

201603710L

DATE: March 3, 2016

TO: Denise Stewart, Director, Audit Division

FROM: Teresa Bostick, Director, Tax Policy Division

SUBJECT: Cost of Goods Sold for Electricity Transmission and Distribution

Issue:

In calculating its cost of goods sold (COGS) deduction, may an integrated utility company include transmission and distribution costs, franchise fees paid for the use of government-owned right of ways, and property taxes and insurance on transmission and distribution assets? In deregulated markets, may retail electricity providers (REPs) include transmission or distribution costs in their COGS deductions?

Background:

An integrated utility company is a company that owns all levels of the supply chain: generation, distribution, and retail services. An integrated utility company, or a member of the combined group that makes up the integrated utility company, owns the electricity that is transmitted and distributed to its customers.

In deregulated markets, generation, distribution, and retail services are separated into different organizations. These companies are typically referred to as power generation companies (PGCs), transmission and distribution utilities (TDUs), and retail electricity providers (REPs). The entities that produce electricity do not distribute or sell the electricity to the end-user. A REP purchases wholesale electricity, delivery service, and related services from the PGCs and TDUs and then sells to customers, the end user.

Section 171.1012(c)(4) allows a taxable entity that produces or acquires goods to sell to include in its COGS deduction "handling costs, including costs attributable to processing, assembling, repackaging, and inbound transportation costs." Section 171.1012(e), however, expressly excludes selling costs and distribution costs, including outbound transportation costs, from the COGS calculation. See Section 171.1012(e)(2) and (3).

The statute and rules do not define "handling costs," "selling costs" or "distribution costs." As a result, there is no definitive guidance about how a taxable entity that is an integrated utility company or the separate entities in a deregulated market, should classify the costs of activities performed on a product, specifically electricity, after production or acquisition but before final sale to the customer.

Policy:**Transmission and Distribution Costs:**

Most electric utility customers cannot use electricity at the voltage on the transmission line. Electricity from the transmission line must be stepped-down at a substation before it is distributed to specific customer areas. The "step-down"

of voltage to the level that a customer can accept the electricity readies the electricity for sale and is a processing activity. The transmission of electricity until it is "stepped-down" is included in this processing activity. Handling costs include processing costs and are included in COGS. Distribution begins once electricity is stepped-down to the customer level. Costs related to distribution cannot be included in COGS.

An integrated utility company owns the electricity and can therefore include in its COGS deduction the costs of transmission to the point of step-down and the step-down. It cannot include the cost of distributing the electricity once it has been stepped down.

In deregulated markets, an REP may include in COGS the costs of acquiring the electricity it resells. These costs include handling costs. The REP may therefore deduct any fees or charges it pays for the transmission of the electricity to the point of step-down and the step-down. It cannot include the fees or charges it pays for the distribution of the electricity once it has been stepped down.

In deregulated markets TDUs do not own the electricity and provide transmission and distribution services. As a result, TDUs may not include transmission or distribution costs in COGS.

Franchise Fees:

The costs of renting or leasing equipment, facilities, or real property directly used for the production of the goods are included in the COGS deduction. See Section 171.1012(c)(7). Franchise fees – effectively, rent paid for the right to install transmission and distribution assets in government-owned rights of ways – are a cost of renting or leasing real property used for production. Because processing is a production activity, integrated electric utilities may include franchise fees related to transmission assets in their COGS deduction. In deregulated markets, TDUs are the entities who would likely incur these costs; however, TDUs cannot deduct these costs as COGS because the TDUs do not own the electricity that they are transmitting and distributing. See Section 171.1012(i).

Real and Personal Property Taxes:

The costs of taxes paid in relation to acquiring or producing any material are included in the COGS deduction. See Section 171.1012(c)(11). This includes property taxes paid on buildings and equipment used to produce the electricity. See Rule 3.588(d)(11). As noted above, because processing is a production activity, integrated electric utilities may include property taxes related to transmission assets in their COGS deduction. In deregulated markets, TDUs are the entities who would likely incur these costs; however, TDUs cannot deduct these costs as COGS because the TDUs do not own the electricity that they are transmitting and distributing. See Section 171.1012(i).

Insurance:

The cost of insurance on a plant or facility, machinery, equipment, or materials directly used in the production of goods is included in the COGS deduction. See Section 171.1012(d)(6). Again, because processing is a production activity, integrated electric utilities may include the cost of insurance related to transmission assets in their COGS deduction. In deregulated markets, TDUs are the entities who would likely incur these costs; however, TDUs cannot deduct these costs as COGS because the TDUs do not own the electricity that they are transmitting and distributing. See Section 171.1012(i).

This information is a clarification of policy and applies to all tax report years that are open within the statute of limitations. We intend to amend Rule 3.588 accordingly.

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