceptions to that purpose; they do not replace that purpose*. This is the simple but essential factor which requires that such provisions be applied narrowly.[17]

The importance of this principle of statutory construction is perhaps most clear when considering outright exemptions from the income tax such as those provided under sec. 501(a) for entities listed in sec. 501(c). Congress has provided that the listed organizations described in these provisions are not subject to the income tax. These are legitimate statements of public policy, but they are also matters of legislative grace and are intended to benefit specific entities for identified activities or purposes.[18] They are *not* hunting licenses for creative thinkers. They are *not* the first act of a script to which clever tax planners can write the second act. They are *not*

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[17] The general acceptance of this principle of statutory construction is confirmed in many court opinions. *See Commissioner of Internal Revenue v. Schleier*, 515 U.S. 323, 328 (1995) (stating that a narrow construction of exclusions from income is the default rule of statutory interpretation); *Commissioner of Internal Revenue v. Jacobson*, 336 U.S. 28, 49 (1949) (asserting that exemptions are "specifically stated and should be viewed with constraint" to further the policy of taxing income comprehensively); *Helvering v. Northwest Steel Rolling Mills*, 311 U.S. 46, 49 (1940) (emphasizing that "[i]t has been said many times that provisions granting special tax exemptions are to be strictly construed"); and *Associated Industries of Cleveland v. Commissioner of Internal Revenue*, 7 T.C. 1449 (1946) (declaring that "a statute creating [tax] exemptions must be strictly construed" and that an organization claiming exempt status must meet "the tests laid down by the statute").

[18] See *Puritan Lawn Memorial Park Cemetery v. United States*, 15 Cl. Ct. 234, 240 (1988) (dealing with a claim of exemption under 501(c) and stating that "exemptions are matters of legislative grace and are strictly and narrowly construed in favor of the government").

a justification for an exempt entity to expand its activities simply because the text does not explicitly forbid such expansion. And they are *not* provisions which, when viewed from the perspective of an "insubstantiality" test or the 85 percent income test or UBIT provisions, actually justify a broader exemption than the statutory text allows.

Because they are to be interpreted narrowly, exemptions have natural limitations around them. The statutory language does not need to state explicitly that an exemption is granted "for this purpose and only for this purpose;" that condition is understood. But if these natural limitations are not recognized and enforced, then an exemption for a designated purpose will simply be a small reduction in revenues justifying an ever larger reduction created when innumerable other activities are pulled within the protection of the entity's basic exemption.

This can become a chain-building process in which a tangential activity is just barely linked to the exempt function, then another activity is linked to the first added activity without regard to the absence of any linkage to the exempt function in the statutory language. As the chain lengthens, each new link may bear some relationship to the prior one, but the exempt activity is nowhere in sight.

The result will be the loss of substantial amounts of revenue as such entities engage in more and more activities that were not identified when the exemption provisions were enacted. Revenues will be further diminished as these exempt entities engage in competition with fully taxable companies which do not have similar economic benefits and, eventually, must leave the business. The limitations of a sec. 501 exemption, therefore, must be recognized and enforced by a narrow application of the statutory language.

Within this analytical context, sections IV and V discuss the evolution of the RECs' exemption and where that evolution should *not* be allowed to lead.

IV. THE RECS' EXEMPT STATUS UNDER THE "LIKE ORGANIZATIONS" PROVISION

The entities which are eligible for exempt status under sec. 501(a) are identified in various separate lists that describe the activities which fulfill the public policy objective for which exemption is granted. The entities listed in sec. 501(c)(12)(A) are --

> Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

RECs are not specifically listed in sec. 501(c)(12) or its predecessors. Instead, an REC's exempt status is based on the "like organizations" provision that originated in section 231(10) of the Revenue Act of 1916 and provided exempt status to a "Farmers' or other mutual hail, cyclone, or fire insurance company, mutual ditch or irrigation company, mutual or cooperative telephone company, or like organization of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting its expenses."

A. Sec. 501(c)(12)'s "like organizations" provision has been interpreted to permit exemptions for certain other entities not expressly enumerated in the statute if they are engaged in activities *similar to* the activities of the enumerated entities.

The term "like organizations" has been interpreted to allow exemptions for entities engaging in activities that are not specifically listed (mutual ditch, irrigation and telephone entities are listed) but that are very similar to the activities that are listed. Although the legislative history provides little guidance, Coalition members recognize that a reasonable interpretation of "like organizations" is that Congress expected some activities to arise that it did not foresee in 1916 but that would be sufficiently similar to the listed activities to warrant granting the exemption to entities engaging in those activities.

Over many decades, courts and the IRS have addressed what is required to be considered a "like organization" for purposes of sec. 501(c)(12). Court opinions and IRS rulings have confirmed that merely being cooperative, mutual or beneficial in structure is not sufficient; there must be a *substantive* similarity as well as a *structural* similarity to the organizations listed if an entity is to be treated as a "like organization." The IRS, in a letter ruling, has summarized the relevant inquiry as follows: "['like organization' applies] only to those mutual or cooperative organizations which are engaged in activities similar in nature to the benevolent insurance, mutual ditch or irrigation activities specified in section 501(c)(12)."[19] This is an appropriately narrow and common sense application of the statutory exemption language, as described more fully in the court opinions and published revenue ruling cited by the IRS in that letter ruling.[20]

In *New Jersey Automobile Club v. U.S.*, for example, the U.S. Court of Claims held that the 1939 statute (which was substantively identical to current sec. 501(c)(12)) did not provide an exemption to a nonprofit motor club that provided its members with services such as emergency road service, travel services, arrangements for car shipments abroad, bail bond service, and

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19 PLR 8109002 (Oct. 31, 1980) *citing Consumers Credit Rural Electric Cooperative Corporation v. Commissioner*, 319 F.2d 475 (6th Cir. 1963); *New Jersey Automobile Club v. United States*, 149 Ct. Cl. 344, 181 F. Supp. 259 (Ct. Cl. 1960), cert. denied, 366 U.S. 964 (1961); and Rev. Rul. 65-201, 1965-2 C.B. 170.

20 We acknowledge that private letter rulings cited in this Memorandum do not have precedential value. They are cited both as sources of information and as examples of prior IRS commentaries on related issues.

accident insurance policy coverage.[21] The court first restated the longstanding principle that any claim for exemption must be clearly defined by the tax statute. Beyond that, the court found that it is not enough that an organization possess characteristics such as mutuality and cooperation that are common to organizations listed in the statute. To be exempt, an organization must also have a function that is like or similar to the functions of the listed organizations. The court found that the auto club did not possess such a function, and it further noted that "an automobile club is too well known and too important" for the court to presume that Congress would list a number of specific organizations in the statute and then expect an auto club to fall under the general catch-all category of "like organizations."[22]

One year after the *New Jersey Automobile Club* case, the Tax Court, in *Consumers Credit Rural Electric Cooperative Corp. v. Commissioner*, held that a cooperative engaging solely in the business of financing customers' purchases and installations of electrical, water and plumbing systems from its members (which were rural electrical cooperatives) was not a "like organization."[23] The cooperative argued that the applicable state statute and federal statute (creating the Rural Electrification Administration) under which it operated revealed a purpose not only to bring electricity to homes, but "to encourage use of the electricity by sponsoring and promoting the wiring of houses, the sale of electrical appliances, and the financing of these activities."[24] The cooperative further claimed that "since all of its member rural electric cooperatives are exempt from taxation under section 501(c)(12)," it follows that, by performing one of the specific functions required by state law, it, too, should be exempt.[25]

The court noted that the cooperative's financing and installation activities may fulfill state and even federal statutes governing rural electrification and then stated that, ". . . this certainly does not mean that it satisfies the test laid down by section 501(c)(12), which is the statute controlling here. We fail to see how petitioner's purpose and operation, which are simply to finance consumer purchases, can qualify it as a 'like organization.'"[26] The court expressly recognized that cooperatives granted exemption under sec. 501(c)(12) "were primarily engaged in the distribution of electric energy to rural areas, and it is this activity which brought them within the meaning of '. . . *like organizations.*'" In this case, the petitioning cooperative's ". . .

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[21] 181 F. Supp. at 262.

[22] *Id.* at 261.

[23] *Consumers Credit Rural Electric Cooperative Corp. v. Comm'r*, 37 T.C. 136 (1961), *aff'd by* 319 F.2d 475 (6th Cir. 1963) ("*Consumers Credit*").

[24] 37 T.C. at 142.

[25] *Id.*

[26] *Id.* at 143.

operation closely resembles that of a commercial bank or finance company . . . . " The court then held that the cooperative was not exempt under sec. 501(c)(12).[27]

Two years after the Sixth Circuit affirmed the Tax Court's decision in *Consumers Credit*, the IRS, in a 1965 revenue ruling, held that a nonprofit cooperative which was formed to sell electrical materials, equipment and supplies and which provided equipment manufacturing, repairing, testing and other electrical services to its members was not a "like organization" under sec. 501(c)(12) and, therefore, was not exempt.[28] In reaching this conclusion, the IRS, relying on the *New Jersey Automobile Club* and *Consumers Credit* cases, noted that ". . . it is clear that the term 'like organizations' as used in the statute is limited by the types of organizations specified in the statute, and is applicable only to those mutual or cooperative organizations which are engaged in activities similar in nature to the benevolent insurance *or public utility type of service or business* customarily conducted by the specified organizations."[29] Therefore, the IRS concluded that, while the activities "may be performed individually by the member cooperatives as an incident to their customary and primary function, *such services and activities are not similar in nature to those customarily performed by a mutual ditch or irrigation company, or a mutual or cooperative telephone company*, and, consequently, the organization does not qualify for exemption from Federal income tax as a 'like organization' under section 501(c)(12) of the Code."[30]

B. The IRS and courts have interpreted and expanded the "like organizations" provision to apply to entities engaged in public utility-type activities.

The first tax exemption expressly granted to an REC appears to have been in a 1923 Bureau of Internal Revenue administrative ruling. This appears to have been among the earliest rulings to apply the "like organizations" provision to a specific set of facts. The provision of the 1921 Act under which the exemption was granted was substantively identical to the original 1916 provision. In that ruling, the cooperative had been formed to take over a bankrupt light and power company to serve only the cooperative's members.[31] Without elaboration, the ruling simply stated that ". . . it appears that the purposes and activities of the M Light and Water Company are such as to bring it within the provisions of section 231(10) of the Revenue Act of 1921. . . ." An affirmative commentary would have been preferable to "it appears that" the entity comes within the statutory language, but no analysis was provided.

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[27] *Id.*

[28] Rev. Rul. 65-201, 1965-1 C.B. 170.

[29] *Id.* at 172 (emphasis added).

[30] *Id.* (emphasis added).

[31] I.T. 1671, II-1 CB 158 (1923).

The absence of further commentary in the 1923 ruling is somewhat troubling because there is no analytical basis for future application of the "like organizations" language. This may have encouraged the chain-building effect of an expanding exemption discussed on page 6 above. Nonetheless, the Coalition acknowledges that a cooperative engaged in rural electrification services is an entity that is reasonably covered by the "like organizations" phrase because this link is attached to the basic statutory language itself.

Since the original 1923 ruling, the IRS has ruled that only public utility-type services are business activities that can serve as the basis for qualification as a "like organization" under sec. 501(c)(12). To determine whether the service provided is "like" a public utility, the IRS has considered the nature of the product or service being provided, regulatory/monopoly factors affecting the business and the type of delivery system used. Although not determinative, one of the principal criteria used in determining if the service is a public utility-type service is whether it is regulated by the state public utility commission (PUC).

To date, the IRS has ruled that natural gas, light, water and sewer services are public utility-type services that would permit a cooperative (including an REC) to qualify as a "like organization while providing such services."[32] The IRS has reasoned that these services are, or are similar to, public utility services because they are provided by pipe or sewer line to a user's home and are regulated by state authorities.

With the public utility-type service as the baseline, the IRS has addressed whether an REC providing electricity services can maintain its exempt status while also providing a non-public utility-type service. In a 1980 letter ruling,[33] the IRS permitted an REC to engage in the sale and servicing of electrical appliances even though such services clearly were non-public utility-type activities. The letter ruling noted that if selling and servicing of electrical appliances were the REC's *only* activities, the entity would not be granted ". . . treatment as a 'like' organization under section 501(c)(12),"[34] a ruling similar in substance to that in the 1965 revenue ruling discussed above. However, the IRS noted that the REC's exemption would not be at risk unless these activities are more than "insubstantial." Then, despite finding that the "relatively large ratio of appliance sales to total income" indicated that such sales were more than

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32 *See, e.g.*, Rev. Rul. 67-265, 1967-2 C.B. 205 in which the Service found that an association that furnishes light and water to its members on a cooperative basis may be exempt under section 501(c)(12) as a "like organization." According to this ruling, light and water services are types of public utility services like those provided by telephone, irrigation and ditch companies. *See also* PLR 9715045 (April 16, 1997) which found that an electric cooperative that furnishes water and sewer services, as well as natural gas, to its members may be tax-exempt under sec. 501(c)(12).

33 PLR 8109002 (October 31, 1980).

34 *Id.*

insubstantial in nature, the IRS moved further to consider whether this service was both "incident to, and in furtherance of," the public utility-type service of furnishing electricity.[35]

The 1980 letter ruling stated that the material issue was whether the sale and servicing of appliances was the usual means or method employed by utilities in the extension of their service and in accomplishing their main business purposes. The IRS noted that "[a]n initial factor indicating that the sale and servicing of appliances by the cooperative is incidental to, and in furtherance of, its primary activity of furnishing electricity to its members is the state law authority for the proposition that sale and servicing of appliances is an integral part of the electric utility business."[36] The IRS appropriately recognized, as it has done in past rulings, that "[s]tate law does not . . . control the question of what is a 'like' organization under section 501(c)(12)."[37] The ruling then continued by stating, "However, an inquiry into the types of activities normally carried on by organizations to accomplish the public utility service of furnishing electricity is relevant to the question of determining whether a particular cooperative electric corporation qualifies as a 'like' organization under section 501(c)(12)."[38]

Quoting *State v. San Antonio Public Service Co.*,[39] the IRS concluded that the sale of electric appliances by the REC was incident to and in furtherance of the provision of electricity insofar as the ". . . the sale of such appliances is the usual method or means employed by utilities in the accomplishment of their main business of manufacturing and selling . . . electricity to the public . . . ."[40]

The letter ruling further noted that the sale and servicing of appliances could, in some circumstances, ". . . amount to a separate business of the utility, which would preclude status as a 'like' organization."[41] In particular, the IRS pointed out that the operation of an appliance business could take on ". . . independent significance from the sale of electricity resulting in the appliance business no longer being incidental to the sale of electricity and therefore the utility could not qualify as a 'like' organization under section 501(c)(12)."[42]

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35 *Id.*

36 *Id.*

37 *Id.*; *See also Consumers Credit, supra* note 23.

38 *Id.*

39 69 S.W.2d 38, 40 (Tex. Com. App. 1934).

40 PLR 8109002 (October 31, 1980).

41 *Id.*

42 *Id.*

C. An entity exempt under the "like organizations" provision cannot engage in unrelated or for-profit activities indirectly through subsidiaries that, if engaged in directly by the entity, would not alone form the basis for an exemption.

RECs are organized under the laws of the various states. While most RECs are established as corporations, they are not necessarily organized under general corporate statutes which contemplate operating on a for-profit basis. For purposes of sec. 501(c)(12), the entity's legal form is not controlling. In the *Consumers Credit* case,[43] a cooperative expressly formed under Texas's electric cooperative statute and operating to fulfill a portion of the purpose of the federal Rural Electrification Act was held not to be exempt as a "like organization" under sec. 501(c)(12). The Tax Court and the Sixth Circuit Court of Appeals held that compliance with relevant state and/or federal laws was not sufficient to establish the claimed exemption because the requirements of sec. 501(c)(12) were not met.[44] Thus, an organization will qualify for exempt status under sec. 501(c)(12) only if it is operated on a cooperative basis *and* is also a "like organization" on substantive grounds.

While a cooperative structure is not sufficient grounds for an exemption, using a subsidiary to undertake non-exempt functions is not sufficient to protect an otherwise exempt cooperative when it undertakes non-exempt activities. For example, in Rev. Rul. 69-575,[45] two farm cooperatives that were exempt under sec. 521 operated subsidiary retail stores providing supplies and equipment to non-members. The subsidiaries were established specifically to provide some separation between the cooperatives' member activities and their non-member activities. The IRS set forth the test for determining whether it is permissible to establish and control a subsidiary while maintaining exempt status -- namely, whether the subsidiary's activities are activities the cooperative itself "might engage in as an integral part of its operations without affecting its exempt status."[46] Citing legislative history, the IRS stated that an exempt cooperative cannot use a subsidiary for conducting operations "on an ordinary profit-making basis."[47]

Based on this test, the IRS revoked the exempt status of both cooperatives. One of the cooperatives lost its tax exemption because the cooperative was operating a for-profit subsidiary. By failing the cooperative structure requirement, the subsidiary caused the cooperative parent itself to be operating without a cooperative structure. The second cooperative lost its exemption, but for a very different reason. The second cooperative was not operating a for-profit subsidiary,

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[43] *Supra* note 23.

[44] *Consumers Credit*, at 143; 319 F.2d at 477-478.

[45] 1969-2 C.B. 134.

[46] *Id.*

[47] *Id.*

but the non-member activities of its subsidiary caused the cooperative to violate the 15 percent test of sec. 521(b)(4) when the activities of the two entities were combined. In this context, the IRS made it clear that it intended to combine the non-member activities of cooperatives and their subsidiaries when applying the 15 percent test.

Rev. Rul. 69-575 sets out a single test that seeks to determine whether the subsidiary is engaging in activities in which the cooperative itself could not engage without losing its exemption. The threshold inquiry appropriately tests whether the subsidiary is formed as a for-profit enterprise -- a *structural* defect that has no subjective element. Assuming the subsidiary is properly formed as a nonprofit cooperative enterprise, the test set out by the IRS next looks to the intended scope of the subsidiary's *substantive* activities in order to determine that the cooperative itself could engage in them without losing its exemption. To the extent the subsidiary engages in activities in which the cooperative itself could engage, the test finally looks to measure the aggregate of the subsidiary's and cooperative's non-member activities for purposes of applying the 15 percent test.

Notwithstanding the test announced and mechanically applied by the IRS in Rev. Rul. 69-575, a recent technical advice memorandum (TAM) appears to confuse the relevant inquiries to be made when testing whether a cooperative's creation and operation of a subsidiary threatens its exemption.[48] The TAM involved a telephone cooperative that formed a for-profit subsidiary to offer cable television services. Citing Rev. Rul. 69-575, the IRS first stated the general rule that the cooperative could not form a subsidiary to engage in any activity in which the cooperative itself could not engage as an integral part of its operations without affecting its exempt status. Correctly noting that the cooperative was formed to provide telephone service, the IRS held that the subsidiary's activities could not be engaged in directly by the cooperative inasmuch as the subsidiary was (i) formed to provide cable services, and (ii) operated on a for-profit basis.[49] It would appear that this should have ended the inquiry and that the telephone cooperative should have had its exemption revoked because it failed the threshold test set out in Rev. Rul. 69-575 -- operating a for-profit subsidiary -- in addition to failing Rev. Rul. 69-575's second line of inquiry -- allowing the subsidiary to engage in activities unrelated to the cooperative's exempt activities.

Notwithstanding that the telephone cooperative should have lost its exemption on two separate grounds based on the test announced in Rev. Rul. 69-575, the IRS did not reach this conclusion. The telephone cooperative's total non-member activities were aggregated with its for-profit subsidiary's activities and tested under the 85 percent test in sec. 501(c)(12). The IRS noted that a cooperative cannot shelter non-member income from the 85 percent test simply by creating a controlled subsidiary to earn and collect that income. Inclusion of the subsidiary's

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[48] TAM 199908038 (March 1, 1999), revising TAM 9722006 (December 2, 1997).

[49] *Id.*

gross income in the cooperative's non-member income caused the cooperative to fail the 85 percent test.

It is not entirely clear why the IRS proceeded to the 85 percent test when a ruling consistent with the IRS's announced test in Rev. Rul. 69-575 clearly would have concluded that a for-profit subsidiary engaged in a different business altogether will result in a loss of the cooperative's exemption. It seems unlikely that the IRS meant to suggest in the TAM that the 85 percent test was the principal or only inquiry that needs to be made. If this were the case, then it would suggest that a cooperative could form a subsidiary to engage in *any* activity (whether for-profit, for a second exempt activity, for an activity linked to its own exempt activity or for any purpose) so long as the 85 percent test is not violated. This not only defies common sense, but also inexplicably ignores the test expressly set out in Rev. Rul. 69-575.

D. The limited legislative history accompanying the enactment of sec. 501(c)(12) and the subsequent amendments thereto establish clear limits on the scope of the exemption.

Since the first REC exemption was granted in the 1923 administrative ruling, there have been two amendments that altered the substantive requirements affecting RECs in the statutory provision that is now sec. 501(c)(12). Both strongly reinforce the principle of narrow statutory construction.

The first amendment was in the Revenue Act of 1924. Congress amended the law to require that only 85 percent -- rather than 100 percent -- of an organization's income had to be collected from members to obtain and maintain exempt status.[50] The accompanying legislative history is sparse. The House floor debate on this amendment[51] indicates that Congress made the change to help smaller companies by allowing them to earn some interest on idle funds without running afoul of the original statutory requirement that the entity's income " . . . consists solely

50 The Revenue Act of 1924, section 231(10).

51 *See* Floor Debate, Cong. Rec. Vol. 65 at 2866-2901 (February 20, 1924). Congressman Purnell reasoned that the change was needed because: "these companies were not able to set aside any surplus; they were not able to expand; they were not able to buy any buildings; thrift was not only discouraged but penalized; they were not able to accept interest on daily balances in banks." *Id.* at 2900. Congressman Dickinson added that "every once in a while there are some of these [mutual insurance] companies which have a few thousand dollars which they want to put on time deposit, and they will put it in a bank for a short time on time deposit. If you do not provide that the principal sources of income shall consist of amounts collected from members, you bar them from having those little incidental revenues which they make out of the small matters. *Id.* at 2866-67. As Congressman McLaughlin explained, "[w]e wish to exempt from taxation the smaller cooperative companies and we wish to frame the law in such a way as to take away from the larger companies the privilege we would extend to the smaller ones." *Id.* at 2901. The IRS cited this same floor debate in PLR 9722006 (December 2, 1997), which suggests this is the only relevant legislative history on this issue.

of assessments, dues, and fees collected from members for the sole purpose of meeting its expenses." The Senate floor debate further illustrates that the 15 percent non-member income limitation had a narrow purpose. It indicates that the 15 percent figure was arrived at in lieu of the more indefinite term "substantially all."[52] This does not suggest that the 15 percent non-member income limitation was intended to become a safe harbor to shelter income generated from non-exempt activities. If anything, it emphasizes that only passive investment uses of excess funds were contemplated. The IRS affirmed this view in the revised TAM regarding a telephone cooperative:

> Although the Congressional debate [on the 85/15 rule] centered on mutual insurance companies, the new 85 percent test applied to mutual and cooperative telephone companies. Congress intended that telephone companies also be allowed a minimal amount of non member income necessary to expand, buy buildings or earn interest on bank accounts.

TAM 199908038, *supra* note 48.

Although 15 percent seems much more than a "minimal amount," there is nothing to suggest a Congressional intention to allow exempt entities to engage in other businesses within that 15 percent protection; at most, the 15 percent test should apply both to passive income being accumulated for future exempt function uses and to income from non-members when the entity is engaging in its exempt activity (such as an REC selling electricity to non-members).

The second amendment was in the Miscellaneous Revenue Act of 1980 which added paragraph (12)(C) to allow a mutual or cooperative electric company to apply the 85 percent test without taking into account any income from pole rentals or from prepayment of loans under the Rural Electrification Act of 1936. Like the 1924 amendment, the 1980 pole rental amendment did not sanction a move by the cooperative into a new business activity. Instead, it allowed the entity to ignore income from an activity that was linked to its exempt activity but that did not actually produce income from members. A narrow interpretation of the exemption had been properly applied, and Congress decided to amend the statute.

Since the 1980 Act, sec. 501(c)(12) has not been amended.

[52] *See* Floor Debate, Cong. Rec. at 7128 (April 25, 1924). Senator Smoot stated "Hardly anyone could arrive at what amount would be 'substantially all,' and we decided to include 85 per cent. In other words, it leaves all of these companies to do business, other than mutual companies, to the extent of 15 per cent. That comes about by having a building erected, perhaps, and they rent the building, and the rents they receive from it ordinarily would be taxable; but as long as they are mutual companies we decided to allow them the 15 per cent."

V. RECS SHOULD NOT BE PERMITTED TO EXPAND THEIR ACTIVITIES INCREMENTALLY TO INCLUDE NON-EXEMPT ACTIVITIES THAT ALONE SHOULD NOT FORM THE BASIS FOR AN EXEMPTION.

The expansion of the original exemption beyond the statutory list of exempt activities to include rural electrification cooperatives seems to have been a reasonable application of the "like organizations" language when the 1923 ruling was issued. Rural electrification was at least a cousin to the rural-oriented activities of the mutual or cooperative ditch, irrigation and telephone entities explicitly listed in section 501(c)(12)'s predecessors. Furthermore, the granting of the first exemption was essentially contemporaneous with the relatively new income tax and its exemptions, as well as with the undertaking of their rural electrification purpose by RECs.

Seventy-five years have now passed since that first exemption was granted, and the RECs' policy objective has been achieved.[53] It appears that RECs are no longer content with continuing their exempt electricity-related businesses under their exempt status, whether their customers currently are in rural areas or growing towns or suburbs of larger cities. Now the RECs appear either to be (i) interpreting the statute to allow them to maintain their exempt status while entering into other lines of business that are in no way linked to rural electrification or even to selling electricity (much less to the activities actually listed in the statute) or (ii) ignoring the statute altogether. Perhaps there are other explanations for the RECs' diversification activities (of which the move into propane is only one), but the problems are the same in any situation:

- There is no reasonable interpretation of the statutory language (whether or not one takes into account the limited legislative history) which supports a continuing tax exemption for an REC which moves into propane -- a business activity for which a cooperative should not obtain an exemption directly.
- There is no public policy justification for allowing an REC to utilize the economic benefits of substantial assets built up over decades of exempt status to compete with taxable companies in the propane business.

There is nothing in either the statutory language or available legislative history which supports the proposition that the sec. 501(c)(12) exemption is to be applied broadly rather than narrowly. If Congress had intended the "like organizations" language to sweep in a wide range of activities, it could have said so on many occasions such as when the income tax was reenacted periodically or when the 1954 Code was enacted or in the many subsequent tax bills that have become law. But Congress has not taken this or any similar action. In fact, the two amendments to sec. 501(c)(12) discussed above reinforce the fundamental principle that exemptions are subject to narrow statutory construction. In both situations, Congress did not rewrite the basic

[53] GAO Report, *supra* note 6, at 9-33.

rule of sec. 501(c)(12) to loosen or eliminate the *substantive* element that is required for an entity to be considered a "like organization." Instead, Congress addressed specific activities -- limited exceptions for passive income earned by the entity and for rental income from non-member uses of poles -- that already were linked to the entity's exempt function but otherwise did not meet the statutory requirement as narrowly applied.

In this context, it is clear that the RECs which are entering the propane business have gone beyond any reasonable application of sec. 501(c)(12) and are engaging in a non-exempt activity. Not surprisingly, our research did not find public evidence of any entity which had sought and was granted an exemption under section 501(c)(12) or its predecessors as a "like organization" based on selling propane as its sole business activity or even as its principal or secondary line of business. Nor are we aware of any IRS ruling that addressed the issue of an already exempt REC moving into the propane business.

There is at least one reason that no such request had been pursued formally by any entity -- namely, the prospect that a new exemption would be denied or that an existing exemption would be revoked. The WUG memo confirms that this was at least the informal result of such inquiries in prior years. Although the expected PLR apparently will conclude otherwise, we can find no basis in the law for the change in views by the IRS that is indicated by the WUG memo. The substance of the expected PLR as described by the WUG memo would represent a further enlargement of the scope of the sec. 501(c)(12) exemption which has already been somewhat expansively interpreted beyond a narrow application of the statutory language. This process should be reversed as one result of a complete review by the IRS of the entire topic.

A. The propane business does not qualify as an activity of a "like organization" because propane is not a public utility-type service, is not related to or incident to a public utility-type service and is in no way similar to entities listed in the statute.

To be a "like organization" for purposes of section 501(c)(12), an entity must have both *structural* and *substantive* similarities to the entities specifically listed. Courts and the IRS have stated this clearly. If a cooperative entity that meets the structural requirement requests an exemption for entering the propane business, it should not qualify as a "like organization" because it fails the substantive requirement for two basic reasons.

First, propane retailers are not public utility-type service providers. Unlike the companies which provide electricity, natural gas, water, sewer, telephone and cable TV services through a single wire or pipe to the customer's house or business, propane retailers do not rely on a single link; propane is delivered in the seller's truck to the customer's tank that is rented from the seller. Unlike public utility-type companies which typically have a monopoly on service and particularly on the single wire or pipe to the customer's house or building, propane companies have no such monopoly; if the customer wants to change suppliers, it calls one of its current supplier's competitors and switches service and changes tanks. Unlike public utilities (including

some, but not all RECs), there is no pricing regulation of propane by a public utility commission; prices are determined among multiple competitors in an area.

The IRS, in the 1965 and 1967 revenue rulings discussed above, clearly articulated its interpretation of the "like organizations" language to include public utility-type services. These services are, thereby, eligible to be treated as exempt activities, but that eligibility is based on their close identification with the activities performed by the entities that are actually listed in the statute.

Propane retailing bears no resemblance to these public utility-type-services; therefore, propane is not an independent basis for an exemption as a "like organization." But based on the WUG memo, we understand that the IRS has ruled that propane sales, regardless of the method of delivery, nonetheless qualify as a "like" activity. Inasmuch as we doubt that the IRS intends to abandon its longstanding position that only public utility-type services qualify as "like organizations," we assume that the IRS has held that propane sales *are* public utility-type services. If so, this represents a precedent-shattering holding given that in the past, according to the WUG memo, representatives of the REC industry:

> . . . informally inquired with the IRS as to whether or not the delivery of propane gas would likewise qualify as an activity eligible for exemption under section 501(c)(12)(A). The National Office was not encouraging.
>
> The EO/EP Branch Chief stated that they had rejected such requests previously and that he doubted that the policy would change. During that discussion, however, we pointed out that the utility industry is rapidly changing, that many investor-owned gas utilities now deliver propane gas either by truck or through pipelines, and that natural gas and propane gas are very similar in chemical composition.
>
> While conceding these facts, the EO/EP Branch Chief said his greatest concern was the means of delivery for propane gas. *Because propane gas is typically delivery [sic] to consumers by truck, the Branch Chief remained skeptical that propane delivery would be a qualifying utility activity* under section 501(c)(12) of the Code.

WUG memo, *supra* note 5 and accompanying text, at 2 (emphasis added).

Both historically and currently, propane retailing lacks the indicia of public utility-type services (*e.g.*, delivery through a single pipeline or link, geographical monopoly and state regulation). With the expected PLR, the IRS is opening the door for an unprecedented and, we assume, unintended invitation for creative minds to add more links to the "like organizations" provision. Apparently, based only on the fact that propane and natural gas (methane) have chemical similarities and that propane *could* be delivered by a pipeline if such a system *could* be constructed by the company, the expected PLR will now add a link to the chain -- a link that is

even further removed from the statutory list of exempt activities. This new link appears to be "petroleum-related gas" rather than something that is "like" ditch, irrigation or telephone services. By attaching it to a public utility-type service such as natural gas (no pretense to an electricity link is offered), this link is at least twice removed from the statutory exemption language. If allowed to remain, what will prevent new links to it and other equally inappropriate activities being treated as "like" those in the statute?

To illustrate the problem created by the reported new IRS position, consider how easily a creative mind could argue that the exemption should extend to (1) the operation of gasoline stations, (2) home heating oil sales and delivery, (3) kerosene sales and delivery, (4) sales of jet fuel and (5) retail sales of motor oil products -- each of which is "petroleum-related" like propane. In the context of other public utilities, the logical extension of the new IRS position would include (1) refuse hauling and trash pick-up, (2) retail battery and solar generating equipment sales, (3) cellular/satellite voice and data communications, (4) home delivery and sales of bottled water, (5) satellite television and video sales/rental, (6) septic tank/field services and (7) limousine/taxi services. As these few examples illustrate, contending that propane is a public utility-type service stretches beyond the bounds of reason and widens the revenue hole so that similarly silly but realistic hypotheticals could be found to fall under the "like organization" provision. The exemption chains will continue to lengthen, and the required relationship between new exempt activities and the statutory list will be gone.

Linking propane to natural gas to justify an exemption confirms the second reason that a cooperative entity entering the propane business should not qualify as a "like organization" -- propane retailers are not providing goods and services similar to those provided by mutual telephone or mutual ditch and irrigation companies. The common sense interpretation of the *substantive* element of the "like organizations" test is that the entity must have a function that is similar or related to the functions of the listed entities; in the words of Rev. Rul. 65-201, exemption is denied if the entity's function is not ". . . similar in nature to those customarily performed . . ." by the entities listed in sec. 501(c)(12), which include benevolent life insurance associations, mutual ditch or irrigation companies and mutual or cooperative telephone companies.

The preceding discussion explains why the propane distribution business is not even similar to the activities which have been recognized over decades as "like" the listed activities. A brief consideration of the list -- benevolent life insurance associations, mutual ditch or irrigation companies, and mutual or cooperative telephone companies -- confirms that the propane retailing business has no similarities at all to what the listed entities themselves do, either now or 80+ years ago when the statutory language was first written. There is nothing which would justify the propane retailing business as a separate type of "like organization" on its own. The history of the propane industry discussed in the Appendix at tab 2 describes its development during this century as a multi-faceted industry which has served a wide range of customers with extensive competition all around the country. Propane service was not one

which was routinely unavailable in rural areas or that required particular subsidies or encouragement to undertake. It developed quite thoroughly over several decades through taxable business structures.

One additional point requires attention -- propane retailing is not an activity that can be appended to another exempt function through the "incident to or in furtherance of" analysis. This analysis was used by the IRS when it allowed an REC to engage in electrical appliance sales[54] even though an entity seeking an exemption for appliance sales activity alone could not obtain an exemption.[55] But the "incident to/in furtherance of" analysis at least pointed to and relied upon a direct relationship between electrical appliances and sales of electricity and the possible increase in load factor for an REC whose patrons were using more electrical appliances. Significantly, there is nothing about the sale of propane that creates either a direct or an indirect relationship with an REC's exempt function. In fact, propane is a *competing*, rather than complimentary, energy resource for home, farm and commercial uses of electricity such as cooking and heating. As such, selling propane is a distinctly *separate* business activity that cannot be tied to an REC's exempt function by the analysis in PLR 8109002 where there was at least a tangential relationship between selling electricity and selling appliances.

B. An REC cannot engage in the propane business even as a small part of its business on the basis of the insubstantiality of the activity, the 85 percent member income test or the UBIT provisions.

If selling propane is not an activity that should justify an exemption independently and if it is not an activity that should merit a favorable ruling using the "incident to/in furtherance of" analysis with respect to an REC's exempt function, what basis exists for allowing an REC to enter the propane business while maintaining its exemption?

The Coalition argues that there is no basis at all. Absent such a basis, the only apparent argument for maintaining an exemption is that other features of the law allow non-exempt activities to be removed from the analysis. The balance of this Memorandum addresses three such features -- the "insubstantiality" test, the 85 percent income limitation and the unrelated business taxable income or UBIT provisions. These were not created or enacted to support an REC engaging in activities such as the propane business. They must not be used to obscure the well-established principle of narrow construction of tax exemptions. They do not justify allowing an REC to do in small increments what it should not be allowed to do as a sole or primary exempt business activity.

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54 PLR 8109002, *supra* note 33.

55 Rev. Rul. 65-201, *supra* note 28.

1. An exempt REC should not be permitted to engage in the propane business <u>on the basis that the activity is insubstantial compared to its exempt function.</u>

The "insubstantiality" test appeared in PLR 8109002 as the first step in the analysis applied to an REC that engaged in selling electrical appliances in addition to its electricity sales function. In the absence of established administrative rulings or case law that address the fate of an entity's exemption when it undertakes a business activity that differs from those in the sec. 501(c)(12) list, the ruling first states that the "proper rule to be applied" in such cases is to deny qualification as a "like organization" if the activity "is more than insubstantial in nature."

We do not find a basis on which to apply such a test to exempt entities, given the principle that exemptions are to be applied narrowly. The test is inherently subjective and creates the need to make judgments that should not be considered with respect to an exempt entity. In so doing, such a test can produce truly odd results. For example, when does an unrelated activity such as propane retailing become substantial in nature? Is an REC that sells $1 million of propane annually (typical revenues for a medium-to-small company) engaging in a *substantial* activity? In the abstract, the answer is clearly "yes" because $1 million of receipts is not a hobby or a part-time business; it is a substantial activity for a small business. But if the test is a relative one -- insubstantial when compared to something else -- the test becomes unworkable very quickly. For example, does the answer depend on the REC's overall revenues? If its electricity sales are $100 million, are the $1 million propane sales substantial? What if that $100 million is composed of $86 million from REC members and the other $14 million is from non-member electric customers. Is the $1 million compared to the total $100 million or the $86 million for which the exemption was originally created? If the REC also is engaging in landscaping and home security system sales of $1 million each, is the "insubstantial" test applied in the aggregate ($3 million from other functions) or separately? Is the test to be applied in a way which allows larger RECs to enter such businesses but prevents smaller RECs from doing so because their electricity sales are too low? How often would the test be applied to an REC, and how often could REC managers and members count on knowing their exempt status before filing an annual return?

These are issues that would be raised if the "insubstantiality" test were actually to be applied. But the letter ruling itself does not appear to place much value on this test. Having stated it, the ruling moves on to the "incident to/in furtherance of" analysis which links the appliance sales to the REC's exempt function of providing electrical service without regard to the fact that such sales would not qualify an entity for an exemption. The substance of the "incident to/in furtherance of" analysis probably stretches to the limit the proper statutory construction principle of narrowly applying an exemption, but that is not relevant to the subject of this Memorandum. Even so, that analysis does not apply to the subject of this Memorandum because propane is in no way linked to electricity sales; it is neither incident to nor in furtherance of an REC's purpose. Propane is an energy resource that competes with electricity.

2. **An exempt REC should not be permitted to engage in the propane business to the extent its income from such unrelated activities does not violate the 85 percent member income test.**

There is no basis on which an REC should be able to maintain its exemption while engaging in the propane business, even if it were to classify all such sales in the 15 percent non-member income category allowed by the statute. The limited legislative history of the 85 percent rule supports the simple and straightforward application of that rule as providing some protection for an entity's exemption when the entity is generating passive revenues from investment of idle funds while preparing to purchase assets for use in its exempt function. The amendment creating the 85 percent test resulted from the fact that such revenues were not coming from members for the purpose of covering losses and expenses for that function.

If Congress intended the other 15 percent to be a safe haven to allow RECs to enter non-exempt businesses, surely there would have been a statutory provision stating this purpose. At a minimum, there would be some supporting legislative history. But neither exists. In fact, the context of the amendments to sec. 501(c)(12) confirms that the overall exemption is intended to be narrow. The amendments have been targeted to particular situations, and Congress has not taken any opportunity to state that the 15 percent non-member income amount is intended to cover these other activities.

3. **An exempt REC should not be permitted to engage in the propane business, subject only to the unrelated business income tax rules inasmuch as they are neither relevant nor effective here.**

The unrelated business income tax ("UBIT") provisions require consideration in this Memorandum only because it may be argued that they actually take into account and then penalize activities such as an REC entering the propane business. We do not find any basis for such a conclusion.

Imposed by sec. 511, UBIT applies to an entity that is exempt by reason of section 501(a), which then leads to the organizations described in sec. 501(c). Therefore, for an entity such as an exempt REC, UBIT will apply to the income from its non-exempt unrelated business activities. This might appear to be the mechanism for addressing the Coalition's concerns -- just impose UBIT on the income from an REC's propane business -- but this would actually reverse the proper analysis and use UBIT as the solution when, in fact, the first step is to determine if the entity is even exempt.

The wording of sec. 511(a) is very clear: "[UBIT] shall apply in the case of any organization . . . which is exempt . . . from taxation under this subtitle by reason of section 501(a)." The exempt status is required before UBIT comes into play. UBIT is *not* a safe haven within which an entity can quarantine an activity that otherwise would jeopardize its exemption.

Only after it is clear that the entity is exempt does UBIT apply with respect to ". . . a trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its . . . function constituting the basis of its exemption. . . ."[56]

Exemptions are applied narrowly because they are essentially contrary to the purpose of the income tax. The priority of exempt status over UBIT has been clear since the first UBIT provisions were enacted. UBIT was enacted in 1950 to apply primarily to charitable, trade and labor organizations and then was expanded in the Tax Reform Act of 1969 to apply to the broad range of exempt entities. Conceptually, UBIT reinforces the limitations that are inherent in statutory exemptions. In practice, it should plug the leaks that have sprung in some exempt entity sectors (although its current effectiveness is open to serious question). But UBIT was not intended to be -- and must not become -- a safe haven for activities that are the grounds for revoking an exemption. This was recognized in 1950 when the provisions were first enacted. The Senate Finance Committee report stated that --

> . . . it is not intended that the tax imposed on unrelated business income will have any effect on the tax-exempt status of any organization. An organization which is exempt prior to the enactment of this bill, if continuing the same activities, would still be exempt after this bill becomes law. In a similar manner, any reasons for denying exemption prior to enactment of this bill would continue to justify denial of exemption after the bill's passage.

Senate Report No. 2375, 81st Cong., 2nd Sess. (1950), 1950-2 C.B. 483, 505.

The priority of exemption over UBIT was reaffirmed when UBIT was extended to apply to exempt entities generally:

> The fact that an unrelated business income tax is payable by an organization is not intended to mean that the organization should, or should not, retain its exemption. This is to be determined on the basis of the organization's overall activities without regard to the fact that some of its activities are subject to the unrelated business income tax.

Conf. Report No. 91/782, 91st Cong., 1st Sess. (1969).

For the reasons discussed in detail above, the entry of an REC into the propane business is grounds for revoking its exemption. That is the result that should be imposed on the REC rather than imposition of UBIT on its propane sales.

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[56] Sec. 513(a).

The importance of the revocation of an exemption as both a conceptual and practical result is reinforced by the inability of UBIT to impose an equivalent corporate income tax burden on the propane business of an REC. This problem is attributable to the difficulties of untangling the REC's activities and expenditures which underlie its propane business from those which are undertaken for its legitimate exempt function.

Unless precise actions are taken to capitalize the propane business as a separate activity and to run it at arms length, an REC is not going to compute any meaningful UBIT on its propane business that imposes on it a corporate tax burden comparable to that on the taxable propane company. As discussed more fully in the Appendix at tab 2, the new entrant into a propane market must make a significant investment to obtain (i) a credible list of potential or existing propane customers, (ii) real property for storage, parking, maintenance and office purposes, (iii) bulk storage tanks, (iv) bobtail trucks for delivery, (v) an inventory of tanks to lease for customers' storage at their locations plus a tank delivery truck, (vi) a group of employees to solicit customers and to provide delivery services, (vii) an inventory of parts, fittings and, in some uses, appliances to service the customers and (viii) employee or outside accounting services. The new entrant also must make use of its own intangible trade name or owners' reputation in the community if it is to compete with established companies. Alternatively, it must develop its own intangible value as quickly as possible.

We are not aware of any REC entering the propane business which has, in effect, built up a separate and taxable company for the purpose of entering a market. Instead, RECs are either (i) entering into joint ventures of various kinds with an established company which then uses the REC's own electricity customers, real estate, employees and trade names or (ii) buying an existing company with REC funds and then putting its assets to work expanding that business. In either case, the significant value of the assets built up under the tax exempt status of the REC need not be taken into account in its pricing policies or its financial assessments in ways that make it at all comparable to the realities faced by taxable propane retailers.

Any new *taxable* entrant into a propane market would be quite pleased to have the benefit of computing its income tax based on revenues that do not require it to recover expenditures for intangibles, such as obtaining a customer list or the costs of decades of building a valuable trade name or acquiring real property or recruiting its basic employee roster. It would be pleased to have a parent or substantial owner with access to cheap capital from governmental agencies. It would be pleased to have a very substantial primary business -- perhaps even a regulated business -- where the costs of various assets have been recovered over many, many years through the prices charged for its primary goods and services, particularly if it happened to be a monopoly so that its customers had no choice other than to pay what it charges (whether they were shareholders/"members" or not).

But these are not possibilities for taxable companies in the propane business. Whether a new entrant in a service area is completely new to the propane business or is an existing propane

company seeking to expand into that market or is another recognized local company seeking to get into the propane business, it must face the costs of the federal income tax and, in many cases, will have borne those costs for many years as it builds its business and its asset values.

To place an REC in the same situation under UBIT would require a substantial reconstruction of the REC's activities and expenses for the purpose computing a tax that is comparable to the corporate income tax. Such reconstruction would illustrate clearly that the REC has not undertaken its propane business on the same or similar terms as a taxable new entrant. The costs of numerous assets will not have been taken into account by the propane operation. The retail pricing of propane will not have been based on expenses actually incurred for that activity. If this is the case, the REC will be selling goods/services at less than cost to customers (most of whom may be REC member patrons for electricity purposes), and that would violate the structural requirement of sec. 501(c)(12) that requires operation on the cooperative principle.

The difficulties of applying UBIT to an REC that undertakes non-exempt activities like propane sales are substantial, but they need not come into play. By making clear that the entry of an REC into the propane business will result in the revocation of its exempt status, the IRS can achieve the correct result without the lengthy, difficult and annual process of reconstructing the REC's activities for the purpose of computing UBIT on the propane business.

VI. CONCLUSION

An REC is granted an exemption under sec. 501(c)(12) only if it is both *structurally* and *substantively* similar to the listed entities and, therefore, is considered to be a "like organization." Courts and the IRS have applied this analysis to various sets of facts over many years, always reaffirming the narrow interpretation of this and other exemption provisions. The courts and IRS have also confirmed that sec. 501(c)(12)'s language is the sole authority for exemption; state cooperative statutes, federal non-tax statutes and other non-Code arguments for 501(c)(12) exemption claims have been rejected.

The move by exempt RECs into the propane business began less than five years ago. Apparently there are very attractive financial reasons for RECs to take this action because the pace of their move into the propane business is accelerating. But these financial reasons are irrelevant to the proper application of the Code. No cooperative entity should be granted an exemption if its sole or even its principal business is propane sales because this business bears no *substantive* similarity to the entities listed in sec. 501(c)(12). Propane retailers are neither identical to nor even similar to the public utility-type service providers which have been held to be "like organizations;" their product is not delivered via a single wire/pipe to a customer's house or business; they do not have any form of monopoly on service areas or on the wire/pipe to their customers; their prices are set by market forces, not regulated by a public utility

commission. Propane is not even "incident to or in furtherance of" an REC's exempt function; in fact, propane is a competing energy resource.

As matters of legislative grace, exemption provisions such as sec. 501(c)(12) certainly can be amended by Congress to enlarge their scope. Congress has done this twice with respect to features of the language affecting RECs, but without giving any indication that an REC is entitled to enter other businesses. One such amendment -- the 85 percent text -- was written for passive income purposes but is now being applied to non-member revenues from the REC's exempt electricity and appliances activities; nonetheless, it cannot reasonably be stretched further to form a shield for protecting revenues from other business activities. The ill-conceived "insubstantial" test is unworkable, but at least it has not been applied. The UBIT rules can pick up the taxation of such non-member income (while the REC maintains its exempt status), but the UBIT wording and legislative history make clear that the entity must be exempt without regard to UBIT. In all cases, the use of subsidiaries or other business structures do not isolate other activities from tainting the REC itself. Therefore, there is no statutory basis for shielding non-exempt activities when assessing an REC's claim for exemption.

In summary, our analysis is this: Propane distribution is not an activity for which a direct exemption should be granted to a cooperative. It is not "like" the ditch, irrigation or telephone services listed as exempt activities in the statute. It is not even related to a public utility business, and such businesses are themselves interpretations of what could be called a "like organization" in the context of the statute's list of exempt activities. In fact, propane is a separate and distinct business from -- even a competing business with -- the RECs' exempt electricity function. For this reason, there is no basis for allowing an REC's exemption to continue when it enters the propane business. This conclusion has been stated and the remedy has been described clearly by the IRS in the case of electrical appliance sales (which already stretch the natural limitations on an REC's exempt function) when PLR8109002 noted, "[this activity] could in some circumstances amount to a separate business activity of the utility, which would preclude status as a 'like' organization under section 501(c)(12)."[57]

The substantive effect of the expected PLR would be to add another link to the chain and further increase the distance between the statute and new activity – a link which has nothing in common with the list of exempt activities in sec. 501(c)(12). The principle of narrow statutory construction already has been strained with respect to RECs in the appliance sales ruling. The principle will be discarded unless the IRS steps away from such technical incremental additions to the scope of the exemption. The Coalition urges the IRS to develop and publish guidelines for revoking an REC's exemption when it expands into propane. The combination of REC activities and the expected PLR make it imperative that these guidelines be comprehensive and be published as quickly as possible.

[57] PLR 8109002, *supra* note 33.

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Tab 1

September 28, 1999

Members of
The Coalition for Fair Competition in Rural Markets

Advance Propane
Alabama Propane Gas Association
Al's Gas Company
Amerigas
Anza Gas Service, Inc.
Atlas Gas Products, Inc.
Barry County Farmers Co-op
Bell Hydrogas, Inc.
Blease Propane Service, Inc.
Blossman Propane Gas Inc.
Blue Flame Propane, Inc.
Bowman Gas & Company
Brewster Propane
Brotherton Propane, Inc.
Cass County Butane Co., Inc.
Cental American Petroleum Co.
Central Texas Energy Supplies, Inc.
Collett Propane, Inc.
Columbus Butane Company, Inc.
Cornerstone Propane
Cress Gas Co.
Dassel's Petroleum, Inc.
Daughtridge Gas Co.
Dixie Gas and Oil Corporation
Domex, Inc.
Drake Gas Co.
D. S. Swain Gas Co., Inc.
Eastern Rulane Sales Corp.
Econogas Service, Inc.
Energetics Propane
Evans Oil & Gas, Inc.
Excel Propane Company
Fallbrook Propane Gas Co.
Ferrellgas
Fevig Oil Company, Inc.
Franger Gas Co., Inc.
Frazier Oil & LP Gas Co., Inc.
Gala Gas Co., Inc.
Gas Equipment Supply Company
Gas Incorporated
Georgia Propane Gas Association, Inc.
Grimm's Propane
Hampton Gas Company, Inc.
Hancock Gas Service, Inc.
Hardy Gas Co.
Harper Gas Service Inc.
Heetco
Henry Oil & Gas Co.
Heritage Propane Partners
Highland Propane Co.
Independent Propane Co.
Iowa Propane Gas Association
Irish Welding Supply Corporation
Jack's Butane Service, Inc.

James L. Hanak
J. I. Banker Gas Service, Inc.
KY Propane Gas Association
L & S Gas Corp.
Lamanco, Inc.
Lange LP Gas Co.
Leran Gas Products
Lewistown Propane & Fertilizer, Inc.
Lorensen Propane Gas, Inc.
Lund Oil, Inc.
Lyle Oil Co. Petroleum Products
L. A. Bexten, Inc.
McMahan's Bottle Gas
McPherson Propane, Inc.
Merritt Oil Company
Momence Bottle Gas Co., Inc.
Mor-Gas, Inc.
Mt. Vernon Bottled Gas, Ltd.
National Propane Gas Association
North County Welding Supply, Inc. DBA
North Georgia Propane, Inc.
Northern Neck Gas Company
Ohio Gas & Appliance Company
Ohio Propane Gas Association
Oklahoma Liquefied Gas Co., Inc.
Ottawa LP Gas Co.
Pacific Propane Service, Inc.
Parker Oil Company, Inc.
Pender Gas & Oil Company
Pennington Gas Service
Propane Gas & Appliance Co., Inc.
Ray Murray, Inc.
Redwood Oil Company
Revere Gas & Appliance
Rull Bros. Propane
S & S L-P Gas Company
S & S Oil and Propane Co., Inc.
Salley's Propane, Inc.
Santa Juanita Gas Service, Inc.
Schluckebier Oil & Propane
Sequoia Gas Co.
Service Gas, Inc.
Sheppard Bros. Gas and Appliance
Shumpert Propane
South Caroline Propane Gas Association
Spalding Gas Inc.
Squibb-Taylor, Incorporated
Suburban Gas
Suburban Propane
Tarantin Tank & Equipment Co.
Taylor Gas Inc.
Tenbrook Sales Inc.
Tesei Petroleum, Inc.
Thermagas
Tugalo Gas Company, Inc.
Wagner Gas & Electric Inc.
Western Propane Gas Association
W. K. Appliances, Inc.

Tab 2

A DESCRIPTION OF THE PROPANE INDUSTRY

A. Propane – Sources and Uses

Propane is a non-toxic, colorless and odorless gas. An identifying odor is added to it so that it can be readily detected. It is a byproduct of both natural gas (methane) production and crude oil refining; butane and other hydrocarbons also result from these processes. Once extracted from oil or natural gas, propane is pressurized to produce the liquid form in which is stored and transported.

Propane is transported from refineries to local bulk storage facilities by barge, tanker, rail, pipeline and truck. Some of the larger propane companies provide their own highway transportation or pipeline terminal services. But most propane distributors are local or regional distributors who purchase propane at these bulk storage facilities and transport it by truck to the storage tanks at their distribution centers. From these locations, local propane distributors deliver the product by bobtail truck to customers who have smaller storage tanks at their businesses and residences. Distributors also sell propane in the familiar portable tanks.

Propane burns as a gas when it vaporizes as it is released from the customer's pressurized tank. As such, it is an energy resource that has a number of uses for both residential and business customers. Residential uses include cooking, space heating, water heating, gas fireplaces and barbecuing, as examples. Commercial customers may also cook with it and use it as a primary or stand-by fuel for heating. The principal commercial use is for agriculture where it is used to dry crops, burn weeds and provide space heating for livestock, but other commercial users include restaurants, hotels and greenhouses, to name just three. Some businesses use propane in small cylinders as fuel for vehicles such as forklifts, particularly when such machinery is operated indoors; these "portability" uses are ones for which propane is particularly well suited. Also, it is used primarily by customers and businesses that do not have access to natural gas distribution networks. In general, "[p]ropane competes against electricity, fuel oil, and natural gas on the basis of price, availability, convenience, environmental cleanliness, and portability."[1]

B. The history and current scope of the industry

The propane industry evolved from efforts to solve the problem of liquids gathering in the first natural gas pipe lines during cold weather. The liquid substance was regarded as a nuisance and periodically was emptied from the tanks. When people began to realize that this liquid was gasoline, a process was developed to extract the gasoline from natural gas. The resulting work of Dr. Walter Snelling, consulting chemist for the local laboratories of the Federal Bureau of Mines, was the "gasol" process he named for making liquid gas in 1912. The gas was pressurized in steel "bottles" weighing about 100 pounds and holding about 2,000 cubic feet of gas as liquid propane several hundred pounds of pressure per square inch. These bottles and

1 Fitch Investors Service, L.P., *Retail Propane Distribution Industry* (July 3, 1995) p. 7.

additional equipment at each customer's location allowed propane to be piped into a house for lighting and cooking. Even street light systems used propane.[2]

The LP-gas industry is generally regarded as starting on May 17, 1912, when American Gasol Co. of Pittsburgh began business. By 1939, the industry had grown more than 1000 times in sales volume, despite the fact that the Great Depression was just ending. Federal government surveys found the number of producers was growing, with 356 establishments engaged in producing compressed and liquefied gases in 1937.

Historical financial data indicate that, at the end of the 1930s, about 223.6 million gallons were sold annually. By the end of World War II, sales were approaching 1.3 billion gallons annually. By 1949, sales had more than doubled and production rose to 2.8 billion gallons. Sales doubled again by 1952.[3] Several cycles of rising and failing growth rates occurred during the next three decades, but data for 1996 confirm that nearly 17.5 billion gallons of propane were sold for various uses in the United States that year. Of this amount, just over 10 billion gallons were sold for residential, commercial, farm, industrial and vehicle fuel purposes. (The balance was sold for chemical uses as a feedstock but probably including some fuel uses, too.)[4]

The industry has become quite large in terms of numbers of companies and is highly competitive. In 1994, there were approximately 8,000 independent marketers operating about 13,500 propane distribution centers around the nation. The 50 largest companies (based on gallons sold) accounted for less than 50 percent of nationwide sales that year, and the five largest companies accounted for only about 27 percent of nationwide sales.[5]

The propane industry is not subject to public utility-type supervision or regulation. Unlike electricity or natural gas utilities, propane companies do not have monopolies as energy resource companies. Neither are they subject to pricing regulations by a public utility commission or any similar agency. Propane is not classified as a hazardous environmental substance by federal or state regulations, but its transportation is regulated under the hazardous materials rules that apply to a number of substances.

Numerous propane firms serve local market areas with relatively low barriers to entry and expansion. According to the Fitch report, retail propane distribution centers --

> . . . typically serve customers within a 25-square mile area. . . . Each center occupies one to three acres of land that accommodates an office/appliance showroom, above-ground storage tank capacity for 15,000 – 60,000 gallons of pressurized liquid propane, an inventory of storage tanks and portable cylinders

---

[2] Raymond Evans, *Liquid Gas Made By Modern Prometheus*, PITTSBURGH SUNDAY POST, Sept. 8, 1912, *reprinted in* BUTANE-PROPANE NEWS, June 1999, p. 2.

[3] The information in this and the preceding paragraph was taken from BUTANE-PROPANE NEWS, pp. 24-35 (June 1999).

[4] National Propane Gas Association, *1996 Propane Market Facts*, Table 06. (1996 is the most recent year for which such data have been compiled.)

[5] Fitch at pp. 2 and 15.

> usually leased to customers, and a fleet of bobtail delivery and rack trucks for periodically filling customers' stationary and portable on-site tanks. The average retail center markets about 685,000 gallons of propane annually. Depending on geographic location, size and type of markets served, and the number of competitors, a distribution center's volume can profitably range between 250,000 – 5,000,000 gallons. Market conditions permitting, national and regional retailers strive to reach the initial threshold for optimizing economies of scale and profitability by developing retail centers that individually deliver approximately one million gallons or more annually.

Fitch Report at 4.

The number of competitors in any given customer base varies from region to region and from city to city. A minimum of five propane retailers generally serve the same geographic area, but the average is eight to ten -- possibly more -- propane retailers in a city or a region. Of this larger number, three or four of the largest companies are likely to be there with four to six smaller retailers, too.

C. Entering the propane business

Entering the propane business requires expenditures for a variety of capital assets and labor costs. Among the most important assets is a list (or multiple lists) of existing or potential propane customers. With a number of competitors already in an area (which is the case all around the country), access to a list of potential customers is essential to the future success of a new entrant into any market area. Competitors are unlikely to sell such lists to a new entrant for any price, so the new entrant must invest in other ways of developing such a list.

Many new entrants into a market are companies formed by former employees of propane companies in the area. They believe that their familiarity with the operation of the business and with at least some of their former employer's customers will provide them with valuable intangibles. In some situations, this can be sufficiently important to give a boost to the new venture; in others, the access to the intangibles of experience and a full customer base is an obstacle that cannot be overcome.

Once potential customers have been identified, the new company must communicate with them and instill some sense of confidence that the company is stable, trustworthy and merits the potential customer's business. A good reputation in the community or a respected trademark/trade name or other identifier of some kind is quite valuable, particularly when the new entrant is seeking to entice current propane users to change their vendors. Door-to-door contacts are expensive because they are labor intensive, but this and other communications and advertising devices must be undertaken.

Physical assets are also essential. Even a relatively small new entrant must obtain a business location with some combination of (i) land on which to place its equipment (its bulk storage tank, bobtail trucks and smaller tanks to be leased to customers with some visibility to the community) and (ii) buildings in which its offices and equipment maintenance/repair facilities are located. With real property either purchased or leased, the company must acquire its storage tanks, bobtail delivery trucks, tank delivery trucks, other vehicles as needed as well as office and communications equipment.

Assets required for start-up propane business

Each new company's situation will be unique due to its particular circumstances. Nonetheless, it is possible to compute a range for the basic costs of starting a business from scratch and acquiring the necessary tangible assets. The cost of acquiring intangibles such as customer lists and a recognized/respected trade name cannot be estimated generally.

Land – Can vary greatly, but say 2 acres in a fairly "visible" area with power		$ 50,000
Building – Also can vary, but modest structure		50,000
Bulk storage, piers, pumps, piping, installed		75,000
Propane delivery (bulk truck) new		60,000
Service truck with boom for tank sets		40,000
Office equipment, service equipment, etc.		30,000
	Subtotal	$305,000
Intangibles		$ xxx,xxx
200 customers/year multiplied by $600 per tank (required each year for new customers)		120,000
Working capital – Inventory, Accounts Receivable		75,000
	Year one total capital	$500,000+++

First year illustrative pro-forma based on 200 customers

Entering the market as a start up company is likely to produce an operational loss for at least the first year in the range of $80,000 to $120,000. The second year probably will generate a smaller loss in the range of $20,000 to $40,000. Again, each situation will be different, but the following is an illustration.

This assumes gross sales of $1,000 per customer and, in a good market, cost of sales of approximately 50%. This would represent a full 12 months of having 200 customers. More typical is one-half this amount as you pick customers up notably over the course of a year.

Sales	$200,000
Cost of Sales	(100,000)
Gross Profit	100,000
Salaries/Wages	(110,000)
Benefits/Taxes	(28,000)
Interest	(40,000)
Fuel	(10,000)
Office supplies, postage & miscellaneous	(30,000)
	($118,000)

Tab 3

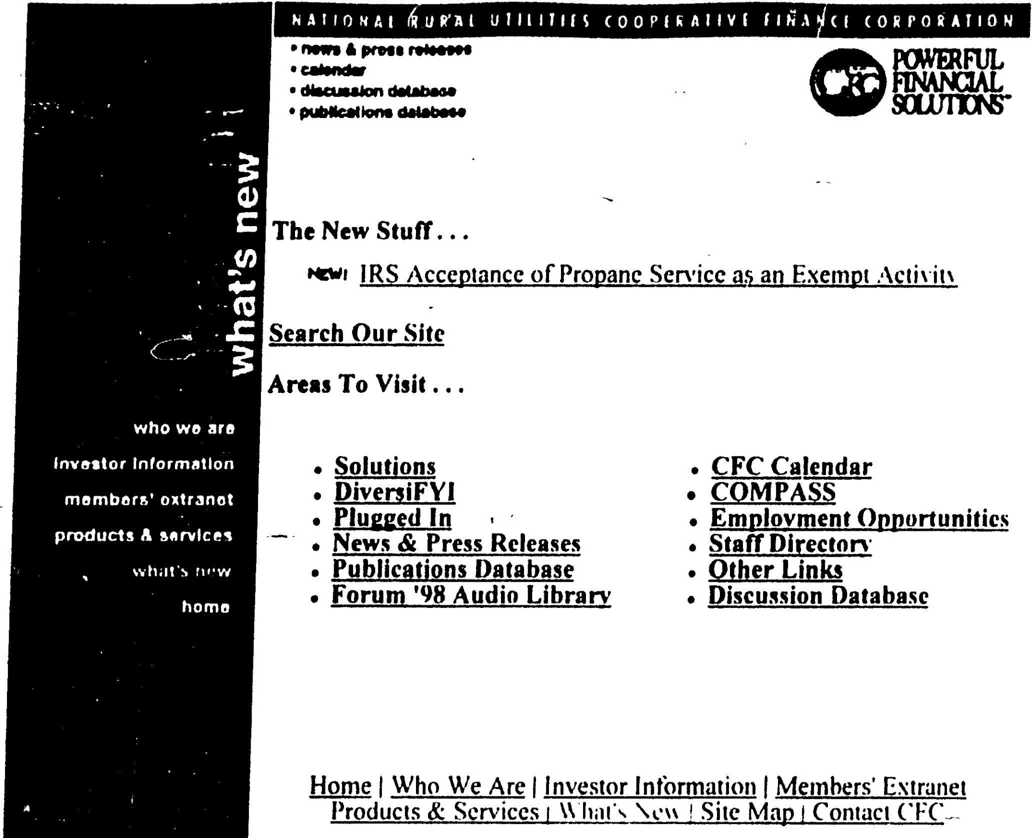
September 28, 1999

RECs THAT HAVE ENTERED THE PROPANE BUSINESS

Rural Electric Cooperative	State
Blue Ridge EMC	North Carolina
Callaway Electric Co-op	Missouri
Clark Energy Cooperative, Inc.	Kentucky
Clearwater Power	Washington
Coosa Valley Electric Co-op, Inc.	Alabama
Dickens Electric Co-op, Inc.	Texas
Edgar Electric Co-op Assn.	Illinois
Farmers RECC	Kentucky
Firelands Electric Co-op, Inc.	Ohio
Flint EMC	Georgia
Four County EMC	North Carolina
Frontier Power Company	Ohio
Fruit Belt Electric Co-op	Michigan
Great Lakes Energy Cooperative	Michigan
Hancock-Wood Electric Co-op, Inc.	Ohio
Heartland REC	Kansas
Hill County Electric Co-op, Inc.	Texas

Rural Electric Cooperative	State
Jackson County RECC	Kentucky
Jackson Electric Co-op. Inc.	Texas
Lyon-Coffey Electric Co-op	Kansas
Ottawa & Allegan/Great Lakes	Michigan
Pioneer Electric Cooperative	Alabama
Polk Burnett Electric Co-op	Wisconsin
Shelby Electric Cooperative	Illinois
Shelby RECC	Kentucky
Southeastern Michigan REC. Inc.	Michigan
Southwestern Electric Co-op. Inc.	Illinois
Tallahatchie Valley EPA	Mississippi
Thumb Electric Co-op. Inc.	Michigan
Top O'Michigan Rural Elec. Co.	Michigan
Tri-County Electric Co-op	Michigan
Warren RECC	Kentucky

Tab 4



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September 9, 1999

Memorandum.

From: Thomas M. Strait
Washington Utility Group

To: Interested Electric Cooperatives

Subj.: IRS Acceptance of Propane Service as an Exempt Activity

We have received requests from a number of electric cooperatives that we provide an explanation of the status of propane service under the provisions of section 501(c)(12)(A) of the Internal Revenue Code of 1986 (hereinafter "the Code"). The purpose of this memorandum is to explain the recent decision of the IRS regarding that service.

As you know, section 501(c)(12) of the Code provides income tax exemption:

> "for benevolent life insurance associations purely of a local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or **like organizations**; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses." [Emphasis added.]

To qualify under the statute, an organization must operate on a mutual or cooperative basis, it must engage in one of the stated activities or an activity of a "like organization", and it must collect 85 percent or more of its gross receipts from members within the approved exempt functions. The cooperative may not just declare itself exempt; rather, it must obtain approval for specific activities from the Internal Revenue Service (IRS). Finally, the income test is applied on an annual basis.

Generally, the term "like organizations" has been interpreted to mean "like utility" organizations. Within that framework, a variety of "utility like activities" have been determined to be eligible under this provision. Some of those activities include generation, transmission and delivery of electricity, provision of cable and satellite television services, provision of water and sewer services, provision of home security and medical alert services, provision of Internet services, and provision of other telecommunication types of functions. Moreover, the IRS has ruled that an exempt cooperative may provide multiple utility services.

The IRS National Office branch responsible for utility cooperatives exempt under section 501(c)(12) and making determinations as to qualifying activities is the Exempt Organizations/Exempt Pensions Branch (EO/EP). New or unusual exemptions almost always go to the National Office, while more common exemption issues may be resolved at the IRS District Director level.

Approximately two and a half years ago EO/EP issued a private letter ruling (PLR 9715045) to a tax exempt electric cooperative granting expanded exemption to the organization for the delivery of natural gas to its members.

> Note: A PLR is applicable only to the taxpayer to which it is issued. While other taxpayers may not rely on the determination, such published rulings serve as good indicators of the National Office's thinking at any given time.

Following the release of that determination, we informally inquired with the IRS as to whether or not the delivery of propane gas would likewise qualify as an activity eligible for exemption under section 501(c)(12)(A). The National Office was not encouraging.

The EO/EP Branch Chief stated that they had rejected such requests previously and that he doubted that the policy would change. During that discussion, however, we pointed out that the utility industry is rapidly changing, that many investor-owned gas utilities now deliver propane gas either by truck or through pipelines, and that natural gas and propane gas are very similar in chemical composition.

While conceding these facts, the EO/EP Branch Chief said his greatest concern was the means of delivery for propane gas. Because propane gas is typically delivery to consumers by truck, the Branch Chief remained skeptical that propane delivery would be a qualifying utility activity under section 501(c)(12) of the Code. However, he said that the IRS would entertain additional requests, and would forward them to the Office of the Assistant Chief Counsel for Exempt Organizations for technical review and consideration.

In May 1998 on behalf of an exempt electric cooperative we submitted a request for ruling that propane gas delivered by delivery truck is an activity eligible for exemption under section 501(c)(12). In that request, we indicated that the electric cooperative planned to deliver propane gas by truck until such time as it was economically feasible to install a pipeline for delivery of the gas.

As part of that request, the cooperative made a number of "management representations" to the IRS. Included among those representations were:

(1) That the cooperative would grant propane customers voting membership within the cooperative;

(2) That a separate propane division would be established in the cooperative for the proper accounting of propane patronage margins; and,

(3) That the estimate for pipeline development was between five to ten years.

Our main arguments for acceptance of propane gas delivery as a "like utility activity" were that investor-owned utility companies routinely sell propane by truck, that gas utilities use propane deliveries as means of expanding their pipeline systems, and that they often inject propane in pipeline systems in order to maintain the BTU content of natural gas deliveries during peak demand periods.

We submitted a second request for ruling on this subject in September 1998. In that request, the electric cooperative proposed to install pipelines in large mobile home parks for the purpose of delivering propane gas. The cooperative made similar representations to those made in the first request including that it eventually would inter-connect the propane pipeline system with a natural gas pipeline.

Both requests were forwarded by the EO/EP to the Assistant Chief Counsel's Office for review and consideration. Over the past year, the IRS contacted us on numerous occasions requesting additional information about the taxpayers' proposed operations, but gave no indication as to the likely outcome of the two ruling requests.

On August 5, 1999 we were contacted by Mr. Michael Seto, an Exempt Organizations Tax Law Specialist, informing us that the National Office had decided to rule favorably on our earlier propane requests. He said that the IRS had accepted propane service as a "like activity" regardless of the means of product delivery. Mr. Seto said, however, the actual issuance of the rulings might be delayed four to six weeks because of the heavy volume of cases at the National Office.

On August 23, 1999 we had follow-up discussions with Mr. Robert C. Harper, the EO/EP Branch Chief. He reconfirmed that the propane requests had been approved and that the IRS would make no distinctions regarding the means of delivery for propane gas. However, he emphasized that this activity, like all others beyond a cooperative's original exemption, must be approved by the IRS. This approval may be sought by ruling request to the National Office or in a request for determination letter from the IRS District Director having jurisdiction over the cooperative. Further, he said that other cooperatives could not blindly rely on PLRs issued to our clients. They must seek their own determinations.

Though unrelated to the propane issues, we also asked Mr. Harper about the status of subsidiary attribution to cooperatives exempt under section 501(c)(12) of the Code. You may recall that in 1998 the Director of Exempt Organizations for the IRS, Mr. Marcus Owens, stated the government's intention to attribute the gross receipts of subsidiaries and affiliates owned or controlled by exempt cooperatives as nonmember income for purposes of the 85 percent member income test. That proposal was suspended pending further review by the IRS following Congressional concern about the matter.

Mr. Harper stated that the review by the IRS and the Treasury Department was complete and that it was the intention of the IRS to issue a Revenue Ruling regarding the topic. Purportedly, Mr. Seto had already drafted the proposed ruling. Though Mr. Harper would not disclose the timing or the content of the proposed Revenue Ruling, IRS staff members have told us that the ruling will most likely attribute nonmember receipts of cooperative affiliates to the parent as nonmember income for purposes of the 85 percent exemption income test.

We have not learned specific provisions or the timing of this new rule. Also, we do not know whether the rule will be applied prospectively only, or if it will affect all open tax years. However, it should be noted that a Revenue Ruling would be applicable to all cooperatives exempt under section 501(c)(12), not just one taxpayer.

In conclusion. the favorable propane rulings of the IRS have yet to be issued. Nevertheless. we are proceeding with a number of new requests for propane based on the recent developments. When the rulings are issued to the cooperatives, the tax law requires the government to publish the determinations within 90 days. However. we have had five or six rulings issued to our clients over the past several years that have yet to be published.

I hope you find this information useful. If you have any questions. please do not hesitate to contact me at (703) 903-9022.

Very truly yours,

Thomas M. Strait

Tab 5

WHY ENTRY BY RURAL ELECTRIC COOPERATIVES INTO PROPANE DISTRIBUTION IS ANTICOMPETITIVE

Timothy Daniel
Josh Feltman
Daniel Goldstein

September 1999

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I. EXECUTIVE SUMMARY

Background

The retail propane market in the United States is fragmented and competitive. Roughly 8,000 independent marketers operate 13,500 propane distribution centers around the nation, with the country's top 50 marketers accounting for less than 40% of nationwide sales. Recently, a number of Rural Electric Cooperatives (RECs), non-profit, tax-exempt membership organizations originally created to bring electric power to rural America, have been entering into subsidiary lines of business, including propane distribution.

While new entry into an industry ordinarily benefits consumers, this is not the case with RECs and propane distribution.[1] Instead, REC entry into propane distribution distorts competition to the ultimate detriment of consumers because the RECs' propane affiliates benefit artificially from the RECs' access to below market interest rates, tax exempt status, and other advantages that depend directly on the RECs' special status as subsidized, monopoly electricity providers. The likely results from REC entry into propane distribution include the exit from the industry of otherwise efficient independent propane distributors, the discouragement of entry and innovation, and higher prices for consumers.

Potential Anticompetitive Behavior

This report identifies three mechanisms by which REC entry into propane distribution could harm competition and consumers: cost-shifting, cross-subsidization, and misinformation to consumers. Evidence gathered from a number of states where RECs have begun distributing propane confirm that these practices are actually occurring.

Cost-shifting occurs when the costs incurred by the REC's propane affiliate migrate to the books of its core electricity business. These costs are subsequently recouped in higher electricity prices. Consumers are ultimately harmed in two ways: electricity prices are higher

[1] This report focuses on the propane industry; however, most of the arguments presented here apply to other unregulated industries which the RECs have entered, including home security and landscaping.

than they otherwise would be, and efficient independent propane distributors lose market share to the REC's propane distribution affiliate, whose costs are artificially reduced by the cost-shifting. If the REC's propane affiliate increases its share of the market significantly, the reduction in competition would provide it the opportunity to increase prices above competitive levels.

Cross-subsidization occurs when the REC's parent electricity business supplies services to its affiliate but the affiliate does not compensate the parent for the true costs of these services, if indeed it provides any compensation at all. Perhaps the most troubling example of cross-subsidization arises when the propane affiliate obtains access to low-interest loans that would not be available but for the special tax-exempt, government-subsidized status of the REC's parent electricity company. These artificial interest-savings could significantly distort competition between REC propane distribution affiliates and independent propane marketers. Other examples of cross-subsidization include the REC's use of the parent's corporate logo and trademark (assets built up over many years with the benefit of tax-exempt status and government-subsidized loans) and the REC's propane affiliate benefiting from market intelligence that could only be obtained by the monopoly electricity provider.

While we draw a conceptual distinction between cost-shifting and cross-subsidization, a particular practice (e.g., the propane affiliate's use of the parent company's personnel and other assets) may have elements of each. In any event, both cost-shifting and cross-subsidization distort competition by lowering artificially the financial (but not economic) costs of the REC's propane affiliate. As such, in discussing specific practices by specific RECs, this report does not dwell on drawing overly fine distinctions between practices that would qualify as cost-shifting and those that would qualify as cross-subsidization.

The third principal category of potential anticompetitive harm from the entry of RECs into the propane business relates to misinformation to consumers. Insofar as RECs are monopolists in their local markets for electricity provision and are often subject to regulation, co-marketing and joint branding of electricity and propane by the REC and its affiliates may result in consumer confusion with respect to several issues. These include: 1) whether the price of propane provided by the REC is regulated by state authorities; 2) whether the REC's

propane business is approved by the state in some fashion and so can be considered particularly reliable or of otherwise superior quality; and, 3) whether consumers are obligated to make propane purchases from their local cooperative, as is the case with their electricity purchases. To the extent that consumers are misled on any of these questions, they may be willing to pay higher prices or accept lower quality for REC propane when, in fact, alternative suppliers provide less expensive and/or higher quality services.

This report does not take the position that *any* expansion of a monopoly utility into an unregulated line of business would be anticompetitive. We acknowledge that, conceptually, expanding into other lines of business could result in real efficiencies from using existing assets and expertise. However, against this conceptual argument we raise two objections with regard to REC entry into propane distribution. First, expansion by RECs into propane distribution is unlikely to yield significant efficiencies because distributing propane has so little in common with distributing electricity. Second, the efficiencies that may exist – primarily with respect to benefiting from a well-known brand name and sharing marketing information about consumers – derive from assets that have been built up during decades of government subsidies. Thus, the claimed efficiencies also qualify, to some extent, as cross-subsidization.

In sum, we believe that the likely harm to competition, and thence to consumers, that could be expected from allowing the unregulated entry of RECs into the propane business will more than outweigh any short-term consumer benefits such entry may bring.

Evidence Regarding Anticompetitive Behavior

At least 31 RECs in at least 13 different states have entered the propane business in the last few years (see Table VI-1). This report focuses on roughly a dozen RECs in four states: Alabama, Kentucky, Michigan, and Texas. Some of the information has been acquired as a result of lawsuits filed by independent propane marketers against RECs. While these lawsuits have generally claimed that REC entry into propane distribution violates the REC's corporate charters, they also have generated evidence that anticompetitive behavior of the types described above may be occurring.

Alabama

Coosa Valley Electric Cooperative entered the propane business by purchasing an existing propane marketing concern. The funds for the purchase appear to have been loaned by a subsidiary of the CFC, a tax-exempt, cooperative bank for RECs built on the subsidized, tax-exempt assets and earnings of its members. In addition, Coosa Valley has roughly $12 million in outstanding loans from the Department of Agriculture at rates as low as 2%. Among other practices, the electric and propane businesses share the same officers, directors, and general manager and, apparently, other staff and facilities. It is unclear whether the propane business compensates the electric business for these items. Propane trucks now bear the Coosa Valley insignia, and propane marketing materials have gone out in electric bills, leading at least one consumer to believe that she was required to buy Coosa's propane if she wanted to continue to be an electric customer.

There is evidence from various local marketers that Coosa Valley has been pricing propane very aggressively, possibly below cost. In addition, a consulting study prepared for a North Carolina REC reports that Coosa Valley increased the total annual sales volume of its propane subsidiary from 1.75 million gallons (under the prior owner) to 3 million gallons in its first year of operation. Such price-cutting and rapid expansion of volume suggest that other than standard competitive forces may be at work.

Kentucky

Four Kentucky RECs have formed joint ventures with Thermogas, one of the nation's largest propane concerns, to provide propane service in their territories. Adopting the names of both companies (e.g. Farmers Thermogas, Jackson Thermogas, etc.), the propane concerns jointly market with their REC affiliates and, in several cases, are operated out of the RECs' existing offices. One objective appears to be to leverage the REC's (government-subsidized) goodwill by leading consumers to view the cooperative, not the for-profit joint venture, as the propane supplier. Similarly, REC meter-readers have been used to gather marketing data on

current and potential propane customers and REC customer lists have been employed for propane-related surveys and advertising. The potential clearly exists for shifting costs from the propane affiliate to the REC's core electricity business.

Whether and to what extent the propane joint ventures have compensated the REC parents for services provided is unknown. However, in comments to the Kentucky Public Service Commission (KPSC) on the question of whether the KPSC ought to regulate transactions between public utilities and their non-utility affiliates, several RECs responded that they are undertaking such transactions with little concern for the anticompetitive consequences of cost-shifting and cross-subsidies. These same comments also revealed that Kentucky RECs' propane subsidiaries are benefiting from low-cost loans from the CFC. Finally, there is some evidence that certain REC propane affiliates are pricing propane very aggressively, perhaps below cost.

Michigan

Great Lakes Energy Cooperative (GLEC) is an REC that vigorously promotes the idea of "one-stop shopping" for all of a customer's energy needs, including propane service. GLEC customers may receive a single bill for both propane and electricity and GLEC services both products at the same customer service centers (and on the same world-wide-web site). Consumers see the REC's logo on propane trucks and in propane advertisements. GLECs electric meter-readers scout out propane-consumers for marketing campaigns and door-drop propane flyers and enable the cooperative to provide "metered" propane service. It is unclear whether the REC's propane affiliate compensates the parent electricity business for these services; if not, cost-shifting and cross-subsidization would be occurring.

In addition, GLEC's entry into propane was funded with loans from the CFC, a practice that could distort competition by providing the REC's propane affiliate with an artificial cost advantage relative to independent propane distributors.

Texas

Hilco Electric Cooperative entered the propane business through a subsidiary in September 1997. Since then, substantial evidence of anticompetitive cross-subsidies and cost shifting has come to light. For instance, the non-profit REC entered into a management contract with its for-profit subsidiary whereby the parent would supply various pieces of equipment (computer, furniture, etc.) and various services (financial, administrative, marketing) and be reimbursed by the subsidiary for material and labor expenses incurred. However, as a matter of practice, charges have been limited to $1,000 per month, apparently substantially below the actual costs incurred. Further, even these $1,000 payments were not made promptly (if at all) and remained as accounts payable on the subsidiary's ledgers for s significant period of time. Similarly, the propane subsidiary has neither compensated the REC for office space, nor for the lot on which it keeps its main propane storage tank, a lot which was purchased for the propane business' exclusive use.

Both Hilco and its propane subsidiary have borrowed substantial funds from the CFC. Hilco (backed by its government-subsidized, tax exempt electricity business) serves as guarantor of the subsidiary's loans, effectively reducing the risk of lending to the propane affiliate. In addition, Hilco has made substantial capital investments (trucks, tanks, etc.) on behalf of the subsidiary. While it appears that the propane subsidiary ultimately reimbursed Hilco for these investments, there is also some evidence that the parent company used its non-profit status to avoid paying state sales taxes, a savings passed, in turn, to the propane subsidiary.

II. INTRODUCTION

The Coalition for Fair Competition in Rural Markets, Inc. ("Coalition") has asked NERA to conduct an economic analysis of the propane distribution industry, with a particular emphasis on the effect on competition and consumers caused by the entry into the propane distribution industry of rural electric cooperatives (RECs). This study provides a theoretical and empirical analysis of this issue, and concludes that both theory and evidence support the conclusion that REC entry into the propane distribution industry has been, and likely will continue to be, anticompetitive.

At the outset, it is important to acknowledge that entry into an industry is generally to be encouraged because entry lowers prices to consumers and provides an opportunity for more efficient entrants to displace less efficient incumbents. At the same time, special cases can arise where free entry may not benefit competition and consumers due to the distortions introduced by certain laws and regulations. For the reasons discussed in this study, we believe that REC entry into the propane distribution business qualifies as one of these special cases.

This study is organized as follows. Section III provides background information on the propane distribution industry and establishes that the industry (even without entry by RECs) qualifies as competitive. Section IV reviews the nature of RECs, with an emphasis on their financing. Section V explains why entry by RECs into unregulated lines of business such as propane distribution could harm competition and consumers. The key concerns are that that the REC will shift costs from the unregulated propane business to its monopoly electricity business and unfairly cross-subsidize the propane business with the assets and expertise possessed by its tax-exempt, government subsidized electricity business. Section VI contains detailed information regarding the practices of RECs in several states and how these practices have affected independent propane marketers. We believe that these episodes confirm that RECs' entry into the propane distribution business has, in fact, exemplified instances of cost-shifting and cross-subsidization that will ultimately harm competition.

III. THE PROPANE DISTRIBUTION INDUSTRY

Propane is a colorless, odorless[2], non-toxic gas that is also known as liquefied petroleum (LP) gas.[3] It is a by-product of natural gas (methane) production and crude oil refining, along with butane and other hydrocarbons. As explained by Fitch Research, "After being extracted from natural gas and crude oil, propane is pressurized into a liquid for safe, economical bulk storage, transportation, and retail distribution to end users' on-site stationary storage tanks and portable cylinders. Releasing propane from a storage container vaporizes the liquid into a clean-burning gas for a wide variety of end use markets..."[4] Propane is a relatively clean fuel, emitting no sulfur dioxide or particulates when burned because it contains no sulfur, only hydrogen and carbon. Most aspects of the propane industry are not regulated, and propane is not classified as a hazardous substance by federal or state authorities.

Propane is transported from refineries to localized, bulk storage facilities by barge, tanker, rail, pipeline or truck. Local propane distributors purchase propane at these bulk storage facilities and transport it by truck to the storage tanks at their local distribution centers. From these locations, local propane distributors deliver the product, by bobtail truck, to final consumers who have smaller storage tanks at their business or residence. For the most part, propane is used by customers and businesses that do not have access to natural gas distribution networks. Some commercial users of propane purchase propane in small cylinders that are designed to power small vehicles (e.g., forklifts) and other machinery used indoors.

According to the National Propane Gas Association, nearly 17 billion gallons of propane were consumed in the United States in 1995, up from less than 13 billion gallons in 1984.[5] Table III-1 contains the most recent National Propane Gas Association (NPGA)/American Petroleum Institute estimates of the quantities and proportions of U.S. propane purchased by various types of end-use customers.

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[2] Propane is generally mixed with an odor-possessing gas so that its presence can be identified.

[3] The boiling point of propane is quite low relative to water and in a range such that at easily attainable pressures propane can be in either a gaseous or liquid state. Propane consumption is often measured in gallons, not cubic feet (as is the case with natural gas).

[4] Fitch Research, "Retail Propane Distribution Industry," (Fitch Research) July 3, 1995, p. 2.

Table III-1

End Use Markets for Propane – 1995

End Use Market	*Gallons (000s)*	*Percent of Total*
Residential	3,177,102	18.92
Commercial*	2,336,105	13.91
Industrial*	1,994,819	11.88
Farm*	1,322,556	7.87
Transport Fuel	466,636	2.78
Total Retail	**9,297,218**	**55.36**
Chemical Feedstock*	7,360,124	43.82
All Other	137,702	0.82
Total	**16,795,044**	**100.00**

*Commercial refers to businesses that use propane for the same purposes as residential customers (e.g. heating, cooking); industrial uses include heat treating, soldering, vulcanizing, and "residential" uses by industrial customers, as well as use by the utility, refinery, and gas industries; farm uses include crop drying and heating for a complex of buildings where the complex typically includes a relatively large propane storage tank and a system of pipes to provide propane to the various buildings; chemical feedstock refers to use of propane as a physical input (i.e. not just a variable energy cost) into petrochemical products.

Sources: American Petroleum Institute (cited in NPGA *1995 Propane Market Facts*) and Fitch Research.

[5] National Propane Gas Association, *1995 Propane Market Facts*, (NPGA Market Facts) Table 6.

While an energy source, propane should not be considered a utility product. As mentioned above, 1) propane sales are almost entirely unregulated, and 2) propane is not delivered directly to homes and business by wire or pipeline, but is carried by truck. As a rule of thumb, propane is often said to begin where natural gas ends; that is, it is most often found in areas lacking a comprehensive natural gas infrastructure. Unlike electricity and natural gas, propane is sold in a competitive market with numerous sellers. Further, propane is neither as essential nor as ubiquitous as electricity. For example, Coosa Valley Electric Cooperative in Alabama serves 19,000 electricity customers, but less that a quarter of these (roughly 4,000) use propane in their homes and businesses.[6]

According to the U.S. Department of Energy's Energy Information Administration,

> the primary factors that affect propane demand in the United States are propane prices, crude oil prices and natural gas prices, macroeconomic growth, and weather... Because of the influence of the highly weather-dependent residential sector, total propane demand generally mirrors the same seasonal patterns as the residential sector, rising during the winter months but falling during the spring and summer.[7]

Roughly 60% of retail propane consumption occurs in the five-month "winter heating season" between mid-October and mid-March.[8] Propane supply, on the other hand, is not seasonal, with the result being that inventories tend to rise and fall in an inverse relationship with weather-driven demand. "During the peak demand months of December, January, and February, propane inventories supply over 20 percent of demand on average... [W]inter inventory withdrawals [average] nearly 33 million barrels [1.4 billion gallons]."[9] Roughly 6 billion gallons of underground storage facilities are employed to compensate for the seasonal supply and demand imbalances. These include pressurized depleted mines and underground salt dome caverns spread through the U.S. (though concentrated in Kansas and along the Gulf

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[6] Appellees' Brief, *Coosa Valley Electric Cooperative vs. Allgas, Inc., et al.*, ("Appellees' Brief") August 12, 1998. Pages 10-14.

[7] Hinton, David and John Zyren, "Propane Market Assessment for Winter 1997-98," (Propane Market Assessment) in Energy Information Administration, *Petroleum Marketing Monthly*, December 1997, p. xvii.

[8] Fitch Research, p. 4.

[9] Propane Market Assessment, p. xv.

Coast) and connected to pipelines. Further, because propane is a by-product of natural gas or petroleum refining, its production does not respond markedly to changes in its own price. Oil refinery operations are dictated by demand for gasoline and heating oil and natural gas production is driven by the demand for methane.

According to Fitch Research and the Energy Information Administration, over 90% of U.S. propane consumption is met by domestic supply, with most of the remaining 10% imported from Canada. Fitch Research also notes that, "During the last decade, the relative importance of gas plant production has been declining, while that of refineries has been increasing."[10] Even in absolute numbers, U.S. gas plant propane production has declined from 193 million barrels in 1984 to 189 million in 1995. During that period, U.S. refinery output increased from 102 to 183 million barrels.[11] Propane imports also increased over the decade while inventories have remained relatively stable (with year-to-year fluctuations) over the long term. Presently, gas plants account for 51% of U.S. propane production, and refineries 49%. While the stability of the domestic production and transportation infrastructure is an overall strength, the propane industry remains somewhat vulnerable to price spikes in crude oil from abroad: there was a brief but sharp increase in the price of propane following Iraq's invasion of Kuwait in 1990.[12]

The retail propane market is fragmented and competitive. According to Fitch Research, there are roughly 8,000 propane retailers nationwide operating roughly 13,500 distribution centers. The top 50 retailers (in terms of gallons) account for only roughly 40% of total national retail sales. The largest retailer sold 829 million gallons in 1994, while number fifty sold 7.7 million.[13] According to Fitch, retail propane distribution centers,

> typically service customers within a 25-square mile area. . . Each center occupies one to three acres of land that accommodates an office/appliance showroom, above-ground storage tank capacity for 15,000–60,000 gallons of pressurized liquid propane, an inventory of storage tanks and portable cylinders usually leased

[10] Fitch Research, p.3.

[11] NPGA Market Facts, Table 2 and Fitch Research, p. 3. One barrel equals 42 gallons of propane.

[12] Fitch Research, p. 3.

[13] Fitch Research, pp. 2, 15.

> to customers, and a fleet of bobtail delivery and rack trucks for periodically filling customers' stationary and portable on-site tanks. The average retail center markets about 685,000 gallons of propane annually. Depending on geographic location, size and type of markets served, and the number of competitors, a distribution center's volume can profitably range between 250,000–5,000,000 gallons. Market conditions permitting, national and regional retailers strive to reach the initial threshold for optimizing economies of scale and profitability by developing retail centers that individually deliver approximately one million gallons or more annually.[14]

Other sources confirm the competitiveness of propane distribution markets. A recent study by the Leak-Goforth Company described the propane market as "open and competitive." In one particular area, eastern North Carolina, the Leak-Goforth study identified more than twenty separate suppliers of propane services.[15] On a similar note, a recent consumer survey conducted by the Warren Rural Electric Cooperative in Kentucky asked consumers to identify the firm that sold them propane and offered the respondents seven separate choices (in addition to an "other" option). Information from a number of other local markets also shows that consumers can choose from among a number of independent propane marketers.[16] There can be little doubt that local propane distribution markets are currently vigorously competitive.

In sum, we believe that the propane industry is vigorously competitive, with numerous firms serving local market areas and with relatively low barriers to entry and expansion. It would seem reasonable to ask, therefore, why RECs have recently begun distributing propane in addition to providing electricity. We believe that REC entry into propane is not the manifestation of healthy competitive forces. To the contrary, we believe that a strong case can be made that REC entry into the propane business is anticompetitive because the RECs would not likely enter the propane business were it not for certain artificial advantages that their electricity businesses can provide their propane affiliates. We develop this argument more fully in the remainder of this report.

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[14] Fitch Research, p. 4.

[15] Leak-Goforth, LLC and Emerson Deese Associates, "LP Gas Feasibility Study: For Four County EMC," 1998, p. 15.

[16] We have seen information on the number of separate propane marketers serving local markets in Alabama, Colorado, Michigan, Nevada, North Carolina, Oklahoma, Tennessee, and Wisconsin.

IV. RURAL ELECTRIC COOPERATIVES

Rural Electric Cooperatives (RECs) are independent, private electric utility businesses owned by the consumers they serve. There are roughly 900 RECs currently operating in 46 U.S. states, serving more than 13 million accounts and 31 million people.[17] As shown in Table IV-1 (following page), RECs provide electricity to 11 percent of the nation's population and account for almost 8 percent of kilowatt-hours sold. The vast majority of RECs are simple distribution cooperatives (i.e., they purchase electricity wholesale, rather than generate it themselves). Roughly 60 are generation and transmission (G&T) cooperatives which, in turn, provide electricity to the distribution co-ops.

Operating under "cooperative principles," RECs are not-for-profit businesses – their purpose is to provide at-cost electric service to their customer/owners. Margins above expenses are either used for capital improvements to the system or distributed to co-op members in proportion to their electric purchases. Prior to distribution, "profits" which are not reinvested are booked as "capital credits" to the members and represent members' ownership equity.

As Table IV-1 demonstrates, the typical REC serves low population density areas where revenues per mile of wire are relatively low. Because such areas are typically more expensive to serve, the federal government continues to support RECs with various tax and loan subsidies which are described below. This is the case despite the fact that the original intent of these programs was to extend basic electric service to rural areas: "(T)hat job has been accomplished. Nearly 100 percent of rural America has electric service compared to 11 percent when (the programs were) created... In other words, rural areas are better served in this respect than America as a whole."[18]

[17] National Rural Electric Cooperative Association (NRECA), "Facts About Electric Cooperatives," www.nreca.org/coops/elecoop3.html.

[18] Friends of the Earth, http://www.essential.org/orgs/FOE/scissors95/greenpart17.html.

Table IV-1

Electric Utility Comparisons – 1998

	Investor Owned	Publicly Owned	Cooperatives	Total Industry
Number of Firms	242	2,013	935	3,190
Median # Customers	341,300	1,700	9,600	
Customer Share	75%	14%	11%	
Revenue Share	78%	13%	8%	
kWh sales share	76%	15%	8%	
Sales (billions of kWh)				
Residential	*766*	*156*	*152*	*1,074*
Commercial	*750*	*129*	*47*	*926*
Industrial	*795*	*145*	*58*	*998*
Other	*63*	*30*	*6*	*99*
Total	2,374	460	263	3,097
Consumers/line mile	34.85	47.76	5.76	
Revenue/line mile	$59,355	$72,255	$7,038	
Distribution plant investment/consumer	$1,549	$1,503	$1,975	
Assets ($billions)	587	158	62	807

Source: National Rural Electric Cooperative Association (NRECA). http://www.nreca.org/coops/elecoop3.html, sourced to Energy Information Administration and NRECA Strategic Analysis, March 1998.

Cooperatives generally pay state and local taxes, including property taxes. However, according to the National Rural Electric Cooperative Association, most are "organized under Section 501(c)(12) of the Internal Revenue Code and are therefore exempt from federal taxation as long as 85 percent of their revenues are derived from business with their members."[19]

RECs obtain investment capital from a number of sources, including retained earnings and private lenders. In addition, RECs qualify for low-interest loans and loan guarantees from the Rural Utilities Service (formerly the Rural Electrification Administration), an agency within the Department of Agriculture that was created during the Great Depression to bring electric, and later telephone, service to rural America. As of September 30, 1996, over 800 RECs had electricity loans outstanding from RUS worth over $32 billion. Of this amount, approximately $9.5 billion was held by 782 distribution cooperatives, while the rest was held by 55 G&Ts.[20]

RUS loans to RECs are tied to tax-free municipal bond rates but, in addition, are capped at 7%. Hardship loans of 5% are available under certain conditions. RUS also guarantees loans to RECs made by the Treasury's Federal Financing Bank (at the Treasury's cost of money plus 0.125 percent). While the terms of these loan programs are generous, prior to the Rural Electrification Loan Restructuring Act of 1993 they were even more so, with the then-lowest hardship rate set at 2 percent. In addition, between 1992 and 1996 RUS wrote off approximately $1 billion in bad electricity loans to various RECs.[21]

Another source of financing for RECs is the National Rural Utilities Cooperative Finance Corporation (CFC). Founded in 1969, the CFC is a private, not-for-profit cooperative association. Its membership consists of 1,052 rural utility systems, primarily RECs and Rural Telephone Companies (RTCs). The principal purpose of the CFC is to provide members with an additional low-cost source of financing to supplement the programs administered by RUS.

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[19] NRECA, "Facts About Electric Cooperatives," www.nreca.org/coops/elecoop3.html.

[20] Testimony of Linda M. Calbom, General Accounting Office, before the House Subcommittee on Government Management, Information and Technology, March 30, 1998, p. 2.

[21] Testimony of Robert E. Robertson, General Accounting Office, before the Senate Committee on Agriculture, Nutrition, and Forestry, July 8, 1997, p. 1. The RECs that required these write-offs were primarily electricity generators, rather than distributors.

From an economic perspective, the CFC is a risk-sharing organization, aggregating the RECs assets (themselves built up on government subsidies) and diversifying away risk in order to access capital markets more efficiently. The CFC is a 501(C) (4) organization, meaning any margins on business with its members is tax deductible. Net margins are distributed back to members in proportion to interest paid on CFC loans.[22] As a result of its capital base and tax-free status, the CFC's bonds are highly rated, allowing the bank to borrow and, consequently, loan funds at rates superior to those which any individual REC (or any independent propane distributor) could obtain on its own.

While the RUS restricts borrowers to using loans for electricity-related projects, CFC funds may be used for any purpose. Indeed, in the Financial Outlook section of its 1998 10-K, the CFC forecast increased demand for its services due to the RECs' increasing "pace of diversification into new businesses, such as gas and propane and new telecommunications services."[23]

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[22] National Rural Utilities Cooperative Finance Corporation 10-K, fiscal year 1998. Downloaded from SEC Edgar Archive.

[23] Ibid.

V. WHY REC ENTRY INTO PROPANE DISTRIBUTION IS ANTICOMPETITIVE

Section III showed that the propane distribution industry has many participants and relatively low barriers to entry – in short, the structure of the industry is competitive. As a result, we can conclude that REC entry into the propane distribution industry is not needed to reduce propane prices from greater-than-competitive levels.[24] This section explains why REC entry into propane distribution may actually harm competition and consumers. The threat of competitive harm arises because the propane distribution businesses affiliated with RECs may benefit from their association with the RECs in ways that run counter to the operation of standard competitive forces. The primary concerns are anticompetitive cost-shifting, anticompetitive cross-subsidization, and misinformation to consumers.[25]

A. Cost-Shifting

The RECs' primary line of business, of course, is the provision of electricity to the consumers and businesses in their service areas. In many, though not all, of the areas where RECs provide electricity, state authorities regulate the prices that the RECs may charge. The purpose of regulating prices is to keep them lower than they would be if the firm were not constrained by regulation. Typically, the prices that the regulators approve depend directly on the costs incurred by the REC in providing electricity.

Under a cost-based regulatory structure, the regulated firm has an incentive to overstate its costs of providing the regulated service in order to justify higher prices. One way for the regulated firm to inflate artificially its costs is to enter unregulated lines of business and then transfer (or "shift") some of the costs incurred in operating the unregulated business to the books of the regulated business. When this strategy is successful, the firm's overall profits

[24] Entry by REC's into an already competitive propane market would potentially lower prices if the RECs were more efficient than the incumbent suppliers of propane services. Given the nature of the propane business and its fundamental difference from the provision of electricity services, we find it unlikely that RECs could supply propane services more efficiently than incumbent firms.

[25] For purposes of our analysis, we assume that the RECs' practices (like those of other nonprofit firms) are subject to the standard application of the antitrust and consumer protection laws.

increase because the price of the regulated product increases toward the monopoly price, i.e., the price the regulated firm would charge if it were not constrained by regulation. Such practices, when they occur, distort competition in both the regulated business (prices are higher than they would be but for the practice) and the unregulated business (costs appear to be lower than they actually are).[26]

With regard to REC expansion into propane distribution, cost-shifting would occur if the REC allocated certain costs incurred by the propane business to the electricity business. For example, in order to enter the propane business, the REC may need to purchase additional computers, hire additional customer service representatives, install additional phone lines, etc. To the extent these incremental costs are allocated to the budget of the REC's electricity business, perhaps because the two business used the same central office location, then the propane affiliate would be shifting its costs to the books of the REC's electricity business. If electricity rates were based on costs, then this practice may harm consumers by leading to higher electricity prices.

Cost-shifting can be prevented, at least in theory, by vigilant regulation. When the REC applied to the relevant regulator for approval to increase its electricity rates, the regulator could deny the request if it could discern that the elevated costs were incurred not by the regulated business but by its unregulated affiliate. But such monitoring is necessarily costly and inevitably imperfect, especially when the diversified firm's incentive is to claim that the costs were legitimately incurred by the regulated business, not shifted from an unregulated business. The regulator's task of monitoring the regulated business is considerably easier if the regulated firm is prohibited from entering into unregulated lines of business or (if such restrictions are deemed too severe) if the regulated firm must maintain completely separate operations for its regulated and unregulated businesses.[27]

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[26] It has long been recognized by economists that firms that are regulated in one market might harm competition and consumers by diversifying into other, unregulated, markets. A clear exposition of this concern can be found in Timothy J. Brennan, "Why regulated firms should be kept out of unregulated markets: understanding the divestiture in United States v. AT&T," The Antitrust Bulletin (Fall 1987), pp. 741-793.

[27] The latter approach was used in the Telecommunications Act of 1996.

We do not have access to information on the costs incurred by RECs in their electricity business and for any additional lines of business they have entered. But evidence discussed later in this report strongly suggests that certain RECs and their affiliates have engaged in cost-shifting practices.[28]

B. Cross-Subsidization

A practice with effects very similar to cost-shifting, but one that can be distinguished conceptually, is cross-subsidization. We define cross-subsidization to occur when the affiliated business receives benefits from the parent business, but the parent business "charges" its affiliate considerably less (perhaps nothing) than the true costs incurred by the affiliated business.[29] By way of example, cross-subsidization would occur if the affiliated business obtains access to a low-interest line of credit that would not be available *but for* the parent business' access to such funds. Cross-subsidization, like cost-shifting, allows the affiliated business to benefit from its affiliation with its parent company in ways that reduce artificially the affiliated business' costs. As a result, competition is distorted and consumers can be harmed.

We distinguish between cost-shifting and cross-subsidization to highlight that some of the advantages enjoyed by the REC's propane business flow directly from the assets and operations of the REC's electricity business. Perhaps most important is that the RECs, whether or not they are regulated in the states where they supply electricity, enjoy tax-exempt status and have access to below-market interest rates from certain lenders. A business affiliated with an REC could benefit directly (but artificially) from these two advantages in the form of tax and interest savings.

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[28] See, for example, the discussion of REC practices in Michigan and Texas.

[29] Put another way, cross-subsidies occur when the parent allows the affiliate access to goods and services at prices below opportunity cost; e.g., when the REC provides its propane affiliate access to loans at below-market rates. By contrast, cost shifting occurs when the affiliate's incremental costs are paid by the parent REC; e.g., when the REC pays the salary of an incremental customer service representative.

This report neither questions nor analyzes the cost savings achieved by RECs through their tax exempt status and access to below-market interest rates – *so long as these savings are limited to the REC's electricity business*. But we do contend that the principles of free and fair competition are violated when these benefits are extended to other lines of business such as propane distribution. When this occurs, the REC's propane distribution business enjoys *artificially* lower costs, thereby distorting the competitive process. An independent propane distributor that is otherwise more efficient than the REC in supplying propane may be driven from the market solely as a result of the REC's artificial cost advantage. In the short term, the economy's productive resources would be used inefficiently. In the longer term, as independent propane marketers are driven out of the market, the REC may eventually be able to increase propane prices due to the reduction in competition.

The concern that independent propane distributors will exit the market, to be followed by price increases by the REC's propane affiliate, is essentially a predatory pricing concern. In most circumstances, predatory pricing concerns can be dismissed because the price increase can be expect to attract new entry (or the re-entry of firms that recently exited), which causes prices to fall back to competitive levels. Consequently, the predatory strategy is rendered unprofitable.

In this instance, however, the predatory strategy is more credible because the artificial cost advantages enjoyed by the REC's propane affiliate can effectively deter new entry after it raises propane prices. In determining whether to enter (or re-enter) a propane market with elevated prices, an independent propane marketer will naturally consider how the REC's propane affiliate will respond to its entry. If the independent propane distributor concludes that its entry will induce the REC affiliate to lower propane prices back to subsidized levels (i.e., below the costs incurred by otherwise efficient independent firms) then the independent propane distributor will be deterred from entering even if prices are currently at supracompetitive levels.

1. **Interest Rates**

If the REC's propane affiliate has access to below-market interest rates, its artificial cost advantage relative to independent propane marketers could be significant. Table V-1 illustrates the relationship between interest rates and the costs of operating a local propane business. The table contains four columns, pertaining to loan amounts of $500,000; $1,000,000, $1,500,000, and $2,000,000. Moving from left to right in Table V-1, the progressively larger loans would be sufficient to establish progressively larger propane operations. The first row of Table V-1 contains the annual payment on the loan assuming that the interest rate is 6.75% and the term of the loan is twenty years. For instance, Table V-1 shows that the annual payment on a loan of $500,000 at an interest rate of 6.75% would be $46,283. This attractive interest rate has recently been available through the CFC to the propane affiliates of RECs.[30]

Below this first row, Table V-1 contains information on five successively higher interest rates, starting with 7.75% (the prime rate as of February 26, 1999) and then moving to rates 1.0 point, 1.5 points, 2.0 points, and 2.5 points above this rate. Moving down the first column, Table V-1 shows that the annual payments on a $500,000, twenty-year loan at an interest rate of 7.75% would be $49,982, or $3,699 higher than the annual payments at 6.75%; at 10.25% the annual payments would increase to $59,935, or $13,452 higher than the annual payments at 6.75%. Moving across Table V-1 displays how these annual payments increase with progressively larger loans. For instance, the entry in the bottom right hand corner of Table V-1 shows that the annual payments on a twenty-year, $2,000,000 loan at 10.25% interest would be $238,940, or $53,807 higher than they would be at an interest rate of 6.75%.

The other figures in Table V-1 translate these higher annual payments into per gallon equivalents, assuming annual sales of 500,000 gallons and 2,000,000 gallons. For instance, for a firm that sold 500,000 gallons per year, a $500,000 twenty-year loan at 9.75% (two points above prime) would impose a per gallon penalty of 2.3 cents relative to a firm that could obtain the same loan at 6.75%; for a $1,000,000 loan the per gallon penalty would be 4.6 cents. Bearing in mind that the retail cost of a gallon of propane is generally less than $1.00, it is

[30] See, for example, Schedule of Mortgage Notes, O&A Electric Cooperative (MI), year ended December 31, 1996.

plausible that an artificial cost advantage of this magnitude would be sufficient to distort competition to the benefit of a propane distributor affiliated with an REC and to the detriment of an otherwise more efficient independent propane distributor.

Table V-2 demonstrates that the cost advantages laid out in Table V-1 are not merely speculative. RECs can borrow money through the CFC at rates lower those available to even the *largest* independent propane distributors. AmeriGas Partners and Ferrellgas, Inc. were the two largest propane dealers in the United States in 1994, as measured by retail gallons delivered.[31] Each, according to their most recent financial statements, has assets in excess of $600 million, including physical property, plant, and equipment (net of depreciation) in excess of $400 million. Yet despite their profitability, large size, and abundant collateral, neither can borrow money at rates competitive with the CFC.[32]

[31] Fitch Research, p. 15. AmeriGas delivered 829 million gallons and Ferrellgas 631 million gallons in 1994.

[32] CFC's most recent bond offering in London had a coupon rate of 4.125 percent, only 46 basis points higher than the German Government's offerings. CFC's debt is rated the same as that of AT&T by both Moody's and Standard and Poor's. (New issue press release, Bloomberg LP, February 19, 1999)

Table V-1

Annual Payments on 20-Year Loans At Various Rates

	Loan Amount			
	$0.5 Million	**$1.0 Million**	**$1.5 Million**	**$2.0 Million**
Annual Payment at 6.75%[1]	$ 46,283	$ 92,567	$ 138,850	$ 185,133
Annual Payment at Prime (7.75%)[2]	49,982	99,965	149,947	199,929
Difference vs. 6.75%	3,699	7,398	11,097	14,796
Difference per Gallon - 0.5mm[3]	0.007	0.015	0.022	0.030
Difference per Gallon - 2mm[4]	0.002	0.004	0.006	0.007
Annual Payment at Prime+1 (8.75%)	53,801	107,602	161,403	215,204
Difference vs. 6.75%	7,518	15,035	22,553	30,070
Difference per Gallon - 0.5mm	0.015	0.030	0.045	0.060
Difference per Gallon - 2mm	0.004	0.008	0.011	0.015
Annual Payment at Prime+1.5 (9.25%)	55,752	111,505	167,257	223,010
Difference vs. 6.75%	9,469	18,938	28,407	37,876
Difference per Gallon - 0.5mm	0.019	0.038	0.057	0.076
Difference per Gallon - 2mm	0.005	0.009	0.014	0.019
Annual Payment at Prime+2 (9.75%)	57,731	115,462	173,193	230,923
Difference vs. 6.75%	11,448	22,895	34,343	45,790
Difference per Gallon - 0.5mm	0.023	0.046	0.069	0.092
Difference per Gallon - 2mm	0.006	0.011	0.017	0.023
Annual Payment at Prime+2.5 (10.25%)	59,735	119,470	179,205	238,940
Difference vs. 6.75%	13,452	26,904	40,355	53,807
Difference per Gallon - 0.5mm	0.027	0.054	0.081	0.108
Difference per Gallon - 2mm	0.007	0.013	0.020	0.027

Table V-1, Continued

Annual Payments on 20-Year Loans At Various Rates

Notes

[1]6.75% is an estimate of the rate paid by Rural Electric Cooperative members of the National Rural Utilities Cooperative Finance Corporation (CFC) for 20-year CFC loans. The CFC's 1998 10-K reports a weighted-average of long-term loans rates to distribution systems of 6.79%. While the actual rate varies, 6.75% is a conservative estimate, likely overstating the true cost of an REC borrowing from the CFC. This is because an REC is an owner as well as a customer of CFC and is entitled to a portion of the CFC's net margins as "patronage capital credits." Such credits essentially allow an REC to borrow at an interest rate equal to CFC's cost of procuring funds on the capital market, plus some allowance for administration. By way of comparison, the CFC has the same credit rating as AT&T, AA-minus. The 30-year notes in AT&T's recent $8 billion debt offering have a coupon rate of 6.5%.

[2]According to the Federal Reserve (http://www.bog/frb/fed/us/releases/H15 htm), the prime rate on February 26, 1998 was 7.75%, the lowest in some time. The average prime rate over all of 1998 was 8.35%, and the rate was as high as 8.5% as recently as September 29, 1998.

[3]According to a study performed by Leak-Goforth Company, LLC for Four County Electric Membership Corporation, 500,000 gallons per year represents the minimum scale at which a propane dealership could be profitable. See Leak-Goforth, "LP Gas Feasibility Study for Four County EMC," 1997, pp. 12, 15.

[4]2,000,000 is an estimate of the maximum viable scale for a single propane "plant," given that there is a limit to the geographic area which can be efficiently serviced out of a single location. The estimate assumes 2,500 customers consuming, on average, 800 gallons of propane per year. Estimates obtained from discussions with various propane industry participants.

Table V-2

National Rural Utilities Cooperative Finance Corporation (CFC) vs. AmeriGas Partners and Ferrellgas, Inc.

	CFC	AmeriGas Partners	Ferrellgas, Inc.
Moody's Rating	A1	Ba3	B1
Standard and Poor's Rating	AA-	BB-	B-
Cost of Long Term Debt[a]	6.74 %	10.13 %	7.85 %

[a] For CFC, "weighted average costs incurred... on its long-term borrowings (Collateral Trust Bonds, Medium-Term Notes, Quarterly Income Capital Securities and debt supported by interest rate swaps); for AmeriGas, coupon rate on Senior Notes issued April 19, 1995 and due April 2007; for Ferrellgas, weighted average of $350 million in Senior Notes at 7.16% due 2005-2013 and $160 million in Senior Notes at 9.375% due 2006.

Sources: Bloomberg LP Research, May 3, 1999; Ferrellgas Partners LP, Form 10-Q, March 17, 1999; AmeriGas Partners LP, Form 10-Q, February 16, 1999; National Rural Utilities Cooperative Finance Corporation, Form 10-K, August 31, 1998.

Neither AmeriGas nor Ferrellgas, much less smaller, local propane distributors, can acquire capital at rates which compete with those of those of RECs who are CFC members. The CFC's not-for-profit and tax-exempt status allows its electric distribution system members to pay only the CFC's cost-of-capital on their CFC loans.[33] Consider, for example, a $1.5 million loan for a propane plant selling 2 million gallons per year. Table V-1 shows that an REC's cost-of-capital advantage relative to AmeriGas and Ferrellgas equals, respectively, nearly 2.0 cents/gallon (10.25% rate vs. 6.75% rate) and greater than 0.6 cents per gallon (7.75% rate vs. 6.75% rate). Note that the per gallon advantage would be correspondingly higher if the hypothetical distributorships were running at less than full capacity, i.e., selling less than 2 million gallons annually.

[33] The CFC's 1998 10-K reports a weighted-average of long-term loan rates to distribution systems of 6.79% ($3.858 billion at a fixed 6.95% and $2.693 billion at a variable 6.55%). However, since CFC is a cooperative, its margins are repaid to members in the form of capital credits, making the effective rate even lower. Generation and Transmission RECs, Telecommunications Organizations, Service Organizations, and Associate Members all pay higher interest rates, on average, than distribution systems, which would allow the CFC to cover operating costs above the cost of capital.

2. Intangible Assets

In addition to these potentially considerable interest savings, an REC's propane affiliate could benefit artificially from assets built up by the REC during its many years as the local electric monopoly. For example, an REC affiliate could benefit considerably from the parent business' well-known brand name, its knowledge of and access to local customers, and its possession of information regarding new construction projects. To a large extent, these advantages are the result of the REC's past and ongoing government subsidy, tax-exempt status, and protection from competition.

With respect to brand name, the advantage is obvious. RECs enjoy the goodwill of customers that stems from their established business relationship. The affiliates of RECs will benefit from this goodwill automatically when they use the REC brand name. Independent propane dealers, on the other hand, must undertake investments in order to establish goodwill.[34]

In terms of knowledge and access to local customers, the propane affiliates of RECs benefit from their parents' existing customer lists and knowledge of customers' energy consumption. If the REC hasn't already discovered which residential and business customers are propane users through member surveys, REC meter-readers can make the determination by scouting out storage tanks. These same meter-readers also may, at virtually no incremental cost, distribute marketing materials door-to-door.

By virtue of its franchise as the sole provider of electricity services, the REC typically knows when new construction projects are underway because those projects inevitably require electricity. During discussions with the builders regarding how best to provide the new project with electricity service, the REC would be provided a unique opportunity to market its propane service as well. Independent propane marketers may never be offered the opportunity to bid on the project if the builder decides to utilize the REC for the installation of the propane tanks and pipes, and for the provision of the propane once the project is completed. Competition is

[34] Recognizing the competitive advantage offered by an established brand name, the California Public Utilities Commission forbade unregulated affiliates of regulated utilities from using their parent's brand name without a disclaimer. PG&E was recently fined $1.68 million for violating this rule. See, Cisma, Tami. "PG&E Branding Penalty Sparks Debate." *Electric Light & Power*, January 1999.

distorted, leading consumers to pay higher prices, when only a single firm is offered the opportunity to provide a service in an otherwise competitive market.

One could argue that diversifying into other lines of business while using the well-known REC logo and other assets and information possessed by the REC represents an efficient expansion of a company successful in one business (electricity) into another related business (propane distribution). We believe, however, that an even more powerful argument is that, in this case, such practices constitute unfair competition. The REC is using assets that were acquired cheaply by virtue of decades of government subsidization that is not available to independent propane distributors. Further, the costs involved in establishing and maintaining the valuable corporate brand name, in developing customer lists, and in maintaining information on new construction projects would almost certainly be included in the costs incurred (and recovered) by the parent electric company. Consequently, the REC's propane distribution business would benefit from this cross-subsidization potentially free of charge.

Ordinarily, the allocation of the fixed and common costs incurred by a firm serving two lines of business does not distort competition. In the present case, however, the asymmetry between the positions of the incumbent RECs and the incumbent propane dealers makes the application of this principle untenable. The RECs can enter the propane business – with its low barriers to entry – but the reverse is not true, due both to the enormous costs of entering the electricity business and the regulatory barriers that preclude it in any event. Hence, there is neither a market check nor an effective regulatory mechanism to prevent RECs from allocating and recovering costs from their various lines of business in ways which fundamentally, and artificially, disadvantage their propane rivals.

3. The FTC on Cross-Subsidization

A recent analysis by the Federal Trade Commission staff summarizes the harms to competition that could flow from cross-subsidization. While the following excerpt refers specifically to the use of the corporate logo by the affiliates of private utilities, the analysis would also pertain to the other examples of cross-subsidization discussed above. And the

concerns voiced by the FTC staff would be magnified when the cross-subsidization derives from a company such as an REC that enjoys advantages over and above its status as a monopolist in a regulated market, such as tax exemptions and access to low interest loans:

> Harm to competition may occur because the unregulated affiliate's access to the logo of its regulated parent gives it a cost advantage that otherwise equally efficient competitors cannot match. The anticompetitive results may include (1) higher-than-necessary average operating (i.e., non-logo-related) costs for the industry and higher prices for consumers due to the continued operation of the affiliate, which can survive with higher-than-necessary costs due to the cross-subsidization; (2) greater market concentration and less competition than would occur absent the cross-subsidization; and (3) discouragement of potential entry that likely would have occurred absent the cross-subsidization, including entry involving innovative products and production processes.[35]

We believe that cost-shifting and cross-subsidization are serious concerns. Yet, we also want to be clear that it is not our position that any expansion by a regulated firm into an unregulated line of business is necessarily anticompetitive. There are certainly cases where it would be efficient for a regulated firm to expand into a related, unregulated business in order to take advantage of certain assets and expertise that can be transferred from the regulated business to the unregulated one. In economic terms, a diversified firm can exploit certain "economies of scope."[36] Possible examples include the expansion by local telephone companies into the long distance telephone business or the expansion of local cable television providers into the provision of local telephone service. There is little doubt that local telephone providers' expertise in operating a local telephone company would permit them to provide long distance service more efficiently than a firm without that expertise, and that the assets that a local cable television provider already has in place to provide television service could be used to provide telephone service as well.

Similarly, we do not deny that an REC may be able to reduce some costs involved in providing propane distribution services by virtue of its existing electricity business. For

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[35] Comment of the Staff of the Bureau of Economics of the Federal Trade Commission, RE: Order on Standards of Conduct, DTE 97-96, Before the Commonwealth of Massachusetts Department of Telecommunications and Energy, October 8, 1998. (footnotes omitted)

[36] Economies of scope exist when a single firm can provide two separate products more efficiently, i.e. at lower cost, than two separate firms.

instance, the REC may be able to send a single bill to customers that purchase both electricity and propane, it may be able to advertise and market both products together, and certain front office personnel may be able to serve both businesses.

We question, however, whether the expansion by RECs into the propane distribution would yield efficiency benefits sufficient to overcome the competitive concerns discussed above. In other words, there do not appear to be significant "economies of scope" for a firm that provides both electricity service and propane distribution services. The electricity business and the propane distribution business (unlike local and long distance telephony or cable television and local phone service) are fundamentally different. The assets and expertise required to operate one can, with the exception of some overhead functions, be separated from the assets and expertise required to operate the other. We conclude, therefore, that any savings attained by the REC in operating both electricity and propane businesses would likely be minimal, and exceeded by the harms caused by the cost-shifting and cross-subsidization described above.

C. Misinformation to Consumers

An REC's use of its familiar company logo in marketing propane could deceive consumers. Specifically, consumers could be harmed when marketing practices (1) convey the false message that the prices charged by the electric utility for nonelectricity services, such as propane, are monitored by state's regulatory authorities to ensure they are "fair and reasonable;" (2) convey the false message to consumers that the state has approved the electric utility's entry into nonelectricity goods and services, implying to consumers that the REC's propane service is more reliable or of higher quality than that provided by independent propane marketers; or (3) convey the false message that consumes are obligated to make their propane purchases from their local cooperative as is the case with their electric purchases. If any of these false messages is conveyed by the use of the logo and brand name, consumers might be willing to pay higher prices for propane distribution services supplied by the REC when, in

fact, other independent propane distribution suppliers offered lower prices and/or superior service.

The FTC staff has recently discussed the possible harm from consumer deception in comments to states considering electricity restructuring. For example, in comments to Massachusetts the FTC staff stated:

> Harm to consumers and competition may occur if elements of the reputation of the regulated firm are not applicable to the unregulated affiliate, but consumers believe that they are applicable when the unregulated affiliate uses the parent utility's logo. For example, an element of a parent firm's reputation might be the credibility of its pledges of high-quality service that are backed by the parent's financial stability as a government-franchised monopoly. If a consumer imputed this same credibility to an affiliate's promises of high-quality service because of its use of the parent's logo, when in fact the affiliate did not have access to the revenues of the monopoly franchise, the consumer could be injured if the affiliate was unable to fulfill its promises in the way the consumer expected. Under such circumstances, the use of the logo by the unregulated affiliate could harm consumers and competition in much the same way as deceptive advertising.[37]

D. Conclusion

This section of the report explains how REC entry into the propane business could be anticompetitive. The proof, however, is in the pudding. Hence, the next section describes the experiences in several states where RECs have entered the propane distribution business and confirms that REC entry has in fact distorted competition in the propane industry.

[37] Comment of the Staff of the Bureau of Economics of the Federal Trade Commission, RE: Order on Standards of Conduct, DTE 97-96, Before the Commonwealth of Massachusetts Department of Telecommunications and Energy, October 8, 1998. (footnotes omitted)

VI. EVIDENCE RELATED TO ANTICOMPETITIVE BEHAVIOR

Table VI-1 (following page) shows that at least 31 RECs in at least 13 different states have entered the propane business in the last few years. This report focuses on roughly a dozen RECs in four states – Alabama, Kentucky, Michigan, and Texas.[38] Much of the information presented herein has been acquired as a result of lawsuits filed by independent propane marketers against RECs. While these lawsuits have tended to focus on state incorporation acts and the nature of the charters of cooperative ventures, they have brought to light evidence of the types of anticompetitive behavior described above.

RECs are subject to some form of rate regulation in 16 out of the 46 states in which they operate.[39] These sixteen states include Michigan, Kentucky, and Texas. However, as of 1995 individual Texas cooperatives may opt out of rate regulation by the Public Utilities Commission by virtue of a majority vote of the membership. REC electric rates in Alabama are not state regulated but instead determined by the REC's boards.

[38] Information about the propane concerns of RECs other than those discussed in the remainder of this report may, in some cases, be found on the world-wide-web. These include Cherryland Electric/Propane (http://www.cecelec.com.htm); Clearwater Power/Propane (http://www.clearwaterpower.com/content.htm); Hancock-Wood Electric/Prism Propane (http://www.hwelectric.com/); Polk-Burnett Electric Cooperative (http://www.polk-burnett.org/); Shelby Electric of Illinois (http://www.shelbyelectric.com/); and Southeastern Energy/Propane (http:www.secoop.com/).

[39] National Rural Electric Cooperative Association, http://www.nreca.org/coops/elecoop3.html

Table VI-1

RECs That Have Entered the Propane Business

REC	State	Entry Method	Propane Partner
Coosa Valley	AL	Acquisition	N/A
Flint EMC*	GA	Startup	N/A
Edgar County	IL	Startup	N/A
Shelby Electric Coop	IL	Startup	N/A
Southwestern	IL	Acquisition	N/A
Heartland Energy	KS	Acquisition	N/A
Lyon-Coffey	KS	Acquisition	N/A
Clark Energy	KY	Startup	Thermogas
Farmers REC	KY	Startup	Thermogas
Jackson Energy	KY	Startup	Thermogas
Shelby Energy Coop	KY	Startup	Thermogas
Warren REC	KY	50% Acquisition	Smith-Douglass LP
Fruitbelt	MI	Startup	Northwestern
Great Lakes	MI	Merger**	Smith's Propane
Ottawa & Allegan/Great Lakes	MI	Startup	Smith's Propane
Southeastern	MI	Acquisition	N/A
Thumb Electric Cooperative	MI	Startup	Farmers Petroleum
Top O'Michigan	MI	Startup	Smith's Propane
Callaway Electric	MO	Startup	MFA Propane
Tallahatchie Electric	MS	Acquisition	N/A
Blue Ridge EMC	NC	Acquisition	N/A
Four County EMC	NC	Startup	Jenkins Gas
Coshocton County	OH	Startup	N/A
Firelands	OH	Acquisition	N/A
Frontier Electric	OH	Unknown	Unknown
Hancock-Wood EC	OH	Startup	Moulton
Dickens County	TX	Acquisition	N/A
Hilco Electric	TX	Startup	N/A
Jackson Electric	TX	Acquisition	N/A
Clearwater Power	WA	Startup	N/A
Polk Burnett	WI	Startup	N/A

Note: Entry method of "Acquisition means the REC purchased a going propane concern. Startup means the REC and, if applicable, its partner created a new concern. "N/A" means that the REC has no partner.

Source: Information received from various independent propane marketers and information retrieved from various sources on the internet.

*Propane venture has been enjoined by the Superior Court of Taylor County, Georgia.
**Great Lakes REC had an existing propane venture which merged with Smith's Propane.

ALABAMA

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BACKGROUND

Coosa Valley Electric Cooperative ("Coosa Electric") is a rural electric cooperative providing electricity to roughly 19,000 consumers in Alabama. In February, 1996, Coosa Electric's board elected to enter the business of propane distribution. Toward this end, Coosa Valley EC formed a subsidiary company called Coosa Valley Propane Services ("Coosa Propane") in April, 1996. Five months later, in September 1996, Coosa Propane purchased a 100 percent interest in an existing propane distributor, DeKalb County LP Gas Company ("DeKalb").[1]

The decision to move into propane in this fashion was approved by the customer/owners of Coosa Electric. In arguing for the entry into propane, Dr. Jim Winn, the president of Coosa Valley EC, stated that when and if the propane business becomes profitable "that of course will reflect and help Coosa Valley electric from an overall profit standpoint and to hopefully lower the cost of the electrical service by the profits of propane going into the electrical side of it." The move would also give the cooperative something "to fall back on" should it lose electrical customers due to deregulation.[2]

In November, 1996, a group of twenty-eight independent propane distributors filed suit to prevent Coosa Valley EC from distributing propane. The allegation was that the formation of a for-profit subsidiary violated the REC's charter. Initial court rulings proved favorable to the independent propane distributors, and DeKalb's marketing and distribution strategies were severely curtailed pending appeal. However, the Supreme Court of Alabama reversed in November 1998, declaring that current Alabama law does not prohibit Coosa Electric from purchasing a propane distributor and entering the business.[3] Since this decision was made,

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[1] Appellees' Brief. *Coosa Valley Electric Cooperative vs Allgas, Inc., et al.*, ("Appellees' Brief") August 12, 1998. Pages 10-14.

[2] Minutes of September 7, 1996 meeting of Coosa Valley Electric Cooperative. Quoted in Apellees' Brief, Coosa Valley Electric Cooperative vs. Allgas, Inc., et al., August 12, 1998, p. 13.

[3] Supreme Court of Alabama: Opinion on Coosa Valley Electric Cooperative vs. Suburban Gas Inc. et al., November 25, 1998.

according to some of the Alabama propane dealers. DeKalb has become more aggressive in marketing and expanding its operations.

While the lawsuit centered on a narrow point regarding interpretation of Alabama corporate law, depositions, exhibits, and other documents produced in the course of the proceeding provide considerable evidence that the REC's operation of the for-profit propane business appears anticompetitive. As discussed below, DeKalb may be the beneficiary of cost-shifting, cross-subsidization, and access to low interest capital as a result of its relationship with Coosa Electric.

EVIDENCE OF ANTICOMPETITIVE BEHAVIOR

Less than a year after its creation, in January 1997, Coosa Propane had incurred $3 million in debt to cover the start-up costs of its new business. Of this amount, $2 million paid for the purchase of DeKalb County LP.[4] The large majority of these funds appear to have been borrowed from National Cooperative Services Corporation (NCSC). NCSC is an affiliate of the CFC that specializes in making loans to (and sometimes even taking equity positions in) RECs' for-profit projects.[5] According to financial statements filed with the Alabama Liquefied Petroleum Gas Board, as of May 31, 1996 Coosa Propane had obtained approval for $2.65 million in credit from NCSC, including a thirty-year loan of $1.0 million, a five-year line of credit for $1.5 million, and a one year letter of credit in the amount of $150,000.[6] At the time, it also had more than $250,000 in loans outstanding from Coosa Electric. These loans were

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[4] Appellees' Brief, p. 14.

[5] See CFC website (http://www.nrucfc.org).

[6] Coosa Valley Propane Services, Inc., Financial Statements, May 31, 1996, p 6. Nevertheless, it is not clear that these loans were ever made, as they were subject to a loan guarantee agreement to be executed by Coosa Electric. It is known that in June 1996 Coosa Electric applied to the Alabama Department of Finance requesting its consent for the Coop to guarantee $1.5 million in loans to Coosa Propane. However, this application was withdrawn when Coosa Electric learned that it had violated its own bylaws by entering the propane business without consulting its members. Eventually, the membership did approve the venture, but it is not clear what became of the NCSC loans or whether the petition to the Department of Finance was reinstated. Given this history, Coosa Electric's established relationship with the CFC, and the fact that Coosa Propane eventually did acquire $3 million in loans from *somewhere*, it seems likely that at least some of the loans did come from NCSC.

uncollateralized, bore no interest, were made from funds acquired through short-term borrowings from CFC, and were to be repaid when Coosa Propane acquired its own financing.

Coosa Electric, like virtually all RECs, is itself a beneficiary of loans from both the CFC and the U.S. Department of Agriculture. Of its $12.4 million obligation to RUS as of April 30, 1996, $584,000 was financed at 2 percent and roughly $11.8 million at 5 percent. Of $5.2 million owed to the CFC as of the same date, $138,000 was financed at a fixed rate of 7.0 percent and the balance at a variable rate of (then) 6.35 percent.

When Coosa Propane was formed, the officers and directors of Coosa Valley EC were installed as the officers and directors of Coosa Propane. After the purchase of DeKalb by Coosa Propane, these same officers and directors became the officers and directors of DeKalb as well. Likewise, one individual, Joe Cade, served as general manager of both the electricity cooperative and Coosa Propane.[8] Whether and to what extent the propane business pays for the services of these individuals is unknown. In any event, there is reason to believe that the cooperative is commingling electric and propane operations, particularly with respect to overhead costs. In a pamphlet mailed to customer/members soliciting their support for the propane venture, Coosa Electric noted that they had hired a manager, Frank Smith, and that:

> He will be assisted by three delivery persons, one service person and a clerical employee. These employees will be responsible for the propane operations, including three delivery trucks and a single service truck.[9]

It seems unlikely that a single clerical employee and a single manager could balance the books, manage the payroll, provide customer service, design and distribute marketing materials, and arrange for the wholesale purchase and delivery of propane without additional support staff. The most obvious candidates to provide such support would be staff at Coosa Electric, whether ultimately compensated by the propane concern or not.

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[7] Coosa Valley Propane Services, Inc., Financial Statements, May 31, 1996, p. 6.

[8] Appellees' Brief, pp. 11, 15.

[9] Coosa Valley Electric Cooperative, "Coosa Valley EC Wants to be Your Total Energy Provider," pamphlet, August 27, 1996.

By purchasing DeKalb and operating it under it its existing name, Coosa Propane was not required to apply to the Alabama Liquefied Petroleum Gas Board for a new LP Gas Dealer Permit. As the purchaser of an ongoing business, it only needed to inform the state petroleum board of the purchase in order to have DeKalb's license transferred to its own name. As part of its notification, Coosa Propane requested (and was granted) the right to paint the cooperative name on the DeKalb cargo vehicles, in addition to the DeKalb name.[10]

The truck-painting reflects Coosa's general strategy of co-marketing electricity and propane and using the cooperative brand name to attract propane customers. The Coosa Electric website includes information on propane services. The aforementioned pamphlet (soliciting member support) is entitled "Coosa Valley EC Wants to be Your Total Energy Provider," and it announces that "Coosa Valley EC will provide the same high quality service for propane consumers that we provide our electric consumers," and "Coosa Valley EC plans to purchase three 30,000 gallon storage tanks..."[11] The implication is that the electric cooperative (EC) will be the one selling the propane.

In the same materials touting the propane business to its members, Coosa Valley explained the benefits of diversification: "About 4,000 households already served by (the cooperative) also use propane. For these consumers, consolidation of energy services to a single supplier will mean added convenience." The "single supplier" concept further betrays the cooperative's views on the need (or the lack of need) to avoid commingling its electric and propane operations. Moreover, whatever the added convenience to consumers, the added convenience to a propane dealer of being affiliated with the local electric monopoly is clear. The cooperative not only knew – prior to entering the propane market – how many of its members used propane ("about 4,000") but, very likely, which ones, how much electricity they use, who their incumbent propane dealer is, etc.

[10] Appellees' Brief, p. 15.

[11] Appellees' Brief, p. 12.

Such Behavior Has and Will Affect the Market

In the first nine months following the acquisition of DeKalb, Coosa Valley increased DeKalb's annualized propane sales from roughly 1.75 million gallons to over 3 million gallons, an increase of over 70 percent.[12] This growth appears to have been mostly at the expense of sales by incumbent independent propane marketers; one propane businessman testified, "the growth of the propane industry is so small, the only way they [the Cooperative's propane gas subsidiary] can survive is by taking my customers."[13] The testimony of other propane distributors echoes this remark, as numerous plaintiffs in the suit against Coosa complained of lost customers.

This successful and dramatic expansion in sales supports the possibility that the behavior identified above is having an effect on the market. Several of the litigants against Coosa Electric have alleged below-realistic cost pricing by Coosa Propane/DeKalb (though perhaps not below Coosa Propane's costs if it is benefiting from cost-shifting and cross-subsidies). The most substantiated of these allegations claims that Coosa is offering prices to large agricultural customers equal to "Mt. Belvieu (a wholesale propane terminal price often used as a benchmark in propane transactions) plus $0.15 per gallon." According to the source in question, transporting propane from Mt. Belvieu would cost approximately $0.09 per gallon and additional operating costs, including labor, final transport, and insurance would result in additional costs of at least $0.13 per gallon. Thus there is a serious question as to whether a price of $0.15 per gallon above Mt. Belvieu is sufficient to cover a reasonable measure of costs.

While we do not have access to a detailed picture of the finances of Coosa Propane, there is at least some support for the concern that Coosa/DeKalb has been pricing predatorily. In Coosa Electric's income statement for the year ended December 31, 1997, propane operations appear to show a $403,538 loss based on propane sales of $2,181,434 and "propane

[12] Leak-Goforth, LLC and Emerson Deese Associates, "LP Gas Feasibility Study: For Four County EMC," 1998, p. 10.

[13] Appellees' Brief, Coosa Valley Electric Cooperative vs. Allgas, Inc., et al., August 12, 1998, p. 41.

expense" of $2,584,972.[14] It appears that the $403,538 loss excludes depreciation and interest charges (and perhaps even propane-related sales, general, and administrative costs), so that Coosa Propane may well have set prices below total costs (and possibly even variable costs) for the calendar year 1997. However, a fuller review of Coosa Propane's financial records may lead to a different conclusion.

[14] Coosa Valley Electric Cooperative and Subsidiaries, Corrected Statement of Revenues and Expenses (Consolidated Financial Highlights), Year Ended December 31, 1997. See Exhibit AL-1.

Exhibit AL-1

Coosa Valley Electric Cooperative
Corrected Statement of Revenues and Expenses
Year Ended December 31, 1997

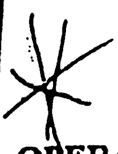
COOSA VALLEY ELECTRIC COOPERATIVE, AND SUBSIDIARIES

[illegible]

Corrected

STATEMENT OF REVENUES AND EXPENSES
(Consolidated Financial Highlights)

Year Ended December 31, 1997



	1997
OPERATING REVENUES	
CVEC	$14,095,031
Coosa Valley Propane Services	2,181,434
Total Sales	16,276,465
OPERATING EXPENSES	
Cost of power	7,614,217
Propane expense	2,584,972
Distribution - operations	139,850
Distribution - maintenance	798,009
Consumer accounts	764,874
Selling	289,416
Administrative and general	1,231,638
Depreciation and amortization	1,1[illegible]4,534
Taxes	274,298
Total operating expenses	14,821,808
OPERATING MARGINS BEFORE FIXED CHARGES	1,45[illegible],657
FIXED CHARGES:	
Interest on long-term debt	1,103,494
Other Interest Expense	81,830
Total Fixed Charges	1,185,324
OPERATING MARGINS AFTER FIXED CHARGES	269,333
G & T AND OTHER CAPITAL CREDITS	179,557
NET OPERATING MARGINS	448,890
NONOPERATING MARGINS	132,005
[illegible]	[illegible]

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adults a
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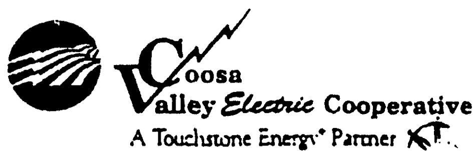
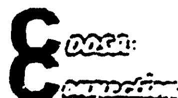
Exhibit AL-2

Selected Pages From Coosa Valley Electric Cooperative World-Wide-Website





Your TOTAL Energ

Coosa Valley Electric Cooperative is a member-owned and operated total energy cooperative providing economic and community development while delivering high quality services at competitive rates with competent and well-trained employees adhering to strong, ethical business practices.

WELCOME

Welcome

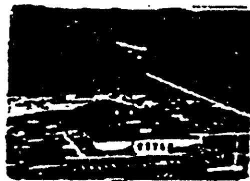
Coosa Connection

Services

About CVEC

Links

A Message from our General Manager:



Coosa Valley Electric Cooperative, Inc., (CVEC), is located just 45 minutes east of Birmingham, Alabama and just over one hour west of Atlanta, Georgia on the I-20 corridor. An excellent location for a business or industrial customer to locate

CVEC is a non-profit, member owned, and democratically run rural electric system. Each year, member/owners have the right to vote for representatives to serve on the board of directors. The directors set policies that will determine the operations of the cooperative. It is our intent to provide reliable, quality electrical service to the membership at the most cost effective price. In fact, we have reduced our residential rates by 10% over the past three years.

There are many services we provide through our **Coosa Connection** program. In addition, we have a propane gas subsidiary - Dekalb County LP Gas, Inc. - with excellent service and competitive prices.

CVEC is also proud to be a Touchstone Energy® Partner. To learn more about Touchstone Energy®, click here.

As a first priority, Coosa Valley's employees are committed to service excellence to our member/owners . It is referred to in our motto as: **"providing outrageous consumer service."** Our business values reflect in our commitment to provide service with integrity, innovation.

to provide service with integrity, innovation, accountability, community service and fairness. We think you will find our service some of the best you have ever experienced.

From our mountains to our lakes, the quality of living in our area is second to none. If you are interested in additional information about this area and CVEC, please contact us.

— Robert Marshall
General Manager

69220 AL HWY 77 • PO Box 837 • Talladega, Alabama • 35160
1-800-273-7210 • (256) 362-4180 • FAX: (256) 761-2615
Email: cvalley@cybrtyme.com

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Welcome

Coosa Connection

Services

About CVEC

Links

SERVICES

If you would like to know more about any of the CVEC Services, call 1-800-273-7210 or send an email to: cvalley@cybrtyme.com

- DeKalb County LP Gas
- Annual Meeting
- Alabama Living Magazine
- Washington Youth Tour

DeKalb County LP Gas Co. Inc.

DeKalb County LP Gas Co. Inc. is a subsidiary of Coosa Valley Electric Cooperative. DeKalb County Gas sells propane gas, appliances, gas logs, gas grills, as well as lease tanks of all sizes.
Consumers can depend on competitive rates and excellent service from this "Coosa Valley Propane Services Company."

DeKalb County LP Gas Co., Inc.
69636 Alabama Highway 77
P.O. Box 6107
Talladega, AL 35160/35161

(256) 362-4780 or 1-800-532-0885

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Annual Meeting

Each year, on the first Saturday following labor day, CVEC holds its Annual Meeting at the Motor Sports Hall of Fame in Talladega. All members of CVEC and their families are invited to attend. In addition to discussion about Cooperative business and the oath of office given to new board members, there are games and activities for all ages, door prizes, bingo for prizes, and other activities. Make plans to be with us this year on Saturday, September 11, 1999! See you there.

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Alabama Living Magazine

Every CVEC member receives Alabama Living, a monthly magazine produced by the Alabama Rural Electric Association (AREA). This magazine is a great source of information on the cooperative and has interesting and informative articles on many aspects of life here in our service area of Alabama. CVEC members are also encouraged to read the newsletter that comes with the monthly invoice billing. Many times, this may be the best form of communicating timely information to you.

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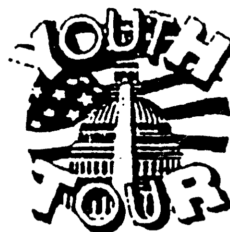
Youth Tour to Washington Essay Contest



Eleventh Grade students in the CVEC service area are eligible to compete in the Washington Youth Tour competition. Students submit essays and take exams which relate to electric cooperatives and their structure. Two students receive an all-expense paid trip to Washington D.C. for a six-day tour! The students will tour attractions such as: U.S. Capitol, Archives, Tomb of the Unknown Soldier and the Smithsonian Institution to name a few.

For further information contact Barbara Edmondson, Coosa Valley Electric Cooperative at 1-800-273-7210, ext.224.

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Exhibit AL-3

Information Sheet Published by the Alabama Propane Gas Association

Rural Electric Cooperatives in the Propane Gas Business

History of Rural Electric Cooperatives — The original purpose of RECs was to bring electricity to rural America. RECs have come a long way from the days when rural farms could not obtain electricity from other sources.

Tax Exemption for Rural Electric Cooperatives — Rural Electric Cooperatives are exempt from federal income taxation under Internal Revenue Service (IRS) Code Section 501(c)(12), so long as 85 percent of their sales are made to the cooperative's electric members. Private sector businesses do not enjoy the luxury of being exempt from federal income taxation.

REC Government Loans — The Rural Utilities Service (RUS), within the Agriculture Department, has made or guaranteed 534 low interest loans during fiscal years 1994 through the first three-quarters of fiscal year 1997, which totaled over 3.1 billion. Private sector businesses do not have access to these low interest loans.

Loan Defaults at Taxpayers Expense — RUS wrote off $1.7 billion in electricity loans from fiscal year 1992 through 1996. The outstanding principal on RUS' direct and guaranteed electricity loans totaled about $37.5 billion at the end of fiscal year 1996.

Rural Electric Cooperatives Providing Non-Utility Services — With electric de-regulation on the horizon, Rural Electric Cooperatives (REC) have increased their efforts to enter non-traditional, diversified business ventures, including the propane gas distribution business. While RECs were created for the specific purpose of furnishing electricity to persons in rural areas, now RECs compete directly with private sector businesses for customers in markets far removed from the provision of electric power. To achieve penetration of these traditional private sector markets, RECs are unfairly using their special privileges as government sanctioned Rural Electric Cooperatives to finance the operations of these diversified ventures.

Competition, but on a Level Playing Field — The propane industry is challenging the entrance of Rural Electric Cooperatives into the propane business not to prevent competition, but to ensure that all business entrants compete equitably on a level playing field. The retail propane industry is a highly competitive business with many competitors vying for the business of consumers in all geographic areas of Alabama.

Unfair Competition — When a REC establishes a diversified, non-power venture which offers products and services, that venture starts out with marketing advantages which no independent enterprise would have. Cooperatives are able to compete unfairly by cross-subsidizing their diversification efforts from their rate base, by shifting the costs of the diversified operations to the utility operations, and by discriminating against private sector competitors through the steering of captive ratepayers to the diversified venture.

A few specific examples of cross subsidization employed by RECs include:

- Physically locating unregulated businesses on REC property (utilization of land and building)

- The use, usually at below cost or at no cost, of REC employees, tools, equipment and vehicles.
- The use of its captive members to promote its subsidiary and its services
- The transfer of customer site data collected for power provision purposes to the diversified venture to be used as marketing information
- The use of established name and logo to provide instant identity and recognition for the diversified venture, usually without any costs or royalties on the part of the diversified venture

It is important to note that while RECs may have financed their non-utility ventures with private capital, without the tremendous asset base, the favorable credit rating, and the human resources of the government sanctioned monopoly which was financed by REA/RUS low or no-interest loans, cooperatives would have difficulty obtaining financing to diversity into non-utility businesses, or they would have had to pay a much higher cost of capital which would translate to higher prices for the new services offered to customers in the competitive sector of the economy

Legal Battle in Alabama — A group of 23 Alabama propane companies filed legal action against an electric cooperative who had acquired sole ownership of an existing propane company. On March 19, 1998, the Circuit Court of Shelby County issued a Summary Judgment stating that it was illegal for Alabama rural electric cooperatives to own and operate propane businesses. The electric cooperative filed an appeal with the Alabama Supreme Court and was granted an opinion in its favor. However, the Supreme Court stated the following: "Although there is validity to the Propane Dealers' arguments that Coosa Electric is 'bootstrapping' its way into the business that it would have no statutory authority to begin as a cooperative, those argument should be directed to the legislature, not to this Court." Therefore, the propane gas industry in Alabama is doing exactly what the Supreme Court instructed it to do

Legislative Activities from Other States — The Virginia Coalition for Fair Competition was successful three years ago in negotiating a Statement of Intent and Standards of Conduct with the public utilities in Virginia The Standards of Conduct would set restrictions and auditing procedures for the use of cooperative funds, personnel, equipment and so forth. The Statement of Intent would have to be initiated one year prior to going into a listed business. Last year, the Rural Electric Cooperatives in Virginia introduced a bill to remove restrictions on them so that they could go into the private sector marketplace. The same coalition opposed that legislation and was instructed by the Virginia Legislature to negotiate the same arrangement with the Rural Electric Cooperatives as they did with the public utilities At this time, negotiations have not been completed with the cooperatives

Also, the Tennessee Legislature passed a similar bill which placed restrictions on public utilities entering the marketplace in its state As with the Virginia standards, among some of the restrictions in place in Tennessee is the prohibition of cross-subsidization and independent auditing authority.

For further information, contact Alabama Propane Gas Association (334) 271-7666

KENTUCKY

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EXHIBIT KY-3: MARKETING MATERIALS OF KENTUCKY REC PROPANE CONCERNS

EXHIBIT KY-4: WORLD-WIDE-WEB MATERIALS OF VARIOUS KENTUCKY RECS

BACKGROUND

Five RECs have recently entered the propane business in Kentucky: Shelby Energy Cooperative, Farmers Electric Cooperative, Clark County Energy Cooperative, Jackson County Electric Cooperative, and Warren Rural Electric Cooperative Corporation. Of the five, only the last, Warren, is not itself a member of East Kentucky Power Cooperative, Inc. (EKPC). EKPC is a generation and transmission (G&T) cooperative located in Winchester, Kentucky which supplies wholesale power to its 18 distribution coop members. It is an equity partner in the propane subsidiaries of both Farmers and Shelby RECs.[1] Warren REC purchases electric power from the Tennessee Valley Authority (TVA). Both EKPC (like any REC) and the TVA benefit from tax and credit subsidies supplied by the federal government.

Four of the five Kentucky REC propane entrants (all but Warren) entered the propane business through a joint venture with Thermogas. Thermogas is the fourth largest propane marketer in the nation, with over 250 million retail gallons delivered from nearly 200 retail distribution centers in 1994.[2] Thermogas's apparent strategy is to use the RECs to enter territories where it does not already operate (none of the REC/Thermogas JV's are in areas previously served by Thermogas outlets). The Thermogas joint ventures are known by a combination of "Thermogas" and the REC's name; e.g., Farmers/Thermogas, Clark Energy/Thermogas, Shelby Energy/Thermogas, Jackson Energy/Thermogas. Warren REC, on the other hand, entered the market by purchasing a 50 percent interest in an existing business, Smith-Douglass Liquid Propane. The restructured entity now operates under the name Propane Energy Partners LLC.

We understand that the REC-Thermogas ventures are generally structured as follows: first, the REC forms a for-profit subsidiary in which the EKPC may or may not have an equity stake. In the case of Farmers REC, the for-profit subsidiary is owned 75 percent by the distribution coop and 25 percent by the G&T coop. This subsidiary then forms a second

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[1] To our knowledge, EKPC is not a partner in the propane subsidiaries of Clark or Jackson. There is no reason to believe that EKPC would be involved in the Warren venture.

[2] Fitch Research, p. 15.

limited liability partnership with Thermogas. In the case of Farmers, the equity split was 50 50 between the REC's propane subsidiary and Thermogas. The resultant joint venture then may, as is the case with Farmers-Thermogas, sign a management contract with Thermogas and property leases with the REC. Chart KY-1 below depicts this corporate structure graphically

EVIDENCE REGARDING ANTICOMPETITIVE BEHAVIOR

In September 1995, Warren Rural Electric Cooperative Corporation sent out a survey to its members regarding "Attitudes and Interests in the Propane Business." (Exhibit KY-1) While the results of this survey could not be obtained by NERA, the survey form and accompanying letter are themselves interesting. As alluded to in Section III of this report, question number of the survey 7 asked, "Who is your present propane supplier" and offered seven specific choices, including both national and local propane marketers, as well as an "other" choice. The existence of so-many incumbents within the service-area of a rural cooperative having less than 50,000 members indicates that the propane market was already competitive before the REC's entry.

The letter accompanying the 1995 Warren survey tells the recipient, "As a propane user, we value your opinion..."[3] Question 4 asks, "Do you own or lease your propane tank," but does not allow for a possibility that the recipient may not have a propane tank. It appears possible, therefore, that Warren did not mail this questionnaire to every one of its members but sent it only to those who were known to be propane users. Whether it was able to identify these members by use of its meter-readers in the field or from previous members surveys, a targeted mailing would illustrate the institutionalized marketing advantages that RECs hold over independent propane businesses.

Independent Kentucky marketers report that local RECs have cross-subsidized their propane concerns in other ways, using meter-readers to identify propane customers, to read

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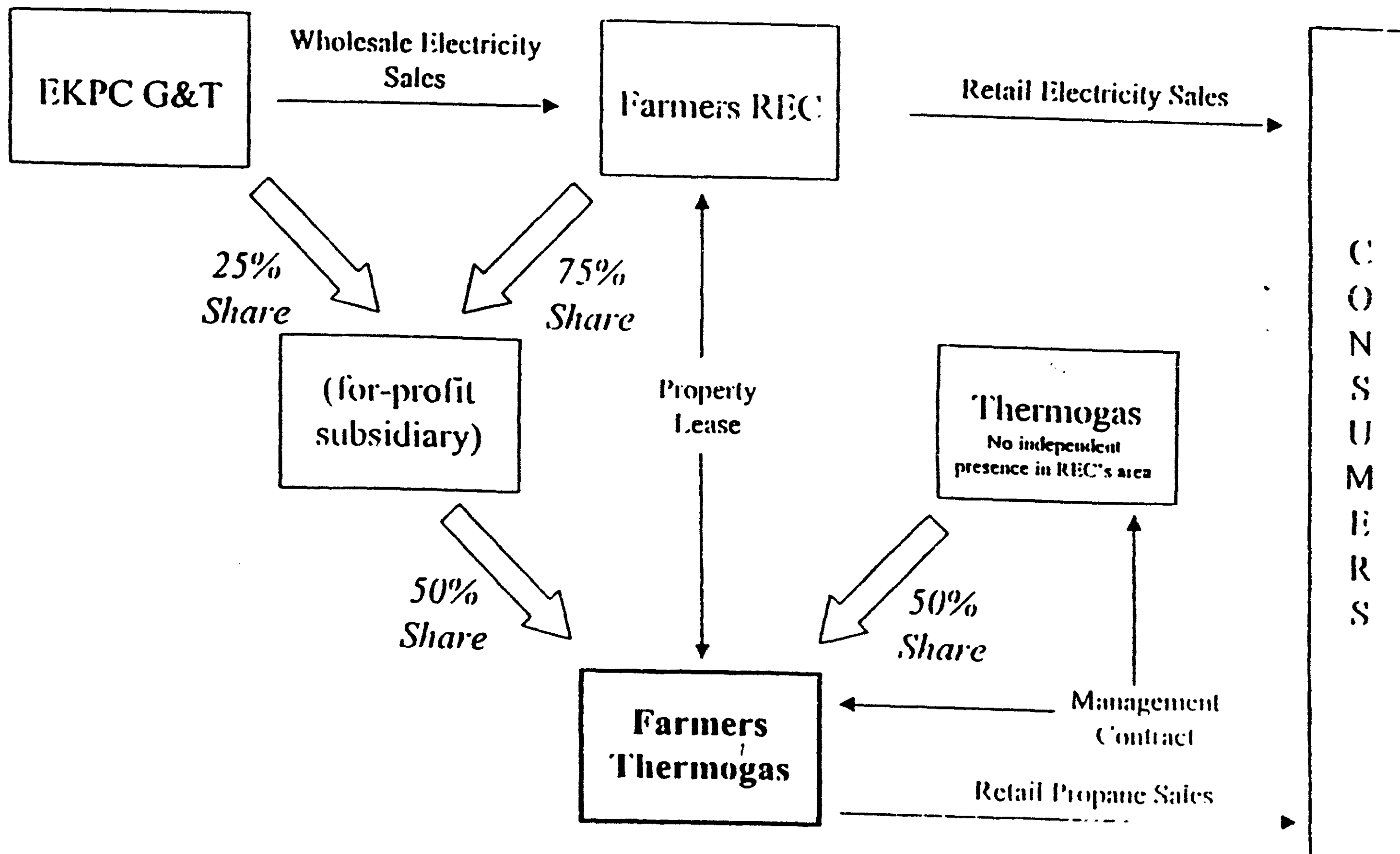
[3] Form letter from Floyd H. Ellis, President of Warren Rural Electric Cooperative Corporation, date September 15, 1995, with survey entitled "Survey of Member Attitudes and Interests in the Propane Business."

Chart KY-1

Ownership Structure of Farmers Thermogas



these customers' tank gauges to determine when they will need a fill-up, and to drop advertising materials at these customers' doors. "Our field employees are busy every day visiting with prospective customers," Clark Energy/Thermogas manager Keith Brownlee told *Kentucky Living* magazine in November 1998 (Exhibit KY-2).[4] Whether or not these field employees are in fact paid as electric meter-readers is unclear, but the article suggests many other opportunities for cost shifting and cross-subsidies. Clark Energy/Thermogas directly employs only five people and operates out of Clark Energy's headquarters in Winchester, Kentucky, suggesting that overhead functions such as bookkeeping and payroll management may be handled by the REC's existing employees.[5] As noted above, Farmers/Thermogas also operates on property owned by the REC. One advertisement for Propane Energy Partners says "Propane Gas and Accessories are available through your Morgantown Warren REC office" (Exhibit KY-3) and, according to a flyer door-dropped by electric meter-readers, if a new customer wants to sign up for propane service, he or she can "Call Propane Energy Partners...or contact any Warren (REC) office." (Exhibit KY-3)

Advertisements also illustrate the RECs' general willingness to allow their brand names, built up on years of government credit and tax subsidies, to be used by for-profit subsidiaries. In the November 1998 issue of *Kentucky Living* magazine, Clark Energy has a multi-page advertising/news supplement (Exhibit KY-2) which includes an article entitled, "The Menu Continues to Grow: Clark Energy Adds Propane to its Service." Both Shelby Energy Cooperative and Jackson Energy Cooperative advertise propane services on their websites, with the latter claiming, "Thermogas propane is part of Jackson Energy's diversified services." (Exhibit KY-4) It is clear that, regardless of actual ownership structures, RECs strive to link the provision of propane with the goodwill generated through their subsidized electric monopolies.

Whether or not these propane companies pay market rates for their space, compensate their parent utilities for use of their brand name, and allocate economically any shared

[4] Crosby, Shanda. "The Menu Continues to Grow: Clark Energy Adds Propane to its Service," *Kentucky Living*, November 1998, p. 5A.

[5] Crosby, pp. 4A-5A. This small number of employees also suggests that the above-referenced "field-employees" who visit with prospective customers probably are employed by the REC, not the propane affiliate.

operating and overhead costs (including advertising as well as labor time) are questions that, due to the proprietary nature of the relevant financial data, remain largely unanswered. Still, some evidence regarding the RECs' attitudes and actions can be garnered from public sources. In December 1997 the Kentucky Public Service Commission (KPSC) ordered various Kentucky utilities to respond to a set of questions on "the need for affiliate transaction rules and cost allocation requirements for all jurisdictional utilities."[6] Among those required to respond was the East Kentucky Power Cooperative, Inc. As noted above, EKPC has an equity stake in the propane subsidiaries of the Farmers and Shelby Coops (making EKPC a partner of Thermogas as well).

EKPC conceded that it "has not adopted a code of conduct for the activities of non-regulated affiliates at this time," and argues that non-profit cooperatives ought not be required to operate independently of their subsidiaries, ought not be prohibited from sharing officers and employees, and, in general ought not be subject to much, if any, oversight by the KPSC. Specifically, it argued that "favorable treatment of a non-regulated division, affiliate, or subsidiary should not be prohibited" and that "a regulated cooperative should not be prohibited from joining with a non-regulated division, affiliate, or subsidiary in promotional, marketing, sales, advertising, or research and development activities."[7]

Among reasons cited for its position, EKPC writes:

> An increasingly competitive market, the *possibility* of non-regulated energy sales, and the *uncertainty* of the structure of a deregulated market, *should it occur*, make it imperative that a utility aggressively protect and enhance its market position. Promotional, marketing, sales, advertising, and research and development activities are critical means of protecting and enhancing market position. Undertaking these with non-regulated affiliates or subsidiaries can reduce the costs of these activities for the utility itself as well as enhance the effectiveness of them.[8] (emphasis added)

[6] Commonwealth of Kentucky Public Service Commission, Order in Administrative Case NO. 369, the Matter of *An Investigation of the Need for Affiliate Transaction Rules and Cost Allocation Requirements for all Jurisdictional Utilities* ("Kentucky Order"), December 19, 1997.

[7] East Kentucky Power Cooperative, Inc., PSC Administrative Case No. 369, "Responses to PSC Order Dated 12/19/97," see especially answers to Questions 6-12.

[8] "Responses to PSC Order Dated 12/19/97," Question 10.

In other words, East Kentucky contends that RECs should be permitted to benefit from co-mingling their various businesses *just in case* competition emerges in their core electric businesses.

Of course, for independent propane dealers there is no "possibility" or "uncertainty" about competition. It exists, and for those facing RECs in Kentucky it apparently exists on uneven terms. The rate at which EKPC makes "loans to subsidiaries is the rate established by the National Cooperative Services Corporation."[9] The NCSC is a subsidiary of the CFC, offering loan terms superior to those which any independent propane dealer is likely to receive (see Sections IV and V). Further, the NCSC and CFC are typically willing to loan 80 percent of the required capital for an REC to enter a new business. The remaining 20 percent in equity comes from internally generated funds earned by a tax-exempt, subsidized, monopoly business.

In its own comments to the KPSC, Shelby Energy Cooperative acknowledged that it "does engage in joint marketing and advertising with Shelby Energy Thermogas in an effort to raise public awareness that Shelby Energy Cooperative, established 60 years ago, can provide its customers immediate access to propane..." It also notes that, "the energy company of the future must be able to offer its customers a variety of energy sources rather than just one."[10] For RECs, that future is now. For independent propane dealers, facing insurmountable regulatory barriers to entering the electricity business, it is still some ways off.

SUCH BEHAVIOR HAS AND WILL AFFECT THE MARKET

Some REC entrants in Kentucky have been pricing very aggressively, prompting several independent propane distributors to question whether their business could be sufficiently remunerative to justify entry. A representative of a national propane concern in competition with Jackson Energy/Thermogas observed that the capital investments required for

[9] "Responses to PSC Order Dated 12/19/97," Question 18.

[10] Shelby Energy Cooperative, PSC Administrative Case No. 369, "Responses to PSC Order Dated 12/19/97," Questions 5, 10.

a *de novo* entrant into propane may require margins greater than those that Jackson has been receiving on its gas.[11]

Independently, another local propane dealer questioned whether Farmers Thermogas' prices for propane cylinders were adequate to generate a reasonable return given the capital investment required (aluminum cylinders of the type supplied by Farmers cost roughly $117 each). He posited that cross-subsidies must be occurring. Farmers has recently been offering prices of roughly $7.00 per cylinder when the previous going rate was on the order of $9.80. The dealer has retained some customers targeted by Farmers by lowering rates to match or beat their offers but notes that such prices are only barely profitable and would not be if his equipment had not already been amortized. He estimated margins above cash operating costs on cylinders of no more than 50-cents at a price of $7.00. Excluding interest payments, this would require 234 refills of a single aluminum cylinder ($117/$0.50 = 234) to cover the capital expense of that cylinder, to say nothing of the trucks and other equipment that need to be amortized and the non-operating sales and administrative expenses that need to be covered.

In other examples of aggressive REC pricing, Propane Energy Partners offered an "August Fill-Up Special" of 74 cents per gallon, while independents were charging 84 cents.[12] Farmers Thermogas offered one customer bulk delivery rate of 69 cents per gallon, compared to 84 cents offered by independent distributors. Jackson/Thermogas offered refills of small, barbecue propane tanks at $6, compared to the market rate of about $10. Such price cutting has resulted in significant margin loss and, in some cases, significant customer defection, for incumbent propane dealers who have had to respond with price cuts of their own.

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[11] The dealer's estimate of Jackson's margins were based on his observation of their prices and his assumption that their propane costs are similar to his own.

[12] See attached Exhibit KY-2.

Exhibit KY-1

Warren REC Survey to Customers Regarding Propane Usage

September 15, 1995

Warren Rural
Electric
Cooperative
Corporation

951 Fairview Avenue
PO Box 1118
Bowling Green, KY
42102

Phone: (502) 842-6541
Fax: (502) 781-3299

Other Locations:

Buck Jenkins
Service Center

Franklin

Leitchfield

Morgantown

September 15, 1995

CONFIDENTIAL

ROBERT B PORTER
478 FRANK KITCHENS RD
MORGANTOWN KY 42261

RE: Certificate No. 15351'/203 (H16S005)

Our mission at Warren RECC is to provide services of superior value which will improve the quality of life of our members and the communities we serve. However, in order to do this, we need your help.

Enclosed is a survey which asks your opinion about Warren RECC expanding our services into some new areas. One service we are studying is the sale of propane gas in addition to electricity. As a propane user, we value your opinion; and we are interested in knowing more about what you expect from this type of service. Please take a few minutes to fill out this survey and give us your thoughts and suggestions.

Everyone who sends back a completed survey will be eligible for a drawing to win your choice of one of the following:

Electric blanket	Telephone answering machine
Cordless telephone	Toaster oven
AM/FM radio cassette player	Coffeemaker

The drawing will be held on October 2, 1995. Please return your survey in the self-addressed, stamped envelope before that date.

Thanks for your help and continued support of the Cooperative program.

FLOYD H. ELLIS - PRESIDENT

nth
Enclosures

September 1995

WARREN RURAL ELECTRIC COOPERATIVE CORPORATION
SURVEY OF MEMBER ATTITUDES AND INTERESTS
IN THE PROPANE BUSINESS

Please read each question carefully. Mark your response with an "X" in the blank provided or indicate your answer as directed in the question.

1. What is your primary energy source for heating each of the following:

HOME	BUSINESS	GRAIN DRYING
___ Propane	___ Propane	___ Propane
___ Natural Gas	___ Natural Gas	___ Natural Gas
___ Electricity	___ Electricity	___ Electricity
___ Wood	___ Wood	___ Wood
___ Geo-Thermal	___ Geo-Thermal	___ Geo-Thermal
___ Other	___ Other	___ Other

2. What is your total annual usage of propane for each of the following:

HOME	BUSINESS	GRAIN DRYING
___ None	___ None	___ None
___ 1-400 gallon	___ 1-400 gallon	___ 1-1,000 gallon
___ 401-600 gallon	___ 401-600 gallon	___ 1,001-3,000 gallon
___ 601-800 gallon	___ 601-800 gallon	___ 3,001-5,000 gallon
___ 801-1,000 gallon	___ 801-1,000 gallon	___ 5,001-7,000 gallon
___ Over 1,000 gallon	___ Over 1,000 gallon	___ Over 7,000 gallon
(Specify) ___________	(Specify) ___________	(Specify) ___________

3. Please mark the appliances in your home that use propane:

___ Clothes Dryer
___ Oven/Range
___ Furnace
___ Water Heater
___ Other
(Please specify) _____________

4. Do you own or lease your propane tank?

___ Own ___ Lease Both ___

5. If you lease, what is your annual lease payment?

___ $0
___ $1- $10
___ $11- $50
___ $51- $100
___ Over $100

6. What size is your propane tank? (or tanks)

___ Less than 500 gallon How many? ____
___ 500 gallon How many? ____
___ 1,000 gallon How many? ____
___ Over 1,000 gallon How many? ____
___ Other (Please specify) _______________

Page 2

7. Who is your present propane supplier? (Could choose more than one.)

___ Amerigas	___ Gasper River Propane
___ Miller's Bottled Gas	___ Southern States
___ Suburban Propane	___ John E. Foster & Son
___ Foster's Gas	___ Other (Please specify) ___

8. When purchasing propane, please rate EACH of the following factors on their degree of importance when determining who your supplier will be. Please circle the number that most closely describes what you think.

	Not Important		Neutral		Very Important
Price	1	2	3	4	5
Company Name	1	2	3	4	5
On-time Delivery	1	2	3	4	5
Tank Leasing Agreement	1	2	3	4	5
Rapport with Delivery Person	1	2	3	4	5
Personalized, Friendly Service	1	2	3	4	5
Loyalty to Supplier	1	2	3	4	5
Other (Please specify) ___	1	2	3	4	5

9. Would you switch from your current propane supplier and buy from Warren RECC if we could offer quality service at a competitive price?

___ Yes ___ No ___ Maybe

10. If no, please tell us why. ___

11. If you purchased propane from Warren RECC, would you prefer to own your tank or lease it from us?

___ Own ___ Lease from Warren RECC ___ Both

12. In summary, do you feel Warren RECC should expand into the propane gas business if the potential exists for financial success?

___ Yes ___ No ___ Maybe

13. Please tell us about your interest in the following other services if they were offered in your area by Warren RECC.

	Not Interested		Neutral		Very Interested
Paging Service	1	2	3	4	5
Home Security System	1	2	3	4	5
Medical Alert System	1	2	3	4	5

Page 3

14. Please rate your feelings toward EACH of the services listed below which are provided by Warren RECC. Please use the following scale:

	Very Negative		Neutral		Very Positive
Water Service	1	2	3	4	5
18" Satellite Dish Sales	1	2	3	4	5
Satellite TV Programming	1	2	3	4	5
Heat Pump Loan Program	1	2	3	4	5
School Appliance Program	1	2	3	4	5
Outdoor Lighting	1	2	3	4	5
Auto-Pay Option	1	2	3	4	5
Levelized Billing	1	2	3	4	5

15. In general, how would you describe your feelings toward Warren RECC?

Very Negative		Neutral		Very Positive
1	2	3	4	5

Please tell us about yourself. All information is confidential and will be used only for analyzing the results of the survey.

16. Your sex: ____ Male ____ Female

17. Your age: ____ Under 21 ____ 21-30 ____ 31-40
____ 41-50 ____ 51-65 ____ Over 65

18. What is your primary source of household income? (You may choose more than one.)

____ Farming
____ Agriculture Related Business
____ Professional
____ Service Industry
____ Social Security
____ Farm and Job
____ Factory/Industrial
____ Office/Sales
____ Pension/Investment
____ Other (Specify) ____________

19. Please tell us about any other services you would like to see provided by your Cooperative or its subsidiaries..

____

____

The following information will allow us to contact you if you are the winner of the prize from our survey drawing.

Name____________________

Address____________________

Phone____________________

Exhibit KY-2

Clark Energy Insert into *Kentucky Living* Magazine

November 1998

CURRENT NEWS
CLARK ENERGY COOP
NOVEMBER 1998
Clark is
expanding
services ...
Story on page 4A.

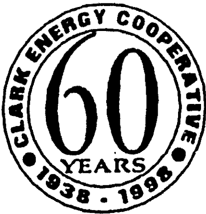
Watts Inside . . .

PAGE 4A
The Menu Continues To Grow

PAGE 6A - 7A
Info-Bits

PAGE 8A
Recipes
Call for Service

On the cover:
Clark Energy now offers propane
Story on page 4A



Current News is produced by Clark Energy Cooperative for its members.

Address all correspondence to Clark Energy Cooperative, P.O. Box 748, Winchester, KY 40392. Phone: (606) 744-4251 or outside Clark County 1-800-992-3269. Please include mailing label from front of *Kentucky Living* when sending address change.

CLARK EC BOARD OF DIRECTORS
Virgil "Jack" Ginter (District 1), Chairman of the Board; William P. Shearer (District 9), Vice Chairman; William Nelson Curry (District 8), Secretary-Treasurer; Steve Hale (District 2); Pauline B. Tuttle (District 3); Phyllis Faulkner (District 4); Seldon Fannin (District 5); James Phelps (District 6); Ollie H. Caudill, Jr. (District 7).

CLARK ENERGY
COOPERATIVE

PARTNERING FOR YOU

Clark Energy's partnership with Thermogas has added an unprecedented level of value to our energy service. You, our members, now have a choice in the kind of energy you wish us to provide. Our new subsidiary, Clark Energy Thermogas, will allow us to supply both your electricity and propane needs with the same level of service and reliability that has made us strong for more than 60 years.

Since 1935, Thermogas has maintained an outstanding national reputation for customer service in the propane business. Its commitment to service, combined with ours, makes for an ideal partnership that will benefit Clark Energy members.

The large percentage of Clark members who already are propane users now have another choice for propane supply. Prospective Clark members have to go no further to receive propane service. Certainly, it will be to our members' benefit to be able to receive all their energy needs from the same source.

By opening up our new propane service to non-members as well, Clark Energy is preparing for a deregulated energy market.

As only the fourth electric cooperative in Kentucky to enter into such an innovative partnership, Clark Energy is proud to be on the leading edge of a quickly changing energy market. When deregulation does come to Kentucky, Clark Energy, by continually adding value to its service, will be secure as a progressive, comprehensive energy provider.

Thermogas' extensive national pipeline network will ensure customers extremely competitive pricing, and a constant fuel supply, regardless of weather or economic conditions.

While Clark Energy Thermogas is a partner with Clark Energy, it is a stand-alone business and is not being subsidized by Clark Energy's electric sales. Because Clark Energy is a member-owned, not-for-profit cooperative, you can be assured that all [illegible] will be used to benefit the customer.

As independent entities for more than six decades, Clark Energy and Thermogas have established ourselves as dependable, knowledgeable, and customer-oriented. Our new partnership will only strengthen those qualities.

Now, when you need efficient, clean-burning propane, you can turn to us. And more importantly, you can know that it will be provided with the same customer commitment that has built Clark Energy's solid foundation since 1938.

President
Clark Energy Cooperative

Touchstone Energy℠
The power of human connections

Are you tired of the fluctuations in heating fuel costs?

Are you tired of the hassle and mess of burning wood?

If you answered yes to at least one of these questions, then you should check out an Electric Thermal Storage (ETS) System.

ETS is a **low cost, safe, comfortable** and **reliable** off-peak heating option. Call Clark Energy Cooperative today for a free heating analysis to see how much you can warm up to comfort while saving on hour heating bills.

1-800-992-3269

CLARK ENERGY

COOPERATIVE

example are also acceptable means." We congratulate Jim on his achievement.

THE MENU CONTINUES TO GROW

Clark Energy adds propane to its service

By Shanda Crosby

Keith Brownlee apologized for stepping out, but this was a call he had to take. A Clark Energy member was on the other line wanting propane service in his new home. Excuse me ... did you say propane?

Indeed.

Partnering with one of the nation's largest and best-respected propane suppliers, Clark Energy is quickly becoming a one-stop energy source.

Brownlee has joined the Clark Energy team to make sure members get the personal service on the propane side that they've come to expect from the electricity side.

This is Clark Energy Thermogas, a new subsidiary dedicated to better serving the energy needs of Clark members.

"We are constantly looking for ways to offer our members more products and services," said Overt Carroll, Clark Energy President and CEO. "Propane was a natural fit."

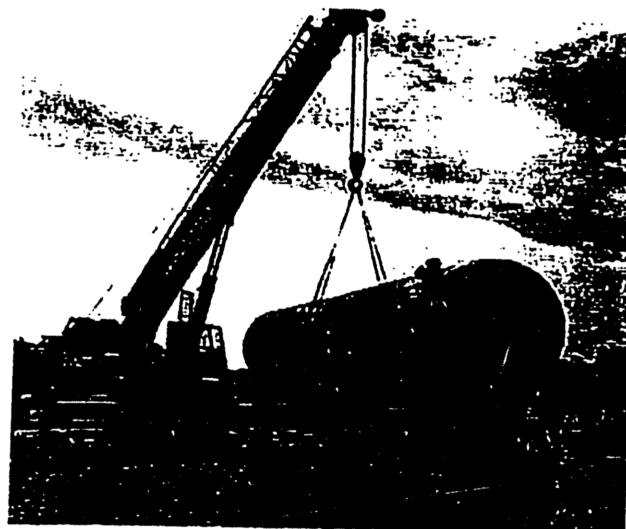
So are Clark Energy and Thermogas. A major player in the propane business for 63 years, Thermogas is known for combining experience and stability with personal attention to the customer. Clark has been known for the same qualities since its beginning in 1938.

"Clark Energy has offered its members excellent value for a long time," Brownlee said. "Thermogas was very impressed with the level of professionalism here. Clark Energy employees work hard to make sure the members are taken care of, and, we have always had the same commitment to customer service. It made sense for us to go into business together."

Formerly a manager of propane sales for a market area in central Illinois, Brownlee has been with Thermogas for 20 years. Since he became Clark Energy Thermogas manager in August, Brownlee has hired four employees to run one of the electric cooperative system's most innovative energy partnerships.

Only the fourth electric cooperative in Kentucky to enter into the propane business, Clark Energy considers it a positive move on behalf of its members. "Many of

our members already are propane users and a large percentage of new members want propane, so we wanted them to be able to call Clark Energy for those needs instead of having to do business with several entities," Carroll said.



Operating from an office at Clark's headquarters in Winchester, Clark Energy Thermogas had customers signed up before its bulk plant was in place on Rockwell Road in September. "There has been a tremendous amount of interest," Brownlee said. "Our field employees are busy every day visiting with prospective customers."

Clark Energy's name recognition and solid reputation in the area, and Thermogas expertise, resources, and proven success in the business, are sure to be a winning combination. "We chose Thermogas because of its reputation and dependability," Carroll said. "If we're going to go into business with somebody, we want them to be the best."

An industry leader in propane supply, Thermogas operates its own fleet of propane transports that deliver exclusively to Thermogas plants and dealers. "Thermogas offers real supply ability to this relationship," Carroll said. "That will allow competitive pricing and price protection programs."

Eventually, Clark Energy Thermogas will offer special prices on state-of-the-art gas burning equipment, such as ranges, space heaters, fireplace logs and grills. The future also holds plans for combined electric and propane billing, budget propane billing, and even credit card billing.

Kenneth Brownlee, Clark Energy/Thermogas Manager

Targeted to Clark Energy members, but available to non-members as well, Clark Energy Thermogas services will reach residential and commercial/industrial customers throughout central and eastern Kentucky.

Brownlee says Clark Energy Thermogas will do its own installations and supply all equipment needed for a propane service connection. "We will take the consumer through the entire process," he said. "We will pride ourselves on personal service."

As electric utilities prepare for a new age of aggressive competition in the energy market, Clark Energy continues to add value to an already solid menu of services. "This is a great benefit for members who want propane in addition to their electric service," Brownlee says. "One call does it all."

If you're interested in propane service or have questions about Clark Energy Thermogas, contact Keith Brownlee at Clark Energy headquarters. The toll free number is 1-877-873-8427.

INFO-BITS

Keep Track Of Smoke Detectors

It's smart and safe to install a smoke detector on every floor of the house, especially near bedrooms. But it's not enough to hook it up and forget about it. Keep your smoke detector in good working order. Here's how:

- Once a month, test each smoke detector in your home. If you have electric smoke detectors, make sure they have battery backups in case of a power outage, and keep the batteries fresh.
- Twice a year, get the family together for a fire drill. Do it on the same days each year, like someone's birthday or anniversary or on the first days of spring and fall.
- Keep your smoke detectors clean. Use your vacuum cleaner's attachment hose to vacuum cobwebs and dust. A dusty detector is less sensitive to smoke.
- Once a year, replace the batteries in every smoke detector. Also, replace the batteries if your smoke detector chirps. That's a warning that you've got a low battery.
- And once every 10 years, buy new smoke detectors.

Don't Waste Money Heating Water!

With winter on the way, it is tempting to think about soaking in a nice hot bath on a cold night. But did you know that a bath takes more hot water than a five-minute shower-and costs you more money? It's true. There are also other simple things you can do to keep your water heating energy bills under control. The U.S. Department of Energy offers these tips:

- Repair leaky faucets promptly; a leaky faucet wastes gallons of water in a short period.
- Insulate your electric hot-water storage tank and pipes, but be careful not cover the thermostat. Or, buy a new water heater with a thick, insulating shell; while it may cost more initially than one without insulation, the energy savings will continue during the lifetime of the appliance.
- Install aerators in faucets and low-flow showerheads.
- Although most water heaters last 10 to15 years, it's best to start shopping for a new one if yours is more than seven years old. Today's models are much more energy efficient than older ones.
- Lower the thermostat on your water heater; units sometimes come from the factory with high temperature settings, but a setting of 115(F provides comfortable hot water for most uses.
- Drain a quart of water from your water tank every three months to remove sediment that impedes heat transfer and lowers the efficiency of your heater.

Call Clark Energy for more information on the efficient operation of your water heater. We will be glad to help you with a variety of other energy efficiency questions and needs. Remember: as a not-for-profit utility, Clark Energy exists to provide you, our members, with services at the best possible price.

MAKE THE SWITCH:

Save Energy with Fluorescent Bulbs

Your family probably spends at least $100 a year on electricity just to keep the light bulbs burning in and around your home. Lighting accounts for about 15 percent of electricity use in our homes, according to the American Council for an Energy Efficient Economy. And most of us use incandescent light bulbs.

ACEEE calls incandescent bulbs ... the kind you screw into lamps and change every few weeks when they burn out ... "heaters in disguise." In fact, 90 percent of the electricity it takes to power an incandescent light bulb is converted to heat, while just about 10 percent of the energy becomes visible light.

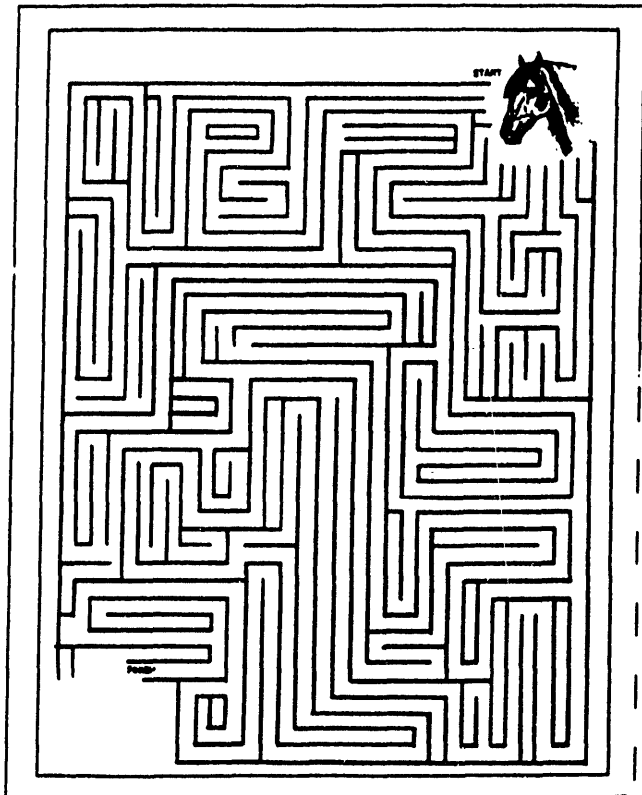
There's a practical alternative to using these energy guzzlers: the compact fluorescent light bulb. More light bulb makers are producing these energy-efficient alternatives in sizes that can fit in all sorts of lamps, ceiling and wall fixtures. And while their warm white light historically has been accompanied by an annoying hum, new versions are absent the hum and flicker of older fluorescents.

Compact fluorescent light bulbs use one-quarter to one-third of the electricity that incandescent bulbs use. And while they're more expensive to buy ... they cost up to $20 ... they last about 10 times longer than standard bulbs. One fluorescent bulb, for instance, will last about as long as 10 ordinary 75-watt incandescent ones, saving the consumer the cost of replacing light bulbs and also about $45 in electricity costs over the life of the bulb.

In fact, ACEEE agrees that if every household in America replaced its incandescent lights with compact fluorescent ones, electricity use for lighting could be cut in half.

...

Our offices will be closed Thursday November 26 and Friday, November 27 for the Thanksgiving Holidays.



RECIPES

EASY DUMPLINGS

5-6 cups broth	1 small can biscuits
1 large can biscuits	1-1/2 cup flour

Pour flour on biscuit board and roll out each biscuit; cut each in quarters. Be sure each piece is covered in flour. Drop in rapidly boiling broth. Cook until dumplings become covered in thick broth. This can also be used for fruit (of your choice) dumplings. Have liquid boiling and drop quartered biscuits in juice.

-Dee Monroe

CRANBERRY SALAD

2 cups ground cranberries	3/4 cup chopped celery
1 cup white sugar	1 chopped apple
1 three oz. package strawberry jello	1/2 cup pecans

Mix sugar into cranberries. Add nuts, celery and apple to cranberries. Mix jello as directed on package. Let jello begin to set before adding to cranberries. Keep refrigerated until ready to serve.

-Ruth Mayo

DON'T STUFF THAT BIRD!

Recent studies indicate that even if a turkey is cooked to the proper internal temperature of 180 degrees, the stuffing may not be sufficiently cooked to kill bacteria. To guarantee safe stuffing, cook it outside the bird. For more food safety issues call the USDA Hotline at 1-800-535-4555.

HOW TO REACH US

Please have your account number ready when you call. The number, for example, (1234567890) is located on the front of your bill in the top left-hand corner of the portion you keep for your records. The number also appears on the mailing label of your monthly issue of Kentucky Living as (KL 1234567890).

Outages And Emergencies: Call 744-4251 or 1-800-992-3269.
Dispatchers are on duty 24 hours a day.

Billing Inquiries And Other Services: Call during office hours, Monday through Friday.

Winchester (headquarters) — 7:30 a.m.- 5:00 p.m. Phone —744-4251 or 1-800-992-3269

Frenchburg — 8:00 a.m.- 4:30 p.m. Phone — 768-2383

Stanton — 8:00 a.m. - 4:00 p.m. Phone — 663-4330

http://www.clarkenergy.com

BEFORE WINTER PUTS YOUR HEATING SYSTEM INTO OVERDRIVE, YOU MAY WANT TO GET A TUNE-UP.

You know what a tune-up does for your car. It runs smoother, works more efficiently, and is less likely to break down. An inspection and tune-up for your heating system can do the same thing. A heating system is a precision engineered machine just like your car. It needs periodic inspection, lubrication and cleaning. Its filters need to be replaced, belts checked, thermostats inspected and all vents cleared of obstructions. So, a visit by a qualified technician may be just the thing before those chilly winter nights. Call a heating system professional today for a tune-up . . . or at least have it taken for a test drive.

CLARK ENERGY
COOPERATIVE

People You Can Count On.

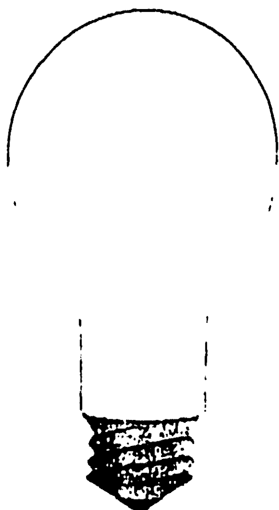
Exhibit KY-3

Marketing Materials of Kentucky REC Propane Concerns

JACKSON

Thermogas

ENERGY



ANOTHER
new idea
from your
cooperative

Jackson Thermogas Energy,
a Jackson Energy company,
now offers propane gas service.

For more information,
call 1-800-262-7480.

New Customer Prize Drawing August 28th

NOW OPEN!

NEW! Home & Business Propane Office

PROPANE ENERGY PARTNERS, LLC

Warren RECC & Miles Enterprises

Propane Gas and Accessories are now available through your Morgantown Warren RECC office!

August Fill-Up Special

74¢ per Gallon

Propane Tanks 250-1000 Gallons - Propane & Natural Gas - Ventless Vanguard Fireplace Logs & Heaters

Call 526-3384 or stop by the Warren RECC office at 112 S. Tyler St.

LEE E. TAYLOR ENGINEERING

LAND PLANNERS ENGINEERS SURVEYORS

NATURAL GAS AND CABLE TV SURVEY FOR PULASKI COUNTY

INFORMATION SHEET

Most rural residents of Pulaski County have been forced to purchase alternative fuels, propane or electricity, and usually at a much higher price than it would cost for natural gas. With the deregulation of natural gas by the federal government, you now have a choice. Lee E. Taylor Engineering of Russellville has developed a system for extending natural gas to rural residents and businesses of Pulaski County. You now have an opportunity to join with your friends and neighbors and own your own gas distribution system similar to the way many of you are benefiting from rural public water distribution.

While we are checking the feasibility of a natural gas distribution system, we are going to check the feasibility of building a fiber optics cable TV system. It will be a "state of the art" system with you, the owners, having some say as to what you have coming into your homes. We can put it right in the ditch with the gas and share the construction cost, thus, making it more economical to construct each utility. This will lower utility costs and provide easier access to the scattered residents in the rural areas.

We need you to do three things that will enable us to better help you. First: Sign the enclosed petition. The first step to getting started on this project is to form a "subordinate service district," which is another department of your county government and will have its own administrative board to set rates and administrative policy. Second: Fill out the survey form enclosed. This will give us some much needed information from which to work in developing feasibility. Third: Return the survey and petition to LEE TAYLOR ENGINEERING, 2621 WEST MAIN STREET, RUSSELLVILLE, AR 72801.

Even if you feel that you do not need either of the proposed services, we want to encourage you to sign the petition and fill out the survey. It may help your neighbors get natural gas and/or cable TV. Some day you may want these utilities yourself. It is imperative that we complete this petition drive so we can get on with the job of getting gas services to rural Pulaski County. There is no financial obligation on anyone at this time. The property owners that request service from the system will pay a small connection fee and meter deposit. They will then pay for services rendered which, for natural gas, will be approximately 50% of what the average residential users normally pay for propane. We will later come back and determine who wants natural gas and/or cable TV service.

PHONE (501) 968-7707 FAX (501) 968-3070 2621 WEST MAIN STREET-SUITE 6 RUSSELLVILLE, ARKANSAS 72801

NATURAL GAS & CABLE TV SURVEY, PULASKI COUNTY

0023320

________________ ________________ ________
Name Address Phone

1. My property is a _____ residence _____ business _____ poultry farm.

2. My residence is _____ less than 5 years old _____ more than 5 years old.

3. We currently heat our residence/business with:
   _____ propane _____ electricity _____ wood _____ natural gas

4. Check the statement which best indicates your level of interest in obtaining gas from the proposed gas distribution system.
   _____ I would connect to the system as soon as it is ready.
   _____ I want gas and would connect within _____ months _____ years.
   _____ I currently have natural gas service.
   _____ I am not interested. Why? ____________________

5. Check the statement which best indicates your level of interest in obtaining service from a "state of the art" cable TV system:
   _____ I would connect to the system as soon as it is ready.
   _____ I want cable TV and would connect within _____ months _____ years.
   _____ I currently have cable TV service.
   _____ I am not interested. Why? ____________________

6. For the families with low to moderate incomes, there may be grant funds from the state to cover part or all of the cost of converting your residence from alternate fuels to natural gas. Low and Moderate income limits as defined by the Arkansas Community and Economic Development Program are as follows:

Low and Moderate Income Limits: Arkansas Community & Economic Development Program (6/15/94)

INCOME LIMITS BY FAMILY SIZE

County	Program	Median Income	1 person	2 persons	3 persons	4 persons	5 persons	6 persons	7 persons	8 persons
Pulaski	Low	37300	13050	14900	16800	18650	20150	21650	23150	24600
	Moderate		20900	23850	26850	29850	32250	34600	37000	39400

If you would like us to seek funds for you, please indicate you need assistance.
_____ Yes _____ No

Thank you for taking five minutes of your time to complete the above survey and the enclosed petition. The petition will let us know if you would like to have the chance to get natural gas service and/or possibly other public utilities for yourself and your neighbors.

PLEASE RETURN THE PETITION AND SURVEY TO:

LEE TAYLOR ENGINEERING
2621 WEST MAIN
RUSSELLVILLE, AR 72801

002310

QUORUM COURT OF PULASKI COUNTY

We the undersigned property owner(s) of Pulaski County, Arkansas, respectfully request by the petition that the Quorum Court of Pulaski County, Arkansas, adopt an ordinance which provides as follows:

a) establishing a subordinate service district for the purpose of constructing a system for the distribution of natural gas and other necessary and convenient utility services and for the delivery of natural gas and other utility services for the residents and business establishments located in the subdistrict that desire to acquire the services from the subdistrict;

b) establishing the boundaries of the subordinate service district as will be set out on or in a map and legal description;

c) establishing the administrative board to govern the operations of the subdistrict and to exercise such powers as the Quorum Court deems appropriate;

d) providing for such other matters as the Quorum Court may deem appropriate.

I have personally signed this petition. I am the owner of property in Pulaski County, Arkansas. My mailing address is correctly written after my signature.

NAME		SPOUSE
	ADDRESS	
	PLEASE RETURN TO:	
LEE E. TAYLOR ENGINEERING	2621 WEST MAIN STREET	RUSSELLVILLE, AR 72801

PROPANE ENERGY PARTNERS, LLC

With over seventy years of combined business experience, Warren RECC and Smith-Douglass LP have formed a new company, ***Propane Energy Partners, LLC***. Propane Energy Partners provides the customer with quality propane gas and service. Safe installation and care of propane products and equipment are top priorities.

The special summer propane fill rate is 74 cents per gallon if application is approved before October 1, 1998.

Propane tanks are available to rent in sizes 250 through 1,000 gallons. Tanks are installed safely at reasonable rates. Reduced tank installation rates are available to the customer who switches from another propane distributor.

Call Propane Energy Partners at 1-800-365-7427, or contact any Warren RECC office.

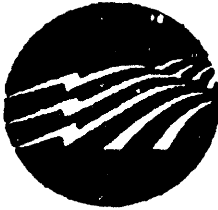
Exhibit KY-4

World-Wide-Web Materials of Various Kentucky RECs

JACKSON ENERGY COOPERATIVE

- **NRECA**
  National Rural Electric Cooperative Association
- **TOUCHSTONE ENERGY**
  Touchstone Energy
- **NRTC**
  National Rural Telecommunications Cooperative
- **EAST KENTUCKY POWER**
  East Kentucky Power
- **RURAL UTILITIES SERVICE**
  Rural Utilities Service

LOCAL NEWS	SERVICE PLUS	RATES & FEES	KID'S STUFF
SERVICE/REPAIR	LINKS	CONTACT US	MEMBERS/STAFF



JACKSON ENERGY COOPERATIVE

JACKSON SERVICE PLUS

Jackson Service Plus is a subsidiary of Jackson Energy Cooperative. The company offers energy-related services to both members and non-members.

Jackson Service Plus currently offers -
- discount long distance telephone service
- security systems for homes and businesses
- tree trimming services and
- propane service

Discount long distance service is offered in a partnership arrangement with WorldCom, Inc.

Rates include:
- Interstate calls after 5 p.m. and all day Saturday and Sunday - 9½¢ per minute.
- Interstate calls before 5 p.m. on week days - 24¢ per minute.
- TalkAround calling card - 30¢ per minute.
- HomeAdvantage Easy plan - 13.2¢ per minute, 24 hours a day.

To sign up for service, call 1-800-736-8074
Pre-paid 30 minute Michael Jordan collector calling cards are also available for $10 at London and McKee district offices.

Security Systems are installed by Jackson Service Plus and monitored by Jackson Energy's 24-hour dispatch service.

The starter package costs $465.75 and includes -
- smoke detector
- two door/window sensors
- interior speaker and
- equipment to operate the system.

Other options are available, and the monthly monitoring charge is $16.50.

Tree Top Professional Tree Service brings 60 years of right-of-way maintenance experience from our business to your home or business. From the removal of unwanted trees, storm damage cleanup, stump removal to sahde tree trimming, our crews can do the job quickly and professionally.

Jackson Thermogas Energy is a business partnership formed by Jackson Energy and Thermogas to offer propane gas in the area. Thermogas is the fourth largest propane retailer in the United States, serving over 300,000 consumers across the country.

country.

Using the buying power of Thermogas, the company can offer consumers low prices, as well as fireplaces, gas logs, and appliances. In fact, Thermogas offers a low price guarantee for the 1998-99 heating season - the price per gallon will not exceed 99.9¢ when a consumer signs up for the Keep Full program.

Thermogas propane is part of Jackson Energy's diversified services and is open to both members and non-members of the electric cooperative.

The office is open Mon. thru Fir., 8am to 4:30pm, and Sat., 8am to 12 noon. The phone number is (606) 878-0690, or toll-free, 1(877) 878-0690.

For more information on any of these services, call 1-800-262-7480, or 606-864-2363.

WELCOME

HOME

Envision Energy Services

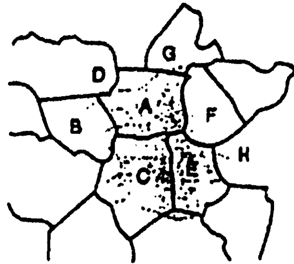
EKPC the company

EKPC the members

Energy Issues

News

Links



FARMERS RECC

AT A GLANCE

A: Hart County
B: Edmonson County
C: Barren County
D: Grayson County
E: Metcalfe County
F: Green County
G: LaRue County
H: Adair County

Total members: 14,092
Total miles of line: 3,172
Percent residential (kilowatt-hour sales): 65 percent
Percent industrial/commercial (kilowatt-hour sales): 35 percent

Farmers Rural Electric Cooperative provides electric service to nearly 15,000 member-accounts located in Adair, Barren, Edmonson, Grayson, Green, Hart, Larue and Metcalfe counties. Farmers RECC employs 73 full- and part-time people, who maintain the cooperative's system using 42 vehicles. In addition, the co-op hires some 30-40 seasonal contractors each year.

In August of 1997, Farmers RECC, through its subsidiary company, and Thermogas Inc. formed a joint venture

company named Farmers Thermogas of Southern Kentucky. Farmers Thermogas offers propane gas sales and services to both co-op members and nonmembers.

Farmers RECC is also a founding member of the Barrens Information Technology System (BITS) that resulted in making Enhanced 911 emergency services available throughout Barren County. The co-op also is a charter member of Envision, a partnership of electric cooperatives providing electrical expertise to commercial and industrial users across the state.

A Touchstone Energy® Partner

The power of human connections

Welcome to Shelby Energy Cooperative

Shelby Energy Cooperative, Inc. is a nonprofit, customer-owned electric distribution cooperative headquartered in Shelbyville, Kentucky. Celebrating its 60th anniversary in 1997, Shelby Energy is among 1,000 electric cooperatives nationwide serving more than 30 million people.

Electric cooperatives serve 10.8 percent of the nation's population, accounting for 7.4 percent of electric energy sold and 5 percent of electricity generated by the electric utility industry.

As a Shelby Energy customer, you are part-owner of the cooperative and may exercise control through the election of directors and by voting on issues at the cooperative's annual meeting held in June or July.

Because the cooperative is a nonprofit organization, revenues collected beyond operating expenses are returned to customers as capital credits when financial conditions allow. Since 1985, Shelby Energy has returned more than $1 million in capital credits to its customers.

The cooperative was formed in 1937 primarily to serve the rural areas of Shelby, Henry and Trimble counties. Loans were secured from the Rural Electrification Administration, now Rural Utilities Service, a branch of the U.S. Department of Agriculture.

Rural Utilities Services (RUS) still provides a portion of Shelby Energy's financing. For more than 25 years, supplemental financing has been obtained from the National Rural Utilities Cooperatives Finance Corporation, an organization formed by rural electric cooperatives to provide them a source of funds to supplement the financing provided by RUS.

Wholesale power is purchased from East Kentucky Power Cooperative, a generation and transmission facility in Winchester, Ky., that is owned by Shelby Energy and 17 other distribution cooperatives in central and eastern Kentucky.Shelby Energy customers are served by 10 power

substations over more than 1,773 miles of distribution lines. Revenues for 1996 were $16.6 million. There are six directors elected from the membership.

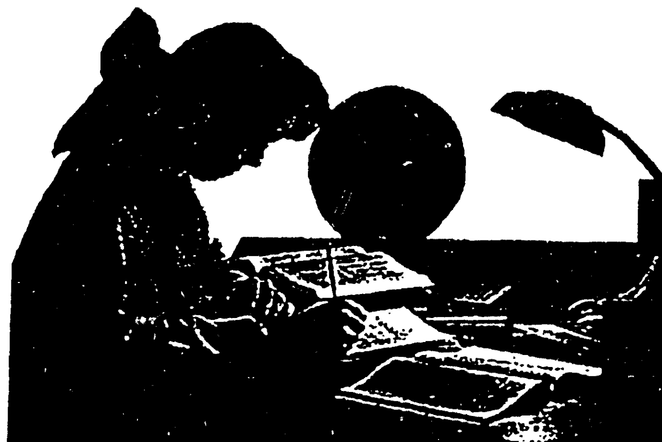
SHELBY ENERGY COMMUNITY NEWS SERVICES & MARKETING

PARTNERSHIP PERSONNEL RATES & SERVICES MAP

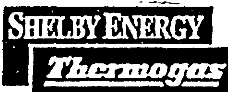
Hosted by Sky1.net

You are Visitor: 268

Touchstone Energy
The power of human connections



Community News

- Shelby Energy's Propane Partnership 

Shelby Energy has a partnership with Thermogas, one of the nation's largest retail propane marketers. The partnership gives Shelby Energy customers and other propane users access to propane experts who value the same standards for quality service, reliability, convenience and fair prices they've come to expect.

Whether you need a full storage tank or just a 20-pound cylinder, Shelby Energy Thermogas can take care of your needs. For more information, call 502-633-4646 or outside Shelby County call toll free 888-259-4646.

- Shelby Energy's Annual Meeting

community

Shelby Energy holds an annual meeting in June or July.
Members elect two directors to the official board and executives report on operations for the previous year. Food, entertainment and prizes are provided.

The 1999 annual meeting will be July 9 at Henry County High School, New Castle, KY.

- Low-cost Electricity - Optional Rates

Electric rates are a bright spot. Shelby Energy's rates are competitive within Kentucky and well below the national average.

Shelby Energy recently added an optional residential, church and school rate, a time-of-day demand rate and an interruptible rate for customers. Please contact the cooperative for eligibility and annual savings.

- Year 2000 Information

For up-to-date year 2000 (Y2K) information, please see the website of our power supplier, East Kentucky Power Cooperative @ http://www.ekpc.com

East Kentucky Power Cooperative is owned by Shelby Energy Cooperative and 16 other electric cooperatives.

- No Health Link To Magnetic Fields

A panel of scientists has concluded after a three-year, congressionally mandated study that fields from electric power lines pose no hazard to human health.

After examining more than 500 studies spanning 17 years, the 16-member committee of the National Research Council said, "Research has not shown in any convincing way that electromagnetic fields common in homes can cause health problems, and extensive laboratory tests have not shown that EMFs
can damage the cell in a way that is harmful to human health."

Concern about the health effects of electromagnetic fields arose in 1979 after studies showed that children living near certain kinds of electric wires were slightly more likely to develop leukemia--a rare form of cancer.

However, when scientists measured the fields inside people's homes, they found no correlation with any disease. The National Research Council report, released last year, suggested that the weak link that
some studies found between nearness to power lines and childhood leukemia may be the result of other
factors, such as air pollution or a location near high traffic density.

The National Research Council is the principle operating arm of the National Academy of Sciences, a private, non-profit institution that provides science and technology advice under a congressional

charter.

Scholarships Available

High school seniors whose parents or guardians are Shelby Energy members are eligible to apply for a $1,000 scholarship from the cooperative. Shelby Energy will award three scholarships to deserving students.

In addition to residency requirements, students must write a 500 word essay. Awards will be made based
on the quality of the essay, grades, community & school involvement and need.

Applications may be obtained from your school guidance counselor office or from the cooperative during February
and March.

The deadline for applications is April 15.

Awards will be made at high school honors programs in the spring.

SHELBY ENERGY PERSONNEL SERVICES & MARKETING

PARTNERSHIP RATES & SERVICES MAP

Welcome to the Clark Energy Cooperative

Clark Energy Cooperative is the electrical service provider for all or part of twelve counties in Central and East-Central Kentucky. Clark Energy serves 20,265 consumers over 2,573 miles of distribution lines.

Click the button below to visit the Clark Energy Thermogas home page!!!!!

Our Address:

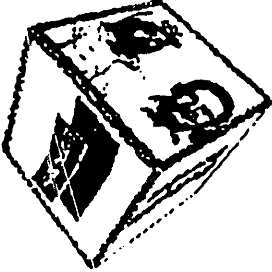
Clark Energy Cooperative
P.O. Box 748
2640 Ironworks Road
Winchester, KY 40392
Phone: (606) 744-4251 or 1-800-992-3269
For outages call 1-800-992-3269 24-hours a day.

Outer Offices:

P.O. Box 14, Halls Lane
Stanton, KY 40380
Phone: (606) 663-4330
And
P.O. Box 152, Highway 36
Frenchburg, KY 40322
Phone: (606) 768-2383

Your Energy Partner

Welcome to the Clark Energy Thermogas Homepage



Clark Energy Thermogas is Central Kentucky's premiere propane supplier. We offer competetive prices and have the experienced personnel to take care of all of your propane needs (residential or commercial). We also carry a full line of high quality propane heaters and grills.

Our office is located in Clark Energy's Winchester office at 2640 Ironworks Road (on Highway 15 between Winchester and Clay City). Office hours are Monday through Friday from 8 am until 5 pm.

Phone: 1-877-873-8427 or 744-5385
E-mail us at propane@clarkenergy.com

Return to http://www.clarkenergy.com

MICHIGAN

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BACKGROUND

Michigan has seen much activity by RECs in the propane industry. Fruit Belt Electric Cooperative and Southeastern Michigan Rural Electric Cooperative each had their own propane subsidiaries before the two cooperatives merged. The resultant entity, Midwest Energy Cooperative, now has its own propane subsidiary, Midwest Propane. Cherryland Propane is another Michigan REC subsidiary, its parent being Cherryland Electric Cooperative. However, the most noteworthy Michigan REC is Great Lakes Energy Cooperative (GLEC), the state's largest cooperative and its third largest electric company overall.

During the summer of 1998, three Michigan RECs – Great Lakes Energy Cooperative, Top O'Michigan Electric Company, and Western Michigan Electric Cooperative – announced plans to merge into a single company to be named Great Lakes Energy Cooperative. Approved by customer/owners on August 8 of that year and commencing joint operations on January 1, 1999, the newly merged firm supplies electricity to approximately 106,000 customers in 26 Michigan counties.

In its application to the Michigan Public Service Commission (MPSC) for approval of the merger, the three partners clearly established their intention to operate in energy markets other than electricity.[1] This declaration was consistent with the established business practices of the three RECs. "In recent years the cooperatives (had) added various subsidiary businesses, including propane sales and services, heating and cooling services, electrician services, insulation services and more."[2] For example, the original Great Lakes Energy (i.e. not the merged company) had a propane subsidiary by the name of Reed City Energy (a joint venture

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[1] Amended and Restated Articles of Incorporation of Great Lakes Energy Cooperative, p. 2. "The objectives of the Corporation shall include, but not necessarily be limited to, the following: (a.) To generate, manufacture, purchase, acquire and accumulate electric energy *and other sources of energy* ("Energy") for its members or patrons; to transmit, distribute furnish, sell and dispose of Energy to its members or patrons; to furnish and sell telecommunication services .." (emphasis added)

[2] "Three-Way Electric Cooperative Merger Takes Effect Jan. 1: Michigan's Newest – and Third Largest – Electric Utility to Officially Open for Business," GLEC website, http://www.glenergy.com/threeway.htm.

with Smith Propane) and an appliance sales and service subsidiary called Oceana Energy.[3] Top O'Michigan and Western Michigan also had propane operations prior to the merger.

In addition to consolidating its various propane concerns, the new Great Lakes Electric Cooperative has recently entered into a wider-ranging agreement with Smith Propane, the original Great Lakes' partner in Reed City Energy. Under the new agreement, GLEC's subsidiary, Great Lakes Utilities Service Corp, has joined Smith Propane in forming a new company named Great Lakes Energy Gas Services (GLEGS).[4] The new company combines the existing joint operations of Smith and GLEC with other, separate Smith and GLEC properties, making it "one of Michigan's largest retail suppliers"[5] of propane.

EVIDENCE REGARDING ANTICOMPETITIVE BEHAVIOR

Many of the potentially anticompetitive practices discussed in Section V are exemplified by Great Lakes Energy Cooperative. The REC's general strategy in propane appears to be to leverage its regulated electric assets to achieve marketing and cost advantages vis-à-vis its propane rivals. However, as shown below, many of these advantages would not be possible but for the relationship with the electricity business, and so may raise competitive concerns.

GLEC (and its constituent companies) vigorously promotes the idea of "one-stop shopping" for all of a customer's energy needs. Customers purchasing both electricity and propane from Great Lakes can receive a single bill, and individual customer service centers can handle all of a customers' needs, whether payment of electric/propane bills, establishment of new electric or propane service, or other.[6] A single site on the world-wide-web can also be accessed for information on and transactions with both the propane and electricity businesses.

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[3] "Merger of O&A Electric Cooperative and Oceana Electric Cooperative Takes Effect January 1, New Company to be Called Great Lakes Energy," GLEC website, http://www.glenergy.com/mergerof.htm

[4] The new propane business is known and marketed as simply Great Lakes Energy, which is also how the electric cooperative is known an marketed. The initials GLEC and GLEGS are only used here to avoid confusion.

[5] "Great Lakes Utilities and Smith's Propane Merge into New Propane Company for Western and Northern Michigan," ("Propane Merger") GLEC website, http://www.glenergy.com/ppane.htm.

[6] See attached Exhibits MI-1 through MI-4 which contain numerous statements and materials published by GLE's component RECs – both pre- and post-merger – which tout "one-stop shopping."

Said one GLEC executive, "The intent is for customers to have the convenience and ability to take care of their electricity and propane needs at any of our 15 Michigan locations. It's a one-stop shopping concept that also includes our energy services in heating and cooling, electrical contracting and insulation."[7]

In combining the operations of its electricity and propane businesses, Great Lakes may very well be providing its propane affiliate with artificial cost advantages. While we have not had the opportunity to review the financial records of the Great Lakes companies, the experiences in other states for which we have more complete information are suggestive: RECs which enter the propane business have the incentive and opportunity to shift costs and cross-subsidize their propane businesses at the expense of their captive electric customers and competition.

GLEC appears to be integrating propane and electricity service more thoroughly than any other REC we have studied. It is not clear that GLEC prevents pure propane-related costs from finding their way to the books of the electricity concern. Nor is it clear that GLEC ensures a reasonable allocation of joint overhead and personnel costs. Were competitive forces acting on the GLEC's core electricity business, these questions would be less pressing. But GLEC remains a regulated monopoly in its service territory. When the REC uses the same offices, personnel, advertising campaigns, etc. for both its regulated electricity service and its unregulated services, it seems plausible that regulatory oversight would be unable to detect and deter cost-shifting and cross-subsidization.

Another marketing concept touted by GLEC (and other REC propane affiliates in Michigan and other states) is "guaranteed pricing," that is, a guarantee that the retail price of a gallon of propane will not rise above a certain level for a given time period.[8] The effect of such retail price guarantees is to shift the risk of unforeseen increases in the wholesale prices of propane from consumers to the propane distributor.

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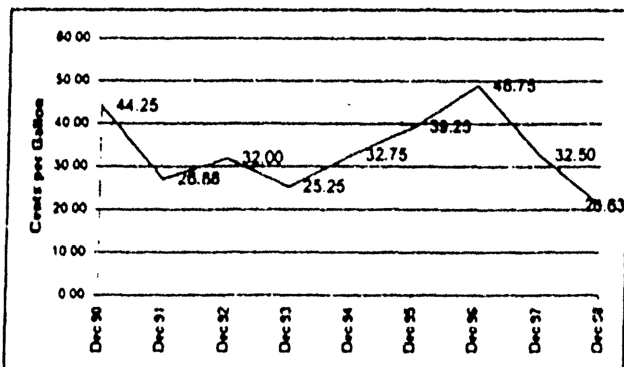
[7] Propane Merger, http://www.glenergy.com/ppane.htm.

[8] See attached Exhibits MI-1 through MI-4, which contain numerous statements and materials published by GLE's component RECs – both pre- and post-merger – which tout "guaranteed pricing."

Chart MI-1

Average Prices of Propane at Mont Belvieu Terminal in the Month of December: 1990 - 1998

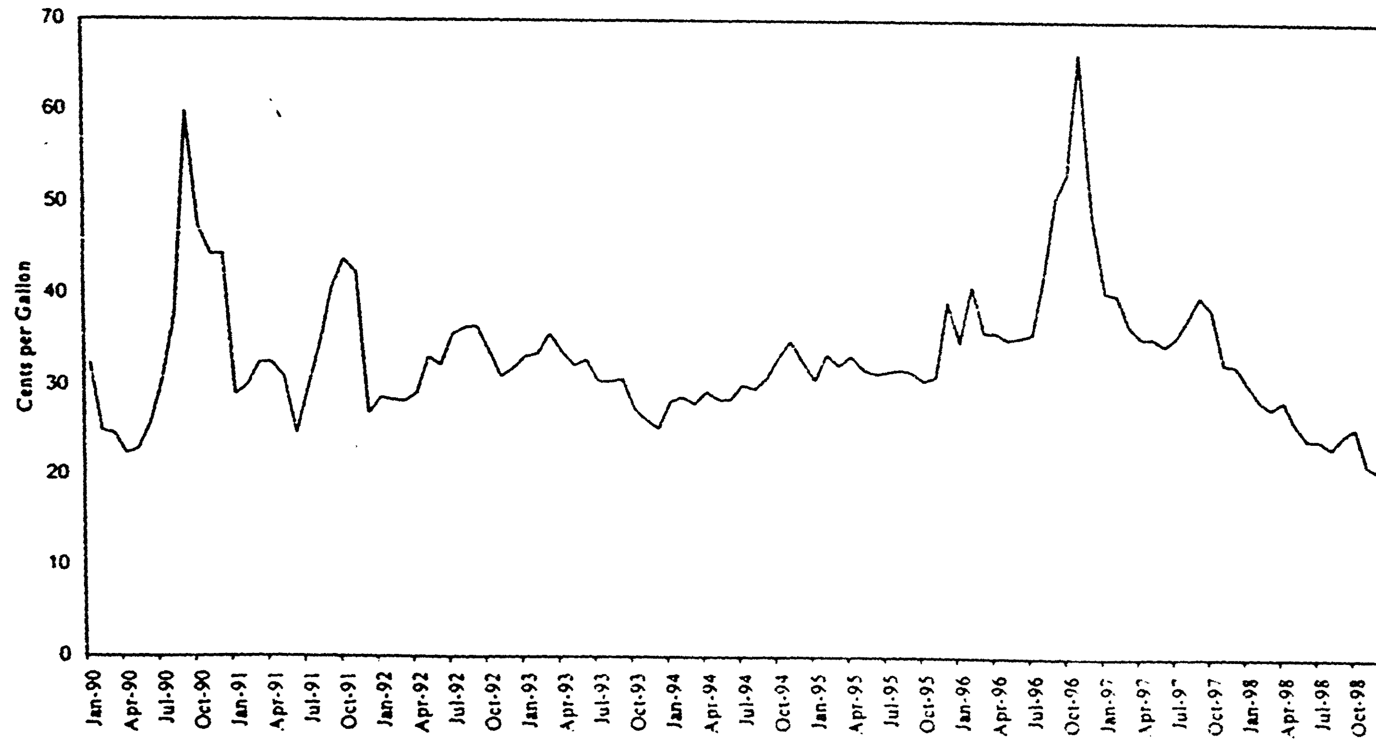


Source: Bloomberg, LP

This risk is not negligible. Periodically, the price of propane moves dramatically in one direction or the other, often due to crude oil price increases or demand spikes led by particularly cold weather. These fluctuations complicate the forecasting of propane prices for even a particular season. As shown in Chart MI-1, year-on-year prices of propane for only the month of December show significant variance. The average December price between 1990 and 1998 was 33.6 cents, but the standard deviation over that period was 9.1 cents. The average December price nearly doubled between December 1993 and December 1996 and then fell 58 percent from that high to only 20.63 cents in December 1998. Chart MI-2 shows the significant variance in the entire monthly price series over the 1990 to 1998 period.

Guaranteed pricing shifts some of the risks of volatile wholesale propane prices form consumers to the propane distributors. While such a shift in risk provides some benefits to consumers, it is notable that price guarantees were not widely offered to consumers prior to RECs' entry into the propane business. It is unlikely that this fact can be attributed to lack of competition in the propane industry – Michigan customers have historically been able to

Chart MI-2
Average Prices of Propane at Mont Belvieu Terminal
1990 - 1998



Source: Bloomberg, LP

choose from among multiple propane marketers, and these marketers have taken steps to buffer customers against price/expenditure fluctuations. For example, it is common practice among propane marketers to offer payment options that smooth the financial burden associated with the natural seasonality of propane consumption. Typically, a customers' total consumption in prior years is used as the basis for calculating an "average month" and this average is billed throughout the year with an adjustment made as necessary at year's end.

An alternative explanation for the appearance of price guarantees is that the propane affiliates of the RECs can afford to offer them because of their access to below-market loans. The availability of such financing permits them to absorb the risk of wholesale price fluctuations more readily than independent propane marketers. To the extent this explanation is valid, an REC propane affiliate would be relying on a cost advantage that derives directly from its relationship with the REC's government-protected, government-subsidized electricity business.

Whether or not they help explain guaranteed pricing, the financing advantages of RECs are not in doubt. At least some of the GLEC propane subsidiaries have benefited from their parents' affiliation with the CFC. Reed City Energy, the original Great Lakes' joint venture with Smith Propane, appears to have been financed with CFC loans. As of December 1996, Great Lakes (then known as O&A Electric Cooperative) had $8.7 million in outstanding loans from the CFC at a weighted average interest rate of 6.82 percent.[9] For reference, between January 1990 and December 1996, the average level of the prime interest rate was roughly 7.85 percent.[10] While the gap between the Great Lakes borrowing rate and the prime rate is substantial, it may understate the differences in the cost of capital, as small businesses frequently borrow at rates one or two points higher than prime.

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[9] Ottawa and Allegan Electric Cooperative, Inc., Schedule of Mortgage Notes for the Year Ended December 31, 1996. The schedule shows that the only sources of debt for O&A other than the CFC were the Rural Utilities Service and the Federal Financing Bank. Funds from the latter two sources are not permitted to be used to fund non-electricity related projects.

[10] Based on daily postings of the Prime Interest Rate provided by Federal Reserve Bank at website http://www.bog.frb.fed.us/releases/H15/update.

Independent Michigan propane dealers frequently note that GLEC and other RECs have been using their electricity meter-readers to gain competitive information for their propane businesses. Meter-readers making electric rounds can, at little or no cost, scout out users of non-REC propane services, identify the incumbent supplier, and note the size of the customer's tank, all of which provides the REC's propane business with valuable marketing advantages. By the same token, the REC's ubiquity gives it an advantage with respect to new construction projects, and some Michigan propane dealers cite this as the most grave threat to fair competition. As GLEC is the only provider of electricity to new projects in its service territory, it is privy to information on these projects' propane needs before that information is available to other independent propane marketers. Such early access may be critical in persuading the manager of the construction project to purchase propane services from the REC in addition to electricity, for which the REC is the only option.

Consumer misinformation issues are also raised by GLEC's practices. As the electricity rates GLEC charges are known to be governed by the MPSC, customers may erroneously infer that the propane rates are regulated as well. In a two-page flyer sent to its customers following the GLEC merger, the former Western Michigan Electric announced to its customers that they would henceforth be receiving bills form GLEC, not Western, and that, "our services have grown to include propane sales and service..." The flyer's heading features the company's services underneath its logo, listing propane second, just after electricity. Later, under the heading "What's the Fuel Cost Recovery on this month's bill?," the flyer states, "Fuel costs are assigned to electric customers by the Michigan Public Service Commission, and the process is audited by the MPSC."[11] While this statement apparently does not apply to propane, consumers may believe that it does (see Exhibit MI-4).

Even where consumers are not misled in this way, the use of the brand name/goodwill built up in the REC's electric business (supported by decades of government subsidies) raises concerns. Since the merger, the Great Lakes companies have used the same logo to advertise both the propane business and the electricity business. Newspaper and magazine

[11] Flyer mailing to customers of Western Michigan Electric Cooperative (now part of Great Lakes Electric Cooperative), undated.

advertisements for the propane business bear the REC logo, as do propane delivery trucks. In general, GLEC's marketing and public relations make absolutely no distinction between the electric cooperative and its for-profit subsidiaries. After the Great Lakes merger and the expansion of the venture with Smith's Propane a press release announced that, "All propane operations will combine and do business as Great Lakes Energy."[12] Hence, the apparent objective is to combine the propane and electric businesses in consumers' minds.

[12] Propane Merger, http://www.glenergy.com/ppane.htm.

Exhibit MI-1

Local Newspaper Article

: fatal accident which
in Mecosta County,
y Edward Bolle Jr., a
veral times into the
lle was pronounced
used to remove the
s Fire/Rescue. Bolle

FIA cuts will be felt at Christmas

By Bill Knapp
Herald News Writer

REED CITY — Church and civic leaders are wondering what kind of a Christmas to expect this year for needy children and their families who have come to depend on the leadership of the Volunteer Services Coordinator at the Family Independence Agency (FIA) in putting that effort together.

The Volunteer Services Coordinator position at the Osceola Family FIA has been vacant since Judith Franklin retired from the post the end of May.

Having served in that capacity since 1988, Franklin coordinated a variety of services including the State Medical Transportation program, the county food pantry, the Osceola Clothing Center and the county wide Christmas program for which provides Christmas gifts and food baskets to hundreds of needy children and their families. Franklin was one of seven staff members from Osceola county to accept an early retirement option offered by the state.

FIA lost approximately 1,800 veteran employees statewide through the Governor's early out retirement option earlier this year; about 700 of those were first line worker positions. FIA Director Martha Livingston Hammons has stated her first priority is to fill critical mission worker positions left vacant by early retirement. Hammons also is exploring the elimination, reassignment and contracting out of some functions performed by certain positions, which in turn would free up staff for vacant first line positions.

The Volunteer Services Coordinator Position is not considered a first line position, and as such is one of those posts being considered for elimination.

Marianne Gravina of the FIA Office of Communications in Lansing said there are eighteen proposals currently being considered, one of which would be to eliminate the position and contract the services out to businesses which coordinate volunteer activities.

A decision is expected sometime by the end of July or beginning of August, Gravina indicated.

FIA/See page 10

One-stop shopping for energy

Reed City — The Reed City area has received a boost of energy to its local economy with the announcement of a new business that gives customers a "one-stop shopping" opportunity to take care of all of their electricity and propane gas needs in one location.

Reed City Energy, a subsidiary of Great Lakes Energy and in joint venture with Smith's Propane, has opened a full service propane operation on U.S. 10, two miles west of U.S. 131. Reed City Energy is the propane supplier to hundreds of homes and businesses in Lake, Osceola, Newaygo, and Mecosta Counties.

The building is also a customer service center for Great Lakes Energy, a customer owned electric utility that serves 11,000 customers in Lake and Osceola Counties.

By late July, customers will be able to take care of their electricity or propane needs at this one location, said Robert Hance, president and chief operating officer of Great Lakes Energy.

At Reed City Energy, customers can pay electric and propane bills, establish new electric or propane service, take care of new construction requirements, get personal help with electric or propane billing questions, transfer existing electric or propane service into their name, and take care of any other business related to their electric or propane service.

Reed City Energy also will feature a mini showroom of furnaces, air conditioners and water heaters for both fuels. The sales, service and installation of these appliances will be available through Reed City Energy and Great Lakes Energy.

The new location includes a [illegible] gallon bulk storage tank, which ensures quick delivery for customers.

"We are preparing for the day when customers will have their choice of electric energy suppliers," Hance said. "Our goal is to not just provide the energy, be it gas or electricity, but to provide solutions to customers' energy needs. We think we can achieve that relationship with customers by providing these additional services and offering other fuel choices."

ENERGY/See page 7

...ned for July 18 for Tracey Cass Spurbeck, of Evart, who is in need of a kidney transplant.

The Second Annual Stag Day Golf Tournament at Spring Valley Golf Course near Reed City is sponsored by the Hersey Fire and Rescue Auxiliary. Fifty percent of all proceeds will go to the young mother of three small children, four-year-old Lindsey, six-year-old Tyler, and 11-year-old Stephanie.

Tracey, now 32, was diagnosed with Glomerulonephritis, a kidney disease, at the age of 19, while in her first year of college. She went to a local doctor for a checkup and Tracey's mother, Mrs. Paul Cass, also of Evart, recalls that Tracey "insisted she didn't ever feel sick. But she was told if it went to 10 percent, she would."

At the present time, Tracey is on medical leave from her managerial duties at the Hot 'N Now, and has been for approximately three weeks.

Tracey has dialysis three days per week at Mercy Hospital in Cadillac, usually a three-hour ordeal each time. In addition to her specialist in Cadillac, Tracey was scheduled to meet with a surgeon this week to discuss plans for a "before winter," Cass said. Tracey has a big family including four sisters and three brothers [illegible] family member [illegible] good donor match. [illegible] family member and another [illegible] presently on an antibiotic for treatment of an ailment have already been ruled out, Cass said.

In addition, "many [illegible] have told her or told [illegible] willing to donate a kidney [illegible] any way they can [illegible] really grateful."

The golf tournament [illegible] shotgun start [illegible] two-man scramble is $5[illegible]

Energy From page 1

From page 1

Reed City Energy is a subsidiary of Great Lakes Energy and is a joint venture of Smith's Propane and Great Lakes Energy. Reed City Energy had been operating out of temporary offices on 200th Avenue since September, before its recent move.

Based in Newaygo, and with district offices in Hart, Wayland, and Reed City, Great Lakes Energy is the customer-owned power company for 40,000 homes and businesses in a 15-county West Michigan area. Smith's Propane, based in Fremont, has been serving thousands of mid- and West Michigan customers since 1956.

McDowell Funeral Home

138 W. Slosson Ave.
PHONE 832-2251

REED CITY, MICHIGAN

Dear Friends,
When death occurs, advance funeral arrangements can help ease a grieving family through a very painful period. Knowing their loved one was able to express what he or she wanted during life removes the pressure of decision. It also gives the family a lasting peace of mind, knowing they have carried out the personal wishes of the deceased.

Respectfully,
John W. McDowell

Place a classified ad in any 6 of Pioneer Group papers for the price of $13. (15 words or less)

DEADLINES FOR CLASSIFIED ADVERTISING
Herald News ~ 12 p.m. Tuesday

6 lines (up to 15 words) 1 time only $3.90

Cost per paper	2 times	3 times	4 times	5 times
	$7.80	$10.80	$14.40	[illegible]

Dates to run ____
Name ____
City ____
Phone ____

Additional Words 20¢ Each

____ ____ ____ ____
____ ____ ____ ____
____ ____ ____ ____
____ ____ ____

Additional words ____

Herald News
101 W. Slosson • Reed City, MI 49677 (616) 832-55[illegible]

Please check which paper you'd like your ad to run in
__ Pioneer __ Tri County __ Pioneer East
__ Lake County Star __ Evart Review
__ River Valley __ FreeWay __ Herald News
__ Lakeview Enterprise

Exhibit MI-2

Propane-Marketing Materials Distributed by Michigan RECs

Great Lakes Energy

Country Lines

A SERVICE OF YOUR ELECTRIC COOPERATIVE

MAY/JUNE 1998

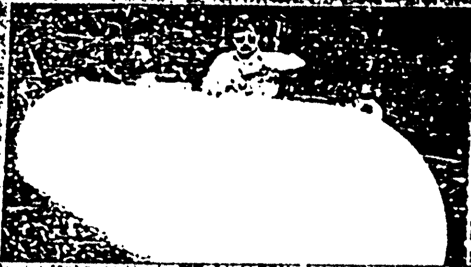
Electrical Contracting

Electricity

Heating & Cooling Sales Services

One call does it all!

Propane



Insulation

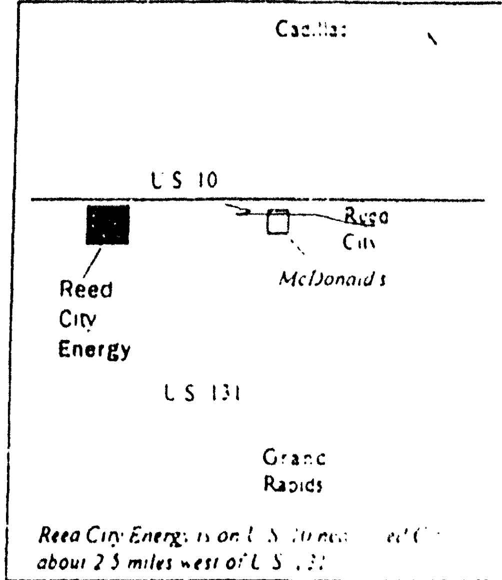
INSIDE...
Great Lakes Energy looks at merger, pages 6, 18, 19

Your full-service energy station

Great Lakes Energy's office in Reed City is called Reed City Energy

Stop by for your electric or propane needs!

- *Pay electric and propane bills!*
- *Apply for new electric or propane service!*
- *Take care of easements and most other requirements for new electric service!*
- *Take care of new construction charges!*
- *Pick up meter bases for new construction!*
- *Get personal help with your billing questions!*
- *Transfer an existing service into your name!*
- *Have an established service reconnected!*
- *Pick up electric and propane water heaters!*
- *Purchase propane appliances and furnaces!*
- *Fill small propane cylinders!*
- *Much more!*



All payments made at our Reed City office are immediately noted on your account the same day!

Great Lakes Energy
1-800-442-2796
• Reed City
• Hart
• Newaygo

Stacie Steig (left), of LeRoy, and Mary Kreidler (right), of northern Newaygo County have years of customer service experience and now help customers at our Reed City office - called Reed City Energy.

JOHN INSERT IN TOM ELECTRIC BILLS THIS MONTH

-500 JAN 1998

We deliver service with our propane

- Customers with our standard size 330 or 500 gallon tank are guaranteed their price won't exceed 97 cents/gallon this heating season (remember last winter?). Our current rate for a gas-heated home is 89.9 cents/gallon.

- Convenient monthly payment plans: have your propane metered and pay for what you actually use each month or pay the same amount each month on our budget plan.

- One call - one bill for both propane and electricity.

- Receive a $100 billing credit if we let you run out of propane.

- Choice of tank colors and more!

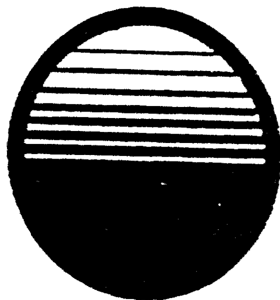
Call 1-888-TOP-MICH (867-6424) for details.

Propane Service

We want to be your propane service provider. That's why we lead the way in offering:

- Your choice of a monthly metered pay-as-you-use plan or a budget program with equal monthly payments so you can get your propane now and pay later
- A reliability guarantee—if you run out of propane, we'll give you $100
- A free furnace-safety inspection when you sign up for our program—includes carbon monoxide and gas-leak testing
- An annual guaranteed price cap to avoid mid-winter price increase surprises
- Automatic fill-up service so you never have to worry about running low on propane.
- 24-hour emergency dispatch service
- Your choice of tank colors—white, tan or gray—to match your home or grounds

You can always depend on Top O' Michigan Propane for reliable service at a fair price. As a Top O' Michigan Electric customer, you'll also enjoy the convenience of one bill and one number to call for both services.



Our Mission

is to provide our customers with outstanding service and the highest quality products in the propane gas business

Southeastern Propane

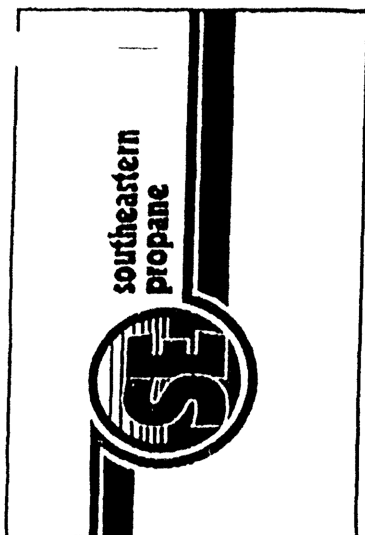
Metered Gas Service

The BEST VALUE for your energy $

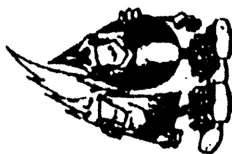
- You're sure to get all the gas you pay for with the Southeastern Propane computerized meter system. You pay for the gas only after you use it.
- Freedom from waiting for gas delivery, giving you more leisure time.
- You don't have to order gas. With metered service you are guaranteed the same low price all year long.
- Service that you have come to expect from the experienced people at Southeastern Propane, 24-hours a day, seven days a week

(Call today about our Level Payment and Auto-Fill Programs)

That is the
Member Advantage!



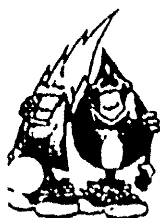
1998 Programs



1610 E. Maumee
Adrian, MI 49221
Located in the Southeastern Energy Office Building

1-800-748-0287

610 E Maumee
Adrian MI 49221



We're Your Energy Company

Southeastern Propane

Metered Gas Service

The BEST VALUE for your energy $

- You're sure to get all the gas you pay for with the Southeastern Propane computerized meter system. **You pay for the gas only after you use it.**

- Freedom from waiting for gas delivery, giving you more leisure time.

- You don't have to order gas. With metered service you are guaranteed the same low price all year long (**2.1 cents per cu. ft. or 77.9 cents per gallon**)**.

- Service that you have come to expect from the experienced people at Southeastern Propane, 24-hours a day, seven days a week.

- Underground tanks also available.

**Subject to budget plan enrollment

We're Your Energy Company

Special Offer

New Customers
Will Receive **FREE**:

- 50 gallons of propane
- Tank installation and/or tank relocation*
- Meter installation*
- **2.1 cents per cu. ft. or 77.9 cents per gallon price guarantee****
- Custom-made limited edition preferred customer baseball-style cap

*Some restrictions may apply
** Subject to budget plan enrollment

Call 1-800-748-0287

8 a.m.-8 p.m. Monday through Friday
or mail completed service request form to:
Southeastern Propane
P.O. Box 869 • Adrian, MI 49221

Service Request Application

Name ______________________

Address ______________________

____

City ______________________

State ____________ Zip ____________

Daytime Phone ______________________

Evening Phone ______________________

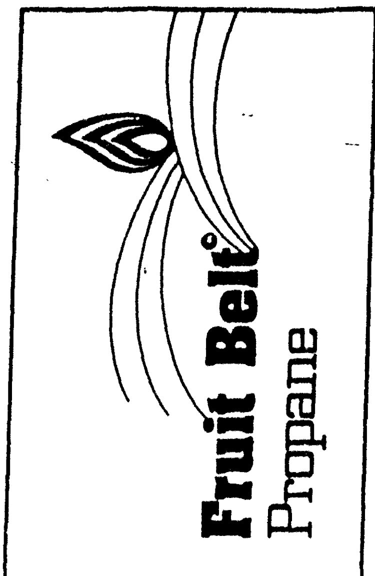
Sq. footage of home ________ I use propane for the following:

☐ Heating ☐ Cooking ☐ Hot water ☐ Dryer ☐ Fireplace

☐ Other ________ Do you use any wood heat? ☐ Yes ☐ No

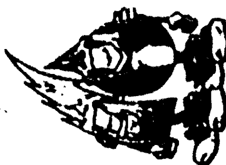
☐ Please call ☐ Please set appointment for new tank set

My current supplier is ______________________



12.

1998 Programs



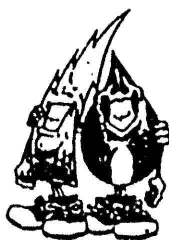
901 E. State Street
Cassopolis, MI 49031
Located in the Fruit Belt Electric Bldg

1-800-492-5989

Dowagiac
0324

Fruit Belt
Propane
901 E. State Street
P.O. Box 127
Cassopolis, MI 49031

*****************ECRWSS**R001
RESIDENT
RURAL ROUTE 1
DOWAGIAC MI 49047



We're Your Energy Company

The newest PROPANE dealer in

top O'michigan Propane

Northern Michigan is a company you already know!

Why Top O' Michigan Propane?

100 years of combined service

Top O' Michigan Electric Company, one of Northern Michigan's most respected energy companies, is now in the propane business. Top O' Michigan has more than 60 years of experience in providing dependable electric service at a fair price. Now this experience is being offered to propane users in the region and those considering a switch to this efficient, economical energy source.

CONVENIENCE

Top O' Michigan customers can now take advantage of "one stop shopping" for their entire energy needs. Top O' Michigan will combine both electricity and propane charges on one bill.

Think of it! Only one payment a month for both propane and electricity—and from a supplier known for quality service.

For your added convenience, we'll accept your MasterCard or American Express credit card.

VALUE

[illegible] entered the propane business to [illegible] value to propane users and better [illegible] promise of no sudden price hikes [illegible] offers exceptionally low up-front [illegible] payment plans from which [illegible] monthly for what you use [illegible] program, or take advantage of [illegible] or Automatic Fill program.

[illegible]

And when you choose Top O' Michigan as your propane supplier, you have a choice [illegible]

SERVICE

[illegible]

PROMPT
FRIENDLY
DEPENDABLE

[illegible]

TEAMMATES

Electricity (and) Propane from your co-op!

Now you can buy propane from Western Michigan Propane, a division of Western Michigan Electric Cooperative. With innovative service offerings such as metered propane service, we pledge outstanding service at a competitive price. Call us today, 1-800-968-3532, or (616) 757-4724.

- Budget Billing
- Metered Service
- Annual Price
- Multiple Payment Options ... Repair

Western Michigan Propane

P.O. Box 248 • 525 W. US 10, Scottville, MI 49454

Exhibit MI-3

Country Lines Magazine Article

March/April 1997

General Manager's Journal

No scary surprises with our propane plan

Dec. 29, 1996, won't be forgotten soon. Propane was delivered to my house that day. Surprise, it's now $1.32 9/10 cents a gallon! The bill totaled $532. Gulp.

"But 12 months ago it was 92.9 cents per gallon and 79.9 cents fifteen months ago," I said to the delivery driver with tears in my eyes. He hopped back into his truck and replied, "Well, everything's going up in price." He then roared away yelling "Happy New Year!"

Yeah, right.

Still stunned, I wandered back inside, flopped into a chair and relayed the gloomy news to my wife. She didn't feel sorry for me either.

"First of all, you're sitting in my chair," she quipped. "Why don't you sit in your own chair?" (Whoops!)

"Second, you have extensive experience with natural gas and propane," she added. "If you don't like it, why don't you quit whining and do something about it?"

Besides spurring me to move to my own chair, my wife's advice prompted me to move ahead on a plan which I had already studied at length. A propane consultant from Kansas had prepared a complete business plan for Top O' Michigan which indicated our entry into the propane business would offer our customers greater value and more energy options.

Your board of directors gave the plan a thorough review and, after much consideration, agreed to start Top O' Michigan Propane which plans to begin making deliveries in May.

We know you will have questions and we admit we don't know all the answers yet. But we will answer the obvious ones first:

Q. What services will Top O' Michigan Propane offer?

- Pay your electricity & propane charges on one monthly bill.
- Reasonable and stable propane prices guaranteed for the entire heating season.
- Convenient monthly payment plan to avoid large unexpected bills.

We will combine billing charges so you can pay for both your electricity and propane on one bill each month.

To avoid surprises like I experienced, steps will be taken to *guarantee* our customers reasonable and stable propane prices for the *entire* heating season.

For those like me who don't like large unexpected bills, Top O' Michigan Propane plans to offer customers either a:

- Monthly budget plan where you pay equal monthly amounts, or a
- Monthly use plan where you pay for the actual amount of propane you use each month, just like year-round residents currently pay for their monthly kwh use.

Either plan would be available to those who have a good bill payment record with Top O' Michigan.

Q. Shouldn't Top O' Michigan concentrate on improving what it does best, which is delivering electricity, and forget about diversifying into another business?

Electric utilities know they must offer competitive rates backed by exceptional service to remain successful. One way to do that is to offer additional services that benefit customers and generate more income. Propane is one of the value-added services we feel will help Top O' Michigan and its customers in the long run.

Q. Should Top O'Michigan compete with propane dealers?

Yes. Good competition is healthy because the customer wins!

Q. Doesn't Top O' Michigan have an unfair advantage because of the free government money at its disposal?

Top O' Michigan *borrows* money from the federal government to pay for improvements to its electric distribution system. That money is not free and will be paid back. No government money or any other type of government guarantees will be used to finance our propane enterprise.

Q. How do you think customers will respond to your offer to sell propane too?

Even before we broke the news about Top O' Michigan Propane, we received a letter from a customer who learned in an earlier *Country Lines* that electric co-ops in general are considering propane and other value-added services.

If his letter is any indication, we expect the phones to be ringing off the walls here soon!

After reading that the co-ops were looking at offering natural gas and propane, Raymond Kinner of Pellston wrote: "Hope it happens before too long. The LP gas company takes us for all they can every winter and we are at their mercy – pay our price or go without gas.

"Keep us informed about it and here is hoping it happens soon."

Kinner also encouraged us to "keep up the good work."

It's because of customers like Ray Kinner that Top O' Michigan is exploring value-added services.

We want to be more than just your electric company. We want to be your total home energy provider!

Exhibit MI-4

Great Lakes Energy Flier

• Electricity • Propane • Heating & Cooling Services
• Electrician Services • Insulation Services • More!

1-800-968-3532

New Great Lakes Energy Bill

Introducing the

bills

You no longer will receive a "Western Michigan Electric" bill. It will be replaced by the new "Great Lakes Energy Cooperative" bill.

Following a successful vote this summer, Western Michigan Electric has joined two other electric cooperatives to become part of the new Great Lakes Energy Cooperative that began operating Jan. 1, 1999.

Yes it is a new name and a new logo that is appearing on all our signs, vehicles and communications. But the people who stand behind the new name and logo are many of the same employees who have proudly provided electric service with a level of quality you have come to expect.

And now, our services have grown to include propane sales and service, heating and cooling services, electrician services, insulation services and more. We will continue to provide these and other improved services under our new name.

We will continue to serve you from our Scottville office along with other local service centers in Hart, Newaygo and Reed City.

Payments:

• Payments should be made out to Great Lakes Energy Cooperative, although those bearing the Western Michigan Electric name will still be accepted.

• Payments can be mailed to our Newaygo office using the enclosed envelope, or you may bring your payment to any office - Scottville, Reed City, Hart, Newaygo, Wayland (open in March), Boyne City, Waters or Kalkaska.

Happy New Year to You and Your Family!

Proper insulation can help lower your energy bills. And we have the insulation experts to help you.

If your home is more than 20 years old, there's a good chance it doesn't have enough insulation in the walls and attic. And that means you might be using - and paying for - more energy than you should be. Homeowners could save up to 70 percent on their heating and cooling bills by adding proper levels of insulation. For a FREE estimate for your old - or new - home, call our insulation professionals today, at 1-800-968-3532. Plus, get 10 % off any insulation job!

1-800-968-3532

Insulation Services

New system for power outage dispatching

In the past, our after-hours power outage dispatching was handled by a firm in Minnesota. To save money and to coordinate power outage dispatching and repair, the Newaygo office will now handle after-hours dispatching. If you experience a power outage, please call us at 1-800-968-3532

Questions on your bill?

If you have questions on your electric bill or about our service, you can still call us in Scottville, at 1-800-968-3532, or (616) 757-4724. Or stop by. We're on U.S. 10 in Scottville, and we're here for you.

What's the Fuel Cost Recovery on this month's bill?

You might notice an extra item on your bill this month. It's called a Fuel Cost Recovery. This is a modification of customers' electric bills to reflect an undercollection in our 1997 power supply - or fuel - costs. The cost of fuel that is used to produce electricity changes frequently, and utilities must estimate what future fuel costs will be for customer billing purposes. Actual fuel costs for the year of 1997 were higher than anticipated and, therefore, customers were charged less than the actual cost. This Fuel Cost Recovery on your bill reconciles that difference.

Fuel costs are assigned to electric customers by the Michigan Public Service Commission (MPSC), and the process is audited by the MPSC.

TEXAS

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EVIDENCE REGARDING ANTICOMPETITIVE BEHAVIOR .... TX 3

SUCH BEHAVIOR HAS AND WILL AFFECT THE MARKET .... TX 7

BACKGROUND

Hilco Electric Cooperative, Inc (HEC) is a Rural Electric Cooperative headquartered in Itasca, Texas. According to the Texas Public Utilities Commission, HEC serves approximately 14,500 customers[1]. In addition to its core electric business, HEC offers a credit card to its members, sells appliances, and manages two local water systems under contract. Further, in 1997 HEC formed Hilco United Services (HUS), a wholly-owned, for-profit subsidiary which entered the propane business in September of that year. HUS started its propane venture from scratch, although it had studied other options, including that of buying an existing propane concern.

Soon after Hilco's propane venture commenced operations (it had acquired roughly 250 customers by December 1997[2]), a suit was filed in the District Court of Hill Country Texas (*Star-Tex Propane, Inc., Et Al vs Hilco Electric Cooperative, Inc., Et Al*), alleging that Texas law prohibited electric cooperatives from entering for-profit ventures. In February of 1999 the presiding Judge granted Defendants' motion for Summary Judgment, allowing the REC to remain in the propane business.

The issue in *Star-Tex vs Hilco* is a narrow question of state corporate law. However, the proceeding has produced a host of documents that would be relevant to an inquiry into the competitive effects of Hilco Electric's actions in the propane market. NERA has obtained copies of two such documents, both depositions of HEC/HUS employees. The first, from December 19, 1997, is of Joe Forman, General Manager of HEC since August 1995 and, more recently, General Manager of HUS. The second, from October 29, 1998, is of Elizabeth Hartnett, a sixteen-year veteran of Hilco Electric Coop then serving as HEC's Finance Accounting Manager but also performing finance and accounting tasks for HUS.

The depositions cover many issues related to the expenditures of HUS and HEC on the propane business, whether HUS reimbursed HEC for propane-related items, and whether sales

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[1] Texas Public Utilities Commission website, "Utility Directories Electric & Telephone Companies Serving Texas," http - www puc.state.tx us/pubinfo/pub-info htm

[2] Oral Deposition of Joe R "Jody" Forman, ("Forman Deposition"), *Star-Tex Propane, Inc. Et Al vs Hilco Electric Cooperative Inc Et Al*, December 19, 1997, p 89.

taxes were paid on items purchased by or for HUS, a for-profit business. At several points, the deposition strongly suggests that cost shifting and cross-subsidization have occurred within the Hilco organization.

EVIDENCE REGARDING ANTICOMPETITIVE BEHAVIOR

The most obvious example of cost-shifting and cross-subsidization involves the salaries of Forman and Hartnett themselves. On top of her responsibilities at HEC, Hartnett is technically the bookkeeper for HUS and claims to spend 10 percent of her time on propane-related activities. HEC General Manager Forman wears many hats for the subsidiary: he is the sole Director, President, Secretary, Registered Agent, and General Manager of Hilco United Services and makes "all decisions regarding the investment and expenditure of its funds..." The two individuals who sign checks for HUS are Joe Forman and Elizabeth Hartnett (both signatures required on each check). And yet, both Hartnett and Forman are directly compensated only by HEC and not by HUS. Further, HUS offers no compensation to HEC for Forman's time and, as discussed below, practically none for that of Hartnett.[3]

Hilco United Services directly employs only four people. A management contract with HEC provides that the subsidiary receive from its parent "financial, marketing, customer service, and clerical services," along with equipment and furniture, in exchange for a monthly payment Among specific items falling under this contract are the following: assistance in the acquisition of long and short term financing; use of the furniture, computer, cash drawer items, adding machines, etc. in HEC's Whitney, TX office (headquarters of HUS), the time of Hartnett and her assistant, as needed to "keep all the records for the Hilco United Services;" the time of HEC's three marketing employees, as needed; and the time of HEC's nine customer service clerks, as needed, including the one who answers the phones, tracks propane sales receipts, takes customer requests for propane refills, and performs general propane-related clerical tasks at the Whitney office.[4]

[3] Forman Deposition, pp 61-64, ; Oral Deposition of Elizabeth Hartnett, *Star-Tex Propane, Inc., Et Al vs Hilco Electric Cooperative, Inc., Et Al*, October 29, 1998, pp. 8-11, 13, 34-36.

[4] Hartnett Deposition, pp 18-30.

Under the terms of the management contract, the payment for all of these services is supposed to be "the actual cost" of materials and labor. However, as a matter of practice, HUS is billed $1,000 per month, or $12,000 per year. This convention could be interpreted as a means of avoiding the expense involved in enumerating actual costs. However, HEC employees break down their time sheets by type of labor performed, and HEC management receives monthly reports indicating the value of labor services (based on individual employees' salaries) performed on behalf of HUS. In fact, Hartnett confirmed that Deposition Exhibit 3 showed that a group of HEC employees performed $2,869.61 worth of labor for HUS in December of 1997 alone, and this figure excludes at least Hartnett herself, perhaps others.[5]

Hartnett claimed to be unable to guess whether this figure represented a typical month, but on the assumption that $3,000 is the average, then we can conclude that HUS is shifting at least $2,000 per month in labor costs alone to the books of HEC, to say nothing of the equipment rental/amortization costs. $2,000 per month is $24,000 per year, or 2.4 cents per gallon of propane for an operation selling 1 million gallons annually. Given that the HUS operation was relatively new and had relatively few customers, this $3,000 assumption, even just for labor, is likely to be low. Similarly, the per-gallon subsidy estimate of 2.4 cents represents a minimum for the first few years' of HUS's small but growing propane operations.

Also disturbing is HUS's record on making even the low $1,000 payments. Despite the fact that Hilco commenced operations in the propane business in September of 1997, no charges were made to HUS until January of 1998, meaning the propane business benefited from four free months. Further, at the time of the Hartnett deposition in October 1998, HUS had not made a single payment to HEC for any of the 9 months of charges that had accrued. The management contract specifies that such payments be made by the 10th day of the month following the charge period and that amounts not paid within 20 days are subject to 1 percent per month interest. No interest charges had been assessed at the time. The deposition did not explore the reasons for the delay in payment.[6]

[5] Hartnett Deposition, pp. 22-24, 30-31, 43, 49-54.

[6] Hartnett Deposition, 55-57.

A final item of concern related to the management contract is workers' compensation and medical insurance coverage for HUS employees, liability insurance on HUS vehicles, and other insurance items. Under the contract, the $1,000 per month covers the administrative cost of HEC providing all of this insurance to HUS. However, HUS is to reimburse HEC for the relevant premiums. At the time of the Hartnett deposition, more than a year after the entry of HUS into the propane business, no such reimbursements had been made.[*]

The relationship between Hilco United Services and Hilco Electric Coop with respect to rental payments is akin to their relationship on payments for management services. In his deposition from September 1997, Forman claimed that when HEC's Whitney office opened in January 1998, HUS would be headquartered there and a lease would be arranged whereby HUS would reimburse HEC for its use. The property cost $115,000. Over a year later, Hartnett had the following exchange with the deposing attorney:

Q Is Hilco United Services paying any rent to Hilco Electric for the office in Whitney?

A Not that I'm aware of.

(...)

Q Are you aware of a commercial lease between Hilco Electric Co-op and Hilco United Services, covering the building in Whitney?

A No, sir, I'm not aware of it.

(...)

Q (This) document appears, to me, to call for a $500-a-month payment to be made by Hilco United Services to Hilco Electric Cooperative for the use of the premises in Whitney. Are you telling me, as someone familiar with the books and records of both organizations, that that payment is not being made?

A That's correct.

Q Were you aware that it was not being paid, or were you aware, before today, that there was a requirement for a payment of rent?

A I was not aware of it.

---

[*] Hartnett Deposition, 40-42.

Beyond the Whitney facility, HEC purchased land near Itasca, TX, an area unrelated to its electric operations. In fact, HUS keeps it's a propane storage tank there. However, HUS makes no rental payments for that land.[8]

HEC also spent money that was never recovered from HUS on lawyers, consultants, meetings, member surveys, and advertising in planning and supporting the propane business. As part of HEC's formative deliberations, approximately $8,000 was paid to a consulting firm, CHG Strategy Group. Roughly $8,000 was also spent on a special meeting of HEC membership to vote on a charter amendment that would permit the coop to entry the propane market. In addition, all of the costs of the *Star-Tex* suit were/are borne by HEC.[9]

The final cost shifting issue raised by the depositions pertains to equipment purchased by Hilco Electric for the propane business, including a pickup truck, flatbed truck, two bobtail trucks, a trencher, various tools, a 30,000 gallon storage tank, and several loads of 250-500 gallon tanks. Allegedly, these items were purchased by HEC before HUS had its own checks printed. HUS was to have reimbursed HEC, although it had not done so at the time of the Forman deposition and the Hartnett deposition does not address the issue. Even assuming the reimbursements were made, the transactions raise other questions. Specifically, the Forman deposition shows that sales taxes were not paid on any of these items at the point of purchase, as HEC is exempt from Texas sales tax. The Hartnett deposition demonstrates that HUS did pay some sales taxes related to at least some of these purchases direct to the state several months later, however the reimbursement form discussed in the deposition is not itemized and Hartnett offers no confirmation that all taxes due were paid. While it is not clear whether the Hilco propane concern illegally and unfairly benefited from its parent's tax-exempt status in this case, the situation is suggestive of both the opportunities and incentives to do so.[10]

With respect to financing, Hilco Electric is a member/borrower of the CFC, having an outstanding debt to the cooperative bank of $17 million and a total credit line of $50 million. Separately, Hilco United Services has itself borrowed $500,000 from the CFC's subsidiary, the

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[8] Forman Deposition, pp. 108, 111, 117-118; Hartnett Deposition, pp. 58-61.

[9] Forman Deposition, pp. 43, 49-51, 55, 59, 91-100, 110; Hartnett Deposition, pp. 57-8.

[10] Forman Deposition, 114, 118-126; Hartnett Deposition, 78-82. The deposing attorney implies that the late payment was made only after, and in response to, his deposition of Forman.

National Cooperative Services Corporation (NCSC). This loan was guaranteed by HEC, despite the fact that the management contract between the two entities provide that neither shall be "responsible for the debts of the other party." Lastly, HUS had, at one point, borrowed $300,000 from HEC on an unsecured basis. The loan was repaid. The deposition does not discuss the details, but given the sources for these loans and the HEC guarantee on the NCSC credit, there is little doubt that the interest rate paid by HUS is significantly lower than that paid by comparable propane businesses. For reference, between January 1990 and April 1999, the average level of the prime interest rate was roughly 7.96 percent,[11] whereas the average rate on CFC loans to distribution cooperatives such as HEC was 6.74 percent (see Section V, especially Tables V-1 and V-2 for a complete discussion).[12]

Lastly, any prospects for joint billing (or other joint operations) of electric and propane service by any competitor other than the REC are foreclosed by the REC's legal electricity monopoly – and indefinitely so. The deregulation bill recently approved by both houses of the Texas legislature and signed by the governor would require retail electricity competition in Texas, but not before January 1, 2002. And even at that late date, the proposed bill exempts RECs (and municipal utilities) unless their members affirmatively vote to open up the local market.

SUCH BEHAVIOR HAS AND WILL AFFECT THE MARKET

Although the lawsuit put a chill on HUS's propane marketing efforts for a time, anecdotal evidence suggests that Hilco may be using subsidies and shifting of costs to charge very low prices, perhaps at levels below costs. For example, HUS allegedly acquired one customer by offering a price per gallon of wholesale-plus-20-cents, where transportation costs alone were running at 8 cents. In addition to this low price, Hilco installed $8000 worth of tanks free of charge, despite the fact that the customer, a retreat center, had only purchased 10,000 gallons of propane per year the previous three years. Even with an operating profit of $0.10 per gallon (which would imply, unrealistically, additional operating costs of only 2 cents per gallon), it will take Hilco 8 years just to make back the up-front investment. In another

---

[11] Interest rates provided by Federal Reserve Bank at website http://www.bog.frb.fed.us/releases/H15/update/.

[12] Forman Deposition, pp. 73, 77-84, 107-108, Harmett Deposition, p. 35.

case, Hilco has been observed to offer to install propane piping on a turnkey basis for $1.00 per foot when the wholesale cost of the pipe itself is $1.65/foot.

charter

Scholarships Available

High school seniors whose parents or guardians are Shelby Energy members are eligible to apply for a $1,000 scholarship from the cooperative Shelby Energy will award three scholarships to deserving students

In addition to residency requirements, students must write a 500 word essay. Awards will be made based
on the quality of the essay, grades, community & school involvement and need

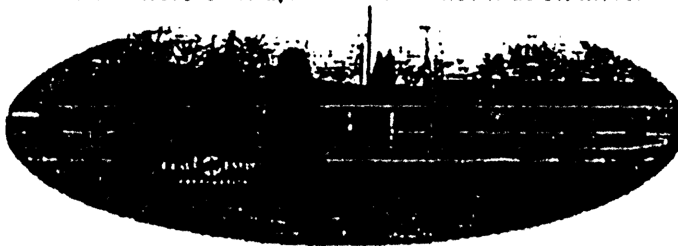
Applications may be obtained from your school guidance counselor office or from the cooperative during February
and March

The deadline for applications is April 15.

Awards will be made at high school honors programs in the spring

Welcome to the Clark Energy Cooperative

Clark Energy Cooperative is the electrical service provider for all or part of twelve counties in Central and East-Central Kentucky. Clark Energy serves 20,265 consumers over 2,573 miles of distribution lines.



Click the button below to visit the Clark Energy Thermogas home page!!!!!

Our Address:

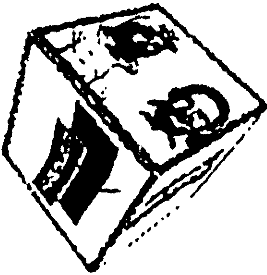
Clark Energy Cooperative
P.O. Box 748
2640 Ironworks Road
Winchester, KY 40392
Phone: (606) 744-4251 or 1-800-992-3269
For outages call 1-800-992-3269 24-hours a day.

Outer Offices:

P.O. Box 14, Halls Lane
Stanton, KY 40380
Phone: (606) 663-4330
And
P.O. Box 152, Highway 36
Frenchburg, KY 40322
Phone: (606) 768-2383

Yo ur E ner gy
Par ner

Welcome to the Clark Energy Thermogas Homepage



Clark Energy Thermogas is Central Kentucky's premiere propane supplier. We offer competetive prices and have the experienced personnel to take care of all of your propane needs (residential or commercial). We also carry a full line of high quality propane heaters and grills.

Our office is located in Clark Energy's Winchester office at 2640 Ironworks Road (on Highway 15 between Winchester and Clay City). Office hours are Monday through Friday from 8 am until 5 pm.

Phone: 1-877-873-8427 or 744-5385
E-mail us at propane@clarkenergy.com

Return to http://www.clarkenergy.com

MICHIGAN

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BACKGROUND

Michigan has seen much activity by RECs in the propane industry. Fruit Belt Electric Cooperative and Southeastern Michigan Rural Electric Cooperative each had their own propane subsidiaries before the two cooperatives merged. The resultant entity, Midwest Energy Cooperative, now has its own propane subsidiary, Midwest Propane. Cherryland Propane is another Michigan REC subsidiary, its parent being Cherryland Electric Cooperative. However, the most noteworthy Michigan REC is Great Lakes Energy Cooperative (GLEC), the state's largest cooperative and its third largest electric company overall.

During the summer of 1998, three Michigan RECs – Great Lakes Energy Cooperative, Top O'Michigan Electric Company, and Western Michigan Electric Cooperative – announced plans to merge into a single company to be named Great Lakes Energy Cooperative. Approved by customer owners on August 8 of that year and commencing joint operations on January 1, 1999, the newly merged firm supplies electricity to approximately 106,000 customers in 26 Michigan counties.

In its application to the Michigan Public Service Commission (MPSC) for approval of the merger, the three partners clearly established their intention to operate in energy markets other than electricity.[1] This declaration was consistent with the established business practices of the three RECs. "In recent years the cooperatives (had) added various subsidiary businesses, including propane sales and services, heating and cooling services, electrician services, insulation services and more."[2] For example, the original Great Lakes Energy (i.e. not the merged company) had a propane subsidiary by the name of Reed City Energy (a joint venture

[1] Amended and Restated Articles of Incorporation of Great Lakes Energy Cooperative, p. 2. "The objectives of the Corporation shall include, but not necessarily be limited to, the following: (a.) To generate, manufacture, purchase, acquire and accumulate electric energy *and other sources of energy* ("Energy") for its members or patrons; to transmit, distribute furnish, sell and dispose of Energy to its members or patrons; to furnish and sell telecommunication services..." (emphasis added)

[2] "Three-Way Electric Cooperative Merger Takes Effect Jan. 1: Michigan's Newest – and Third Largest – Electric Utility to Officially Open for Business," GLEC website, http://www.glenergy.com/threeway.htm.

with Smith Propane) and an appliance sales and service subsidiary called Oceana Energy.[3] Top O'Michigan and Western Michigan also had propane operations prior to the merger.

In addition to consolidating its various propane concerns, the new Great Lakes Electric Cooperative has recently entered into a wider-ranging agreement with Smith Propane, the original Great Lakes' partner in Reed City Energy. Under the new agreement, GLEC's subsidiary, Great Lakes Utilities Service Corp, has joined Smith Propane in forming a new company named Great Lakes Energy Gas Services (GLEGS).[4] The new company combines the existing joint operations of Smith and GLEC with other, separate Smith and GLEC properties, making it "one of Michigan's largest retail suppliers"[5] of propane.

EVIDENCE REGARDING ANTICOMPETITIVE BEHAVIOR

Many of the potentially anticompetitive practices discussed in Section V are exemplified by Great Lakes Energy Cooperative. The REC's general strategy in propane appears to be to leverage its regulated electric assets to achieve marketing and cost advantages vis-à-vis its propane rivals. However, as shown below, many of these advantages would not be possible but for the relationship with the electricity business, and so may raise competitive concerns.

GLEC (and its constituent companies) vigorously promotes the idea of "one-stop shopping" for all of a customer's energy needs. Customers purchasing both electricity and propane from Great Lakes can receive a single bill, and individual customer service centers can handle all of a customers' needs, whether payment of electric/propane bills, establishment of new electric or propane service, or other.[6] A single site on the world-wide-web can also be accessed for information on and transactions with both the propane and electricity businesses.

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[3] "Merger of O&A Electric Cooperative and Oceana Electric Cooperative Takes Effect January 1; New Company to be Called Great Lakes Energy," GLEC website, http://www.glenergy.com/mergerof.htm

[4] The new propane business is known and marketed as simply Great Lakes Energy, which is also how the electric cooperative is known an marketed. The initials GLEC and GLEGS are only used here to avoid confusion.

[5] "Great Lakes Utilities and Smith's Propane Merge into New Propane Company for Western and Northern Michigan," ("Propane Merger") GLEC website, http://www.glenergy.com/ppane.htm.

[6] See attached Exhibits MI-1 through MI-4 which contain numerous statements and materials published by GLE's component RECs – both pre- and post-merger – which tout "one-stop shopping."

Said one GLEC executive, "The intent is for customers to have the convenience and ability to take care of their electricity and propane needs at any of our 15 Michigan locations. It's a one-stop shopping concept that also includes our energy services in heating and cooling, electrical contracting and insulation."[7]

In combining the operations of its electricity and propane businesses, Great Lakes may very well be providing its propane affiliate with artificial cost advantages. While we have not had the opportunity to review the financial records of the Great Lakes companies, the experiences in other states for which we have more complete information are suggestive: RECs which enter the propane business have the incentive and opportunity to shift costs and cross-subsidize their propane businesses at the expense of their captive electric customers and competition.

GLEC appears to be integrating propane and electricity service more thoroughly than any other REC we have studied. It is not clear that GLEC prevents pure propane-related costs from finding their way to the books of the electricity concern. Nor is it clear that GLEC ensures a reasonable allocation of joint overhead and personnel costs. Were competitive forces acting on the GLEC's core electricity business, these questions would be less pressing. But GLEC remains a regulated monopoly in its service territory. When the REC uses the same offices, personnel, advertising campaigns, etc. for both its regulated electricity service and its unregulated services, it seems plausible that regulatory oversight would be unable to detect and deter cost-shifting and cross-subsidization.

Another marketing concept touted by GLEC (and other REC propane affiliates in Michigan and other states) is "guaranteed pricing," that is, a guarantee that the retail price of a gallon of propane will not rise above a certain level for a given time period.[8] The effect of such retail price guarantees is to shift the risk of unforeseen increases in the wholesale prices of propane from consumers to the propane distributor.

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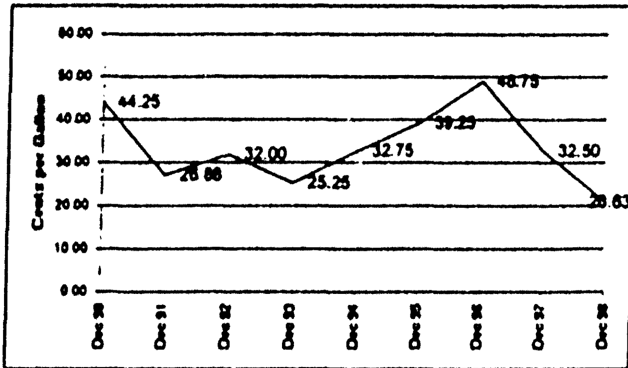
[7] Propane Merger, http://www.glenergy.com/ppane.htm.

[8] See attached Exhibits MI-1 through MI-4, which contain numerous statements and materials published by GLE's component RECs – both pre- and post-merger – which tout "guaranteed pricing."

Chart MI-1

Average Prices of Propane at Mont Belvieu Terminal in the

Month of December: 1990 - 1998

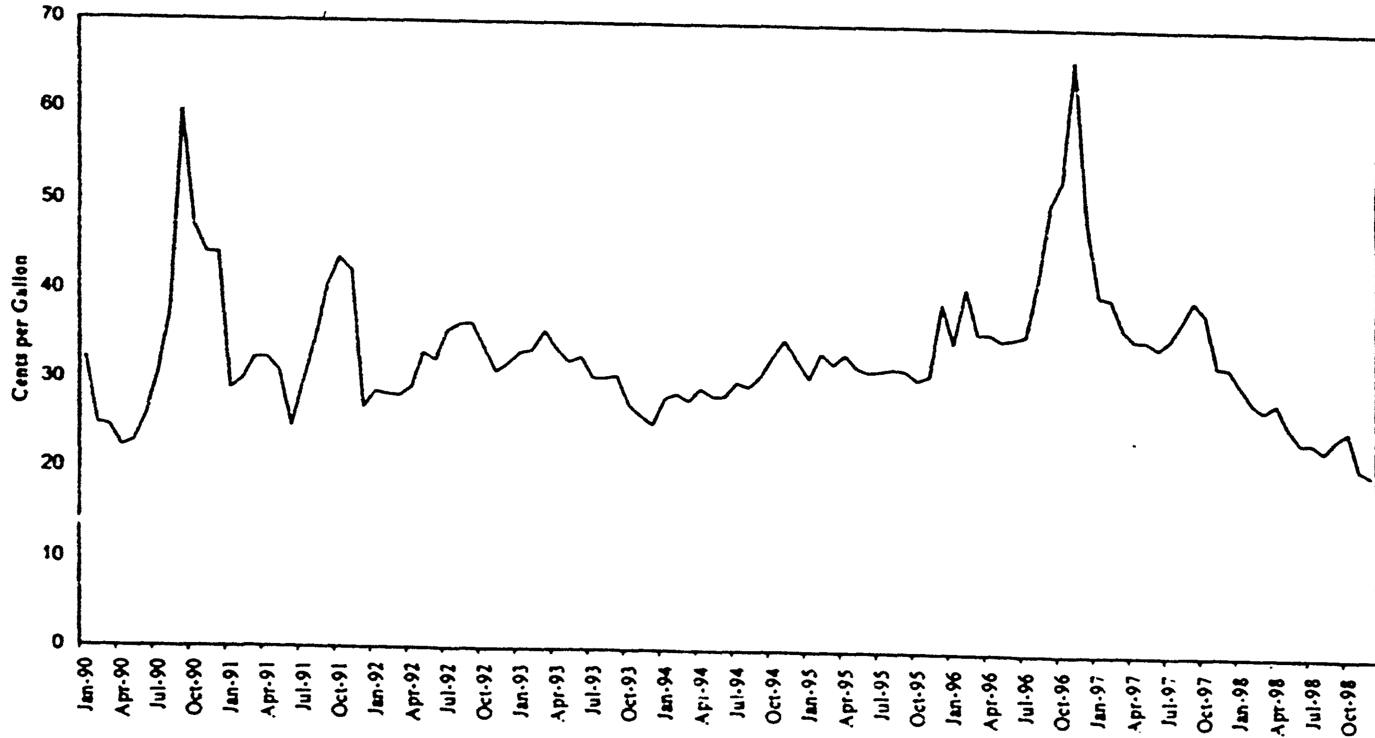


Source Bloomberg, LP

This risk is not negligible. Periodically, the price of propane moves dramatically in one direction or the other, often due to crude oil price increases or demand spikes led by particularly cold weather. These fluctuations complicate the forecasting of propane prices for even a particular season. As shown in Chart MI-1, year-on-year prices of propane for only the month of December show significant variance. The average December price between 1990 and 1998 was 33.6 cents, but the standard deviation over that period was 9.1 cents. The average December price nearly doubled between December 1993 and December 1996 and then fell 58 percent from that high to only 20.63 cents in December 1998. Chart MI-2 shows the significant variance in the entire monthly price series over the 1990 to 1998 period.

Guaranteed pricing shifts some of the risks of volatile wholesale propane prices form consumers to the propane distributors. While such a shift in risk provides some benefits to consumers, it is notable that price guarantees were not widely offered to consumers prior to RECs' entry into the propane business. It is unlikely that this fact can be attributed to lack of competition in the propane industry -- Michigan customers have historically been able to

Chart MI-2
Average Prices of Propane at Mont Belvieu Terminal
1990 - 1998



Source: Bloomberg, LP

choose from among multiple propane marketers, and these marketers have taken steps to buffer customers against price/expenditure fluctuations. For example, it is common practice among propane marketers to offer payment options that smooth the financial burden associated with the natural seasonality of propane consumption. Typically, a customers' total consumption in prior years is used as the basis for calculating an "average month" and this average is billed throughout the year with an adjustment made as necessary at year's end.

An alternative explanation for the appearance of price guarantees is that the propane affiliates of the RECs can afford to offer them because of their access to below-market loans. The availability of such financing permits them to absorb the risk of wholesale price fluctuations more readily than independent propane marketers. To the extent this explanation is valid, an REC propane affiliate would be relying on a cost advantage that derives directly from its relationship with the REC's government-protected, government-subsidized electricity business.

Whether or not they help explain guaranteed pricing, the financing advantages of RECs are not in doubt. At least some of the GLEC propane subsidiaries have benefited from their parents' affiliation with the CFC. Reed City Energy, the original Great Lakes' joint venture with Smith Propane, appears to have been financed with CFC loans. As of December 1996, Great Lakes (then known as O&A Electric Cooperative) had $8.7 million in outstanding loans from the CFC at a weighted average interest rate of 6.82 percent.[9] For reference, between January 1990 and December 1996, the average level of the prime interest rate was roughly 7.85 percent.[10] While the gap between the Great Lakes borrowing rate and the prime rate is substantial, it may understate the differences in the cost of capital, as small businesses frequently borrow at rates one or two points higher than prime.

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[9] Ottawa and Allegan Electric Cooperative, Inc., Schedule of Mortgage Notes for the Year Ended December 31, 1996. The schedule shows that the only sources of debt for O&A other than the CFC were the Rural Utilities Service and the Federal Financing Bank. Funds from the latter two sources are not permitted to be used to fund non-electricity related projects.

[10] Based on daily postings of the Prime Interest Rate provided by Federal Reserve Bank at website http://www.bog.frb.fed.us/releases/H15/update/.

Independent Michigan propane dealers frequently note that GLEC and other RECs have been using their electricity meter-readers to gain competitive information for their propane businesses. Meter-readers making electric rounds can, at little or no cost, scout out users of non-REC propane services, identify the incumbent supplier, and note the size of the customer's tank, all of which provides the REC's propane business with valuable marketing advantages. By the same token, the REC's ubiquity gives it an advantage with respect to new construction projects, and some Michigan propane dealers cite this as the most grave threat to fair competition. As GLEC is the only provider of electricity to new projects in its service territory, it is privy to information on these projects' propane needs before that information is available to other independent propane marketers. Such early access may be critical in persuading the manager of the construction project to purchase propane services from the REC in addition to electricity, for which the REC is the only option.

Consumer misinformation issues are also raised by GLEC's practices. As the electricity rates GLEC charges are known to be governed by the MPSC, customers may erroneously infer that the propane rates are regulated as well. In a two-page flyer sent to its customers following the GLEC merger, the former Western Michigan Electric announced to its customers that they would henceforth be receiving bills form GLEC, not Western, and that, "our services have grown to include propane sales and service..." The flyer's heading features the company's services underneath its logo, listing propane second, just after electricity. Later, under the heading "What's the Fuel Cost Recovery on this month's bill?," the flyer states, "Fuel costs are assigned to electric customers by the Michigan Public Service Commission, and the process is audited by the MPSC."[11] While this statement apparently does not apply to propane, consumers may believe that it does (see Exhibit MI-4).

Even where consumers are not misled in this way, the use of the brand name/goodwill built up in the REC's electric business (supported by decades of government subsidies) raises concerns. Since the merger, the Great Lakes companies have used the same logo to advertise both the propane business and the electricity business. Newspaper and magazine

[11] Flyer mailing to customers of Western Michigan Electric Cooperative (now part of Great Lakes Electric Cooperative), undated

advertisements for the propane business bear the KEC logo, as do propane delivery trucks. In general, GLEC's marketing and public relations make absolutely no distinction between the electric cooperative and its for-profit subsidiaries. After the Great Lakes merger and the expansion of the venture with Smith's Propane a press release announced that, "All propane operations will combine and do business as Great Lakes Energy."[12] Hence, the apparent objective is to combine the propane and electric businesses in consumers' minds.

[12] Propane Merger, http://www.glenergy.com/ppane.htm.

Exhibit MI-1

Local Newspaper Article

[illegible]

- fatal accident which [illegible] in Mecosta County, [illegible] by Edward Bolte Jr., a [illegible] several times into the [illegible] he was pronounced [illegible] used to remove the [illegible] Fire/Rescue. Bolte

FIA cuts will be felt at Christmas

By Bill Knapp
Herald-Review Writer

REED CITY — Church and civic leaders are [illegible] what kind of a Christmas to expect this year for area children and their families who have come to depend on the leadership of the Volunteer Services Coordinator at the Family Independence Agency (FIA) in putting that effort together.

The Volunteer Services Coordinator position at the Osceola Family FIA has been vacant since Judith Franklin retired from the post the end of May.

Having served in that capacity since 1988, Franklin coordinated a variety of services including the State Medical Transportation program, the county food pantry, the Osceola Clothing Center and the county-wide Christmas giving effort which provides Christmas gifts and food baskets to hundreds of needy children and their families. Franklin was one of seven staff members from Osceola county to accept an early retirement option offered by the state.

FIA lost approximately 1,000 veteran employees statewide through the Governor's early out retirement option earlier this year; about 700 of those were first line worker positions. FIA Director Marilyn Livingston Hammons has stated her first priority is to fill critical mission worker positions left vacant by early retirement. Hammons also is exploring the elimination, reassignment and contracting out of some functions performed by certain positions, which in turn would free up staff to vacant first line positions.

The Volunteer Services Coordinator Position is not considered a first line position and as such is one of those posts being considered for elimination.

Marguerite Gravina of the FIA Office of Communications in Lansing said there are eighteen proposals currently being considered, one of which would be to eliminate the position and contract the services out to businesses which coordinate volunteer activities.

A decision is expected sometime by the end of July or beginning of August, Gravina indicated.

FIA/See page 10

One-stop shopping for energy

Reed City — The Reed City area has received a boost of energy to its local economy with the announcement of a new business that gives customers a "one-stop shopping" opportunity to take care of all of their electricity and propane gas needs in one location.

Reed City Energy, a subsidiary of Great Lakes Energy and in joint venture with Smith's Propane, has opened a full service propane operation on U.S. 10 two miles west of U.S. 131. Reed City Energy is the propane supplier to hundreds of homes and businesses in Lake, Osceola, Newaygo, and Mecosta Counties.

The building is also a customer service center for Great Lakes Energy, a customer owned electric utility that serves 11,000 customers in Lake and Osceola Counties.

By late July, customers will be able to take care of their electricity or propane needs at this one location, said Robert Hance, president and chief operating officer of Great Lakes Energy.

At Reed City Energy, customers can pay electric and propane bills, establish new electric or propane service; take care of new construction requirements, get personal help with electric or propane billing questions, transfer existing electric or propane service into their name, and take care of any other business related to their electric or propane service.

Reed City Energy also will feature a mini showroom of furnaces, air conditioners and water heaters for both fuels. The sales, service and installation of these appliances will be available through Reed City Energy and Great Lakes Energy.

The new location includes a 30,000 gallon bulk storage tank, which ensures quick delivery for customers.

"We are preparing for the day when customers will have their choice of electric energy suppliers," Hance said. "Our goal is to not just provide the energy, be it gas or electricity, but to provide solutions to customers' energy needs. We think we can achieve that relationship with customers by providing these additional services and offering other fuel choices."

ENERGY/See page 7

...ned for July 18 for Tracey Cass Spurbeck, of Evart, who is in need of a kidney transplant.

The Second Annual Stag Day Golf Tournament at Spring Valley Golf Course near Reed City is sponsored by the Hersey Fire and Rescue Auxiliary. Fifty percent of all proceeds will go to the young mother of three small children, four-year-old Lindsey, six-year-old Tyler and 11-year-old Stephanie.

Tracey, now 32, was diagnosed with Glomerulonephritis, a kidney disease, at the age of 19, while in her first year of college. She went to a local doctor for a checkup and Tracey's mother, Mrs. Paul Cass, also of Evart, recalls that Tracey "insisted she didn't ever feel sick. But she was told it it went to 10 percent, she would [illegible]

At the present time, Tracey is on medical leave from her managerial duties at the Hot 'N Now, and has been for approximately three weeks.

Tracey has dialysis three days per week at Mercy Hospital in Cadillac, usually a three-hour ordeal each time in addition to her specialist in Cadillac. Tracey was scheduled to meet with a surgeon this week to discuss plans for a [illegible] "before winter." Cass said. Tracey has a big family including [illegible] and three brothers [illegible] family member [illegible] good donor match. [illegible] family member and another [illegible] presently on an antibiotic [illegible] ment of an ailment have already been ruled out, Cass said.

In addition, "many [illegible] have told her or told [illegible] willing to donate a kidney [illegible] in any way they can [illegible] really grateful."

The golf tournament [illegible] shotgun start [illegible] two-man scramble is $55 per pe[illegible]

Energy From page 1

Reed City Energy is a subsidiary of Great Lakes Energy and is a joint venture of Smith's Propane and Great Lakes Energy. Reed City Energy had been operating out of temporary offices on 200th Avenue since September, before its recent move.

Based in Newaygo, and with district offices in Hart, Wayland, and Reed City, Great Lakes Energy is the customer-owned power company for 40,000 homes and businesses in a 15-county West Michigan area. Smith's Propane, based in Fremont, has been serving thousands of mid- and West Michigan customers since 1956.

138 W. Slosson Ave.
PHONE 832-2251

REED CITY, MICHIGAN

Dear Friends,

When death occurs, advance funeral arrangements can help ease a grieving family through a very painful period. Knowing their loved one was able to express what he or she wanted during life removes the pressure of decision. It also gives the family a lasting peace of mind, knowing they have carried out the personal wishes of the deceased.

Respectfully,

John W. McDowell

DEADLINES FOR CLASSIFIED ADVERTISING
Herald News ~ 12 p.m. Tuesday

6 lines (up to 15 words) 1 time only $3.90

Cost per paper	2 times	3 times	4 times	5 times
	$7.80	$10.80	$14.40	[illegible]

Dates to run ______

Name ______

City ______

Phone ______

Additional Words 20¢ Each

Herald News

101 W. Slosson • Reed City, MI 49677 (616) 832-55[illegible]

Please check which paper you'd like your ad to run in

__ Pioneer __ Tri County __ Pioneer East
__ Lake County Star __ Evart Review
__ River Valley __ FreeWay __ Herald-News
__ Lakeview Enterprise

Exhibit MI-2

Propane-Marketing Materials Distributed by Michigan RECs

Great Lakes Energy

A SERVICE OF YOUR ELECTRIC COOPERATIVE

Electrical Contracting

Electricity

Heating & Cooling Sales, Services

One call does it all!

Propane

Insulation

INSIDE...

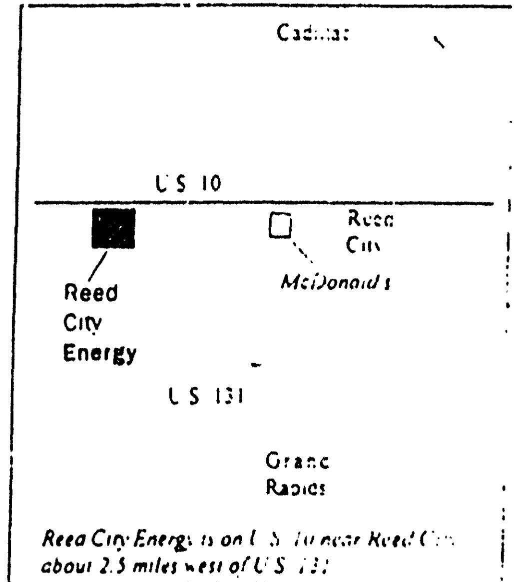
Great Lakes Energy looks

Your full-service energy station

Great Lakes Energy's office in Reed City is called Reed City Energy.

Stop by for your electric or propane needs!

- *Pay electric and propane bills!*
- *Apply for new electric or propane service!*
- *Take care of easements and most other requirements for new electric service!*
- *Take care of new construction charges!*
- *Pick up meter bases for new construction!*
- *Get personal help with your billing questions!*
- *Transfer an existing service into your name!*
- *Have an established service reconnected!*
- *Pick up electric and propane water heaters!*
- *Purchase propane appliances and furnaces!*
- *Fill small propane cylinders!*
- *Much more!*



All payments made at our Reed City office are immediately noted on your account the same day!

Great Lakes Energy
1-800-442-2796
• Reed City
• Hart
• Newaygo

Stacie Steig (left), of LeRoy, and Mary Kreidler (right), of northern Newaygo County, have years of customer service experience and now help customers at our Reed City office - called Reed City Energy.

JOHN INSERT IN TOM ELECTRIC BILLS
THIS MONTH
560 JAN 1998

We deliver service with our propane

• Customers with our standard size 330 or 500 gallon tank are guaranteed their price won't exceed 97 cents/gallon this heating season (remember last winter?). Our current rate for a gas-heated home is 89.9 cents/gallon.

• Convenient monthly payment plans: have your propane metered and pay for what you actually use each month or pay the same amount each month on our budget plan.

• One call - one bill for both propane and electricity.

• Receive a $100 billing credit if we let you run out of propane.

• Choice of tank colors and more!

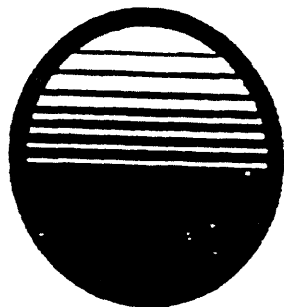
Call 1-888-TOP-MICH (867-6424) for details.

Propane Service

We want to be your propane service provider. That's why we lead the way in offering:

- Your choice of a monthly metered pay-as-you-use plan or a budget program with equal monthly payments so you can get your propane now and pay later
- A reliability guarantee—if you run out of propane, we'll give you $100.
- A free furnace-safety inspection when you sign up for our program—includes carbon monoxide and gas-leak testing.
- An annual guaranteed price cap to avoid mid-winter price increase surprises.
- Automatic fill-up service so you never have to worry about running low on propane.
- 24-hour emergency dispatch service.
- Your choice of tank colors—white, tan or gray—to match your home or grounds.

You can always depend on Top O' Michigan Propane for reliable service at a fair price. As a Top O' Michigan Electric customer, you'll also enjoy the convenience of one bill and one number to call for both services.



Our Mission

is to provide our customers

with outstanding service and

the highest quality products in

the propane gas business

Southeastern Propane

Metered Gas Service

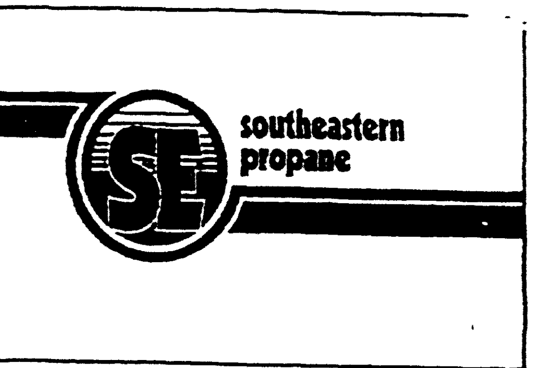
The BEST VALUE for your energy $

- You're sure to get all the gas you pay for with the Southeastern Propane computerized meter system. You pay for the gas only after you use it.
- Freedom from waiting for gas delivery, giving you more leisure time.
- You don't have to order gas. With metered service you are guaranteed the same low price all year long.
- Service that you have come to expect from the experienced people at Southeastern Propane, 24-hours a day, seven days a week

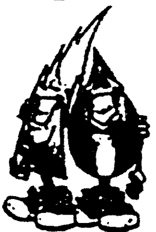
(Call today about our Level Payment and Auto Fill Programs)

That is the

Member Advantage!



1998 Programs



1610 E. Maumee
Adrian, MI 49221
Located in the Southeastern Energy Office Building

1-800-748-0287

610 E. Maumee
Adrian, MI 49221

We're Your Energy Company

Southeastern Propane

Metered Gas Service

The BEST VALUE for your energy $

- You're sure to get all the gas you pay for with the Southeastern Propane computerized meter system. **You pay for the gas only after you use it.**
- Freedom from waiting for gas delivery, giving you more leisure time.
- You don't have to order gas. With metered service you are guaranteed the same low price all year long (**2.1 cents per cu. ft. or 77.9 cents per gallon**)**.
- Service that you have come to expect from the experienced people at Southeastern Propane, 24-hours a day, seven days a week.
- Underground tanks also available.

**Subject to budget plan enrollment

We're Your Energy Company

Special Offer

New Customers
Will Receive **FREE**:

- 50 gallons of propane
- Tank installation and/or tank relocation*
- Meter installation*
- **2.1 cents per cu. ft. or 77.9 cents per gallon price guarantee****
- Custom-made limited edition preferred customer baseball-style cap

*Some restrictions may apply
** Subject to budget plan enrollment

Call 1-800-748-0287

8 a.m.-8 p.m. Monday through Friday
or mail completed service request form to:
Southeastern Propane
P.O. Box 869 • Adrian, MI 49221

Service Request Application

Name ______________________

Address ______________________

____

City ______________________

State ______________ Zip ______________

Daytime Phone ______________________

Evening Phone ______________________

Sq. footage of home ________ I use propane for the following:

☐ Heating ☐ Cooking ☐ Hot water ☐ Dryer ☐ Fireplace

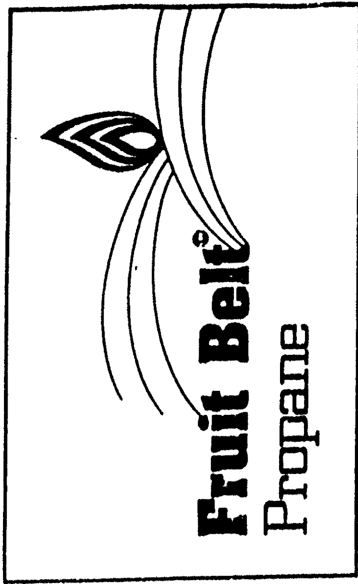
☐ Other ________ Do you use any wood heat? ☐ Yes ☐ No

☐ Please call ☐ Please set appointment for new tank set

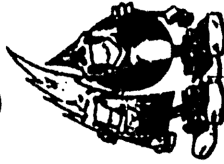
My current supplier is ______________________

[illegible]

12.



1998 Programs



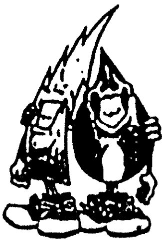
901 E. State Street
Cassopolis, MI 49031
Located in the Fruit Belt Electric Bldg.

1-800-492-5989

Dowagiac 0324

901 E. State Street
P.O. Box 127
Cassopolis, MI 49031

*******************ECRWSS**R001
RESIDENT
RURAL ROUTE 1
DOWAGIAC MI 49047



We're Your Energy Company

The newest PROPANE dealer in

top O'michigan *Propane*

Northern Michigan is a company you already know!

Why Top O' Michigan Propane?

100 years of combined service

Top O' Michigan Electric Company, one of Northern Michigan's most respected energy companies, is now in the propane business. Top O' Michigan has more than 60 years of experience in providing dependable electric service at a fair price. Now this experience is being offered to propane users in the region and those considering a switch to this efficient, economical energy source.

CONVENIENCE

Top O' Michigan customers can now take advantage of "one-stop shopping" for their entire energy needs. Top O' Michigan will combine both electricity and propane charges on one bill.

Think of it. Only one payment a month for both propane and electricity—and from a supplier known for quality service.

For your added convenience, we'll accept your MasterCard or American Express credit card.

VALUE

[illegible] entered the propane business [illegible] value to propane users and better [illegible] promise of no sudden price hikes [illegible] offers exceptionally low up-front [illegible] payment plans from which [illegible] monthly for what you use [illegible] program, or take advantage of [illegible] Automatic Fill program [illegible]

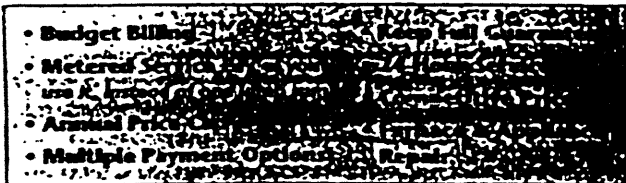
And when you choose Top O' Michigan as your propane supplier, you have a choice [illegible]

SERVICE

[illegible]

PROMPT
FRIENDLY
DEPENDABLE

[illegible]



Electricity and Propane from your co-op!

Now you can buy propane from Western Michigan Propane, a division of Western Michigan Electric Cooperative. With innovative service offerings such as metered propane service, we pledge outstanding service at a competitive price. Call us today, 1-800-968-3532, or (616) 757-4724.

- Budget Billing
- Metered Service
- Annual Price
- Multiple Payment Options

Western Michigan Propane

P.O. Box 248 • 525 W. US 10, Scottville, MI 49454

A Touchstone Energy Partner

Exhibit MI-3

Country Lines Magazine Article

March/April 1997

General Manager's Journal

No scary surprises with our propane plan

Dec. 29, 1996, won't be forgotten soon. Propane was delivered to my house that day. Surprise, it's now $1.32 9/10 cents a gallon! The bill totaled $532. Gulp.

"But 12 months ago it was 92.9 cents per gallon and 79.9 cents fifteen months ago," I said to the delivery driver with tears in my eyes. He hopped back into his truck and replied, "Well, everything's going up in price." He then roared away yelling "Happy New Year!"

Yeah, right.

Still stunned, I wandered back inside, flopped into a chair and relayed the gloomy news to my wife. She didn't feel sorry for me either.

"First of all, you're sitting in my chair," she quipped. "Why don't you sit in your own chair?" (Whoops!)

"Second, you have extensive experience with natural gas and propane," she added. "If you don't like it, why don't you quit whining and do something about it."

Besides spurring me to move to my own chair, my wife's advice prompted me to move ahead on a plan which I had already studied at length. A propane consultant from Kansas had prepared a complete business plan for Top O' Michigan which indicated our entry into the propane business would offer our customers greater value and more energy options.

Your board of directors gave the plan a thorough review and, after much consideration, agreed to start Top O' Michigan Propane which plans to begin making deliveries in May.

We know you will have questions and we admit we don't know all the answers yet. But we will answer the obvious ones first:

Q. What services will Top O' Michigan Propane offer?

- Pay your electricity & propane charges on one monthly bill.
- Reasonable and stable propane prices guaranteed for the entire heating season.
- Convenient monthly payment plan to avoid large unexpected bills.

We will combine billing charges so you can pay for both your electricity and propane on one bill each month.

To avoid surprises like I experienced, steps will be taken to *guarantee* our customers reasonable and stable propane prices for the *entire* heating season.

For those like me who don't like large unexpected bills, Top O' Michigan Propane plans to offer customers either a:

- Monthly budget plan where you pay equal monthly amounts, or a
- Monthly use plan where you pay for the actual amount of propane you use each month, just like year-round residents currently pay for their monthly kwh use.

Either plan would be available to those who have a good bill payment record with Top O' Michigan.

Q. Shouldn't Top O' Michigan concentrate on improving what it does best, which is delivering electricity, and forget about diversifying into another business?

Electric utilities know they must offer competitive rates backed by exceptional service to remain successful. One way to do that is to offer additional services that benefit customers and generate more income. Propane is one of the value-added services we feel will help Top O' Michigan and its customers in the long run.

Q. Should Top O' Michigan compete with propane dealers?

Yes. Good competition is healthy because the customer wins!

Q. Doesn't Top O' Michigan have an unfair advantage because of the free government money at its disposal?

Top O' Michigan *borrows* money from the federal government to pay for improvements to its electric distribution system. That money is not free and will be paid back. No government money or any other type of government guarantees will be used to finance our propane enterprise.

Q. How do you think customers will respond to your offer to sell propane too?

Even before we broke the news about Top O' Michigan Propane, we received a letter from a customer who learned in an earlier *Country Lines* that electric co-ops in general are considering propane and other value-added services.

If his letter is any indication, we expect the phones to be ringing off the walls here soon!

After reading that the co-ops were looking at offering natural gas and propane, Raymond Kinner of Pellston wrote: "Hope it happens before too long. The LP gas company takes us for all they can every winter and we are at their mercy – pay our price or go without gas.

"Keep us informed about it and here is hoping it happens soon."

Kinner also encouraged us to "keep up the good work."

It's because of customers like Ray Kinner that Top O' Michigan is exploring value-added services.

We want to be more than just your electric company. We want to be your total home energy provider!

Exhibit MI-4

Great Lakes Energy Flier

• Electricity • Propane • Heating & Cooling Services
• Electrician Services • Insulation Services • More!

1-800-968-3532

New Great Lakes Energy Bill

You no longer will receive a "Western Michigan Electric" bill. It will be replaced by the new "Great Lakes Energy Cooperative" bill.

Following a successful vote this summer, Western Michigan Electric has joined two other electric cooperatives to become part of the new Great Lakes Energy Cooperative that began operating Jan. 1, 1999.

Yes it is a new name and a new logo that is appearing on all our signs, vehicles and communications. But the people who stand behind the new name and logo are many of the same employees who have proudly provided electric service with a level of quality you have come to expect.

And now, our services have grown to include propane sales and service, heating and cooling services, electrician services, insulation services and more. We will continue to provide these and other improved services under our new name.

We will continue to serve you from our Scottville office along with other local service centers in Hart, Newaygo and Reed City.

Payments

- Payments should be made out to Great Lakes Energy Cooperative, although those bearing the Western Michigan Electric name will still be accepted.

- Payments can be mailed to our Newaygo office using the enclosed envelope, or you may bring your payment to any office - Scottville, Reed City, Hart, Newaygo, Wayland (open in March), Boyne City, Waters or Kalkaska.

Happy New Year to You and Your Family!

Proper insulation can help lower your energy bills. And we have the insulation experts to help you.

If your home is more than 20 years old, there's a good chance it doesn't have enough insulation in the walls and attic. And that means you might be using - and paying for - more energy than you should be. Homeowners could save up to 70 percent on their heating and cooling bills by adding proper levels of insulation. For a FREE estimate for your old - or new - home, call our insulation professionals today, at 1-800-968-3532. Plus, get 10 % off any insulation job!

1-800-968-3532

New system for power outage dispatching

In the past, our after-hours power outage dispatching was handled by a firm in Minnesota. To save money and to coordinate power outage dispatching and repair, the Newaygo office will now handle after-hours dispatching. If you experience a power outage, please call us at 1-800-968-3532

Questions on your bill?

If you have questions on your electric bill or about our service, you can still call us in Scottville, at 1-800-968-3532, or (616) 757-4724. Or stop by. We're on U.S. 10 in Scottville, and we're here for you.

What's the Fuel Cost Recovery on this month's bill?

You might notice an extra item on your bill this month. It's called a Fuel Cost Recovery. This is a modification of customers' electric bills to reflect an undercollection in our 1997 power supply - or fuel - costs. The cost of fuel that is used to produce electricity changes frequently, and utilities must estimate what future fuel costs will be for customer billing purposes. Actual fuel costs for the year of 1997 were higher than anticipated and, therefore, customers were charged less than the actual cost. This Fuel Cost Recovery on your bill reconciles that difference.

Fuel costs are assigned to electric customers by the Michigan Public Service Commission (MPSC), and the process is audited by the MPSC.

TEXAS

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BACKGROUND

Hilco Electric Cooperative, Inc. (HEC) is a Rural Electric Cooperative headquartered in Itasca, Texas. According to the Texas Public Utilities Commission, HEC serves approximately 14,500 customers.[1] In addition to its core electric business, HEC offers a credit card to its members, sells appliances, and manages two local water systems under contract. Further, in 1997 HEC formed Hilco United Services (HUS), a wholly-owned, for-profit subsidiary which entered the propane business in September of that year. HUS started its propane venture from scratch, although it had studied other options, including that of buying an existing propane concern.

Soon after Hilco's propane venture commenced operations (it had acquired roughly 250 customers by December 1997[2]), a suit was filed in the District Court of Hill Country Texas (*Star-Tex Propane, Inc., Et Al vs. Hilco Electric Cooperative, Inc., Et Al.*), alleging that Texas law prohibited electric cooperatives from entering for-profit ventures. In February of 1999 the presiding Judge granted Defendants' motion for Summary Judgment, allowing the REC to remain in the propane business.

The issue in *Star-Tex vs. Hilco* is a narrow question of state corporate law. However, the proceeding has produced a host of documents that would be relevant to an inquiry into the competitive effects of Hilco Electric's actions in the propane market. NERA has obtained copies of two such documents, both depositions of HEC/HUS employees. The first, from December 19, 1997, is of Joe Forman, General Manager of HEC since August 1995 and, more recently, General Manager of HUS. The second, from October 29, 1998, is of Elizabeth Hartnett, a sixteen-year veteran of Hilco Electric Coop then serving as HEC's Finance Accounting Manager but also performing finance and accounting tasks for HUS.

The depositions cover many issues related to the expenditures of HUS and HEC on the propane business, whether HUS reimbursed HEC for propane-related items, and whether sales

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[1] Texas Public Utilities Commission website, "Utility Directories: Electric & Telephone Companies Serving Texas," http://www.puc.state.tx.us/pubinfo/pub-info.htm

[2] Oral Deposition of Joe R. "Jody" Forman ("Forman Deposition"), *Star-Tex Propane, Inc., Et Al vs. Hilco Electric Cooperative, Inc., Et Al.*, December 19, 1997, p. 89.

taxes were paid on items purchased by or for HUS, a for-profit business. At several points, the deposition strongly suggests that cost shifting and cross-subsidization have occurred within the Hilco organization.

Evidence Regarding Anticompetitive Behavior

The most obvious example of cost-shifting and cross-subsidization involves the salaries of Forman and Hartnett themselves. On top of her responsibilities at HEC, Hartnett is technically the bookkeeper for HUS and claims to spend 10 percent of her time on propane-related activities. HEC General Manager Forman wears many hats for the subsidiary: he is the sole Director, President, Secretary, Registered Agent, and General Manager of Hilco United Services and makes "all decisions regarding the investment and expenditure of its funds..." The two individuals who sign checks for HUS are Joe Forman and Elizabeth Hartnett (both signatures required on each check). And yet, both Hartnett and Forman are directly compensated only by HEC and not by HUS. Further, HUS offers no compensation to HEC for Forman's time and, as discussed below, practically none for that of Hartnett.[3]

Hilco United Services directly employs only four people. A management contract with HEC provides that the subsidiary receive from its parent "financial, marketing, customer service, and clerical services," along with equipment and furniture, in exchange for a monthly payment. Among specific items falling under this contract are the following: assistance in the acquisition of long and short term financing; use of the furniture, computer, cash drawer items, adding machines, etc. in HEC's Whitney, TX office (headquarters of HUS); the time of Hartnett and her assistant, as needed to "keep all the records for the Hilco United Services;" the time of HEC's three marketing employees, as needed; and the time of HEC's nine customer service clerks, as needed, including the one who answers the phones, tracks propane sales receipts, takes customer requests for propane refills, and performs general propane-related clerical tasks at the Whitney office.[4]

---

[3] Forman Deposition, pp. 61-64, ; Oral Deposition of Elizabeth Hartnett, *Star-Tex Propane, Inc. Et Al vs Hilco Electric Cooperative, Inc., Et Al*, October 29, 1998, pp. 8-11, 13, 34-36.

[4] Hartnett Deposition, pp. 18-30.

Under the terms of the management contract, the payment for all of these services is supposed to be "the actual cost" of materials and labor. However, as a matter of practice, HUS is billed $1,000 per month, or $12,000 per year. This convention could be interpreted as a means of avoiding the expense involved in enumerating actual costs. However, HEC employees break down their time sheets by type of labor performed, and HEC management receives monthly reports indicating the value of labor services (based on individual employees' salaries) performed on behalf of HUS. In fact, Hartnett confirmed that Deposition Exhibit 3 showed that a group of HEC employees performed $2,869.61 worth of labor for HUS in December of 1997 alone, and this figure excludes at least Hartnett herself, perhaps others.[5]

Hartnett claimed to be unable to guess whether this figure represented a typical month, but on the assumption that $3,000 is the average, then we can conclude that HUS is shifting at least $2,000 per month in labor costs alone to the books of HEC, to say nothing of the equipment rental/amortization costs. $2,000 per month is $24,000 per year, or 2.4 cents per gallon of propane for an operation selling 1 million gallons annually. Given that the HUS operation was relatively new and had relatively few customers, this $3,000 assumption, even just for labor, is likely to be low. Similarly, the per-gallon subsidy estimate of 2.4 cents represents a minimum for the first few years' of HUS's small but growing propane operations.

Also disturbing is HUS's record on making even the low $1,000 payments. Despite the fact that Hilco commenced operations in the propane business in September of 1997, no charges were made to HUS until January of 1998, meaning the propane business benefited from four free months. Further, at the time of the Hartnett deposition in October 1998, HUS had not made a single payment to HEC for any of the 9 months of charges that had accrued. The management contract specifies that such payments be made by the 10th day of the month following the charge period and that amounts not paid within 20 days are subject to 1 percent per month interest. No interest charges had been assessed at the time. The deposition did not explore the reasons for the delay in payment.[6]

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[5] Hartnett Deposition, pp. 22-24, 30-31, 43, 49-54.

[6] Hartnett Deposition, 55-57.

A final item of concern related to the management contract is workers' compensation and medical insurance coverage for HUS employees, liability insurance on HUS vehicles, and other insurance items. Under the contract, the $1,000 per month covers the administrative cost of HEC providing all of this insurance to HUS. However, HUS is to reimburse HEC for the relevant premiums. At the time of the Hartnett deposition, more than a year after the entry of HUS into the propane business, no such reimbursements had been made.[7]

The relationship between Hilco United Services and Hilco Electric Coop with respect to rental payments is akin to their relationship on payments for management services. In his deposition from September 1997, Forman claimed that when HEC's Whitney office opened in January 1998, HUS would be headquartered there and a lease would be arranged whereby HUS would reimburse HEC for its use. The property cost $115,000. Over a year later, Hartnett had the following exchange with the deposing attorney:

> Q Is Hilco United Services paying any rent to Hilco Electric for the office in Whitney?
>
> A Not that I'm aware of.
>
> (...)
>
> Q Are you aware of a commercial lease between Hilco Electric Co-op and Hilco United Services, covering the building in Whitney?
>
> A No, sir, I'm not aware of it.
>
> (...)
>
> Q (This) document appears, to me, to call for a $500-a-month payment to be made by Hilco United Services to Hilco Electric Cooperative for the use of the premises in Whitney. Are you telling me, as someone familiar with the books and records of both organizations, that that payment is not being made?
>
> A That's correct.
>
> Q Were you aware that it was not being paid, or were you aware, before today, that there was a requirement for a payment of rent?
>
> A I was not aware of it.

---

[7] Hartnett Deposition, 40-42.

Beyond the Whitney facility, HEC purchased land near Itasca, TX, an area unrelated to its electric operations. In fact, HUS keeps it's a propane storage tank there. However, HUS makes no rental payments for that land.[8]

HEC also spent money that was never recovered from HUS on lawyers, consultants, meetings, member surveys, and advertising in planning and supporting the propane business. As part of HEC's formative deliberations, approximately $8,000 was paid to a consulting firm, CHG Strategy Group. Roughly $8,000 was also spent on a special meeting of HEC membership to vote on a charter amendment that would permit the coop to entry the propane market. In addition, all of the costs of the *Star-Tex* suit were/are borne by HEC.[9]

The final cost shifting issue raised by the depositions pertains to equipment purchased by Hilco Electric for the propane business, including a pickup truck, flatbed truck, two bobtail trucks, a trencher, various tools, a 30,000 gallon storage tank, and several loads of 250-500 gallon tanks. Allegedly, these items were purchased by HEC before HUS had its own checks printed. HUS was to have reimbursed HEC, although it had not done so at the time of the Forman deposition and the Hartnett deposition does not address the issue. Even assuming the reimbursements were made, the transactions raise other questions. Specifically, the Forman deposition shows that sales taxes were not paid on any of these items at the point of purchase, as HEC is exempt from Texas sales tax. The Hartnett deposition demonstrates that HUS did pay some sales taxes related to at least some of these purchases direct to the state several months later, however the reimbursement form discussed in the deposition is not itemized and Hartnett offers no confirmation that all taxes due were paid. While it is not clear whether the Hilco propane concern illegally and unfairly benefited from its parent's tax-exempt status in this case, the situation is suggestive of both the opportunities and incentives to do so.[10]

With respect to financing, Hilco Electric is a member/borrower of the CFC, having an outstanding debt to the cooperative bank of $17 million and a total credit line of $50 million. Separately, Hilco United Services has itself borrowed $500,000 from the CFC's subsidiary, the

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[8] Forman Deposition, pp. 108, 111, 117-118; Hartnett Deposition, pp. 58-61.

[9] Forman Deposition, pp 43, 49-51, 55, 59, 91-100, 110; Hartnett Deposition, pp. 57-8.

[10] Forman Deposition, 114, 118-126; Hartnett Deposition, 78-82. The deposing attorney implies that the late payment was made only after, and in response to, his deposition of Forman.

National Cooperative Services Corporation (NCSC). This loan was guaranteed by HEC, despite the fact that the management contract between the two entities provide that neither shall be "responsible for the debts of the other party." Lastly, HUS had, at one point, borrowed $300,000 from HEC on an unsecured basis. The loan was repaid. The deposition does not discuss the details, but given the sources for these loans and the HEC guarantee on the NCSC credit, there is little doubt that the interest rate paid by HUS is significantly lower than that paid by comparable propane businesses. For reference, between January 1990 and April 1999, the average level of the prime interest rate was roughly 7.96 percent,[11] whereas the average rate on CFC loans to distribution cooperatives such as HEC was 6.74 percent (see Section V, especially Tables V-1 and V-2 for a complete discussion).[12]

Lastly, any prospects for joint billing (or other joint operations) of electric and propane service by any competitor other than the REC are foreclosed by the REC's legal electricity monopoly – and indefinitely so. The deregulation bill recently approved by both houses of the Texas legislature and signed by the governor would require retail electricity competition in Texas, but not before January 1, 2002. And even at that late date, the proposed bill exempts RECs (and municipal utilities) unless their members affirmatively vote to open up the local market.

SUCH BEHAVIOR HAS AND WILL AFFECT THE MARKET

Although the lawsuit put a chill on HUS's propane marketing efforts for a time, anecdotal evidence suggests that Hilco may be using subsidies and shifting of costs to charge very low prices, perhaps at levels below costs. For example, HUS allegedly acquired one customer by offering a price per gallon of wholesale-plus-20-cents, where transportation costs alone were running at 8 cents. In addition to this low price, Hilco installed $8000 worth of tanks free of charge, despite the fact that the customer, a retreat center, had only purchased 10,000 gallons of propane per year the previous three years. Even with an operating profit of $0.10 per gallon (which would imply, unrealistically, additional operating costs of only 2 cents per gallon), it will take Hilco 8 years just to make back the up-front investment. In another case, Hilco has been observed to offer to install propane piping on a turnkey basis for $1.00 per foot when the wholesale cost of the pipe itself is $1.65/foot.

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[11] Interest rates provided by Federal Reserve Bank at website http://www.bog.frb.fed.us/releases/H15/update/.

[12] Forman Deposition, pp. 73, 77-84, 107-108; Harmett Deposition, p. 35.

STATEMENT OF THE GOVERNORS' PUBLIC POWER ALLIANCE

The Governors' Public power Alliance is pleased to submit this statement for the record to the Senate Finance Committee of the United States Senate on federal income tax issues relating to restructuring of the electric power industry. We commend Senator Frank Murkowski, chairman of the subcommittee, for holding a hearing on this critical subject. The Alliance is specifically concerned about electricity restructuring provisions as they pertain to the future use of tax-exempt bonds for community-owned electric utility systems. In this regard, the Governors' Public Power Alliance is in strong support of S. 386, the Bond Fairness and Protection Act, a bill introduced by Senator Slade Gorton and Senator Bob Kerrey.

The Governors' Public Power Alliance, a bipartisan coalition of governors, was formed so that federal initiatives do not disadvantage millions of Americans who are served by locally and consumer-owned electric utilities.

Nebraska Governor Mike Johanns and Tennessee Governor Donald Sundquist chair the coalition. Alaska Governor Tony Knowles is vice chairman. Other coalition members are South Dakota Governor Bill Janklow, Puerto Rico Governor Pedro Roselló and Washington Governor Gary Locke.

The Alliance and Electric Restructuring

One of every four consumers receives electric power from consumer-owned electric systems or member-owned rural electric cooperatives. These are locally owned assets that for more than 115 years have made enormous contributions to the nation's economic prosperity and in our states, cities and rural areas. Their local ownership and not-for-profit mission makes them very different from private companies, requiring different solutions to the challenges of the new marketplace envisioned by electricity industry restructuring.

The federal government cannot create one model and expect all 50 states to follow it. Every one of our states has unique characteristics that will make a federal model unworkable, unfair and costly to consumers.

We are concerned that consumers served by local and regional electric systems may be overlooked in federal legislative and regulatory proposals. About 45 million Americans—or 14 percent of electricity customers—receive electricity from more than 2,000 community-owned electric utilities operated by states, municipalities, counties or other political subdivisions.

Like hospitals, community schools, water, sewer, parks, police and fire departments, these "public power" systems are locally created institutions that provide an essential public service at a reasonable, not-for-profit cost. Public power systems are governed democratically through their state and local government structures. They operate in sunshine, subject to open meeting laws, public records laws and conflict of interest rules. They are governed at the local level, usually by the city council, or an elected or appointed board.

Public power's first and only purpose is to provide excellent, efficient and reliable service to their local citizens and customers at the lowest possible cost. Local power customers are direct stakeholders in the utilities' operations and future. In turn, public power utilities are community institutions with community-wide goals.

As state and local government entities, they boost economic development, pay taxes and make in-lieu-of-tax payments to states and communities, and lower citizen costs through coordination of services with other government entities such as natural gas, water and sewer departments. This results in lowered utility costs as well as lowered costs of government for the owners/citizens. Local electric systems give citizens—as direct stakeholders—opportunities to participate in service, financial and operating decisions. For purposes of competition, they serve as an important yardstick against which to measure the price, service, reliability and performance of private power companies.

While restructuring the electricity industry and introducing competition will likely give consumers new choices in terms of their purchase of electric power, through their state and local governments, consumers have always had a choice between creating their own public power systems or awarding franchises to private power companies. We wish to preserve this choice for all citizens.

Electric Utility Restructuring and Tax Exempt Bonds

Generation, transmission and distribution facilities owned by public power systems were financed through the issuance of tax exempt bonds. These bonds, like bonds for other governmental purposes, carry with them restrictions on the amount of private use allowed for those facilities. While sound tax policies may warrant certain restrictions on private use of public facilities, public power facilities have been singled out for unduly restrictive treatment in the federal tax code.

Private use restrictions previously had a negative but manageable impact on the financing of community electric systems. In their new form—and the new competitive environment—they will restrict the financing of governmental facilities far beyond the intention of Congress expressed in the Tax Reform Act of 1986. The restrictions are also contrary to the goals of the Energy Policy Act of 1992 and will impermissibly infringe upon the historical and fundamental right of the citizens of their locale to act as a community and utilize their own best judgment in the provision of governmental services.

For example, private use restrictions, long acknowledged as sound public policy, carry additional punitive measures when placed in the context of electricity restructuring. Today, with more than half of all states moving to some form of electricity deregulation, community owned electric systems face serious financial consequences as the result of changing electric policy.

Under old rules, private use restrictions, including the use of community owned utilities' transmission facilities by private parties, were understandable. But in a new competitive marketplace, those same private use restrictions often specifically prohibit public power systems from opening up their transmission lines—exactly the opposite effect called for by the Federal Energy Regulatory Commission (FERC) in Order 388.

In addition, private use restrictions severely limited the ability of public power systems to sell power to individual customers through tailored, one-to-one contracts even to their existing customers. Bilateral contracts are the way business is conducted in retail markets. Community owned electric utilities that lose customers and cannot make up for those sales because their hands are tied by the current private use restrictions will have to raise rates for their remaining customers. This is the exact opposite of what electric restructuring is to achieve: lowered costs for all consumers.

What happens to municipal electric systems that exceed the restrictions placed on their bonds? Those bonds become retroactively taxable and new, taxable bonds would have to be issued to cover the debt. With nearly $80 billion in outstanding bonds issued by community owned electric systems, the financial consequences could be dire indeed, especially for the utilities' ratepayers.

Clearly, federal tax policy is in conflict with ever-changing energy policy. A legislative proposal to help solve this problem has been offered in both the Senate and the House. The Bond Fairness and Protection Act, introduced in the 106th Congress by Senator Slade Gorton and Senator Bob Kerrey as S. 386, is a fair and reasonable solution to the problems posed by the private use restrictions on public power bonds. At this point, the bill has been co-sponsored by 30 senators, including several members of the Finance Committee. A similar bill, H.R. 721, has been introduced in the House of Representatives.

The Bond Fairness and Protection Act is simple: it provides state and locally owned utilities with two options for obtaining the necessary level of relief they need to enter competitive electricity markets without jeopardizing the tax exempt status of outstanding bonds or raising rates. The bill would help federal tax policy keep pace with energy policy, making it possible for community owned electric systems to comply with state restructuring plans, comply with FERC Order 888, and pursue the goals of the Energy Policy Act of 1992.

S. 386 would clarify existing tax laws pertaining to private use rules in a competitive arena and encourage community owned systems to open up their transmission systems to allow their customers to participate in competition.

If a system seeks private use relief, the bill requires those taking this relief to make significant concessions on the future use of tax exempt bonds by giving up the right to issue such debt for new generation facilities, while retaining the same right to issue tax exempt debt for both transmission and distribution facilities. It is important to note that only the generation side of the industry—not transmission and distribution—is being deregulated and opened up to competition. The latter sectors will continue to be treated as regulated monopolies.

If no private use relief is needed or sought, a system can continue to serve its customers using tax exempt debt for all its facilities. Current private use restrictions will continue to apply. Perhaps most important of all, S. 386 also respects state and local authority by allowing those decisions to be made at the state and local level, not the federal level.

The public power community is not the only sector of the industry facing a problem found in the federal tax code. Indeed, the Governors' Public Power Alliance understands that both rural electric cooperatives and private, investor owned utilities are also facing challenges posed by state restructuring efforts, and that both sectors have also asked Congress for legislative solutions. For this reason, the Alliance

urges Congress to address all transition tax issues affecting all sectors of the electric industry on the same footing, and pursue legislative solutions simultaneously.

The Administration's Proposal, S. 1048

The Clinton Administration should be commended for tackling this difficult taxation issue. We are encouraged to see the Administration's proposal seeks to "modify" and revise tax exempt bond rules as part of electric utility restructuring "so that consumers benefit from competition." To encourage public power systems to implement retail competition, the proposal states that outstanding bonds previously issued to finance generation and distribution facilities would continue their tax exempt status "even if the issuer implements retail competition." Similarly, bonds issued to finance transmission facilities would also continue their tax exempt status "even if private use resulted from allowing nondiscriminatory open access" to those facilities, including, for example, participation in an independent system operator.

However, the same proposal prohibits public power systems from building both generation and transmission facilities in the future with tax exempt bonds. While we fully appreciate the political debate surrounding this issue, we are particularly concerned about the essence of this provision: community owned electric systems, especially the majority of the small systems around this country, could no longer exercise their right of local control and regulation, and may be unnecessarily burdened by an overly restrictive proposal.

The transmission provision is particularly troubling. While the generation side of the electric industry is currently undergoing a major transformation, the transmission side is not—transmission will remain, for the foreseeable future, a regulated monopoly. For all the discussion about independent system operators, regional transmission organizations and transco's, several critical questions remain about transmission. For this reason, retaining the ability to issue tax exempt debt for transmission facilities is critical to the future of community owned electric systems.

Issues of Particular Concern

All generation, transmission and distribution facilities in Nebraska are publicly owned—a choice made by the citizens of the state more than 60 years ago. Even as other states today consider electric restructuring, Nebraskans remain resolute that they will be best served into the 21st century by publicly owned systems. No credible study to date has demonstratively proved that customers will pay less for their electricity, have competitive options or be more reliably served.

Policymakers have become extremely concerned with reliability of transmission and distribution systems and the impact restructuring will have on those essential components. Recent outages have suggested that some distribution and transmission systems may be imperiled because of long-delayed maintenance and an inability to keep pace with the nation's growing demand for electricity.

A prime example of the impact of excluding transmission and distribution facilities (as proposed in the Administration's bill) is the recently built Pauline-Moore Transmission Line that runs from central to eastern Nebraska. This addition to the state's transmission system increases its reliability, something restructuring is supposed to do. This line was installed as a result of the collapse of the only transmission line between power plants in western Nebraska and eastern electricity users. If tax rules like those proposed by the Administration had been in effect at the time, this line probably would not have been built, resulting in likely future power disruptions for consumers in the state.

On October 29th, the Electric Power Research Institute released a study that found transmission and distribution systems at particular risk for failure. "The potential for large-scale outages and disruption on this vast interconnected grid is considered higher than at anytime since the great Northeast blackout 35 years ago." The Institute also found the dramatic increase in wholesale power trading resulting from deregulation was also a cause for concern. "The 50-year old grid was simply never designed to handle the volume and frequency of power trades that we're seeing today. This trend is only expected to increase as competition becomes more widely adopted."

Closing Thank You

We appreciate the opportunity to submit this statement for the record. We look forward to working with the Committee in the future on these and other matters.

STATEMENT OF HON. J.D. HAYWORTH

INTRODUCTION

I want to thank Chairman Murkowski for holding this hearing and allowing me to submit testimony for the record. This is an important hearing because it will focus specifically on the tax issues involved in electricity deregulation, a highly technical but vital piece needed to help solve the electricity deregulation puzzle.

I would like to discuss briefly my legislation, H.R. 721, The Bond Fairness and Protection Act of 1999, which focuses on some tax issues that arise in the transition from a regulated to a deregulated market. I believe these issues need to be addressed to ensure the vigorous but fair competitive environment envisioned by deregulation advocates.

PRIVATE USE RULES

A relatively small but important part of today's electricity market is comprised of community-owned and operated utilities also known as public power or municipal utilities. Public power utilities are not-for-profit entities that are accountable to their customers, generally the citizens of the municipality or state in which they are located. Like other state or local governmental entities, public power utilities have no practical source of external financing other than the municipal bond markets. As you know, state and local government entities are granted the right to issue debt that is exempt from federal taxation. As government-owned and operated businesses, public power systems throughout the country have for decades issued tax-exempt bonds to finance facilities and their operation. The right to issue tax-exempt debt, while vital to ensuring low cost, reliable service to public power customers, does not come without restrictions and limitations.

In exchange for the right to issue tax-exempt bonds to investors, public power systems must operate under a strict regime of federal tax rules governing their ability to issue such debt. These rules generally limit private business use of tax-exempt bond-financed facilities ("private use rules").

In the regulated electricity market of the past, the private use rules were cumbersome but manageable. However, with the Energy Policy Act of 1992, Congress began to significantly alter the regulated monopoly by introducing the element of competition into the wholesale marketplace. The 1992 legislation, along with FERC Orders 888 and 889, have prompted an open transmission network allowing greater choice of wholesale power supply. While open transmission continues to evolve through developments in the marketplace and legislative and regulatory initiatives, the private use restrictions are a factor impeding attainment of fully open transmission. This stifles a competitive wholesale marketplace as contemplated by Congress in 1992.

In addition to wholesale deregulation, many states, like my home state of Arizona, are implementing retail choice. With greater competition, publicly-owned utilities face some difficult choices under today's private use rules. In a deregulated competitive environment, for instance, large private business customers will seek and obtain specially tailored contracts to meet their special electricity needs, just as they do in buying any product. If the private use rules in effect today remain intact, a public power utility may be prevented from offering its customers such a contract, even to private businesses in its own service territory that it has been serving for decades. If the utility does offer such specially tailored contracts, those actions could violate the private use rules and therefore jeopardize the tax-exempt status of the utility's outstanding debt.

As the number of states joining the deregulated marketplace grows, the existing private use rules are threatening many communities that are served by public power with significant financial penalties as they adjust to the changing marketplace. In effect, the rules are forcing publicly-owned utilities to face the prospect of violating the private use rules, or choosing not to compete at all and walling off their customers. In either case rates for customers would rise—the precise opposite of what deregulation is supposed to achieve.

UPDATING THE PRIVATE USE RULES

For the reasons that I have just outlined, I believe that the private use rules urgently need to be updated to adapt to the emerging deregulated electricity marketplace.

Therefore, together with Rep. Robert Matsui (D–CA), I have introduced H.R. 721, the Bond Fairness and Protection Act of 1999. I am proud to report that this bill has attracted the bipartisan support of 99 cosponsors in the House of Representatives. Our bill is nearly identical to the Gorton-Kerrey bill, S. 386, in the Senate

that enjoys similar bipartisan support, including seven members of the Finance Committee: Senators Kerrey, Jeffords, Thompson, Grassley, Moynihan, Hatch, and Robb.

Our legislation would provide publicly-owned utilities with an option: they can continue to issue tax-exempt bonds for generation, transmission and distribution facilities under a set of private use rules clarified to provide a modest set of changes to deal with deregulation; or they can elect to generally forego the ability to issue tax-exempt debt for new generation facilities, but with a grandfather of their existing tax-exempt bonds from the adverse application of the private use rules.

The clarifications to the private use rules proposed in the legislation are intended to accommodate the reality of operating in a deregulated market. Specifically, private use would not include certain "permitted open access transactions." The bill lists the following activities as permitted open access transactions: (1) providing open access transmission service consistent with FERC Order No. 888 or with state open transmission access rules; (2) joining a FERC-approved Independent System Operator (ISO), Regional Transmission Organization (RTO), power exchange, or providing service in accordance with an ISO, RTO, or power exchange tariff; (3) providing open access distribution services to competing retail sellers of electricity; or (4) if open transmission or distribution services are offered, contracting for sales of power at non-tariff rates with on-system purchasers or existing off-system purchasers.

This legislation attempts to balance the interests of all stakeholders in electricity deregulation while keeping the interests of the consumer paramount. It strikes a compromise between publicly-owned utilities and investor-owned utilities by providing an option for publicly-owned utilities to address the problem of how to comply with private use restrictions in a deregulated world, an option that involves significant tradeoffs for the publicly-owned utilities that seek to utilize it. At the same time, it honors promises made to bondholders under contract and existing tax law, thereby avoiding the inequitable consequence of applying old rules to the new deregulated world of electricity.

ADMINISTRATION EFFORTS AT PRIVATE USE RELIEF

The Administration has recognized the need to address private use rule problems and has attempted to afford publicly-owned utilities some opportunity to participate in a deregulated market as indicated by its temporary regulations and FY 2000 budget proposals. However, neither the temporary regulations nor the proposals contained in the Administration's deregulation plan address all of the serious problems associated with private use rules, or offer the flexibility that our legislation provides. Further, the temporary regulations, unless finalized, will expire in January of 2001. In short, we need a legislative fix to this problem.

COMPREHENSIVE DEREGULATION LEGISLATION

In this testimony I have tried to summarize the changes to present law that I believe are necessary as part of a deregulated environment. I am also acutely aware that public power is not the only stakeholder involved in the deregulation debate. Current providers of electricity to America include not only public power systems but also investor-owned utilities and electric cooperatives.

Clearly, all sectors of the industry require some measure of relief because of the move to a competitive marketplace. Further, addressing the problems of any one segment of the market while ignoring the others could provide an unfair advantage for one type of entity over the others. In fact, the Administration has recognized the essential nature of this "linkage" by including both limited private use relief and nuclear decommissioning proposals in its FY 2000 budget and its deregulation plan.

This linkage, however, was broken with the passage of The Taxpayer Refund and Relief Act of 1999, (H.R. 2488), which included only nuclear decommissioning relief.

While the veto of the tax bill has rendered the issue moot for now, there are certain to be other attempts to legislate in this area in the future.

I believe it is vital that the private use rule modifications for public power systems move simultaneously with nuclear decommissioning tax relief for investor-owned utilities and other transition relief for cooperatives. Equitable treatment of all industry participants is essential to achieving the goals of electricity deregulation: affordable and reliable electricity for all.

Thank you for giving me this opportunity to submit testimony for the record of this hearing. I urge you, Mr. Chairman, to continue your efforts to address the im-

portant tax ramifications brought about by deregulation and I stand ready to assist you and the Subcommittee in any way I can.

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