Fiscal Stress MONITOR

Independent Research about Regional Trends

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Currents of Change:

Municipal Utility Transfers Go on a Diet

When Los Angeles' mayor ran into a tight corner with his budget and he wanted to expand police services, he looked to the utility for help. The jump in transfers in 1994 from the Los Angeles Department of Water and Power's (LADWP) caused such a stir that the California legislature is considering a bill to put a statewide clamp on the practice of utility transfers.

In This Issue:

When Tulsa, Oklahoma was looking for sources to fund salary increases two years ago, the city's most prominent union leader suggested an enterprise fund transfer. The mayor pointed out that the city had already increased its transfers from one percent to more than five percent. Then Finance Director Ron Payne told *Tulsa World*, "There is already a regular transfer from such funds into the city's general budget, which goes to pay most city salaries."

Municipal utilities have historically been a cash cow for municipalities. The American Public Power Association (APPA) recently surveyed municipal utilities and found that 74% make payments to local government.

Most utilities use a formula for making transfers. However, at least in the random sampling of municipalities we looked at, transfers are increasing. Following the rash of tax limitation votes in the early 1990's, economic pressure and tight budgets, municipalities foraging for revenues have dug deeper into their utility funds over the last few years.

Dramatic changes in the electric utility industry are causing municipal utilities to slim down. Margins available for transfer are thinning out. In today's era of industry competition, higher utility rates to support a transfer habit are harder to justify. Add municipalities' penchant for charging industrial customers proportionately more than residential customers and the recipe is for economic stagnation, or worse, fiscal crisis.

PILOT Payments

The traditional explanation for utility transfers to general government is "payment in lieu of taxes" or PILOT payments. The argument goes like this: municipalities have invested in their utility systems by supporting debt and sacrificing tax revenues through the utility's tax exemption. The PILOT payment is a fair return on investment.

Payments to municipalities can also take the form of gross receipts taxes or charges for certain municipal functions against the utility budget. (These may include free service for street lights, municipal buildings as well as harder-to-track allocation of overhead costs.)

Among APPA's survey group 50% paid some kind of gross receipts tax or public utilities commission fees. Fifty-two percent provided free or

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reduced price service for their municipalities.

If PILOT payments equated to taxes, we'd expect to see some relationship between private utility taxes and public utility payments. But APPA's survey shows otherwise. APPA polled distribution systems, both investor owned and publicly owned, to determine their 1992 payments to government (as a percent of operating revenues.) In the aggregate, both ownership systems contribute about 5.8% revenues. However, disaggregating the numbers on a regional basis reveals a different pattern.

The table on the next page highlights this pattern. In geographic regions where taxes are high (as measured by IOU payments as a proxy for taxes), utility transfers are lower. In regions that have lower property and other taxes, utility transfers tended to be considerably higher.

In the high tax states of the Northeast, municipalities rely less on transfers. In Arkansas, Louisiana, Oklahoma and Texas, utility transfers are significantly higher than the taxes investor-owned utilities pay, helping to lower property taxes.

APPA also found that the utilities most likely to have an explicit formula for making transfers were the largest ones that are governed by an independent board. The smallest utilities controlled by a city council were least likely to have stated transfer policies. The majority of transfers are based on city ordinance or city charter but some, like utilities in the state of Nebraska and in Tennessee follow state law. Utilities contracting with the Tennessee Valley Authority are also constrained in the level of transfers permitted.

California

In California, where the Public Utilities Commission recently passed a reform program leading to market-based power, municipal utilities have been reliant on transfers. What with California's general anti-tax, anti-government sentiment, dipping into the utility pot is one way to maintain the level of local government budgets.

The Los Angeles Department of Water and Power has long had an annual budget issue of coming up with rates to cover utility costs as well as finance the city transfer. The political dependency between the city and the utility is clear: the City Council must grant rate increases if it wishes to have its transfer. With the city council in charge of approving utility rates as well as transfers, some argue that the LADWP should be independently governed.

Following years of a steady 5% transfer, amounting to between $70-$100 million, Mayor Riordan sought to increase the transfer -- largely to help the city's fiscally strained budget and meet promises to expand police services.

In 1994, the utility increased its transfer to $174 million. Budget planners estimated that the utility could sell $74 million of unused property. As real estate transactions go, it was soon found that some of the properties were not ultimately worth original estimates and sales would take longer than expected.

The transfer has sparked serious controversy. Proponents argued that transfers amount to an "in lieu of tax" payment -- what the utility would pay if it were investor-owned. Opponents argue that ratepayers already absorb a 10% utility tax in addition to the municipal transfer. The diverted surplus could be used for system maintenance and capital improvements or alternatively to save ratepayers money.

Anger over the transfers has reached the state level. Assemblyman Katz has sponsored a bill, AB 318 that would

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Investor-Owned vs. Publicly-Owned Utilities Payments to Government by Region (as percent of operating revenue) 1992

Region	Median IOU Payment	Median Publicly-Owned Contribution
Northeast	8.0%	2.5%
Atlantic	5.6%	8.0%
East North Central	5.2%	3.6%
East South Central	3.4%	6.1%
West North Central	6.9%	5.2%
West South Central	5.1%	10.7%
Mountain	5.2%	8.4%
Pacific Northwest	6.3%	5.8%
Pacific Southwest	4.0%	5.5%
Aggregate U.S.	5.8%	5.8%

Northeast: CT, ME, MA, NH, NJ, NY, PA, RI, VT

Atlantic: D.C., DE, FL, GA, MD, NC, SC, VA, WV

East North Central: IL, IN, MI, OH, WI

East South Central: AL, KY, MS, TN

West North Central: IA, KS, MN, MO, NB, ND, SD

West South Central: AR, LA, OK, TX

Mountain: CO, MT, NM, UT, WY

Pacific Northwest: AK, ID, OR, WA

Pacific Southwest: AZ, CA, NV

Note: Distribution systems only.

Source: American Public Power Association. The investor-owned utilities in the study provide 98% of all kwh sales to ultimate consumers of IOU's; the publicly-owned systems provide 85% of all kwh sales to ultimate consumers of publicly owned power.

put the clamp on fund transfers from all water and power utilities to their respective municipalities. The bill has passed the Assembly and is awaiting Senate action.

Elsewhere in California, the city of Riverside transfers 11.5% of operating revenues from the water system and 10.5% of electric system revenues to the General Fund . Twenty percent of the city's General Fund budget is dependent on utility revenues. The City Council is considering lowering its dependence and has charged budget makers to present alternatives. The utility is slimming down as well, in preparation for the coming competition in the California utility market.

North Carolina

In North Carolina, municipalities that participate in the North Carolina Eastern Municipal Power Agency (NCEMPA) are looking at slimmer transfers. As the *Triangle Business Journal* put it, "(NCEMPA) is gasping for fresh air to prevent an untimely choke of its financial base." NCEMPA has more than $3.6 billion debt outstanding and provides power to 32 eastern North Carolina communities. At issue is the agency's participation in Carolina Power and Light's costly nuclear facilities. To meet growing

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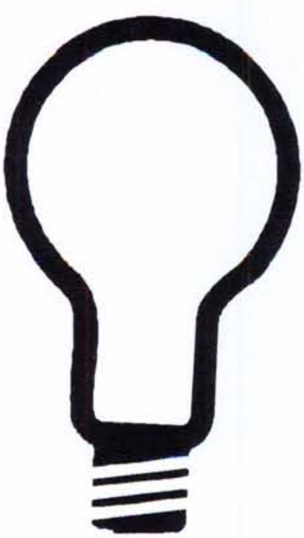
debt service, the 32 municipalities are faced with raising property taxes.

It is questionable whether the communities will be able to mount higher tax rates following years of being subsidized by the utility. Robert High, Deputy Treasurer of the state, commented that many North Carolina communities have used utility surpluses for years to build public facilities while maintaining low property tax rates. "Now they will have to become just like all the other municipalities", he said.

High told the *Triangle Business Journal*, "Until now, it seems like the cities have decided to have higher power rates to supplement having lower property tax rates. What we are watching closely whether the agencies can afford to have such high power rates in a competitive environment and continue to grow."

The agency's utility rates are 26% higher than investor-owned Carolina Power and Light and almost 50% higher than Duke Power. Some of NCEMPA's troubles stem from the agency's involvement in CP&L's nuclear facilities. The agency has one of the highest debt ratios in the industry at more than 200%.



One route to improving electric competition is to limit the ability to transfer funds. This will clearly hurt a number of communities. "...the communities will be facing an even bleaker situation in the future if the state treasurer curbs the amount of utility profits the communities can transfer to prop up general funds...." according to a recent issue of the *Triangle Business Journal.* According to the journal, Belhaven has been transferring about 23% of the utility's profits, Enfield, 35%, Wilson, 4.9% and Selma 14.7%. About 40% of Enfield's General Fund budget is dependent on utility transfers. Raising property taxes to the maximum that state law allows would still not come near supplanting the money from the electric fund.

For municipalities participating in North Carolina Municipal Power Agency No. 1, the situation is similar. The agency owns 75% of the Catawba Unit 2 nuclear plant co-owned by Duke Power. As an incentive to become involved in the project, at a time when growth in the economy was booming, Duke Power contractually agreed to buy back a portion of power over a number of years. Duke Power's purchases were to ratchet down by half last year and will fully phase out by 2002. Anticipated growth that was supposed to make up the difference hasn't materialized. As a result, the municipalities involved in the project are faced with higher utility rates or limiting dependence on transfers.

Duke Power is in the market for acquisition of assets however, and may be eyeing participant's systems. As the *Charlotte Business Journal* recently wrote: "A possibly more palatable solution calls for NCMPA1 cities to reduce the electricity profits they transfer to their general funds -- as many have, thus forcing them to raise taxes, reduce services or take on more city debt."

Were Duke to take over some of the more beleaguered utilities, sale to the IOU could end the gravy train of utility transfers, possibly putting the municipalities into shock.

Utilities For Sale

The city of Austin, Texas has wanted to sell its electric utility system for years. The city's investment in 16% of the South Texas Nuclear Project has laden the system with debt and lots of headaches.

Last summer, a negative report about the utility by Standard and Poor's put a damper on prospects for a sale. S&P cited heavy transfers to the General Fund and the city's investment in the nuclear project. The rating agency is concerned about the utility's ability to maintain favorable rates in the face of a more competitive market.

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The city plans a number of actions over the next two months. The city council will consider issuing an RFP for sale of the utility. (The city has previously issued an RFP for sale of the city's 16% share of the South Texas Project but had no feasible offers).

Price Waterhouse is finalizing a report on the utility's organizational structure and its ability to compete in today's marketplace.

Also under discussion is a possible power pooling "alliance" among the larger public systems: Lower Colorado River Authority, Brazos Electric Cooperative and the Austin and San Antonio utility systems. These utilities, along with the Texas Municipal Power Agency have contracted with Duke Engineering to study what economies of scale, if any could be achieved among the publicly-owned systems.

Meanwhile, the city continues to pursue litigation against Houston Lighting and Power, manager and 30.8% owner of the South Texas Project -- for significant outages in 1993-1994. In addition to unexpected fuel costs during the year-long outage, Houston Lighting and Power spent over $360 million for operating and maintenance, nearly 60% more than the prior year. To maintain safety and efficiency of the nuclear plants, participants will be paying higher on-going costs in the future.

To sell the utility, city managers in Austin will somehow have to cover the annual transfers to the General Fund in addition to their debt. The city depends on transfers of surplus from the utility, to the tune of 22% of the General Fund budget in 1994. Included in any sale price would need to be a plan for endowing or covering the utility transfers.

The city of Lubbock, Texas also considered selling its utility last summer. Lubbock is one of the few systems around the country that has had retail competition for years. In some parts of the city, Lubbock Power and Light (LP&L) and Southwestern Public Service have parallel lines. The two companies, public and private have always vied for customers. Critics have argued that the duplication is inefficient and costly, but as Tommy Buchanan, of LP&L said, "The competition has always kept both sides on their toes."

When Southwestern Public Service proposed to pay the city more than $140 million for their system last summer the council gave it some serious thought.

Utility transfers have helped keep city taxes low. The utility transferred about 12% of gross revenues to the city in 1995, considerably more that what a private utility would pay in taxes. Taxes from Southwestern would only account for about half of the transfer according to Buchanan. The other half would come from proceeds of sale -- set up as an "endowment" with interest earnings available for transfer.

LP&L is in generally healthy shape, with low debt levels and a sizable surplus. The cost of power is lower than their competitor. The utility would love to sell some of its surplus outside its franchise area. Buchanan estimates the utility could increase its revenues by nearly 50%.

When the council proposed a referendum on the sale for last November's ballot, the phone lines heated up. The reason: people in Lubbock like the competition and they didn't want the city council to have that much money in their hands. ⌘

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