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## IOWA ASSOCIATION OF MUNICIPAL UTILITIES

### **Municipal Transfer Replacement Tax – Supplemental Background Information**

In replacing the old way of taxing utility property, investor-owned utilities sought to shift property taxes to the delivery end of the business.<sup>1</sup> The change gave existing utilities a competitive advantage in that property taxes would be paid for deliveries over the incumbent utility's distribution system, whether or not the utility was successful in keeping the generation or gas commodity business. MidAmerican Energy initially argued for a statewide replacement tax, i.e., a tax calculated by dividing the total dollar amount of electric utility property taxes by the total kWh sold in Iowa. They proposed the same approach for the gas replacement tax. Municipal gas utilities paid very little property tax under the old system (zero if all their facilities were in town). Most municipal electric utilities also had very low property tax payments, since facilities within the city were not subject to tax. The MEC proposal would have shifted taxes from IOUs to municipals and RECs and we were successful in blocking a uniform delivery tax.

Though we won round one, legislative leaders directed us to work with the investor-owned utilities, RECs, the Department of Revenue, and other interested parties to prepare new legislation. In developing the final bill, IAMU argued that if it was fair to replace property taxes with a delivery tax, it was also fair to replace payments made by municipal utilities in lieu of property taxes. All the parties agreed. So, the intent of the transfer replacement tax is to ensure that transfers of excess funds could continue in a competitive retail market.<sup>2</sup> In the absence of a transfer replacement tax, loss of customers to a competing supplier could either reduce the ability of the municipal utility to sustain the same level of transfers or would shift the transfer burden to remaining customers. This

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<sup>1</sup> Investor-owned utility property was centrally assessed under the old system. Under central assessment, about 50 percent of the property valuation of a utility was determined by its stock value. Another 40 percent was based on various measures of capital cost and debt. Only 10 percent of the tax was based on the actual value of utility assets. In fairness to investor-owned utilities, they made a reasonable argument that if Iowa adopted retail competition for electricity and gas, stock prices could become more volatile and tax revenue for local governments could be put at risk. As it turns out, retail competition for electricity has been a failure nearly everywhere it has been tried and that threat did not materialize. However, vertically integrated electric utilities have divested transmission or functionally separated transmission, generation, and distribution to meet requirements associated with wholesale competition. Many historically solid utilities like Northern States Power (now Xcel Energy) have seen their stock prices plummet. Alliant Energy stock has also taken a hit. So the change to a replacement tax has held property tax receipts at stable levels and avoided steep declines.

<sup>2</sup> Transfers from an enterprise fund to the general fund or any other fund of the city must be made in accordance with section 384.89. To date, no one has challenged the fact that non-cash transfers violate this code requirement, but an argument to that effect could certainly be made.

tax converts transfers into a tax paid on all taxable deliveries, regardless of who made the delivery.

The transfer tax rate is technically set by the City Council (the taxing authority), however, the calculation is nearly automatic.<sup>3</sup> The rate is determined using a five-year floating average of transfers. The tax itself is based on deliveries in the single tax year. The municipal electric or gas utility is probably the only current taxpayer for the transfer tax. You would have additional taxpayers, if a local individual or business installed their own generation and the generation ran at greater than a 20% capacity factor.

In dealing with the municipal utility as taxpayer, note that a single year's deliveries may be higher or lower than the recent 5-year average, depending on weather and other changes in load. Consequently, the credit may be higher or lower than the tax. The tax and credit can be balanced by the governing body of the utility through adjustments in current year transfers, assuming the total transfer is not set by a formula. Alternatively, the agreement for transferring funds should provide for the balance or deficit to carry-over for adjustment in a later year.

We have recommended to both our electric and gas members that they begin converting non-cash transfers into cash transfers, so that the city general fund is protected, should a loss of customers through retail competition or bypass otherwise restrict the ability of the utility to continue to provide the non-cash services. When the city receives "free" electricity from its municipal electric utility or "free" gas from the municipal gas utility, it is getting a non-cash transfer. As you know, there is nothing free about utility service. By converting it to a cash transfer – billing the city or other departments – then transferring the equivalent cash, you protect the utility's ability to continue the transfer if customers are lost to competition, bypass, or self generation.

There are other reasons to convert non-cash transfers to cash transfers, not the least of which is that it provides a price signal to the user. If one department provides "free" services to another, the receiving department may not feel it has an incentive to use the service efficiently. That is a recipe for waste. In practical terms, what you want is to have all city employees share responsibility to stop drinking fountains from running constantly, turn off lights when not needed, and turn down thermostats and close doors and windows in the heating season to save gas. If the service shows up in their budget, they are more likely to use it wisely.

We have not suggested that conversion of non-cash transfers be taken to an extreme. For example, billing for use of one department's equipment by another would probably take too much time and effort. For free or discounted electricity and gas, however, the conversion makes sense even without the competitive threat. It's a common-sense business decision.

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<sup>3</sup> The governing body of a municipal utility can direct that certain transfers not be included in the calculation of the transfer replacement tax rate. This authority is especially valuable where a utility makes a one-time transfer of a significant amount of money, e.g., for a main street development project. By excluding an extraordinary transfer, the governing body prevents the skewing of the transfer replacement tax rate.