

Options for the Utility Users' Tax



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Monterey Bay Public Policy Group

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Should the City of Marina Reduce or Eliminate the Utility Users' Tax?

Executive Summary

With the rapid increase in fuel and utilities prices over the past twelve months, consumers and businesses have come under increasing financial pressure to lower consumption and, in the case of businesses, to increase prices. As the prospect of lower utility prices in the short-term dims, several municipalities in the Monterey Bay region are examining whether Utility Users' Taxes (UUTs) should be reduced or eliminated altogether. In the Monterey Bay region, the UUT is a 2 to 6 percent levy on utility consumption. Our understanding is that the primary motivation for the reduction or elimination of the UUTs is to ease the burden of increased electrical and natural gas prices on lower- and moderate-income consumers and businesses. Unlike a means-tested relief program where participants must meet specific income levels before qualifying for relief, a reduction or elimination of the UUT would benefit all consumers and businesses in the municipality's jurisdiction, regardless of income. Utility consumption increases with income, so primary benefit of any UUT reduction or elimination would accrue to consumers and business with higher, rather than lower, incomes. At the same time, the municipality would see an immediate reduction in revenues from the UUT reduction or elimination, placing significant financial pressure on the municipality's budget at the same time local sales and property tax revenues are likely to remain relatively stagnant. Given the limited tax bases available to local municipalities, the UUT reduction or elimination may result in a reduction in local services while providing the greatest absolute benefit to higher-income consumers and businesses. Instead of reducing or eliminating the UUT, UUT revenues above the historical yield could be used for lower- and moderate-income education, outreach, and relief.

Introduction

With the rapid increase in fuel and utilities prices over the past twelve months, consumers and businesses have come under increasing financial pressure to lower consumption and, in the case of businesses, to increase prices (Table 1). As the prospect of lower utility prices dims, several municipalities in the Monterey Bay region are considering whether Utility Users' Taxes should be reduced or eliminated altogether. Reducing or eliminating the Utility Users' Tax (UUT) would provide an immediate financial benefit to consumers and businesses within the municipality's jurisdiction. The financial benefit is dependent upon two factors: (1) the consumption of utilities by the consumer and business; and (2) the tax rate levied on utility consumption. Currently in the Monterey Bay region, UUT rates range from 2 to 6 percent, with some municipalities levying different rates on individuals and businesses.

The City of Marina levies a five percent UUT for all consumers with a means-tested exemption for lower income consumers. We conservatively project that the UUT will generate approximately \$1 million dollars in revenue in 2001 if consumption holds steady and utility prices remain within their current range.¹ Reducing the UUT would have an immediate and significant impact on revenues which, given the limited tax base available to the City, would in all likelihood result in a reduction in current service levels. As the pace of economic growth moderates in the short-term, the City is also likely to experience a reduced rate of growth in sales and property tax revenues. Expenditures for fuel, electricity, and natural gas are also likely to remain above historical levels in the short-term. In this short policy note, we examine the potential impact of a reduction or elimination of the UUT on consumers, businesses, and local governments with specific focus on the City of Marina.

Background

To understand the policy question before the City of Marina and other Monterey Bay municipalities, we must first discuss the energy market in California. We focus on the market for natural gas and the market for electricity, as we believe that these two markets will have the greatest impact on local municipalities over the coming months. As illustrated in Table 2, natural gas is the largest source of power in the California, accounting for roughly 31% of power generation. Deregulation changed the way electrical power was bought and sold in California and failed to produce the expected benefits. The failure of deregulation is likely to lead to increased electrical prices as the debt burden of the utilities is transferred to individuals and businesses.

Natural Gas: Natural gas prices have risen significantly over the past year, surpassing nearly all forecasts. In December 2000, the spot price at the Henry Hub – the

¹ Our projection is based upon a historical revenue level of \$950,000 with a 3 percent rate of inflation and 5 percent increase in consumption. Given the rapid increase in utility prices, we believe that a revenue estimate of approximately \$1 million is very conservative and defensible.

benchmark for U.S. natural gas prices – averaged \$6.31 per million British Thermal Units (MmBtu), over three times the average spot price in December 1999. In California, the increase in natural gas prices has been even more significant, with daily spot prices averaging \$15 MmBtu, and at one point in December 2000, \$69 per MmBtu, a national historical high for natural gas. At times, natural gas spot prices in California were four times higher than other regions in the United States.²

Why have natural gas prices increased dramatically over the past year? Natural gas, much like gasoline and other commodities, is bought and sold in an unregulated market with price being determined by supply and demand. While the supply of natural gas has remained relatively constant, the demand for natural gas has increased significantly over the last decade. Producers of electricity have been shifting to natural gas over the past decade as a cleaner burning alternative to coal and oil power generation, steadily increasing the demand for natural gas. At the same time, the economic expansion over the past ten years has increased the demand for natural gas from consumers and businesses alike. Finally, an early onset of winter in the Midwest and East in the last quarter of 2000 caused an early and sustained spike in demand for natural gas. Coupled with California's demand for natural gas (California only produces 15% of the natural gas it consumes), these factors have combined to push natural gas prices well above historical levels. Given that natural gas pipelines are operating at or near their capacity, it is unlikely that increased supply will cause short-term prices for natural gas to fall.

Electrical Prices: The market for electricity has been subject to many of the same forces that have adversely affected natural gas prices. Electric generation capacity in California has remained relatively stagnant over the past five years. At the same time, consumer and business demand for electricity has increased as a result of the economic expansion. While demand has increased by approximately 30%, new generation capacity has only increased by 6%. While wholesale prices for electricity have increased dramatically since 1999, consumers have been largely sheltered from increased wholesale prices due to a cap on consumer prices. However, it is unlikely, given the rapid and sustained increases in wholesale prices, that consumer prices will remain capped at the current levels over the long-term.

Why did deregulation fail? The decision to alter the structure of the California electricity market was, in retrospect, conducted without sufficient policy analysis and public input. In response to utility and large industry concerns, the wholesale market for electricity was deregulated so that market supply and demand would determine the wholesale price for electricity in California. At the same time, consumer prices were capped above the prevailing market rate to allow the public utilities to pay off their existing debt. Consumer prices were to be deregulated after the utilities' debt was retired. The underlying assumption of this market structure was that oil and natural gas prices would continue to remain near their historic lows and that competition would, over time, lower the wholesale price of electricity generation. As the wholesale price declined, the

² See *Federal Reserve Bank of San Francisco Economic Letter 2001-04* dated February 9, 2001.

utilities' debt would be retired at an increasing rate, and once the debt was retired, consumer prices would fall in line with wholesale prices; that is, consumer prices would fall in response to increased competition.

Unfortunately, what occurred in the California energy market was a failure to question the key policy assumption. As oil and natural gas prices increased, utilities found the gap between wholesale and consumer prices declining, until wholesale prices were higher than consumer prices. At this point, the utility companies (primarily Pacific Gas and Electric and Southern California Edison, among others) found themselves in the position of selling retail power at a loss because of the price cap on consumer rates. As the financial position of the major utilities worsened, the wholesale market for electricity (known as the Power Exchange) experienced significant declines in trading volume. The market collapsed in January 2001 as the financial position of the major utilities continued to deteriorate.

What is the potential impact of the current energy crisis on local municipalities?

Given the state of energy markets in California, a question of concern for local policymakers is the potential impact of the energy crisis on tax revenues and expenditures. We focus first on expenditures before turning to a discussion of the potential impact on revenues.

Expenditures: Local municipalities are likely to experience increased direct expenditures for natural gas, electricity, gasoline, and other petroleum related products. Although no municipality in the Monterey Bay region will be immune from increased utility and fuel prices, municipalities concentrated in smaller geographic areas (Carmel, Marina, Monterey, Pacific Grove, Seaside) will experience a smaller impact on expenditures than those municipalities spread over a larger geographic area (Salinas) or farther from the other municipalities in Monterey County (King City). Municipalities will also face the problem of increased prices for transportation related goods and services, which will likely outstrip forecasted price increases for 2001.

UUT Revenues: Municipalities that levy a UUT are likely to see a significant increase in UUT revenues in the first half of 2001 relative to 2000. Given the dramatic and apparently sustained increase in natural gas prices and the short-term increases in electric rates approved by the Public Utility Commission, UUT revenues should increase throughout the first half of 2001.³

Sales Tax Revenues: While UUT revenues may increase significantly in the first half of 2001, the other tax bases may be adversely affected by increasing utility and fuel prices. Cities that are relatively more dependent upon sales tax revenues will be more susceptible to this slowdown than cities with larger concentrations of homeowners than

³ A 9% increase in residential electric rates was imposed in January 2001. The 10% rate cut passed in 1996 is scheduled to expire in 2002.

businesses. As the rate of economic growth slows, it is likely that the rate of growth in sales tax revenues will fall relative to previous years.

Property Tax Revenues: As with sales tax revenues, the growth in property tax revenues is likely to decrease relative to previous years. Given the rapid increase in housing prices over the past five years, the property market may also be entering a period of slow growth relative to the rest of the state. Unlike the sales tax, cities with relatively few businesses and large concentrations of single-owner homes will be more susceptible from reduced revenues from the slowing real estate market.

Grant and Transfer Revenues: An additional concern for Monterey County and the municipalities in the Monterey Bay region is the state government entering the power generation business. The state is currently acting as the purchaser of last resort to ensure that blackouts do not occur.⁴ As the state diverts increasing amounts of financial resources to the power generation effort, resources available to county and municipal governments could decrease over time. Given the Governor's public statements against increasing utility rates and the potential for wholesale prices to remain above the current capped retail level for a sustained period of time, state revenues diverted to energy production could result in decreased grant and transfer revenues to county and local governments in the short-term. Even if utility rates were to rise to the level desired by the utility companies (which would correspond to an approximately 30% increase according to statements before the Public Utilities Commission), the debt incurred by these companies over the past year (now in excess of \$13 billion) would take some time to eradicate.

Prognosis: The likelihood of the municipalities in the Monterey Bay region experiencing increased fiscal stress over the next year has increased due to the instability in the energy prices and the declining rate of economic growth. Maintaining current public service levels is likely to require increased expenditures due to increased energy prices. If the municipalities are willing to decrease service levels to lower expenditures, then the need for increased expenditures is likely to diminish in the short-term. Local revenues may come under pressure due to the slowing rate of economic growth and the diversion of state resources to providing a resolution to the energy crisis. Increased UUT revenues may serve to cushion the fiscal impact.

Should the Utility Users' Tax be reduced or eliminated?

Should the local tax on utility expenditures be reduced or eliminated to alleviate the financial impact of the energy crisis on low- to moderate-income households? In this section, we provide a brief analysis of this question using hypothetical data on consumers

⁴ The state government has already spent over \$1.5 billion purchasing electricity on an emergency basis. The current proposal for the state to purchase transmission lines may cost from \$3 to \$5 billion (Los Angeles Times, February 17, 2001).

to illustrate the potential benefits and costs associated with a UUT reduction or elimination and offer some policy guidance.

As noted in the introduction, reducing or eliminating the UUT will provide an immediate financial benefit to all consumers, regardless of income. As the UUT is levied on utilities consumed which rise with income earned, the benefit of the UUT reduction or elimination may accrue to those with the greatest ability to pay the UUT, higher-income consumers. Households that meet certain income qualifications are also eligible for an exemption from the UUT and may also qualify for one of several energy assistance programs.⁵

In Table 3 we present a simple illustration of the incidence of the UUT. We assume that each household spends 5% of their annual income on utilities. If we assume that the lower-income household qualifies for utility-assistance programs, then the annual expenditure of the lower-income household after taxes and benefits is only 3.6% of income rather than 5% of income. If we assume that a lower-income household also qualifies for a UUT exemption, then expenditures as a percentage of income are lower than 3.6%.

Let us assume for a moment that a lower-income household qualifies but does not take advantage of the HEAP and CARE programs or the UUT exemption. In this case, the household will spend more than 5% of their income on utilities due to the UUT. If the municipalities in the Monterey Bay region are concerned with the potential impact of the UUT on lower-income households, then ensuring that these households are aware of and taken advantage of the UUT exemption (or enacting a means-tested UUT exemption where one is not present) appears to be a prudent course of action. As illustrated in Table 3, eliminating the UUT would produce a larger absolute benefit to higher-income households relative to moderate- and lower-income households. In other words, the households with the greatest ability to pay would enjoy the largest absolute benefit.

Should the UUT be reduced or eliminated due to increased energy prices? At this time, keeping the UUT in place will mitigate the impact of the need of increased expenditures to sustain current service levels and the possibility of revenue growth slowing due to economic conditions. If the consensus is that lower income households are not taking advantage of the UUT exemption, then using a portion of the increase in UUT revenues for outreach and education will address this concern. The income threshold for the UUT exemption could also be increased to allow more moderate-income households to participate in the UUT exemption program

⁵ These programs include Home Energy Assistance Program (HEAP), California Alternative Rates for Energy (CARE), and Relief for Energy Assistance through Community Help (REACH). See Monterey County Herald, February 19, 2001.

Table 1: Consumer Price Index : Urban Consumer Fuels and Utilities

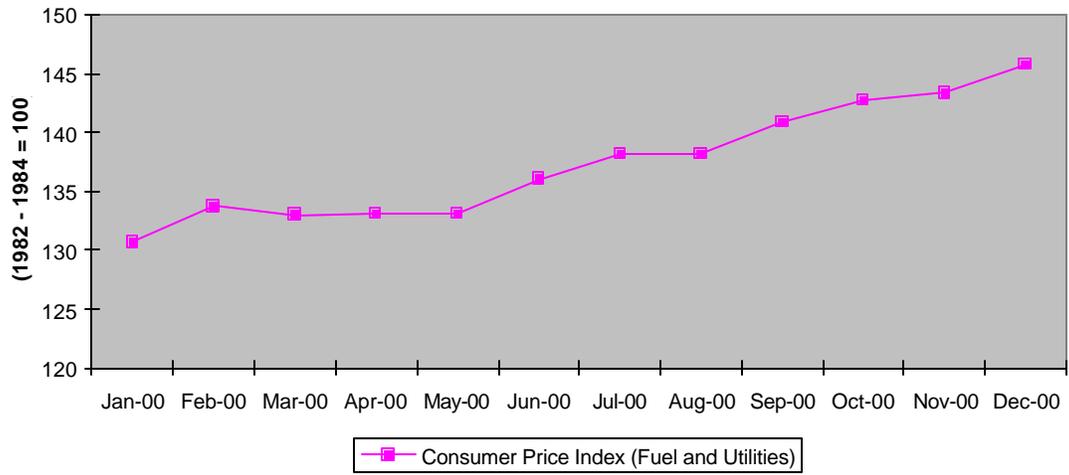


Table 2
California Net Power Generation

Fuel Type	1998 Gigawatt Hours	1998 Distribution	1999 Gigawatt Hours	1999 Distribution
Coal	52,430	20.2%	51,460	19.8%
Large Hydroelectric	56,407	21.8%	52,082	20.1%
Natural Gas	81,491	31.4%	80,497	31.0%
Nuclear	41,353	16.0%	42,030	16.2%
Oil & Diesel	4	0.0%	1,671	0.6%
Eligible Renewables	27,500	10.6%	31,625	12.2%
<i>Of which:</i>				
<i>Biomass & Waste</i>	5,060	2.0%	5,119	2.0%
<i>Geothermal</i>	12,400	4.8%	12,786	4.9%
<i>Small Hydro</i>	6,425	2.5%	8,916	3.4%
<i>Solar</i>	839	0.3%	954	0.4%
<i>Wind</i>	2,776	1.1%	3,850	1.5%
Totals	259,185	100%	259,365	100%

Note: California Energy Commission 1999, 2000. Net power generation is defined as the percentage of annual generation produced in California for consumption in the state during the previous calendar year for each of the statute's fuel type categories. Imports of out-of-state fuel generation are added in, but both self-generation and specific purchases by fuel type are subtracted out.

Table 3
 Absolute Benefit to Reducing or Eliminating the Utility Users' Tax
 Four-Person Household Assuming 5% Annual Income Utility Consumption

Annual Household Income	Annual Utility Expenditure	Monthly Utility Expenditure	Annual Utility Tax Payments	Minimum HEAP Benefit	CARE Rate Reduction Benefit	Net Utility Payment	Net Utility Payment as % of Income	Net Utility Payment with UUT Elimination
\$25,000	\$1,250.00	\$104.17	\$63	\$220	\$188	\$905	3.62%	\$842
\$50,000	\$2,500.00	\$208.33	\$125	\$0	\$0	\$2,625	5.25%	\$2500
\$100,000	\$5,000.00	\$416.67	\$250	\$0	\$0	\$5,250	5.25%	\$5000