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BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 04-0009
	)	
. . .	)	Registration No. . . .
	)	Document No. . . .
	)	Audit No. . . .
	)	Docket No. . .

[1] RULE 162: ELECTRICITY CONTRACTS. A person trading in electricity contracts is deemed to be engaged in a financial business and is taxable on the gain realized from the trading activity.

[2] RCW 82.04.310(2): ELECTRICITY CONTRACTS -- FUTURES CONTRACTS-- FORWARD CONTRACTS. A contract for the sale of electricity is not a "forward contract" for the sale of the underlying commodity for purposes of RCW 82.04.310(2) where the parties do not anticipate physical delivery of electricity.

[3] RCW 82.04.310(2): ELECRICITY CONTRACTS -- FUTURES CONTRACTS-- FORWARD CONTRACTS. A "forward contract" for the sale of electricity is not a sale of the underlying commodity for purposes of RCW 82.04.310(2), if physical delivery does not in fact occur.

[4] RCW 82.04.310(2): LEGISLATIVE INTENT. Legislative intent of RCW 82.04.310(2) was to treat power marketers the same as power and light businesses, *i.e.*, to relive them of paying either public utility tax or B&O tax on sales of electricity for resale within or without the state. The intent was not to eliminate the B&O tax on businesses that merely trade in electricity contracts.

Rosenbloom, A.L.J. -- A wholesale power marketer petitions for correction of the assessment of Service & Other Activities B&O tax on gains realized from trading in electricity "forward contracts" alleging that these amounts are exempt under RCW 82.04.310(2), which provides a B&O tax exemption for amounts received for the sale of electrical energy for resale within or outside the state. We conclude that trading in electricity forward contracts that do not go to

physical delivery does not constitute a sale of the underlying electricity. Therefore, Service & Other Activities B&O tax was properly assessed on gains realized from "booked out" electricity forward contracts. Taxpayer's petition for correction is denied.[1]

ISSUE

Do gains realized from trading in electricity forward contracts that do not go to physical delivery qualify for exemption under RCW 82.04.310(2), which provides a B&O tax exemption for amounts received for the sale of electrical energy for resale within or outside the state?

FINDINGS OF FACT

. . . (Taxpayer) is a wholesale power marketer registered with the Federal Energy Regulatory Commission (FERC). Taxpayer does not own or operate any generating, transmission, or distribution facilities. Taxpayer was formerly located in . . . , Washington and conducted business there [until] it closed its operations in this state.

During the time period at issue, Taxpayer was one of approximately . . . members of the Western Systems Power Pool or "WSPP." Almost all (over 95%) of Taxpayer's wholesale electricity trading was conducted under the WSPP Agreement, which included the following recitation: "The Parties acknowledge that all transactions under this agreement are forward contracts . . . ."

Almost all of the forward contracts were settled as "book outs," in which one or more other parties that had contracted to buy or sell the same amount of electricity for delivery at the same place and date ended up off-setting the contracts before the time of delivery. Taxpayer testified at the hearing that it had employees "on call" in the event Taxpayer was required to actually arrange for the delivery of electricity because of a failed "book out." However, Taxpayer stated that this happened rarely, if at all, and Taxpayer has no record of such an occurrence.

On . . . , 1999, prior to engaging in business, Taxpayer asked the Department for a letter ruling regarding its tax liability. The Department's Taxpayer and Information Section (TI&E) responded with a letter dated September 24, 1999 advising that Taxpayer would be liable for Service & Other Activities B&O tax on gains realized from trading in electricity contracts. Taxpayer initially paid Service & Other Activities B&O tax on its trading gains in accordance with the TI&E letter.

Sometime later, Taxpayer states that its comptroller contacted the Department and was orally advised that Wholesaling B&O tax was the correct classification for its business activities, whereupon Taxpayer began paying Wholesaling B&O tax on gains realized from trading in electricity contracts.

The Department's Audit Division (Audit) audited Taxpayer's records for the period . . . , 1999 though . . . , 2002 and issued an assessment for additional taxes and interest. The bulk of the

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

deficiency resulted from Audit's reclassification of electricity contract trading gains from the Wholesaling B&O tax to the Service B&O tax classification.

Taxpayer does not dispute the reclassification of electricity contract trading gains; however, Taxpayer argues that any transactions on or after June 8, 1999, the effective date of RCW 82.04.310(2), are exempt under that provision.

Taxpayer asserts that forward contracts are distinguishable from futures contracts. According to Taxpayer, futures contracts are sold on commodity exchanges and are purely financial instruments – an agreement to buy or sell a commodity at some future date. In the event of a book out there is an immediate settlement of the offsetting contracts and the duty to actually perform the contract is extinguished.

In contrast, Taxpayer states that a forward contract conveys title to the underlying property at the time the contract is executed, with delivery to occur at a future date. In the event of a book out, settlement occurs after the delivery date. The seller remains obligated to deliver the goods at the specified date if a book out does not occur as expected.

Taxpayer contends, therefore, that it was actually selling electricity for resale as opposed to merely trading in financial instruments. Consequently, Taxpayer asserts it is entitled to the exemption provided in RCW 82.04.310(2) under the express statutory language.

Even if RCW 82.04.310(2) is ambiguous, Taxpayer argues that the legislature intended wholesale electricity trading revenues of power marketers, such as Taxpayer, to be exempt under the new law.

Taxpayer argues that entitlement to the exemption is further reinforced by the fact that Taxpayer was required to file for and obtain a FERC-approved tariff for its wholesale electricity trading as a "reseller of electricity" in interstate commerce. Although federal authority is not controlling in the interpretation of state statutes, Taxpayer argues that it can be persuasive where the text of both federal and state laws are similar or where they relate to the same subject matter.

Finally, Taxpayer asserts that there is no inconsistency in its position that it should be taxed on a net gain basis for periods prior to June 8, 1999, the effective date of RCW 82.04.310(2), but that its gross receipts are exempt thereafter. Taxpayer argues that its trading involved *both* the financial trading of forward energy contracts at a rapid pace under circumstances very similar to the trading of securities *and* constituted the sale for resale of traded energy.

ANALYSIS

The Washington Public Utility Tax applies to the gross income of a light and power business, which is defined as a business that operates a plant or system for the generation, production, or distribution of electrical energy. RCW 82.16.020(1)(b) and 82.16.010(5). RCW 82.04.310(1) provides a B&O tax exemption for business activities that are subject to the public utility tax.

Businesses that do not own or operate generating, transmission, or distribution facilities do not fall within the definition of "light and power business" and are therefore not subject to public utility tax. Instead, sales of electricity by a business other than a light and power business are subject to B&O tax under "Service & Other Activities" classification based on the gross income of the business as provided in RCW 82.04.290(2), except that sales of electricity for resale within or without the state are exempt under RCW 82.04.310(2).

[1] However, businesses that merely trade in electricity contracts are deemed to be engaged in a financial business and are taxable on the gain realized from the trading activity, rather than on gross receipts, because RCW 82.04.080 defines "gross income of the business" to include "gains realized from trading in stocks, bonds, or other evidences of indebtedness."

Taxpayer argues that its forward contracts, as distinguished from futures contracts, are not merely financial transactions, but instead involve the actual sale of electricity for resale. We disagree. The distinction between futures contracts and forward contracts is important for federal regulatory purposes – futures contracts are subject to the jurisdiction of the Commodities Futures Trading Commission (CFTC) while forward contracts are not – but we are not convinced that there is a material distinction between the two for Washington B&O tax purposes, particularly where, as here, the forward contracts do not go to physical delivery.

[2] The Commodity Exchange Act, as amended, (CEA) does not actually use the term "futures contract" or "forward contract." Instead, the CEA gives the CFTC exclusive jurisdiction over "transactions involving contracts of sale of a commodity for future delivery." 7 U.S.C. Sec. 2(a)(1)(A) (2001) (*i.e.*, so-called futures contracts). However, the CEA also provides that the term "future delivery" does not include "any sale of any cash commodity for deferred shipment or delivery." 7 U.S.C. Sec. 1a(19) (2001) (*i.e.*, the so-called forward contract exclusion).

Because the terms are not explicitly defined in the CEA, it has been left to the courts and the CFTC to sort out the fine distinctions between futures contracts and forward contracts.

Writing in 1999, one commentator noted:

> While the line between forward and futures contracts is anything but bright, in the past the CFTC has not exerted jurisdiction over contracts between commercial parties that use the subject of the contract in their business, <u>where physical delivery was possible, anticipated and routinely occurred</u>, and where the contract was negotiated individually and not assignable without consent.

Fortnightly September 1, 1999 Articles PERFORMANCE OR BREACH? TOWARD A STANDARDIZED CONTRACT FOR WHOLESALE ELECTRICITY, Edward J. Finn [FNa] 137 No. 16 Pub. Util. Fort. 62, 66-67. (Emphasis added.)

Rather than attempting to draw a bright-line distinction between electricity forward contracts and future contracts, Congress enacted the Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000). This measure provides a safe harbor for certain

transactions in exempt commodities, including electricity, between qualifying parties. Thus, power marketers are now exempt from CFTC jurisdiction regardless of whether physical delivery is anticipated and routinely occurs.

The courts have held that the cash forward contract exclusion is "unavailable to contracts for purely speculative purposes which are not predicated upon the expectation that delivery of the actual commodity by the actual seller to the original contracting buyer will occur in the future." *CFTC v. Noble Metals Int'l, Inc.*, 67 F.3d 766, 772 (9th Cir.1995), *quoting CFTC v. Co Petro Mktg. Group, Inc.*, 680 F.2d 573, 579 (9th Cir.1991).

In *Noble Metals, supra,* the court found that the defendants' "forward delivery program" contracts for purchases of precious metals were futures contracts subject to CFTC jurisdiction. Among the vast number of purchasers, only a handful contemplated actual delivery. The defendants nevertheless argued that the contracts satisfied the "delivery" requirement because they required the buyer to "take or make delivery of the merchandise contracted." According to the defendants, this satisfied the requirement by transferring, *i.e.*, "delivering," title to the purchaser, even though the precious metal was held by a third-party depository.

The court rejected the notion that the delivery requirement could be satisfied by the simple device of a transfer of title, as follows:

> As we said in *Co Petro*, "a cash forward contract is one in which the parties contemplate physical transfer of the actual commodity." If this were not so, the cash forward contract exception would quickly swallow the futures contract rule.
>
> "[S]elf-serving labels that the defendants choose to give their contracts should not deter the conclusion that their contracts, as a matter of law, [are futures contracts subject to the CEA]." (Citations omitted.)

Noble Metals, 67 F.3d at 773 (emphasis and parentheses supplied, brackets in the original).

The court concluded that the contracts were futures contracts since "there was no legitimate expectation that [defendants'] customers would take actual delivery of the metal they bought." *Id.*

We find little to distinguish Taxpayer's contracts from those considered in *Nobel Metals, supra.* They purport to be forward contracts, and Taxpayer asserts that they conveyed title at the time of execution. However, it is undisputed that Taxpayer made physical delivery of electricity rarely, if at all. We are not convinced that Taxpayer's contracts were in fact forward contracts.

[3] Even if we assume Taxpayer's transactions were forward contracts, we do not believe that those transactions that do not go to physical delivery constitute a sale of the underlying commodity. Consequently, we conclude trading gains from booked out forward contracts does not constitute amounts received from "the sale of electrical energy for resale" and do not qualify for exemption under RCW 82.04.310(2).

[4] Even if RCW 82.04.310(2) were ambiguous, we find no evidence that the legislature intended to exempt electricity contract trading gains of power marketers. Prior to the Enactment of Laws of 2000, Ch. 245 (EHB 2755), there was a public utility tax exemption for a) for sales of electricity by one light and power business to another for resale within the state, and b) amounts derived from the production, sale, or transfer of electrical energy for resale or consumption outside the state. However, power marketers selling electricity for resale were subject to Service & Other Activities B&O tax. In addition, sales of electricity by a light and power business to a non-utility (*e.g.*, a power marketer) for resale did not qualify for the public utility tax exemption.

The legislature amended the public utility tax exemption to apply to any sale (*i.e.*, not just sales to another light and power business) for resale within or outside the state. RCW 82.16.050(9), as amended by Laws of 2000, Ch. 245, § 1. At the same time, the legislature created a B&O tax exemption for "amounts received by any person for the sale of electrical energy for resale within or outside the state." RCW 82.04.310(2), Laws of 2000, Ch. 245, § 2.

The legislature clearly intended to put power marketers on the same footing as power and light businesses, *i.e.*, to relieve them of paying any tax on sales of electricity for resale within or without the state. There is no evidence of legislative intent to eliminate the tax on businesses that merely trade in electricity contracts.

Taxpayer argues that its entitlement to the exemption is reinforced by the fact that it falls under the jurisdiction of FERC as a "reseller of electricity" in interstate commerce. To the contrary, we find that the manner in which power marketers have been regulated by FERC supports our finding that a booked out forward contract does not constitute a sale of the underlying commodity.

FERC is an independent federal regulatory agency under the U.S. Department of Energy with regulatory authority over the "sale of electric energy at wholesale in interstate commerce." 16 U.S.C. § 824(b)(1). FERC has jurisdiction over any "public utility," which the Federal Power Act (FPA) defines as any person who owns or operates facilities subject to FERC's jurisdiction 16 U.S.C. § 824(e).

It is well-established that a power marketer is a "public utility" subject to FERC jurisdiction when it purchases wholesale electric power for resale, notwithstanding that the power marketer does not operate generating or transmission facilities. *See Citizens Energy Corp.*, 35 FERC ¶ 61,198 (1986). It does not follow, however, that all of a power marketer's activities constitute wholesale sales.

Public utilities are required to file with FERC:

> schedules showing <u>all rates and charges for any</u> transmission or <u>sale subject to the jurisdiction of the Commission</u>, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

16 U.S.C.A. § 824d(c) (emphasis supplied.)

Power marketers have argued that booked out transactions are not subject to this reporting requirement because they do not involve the physical delivery of electric energy. In response, FERC ruled that power marketers were only required to report those transactions that go to physical delivery. *See Morgan Stanley Capital Group, Inc.*, 69 FERC ¶ 61,175 (1994), *order on reh'g*, 72 FERC ¶ 61,082 (1995); and *Annual Charges Under the Omnibus Budget Reconciliation Act of 1986*, 87 FERC 61,074 (1999). In other words, FERC presumably concluded that a booked out transaction did not constitute a "sale" subject to its jurisdiction.

FERC issued a subsequent ruling requiring book outs to be reported. However, in response to objections that FERC lacked jurisdiction over transactions that do not result in physical delivery, FERC responded as follows:

> We find that these objections focus on the wrong issue and are without merit. The Commission is not here asserting (or disclaiming) jurisdiction over the underlying sales transactions. Instead, the Commission is deciding what information must be reported to us by public utilities.

99 FERC ¶ 61, 107 (2002), at paragraph 281 (emphasis supplied).

In other words, FERC has in the past recognized that booked out forward contracts, like futures contracts, are purely financial transactions and do not constitute a sale of the underlying commodity. While there is some language in 99 FERC ¶ 61, 107 (2002) suggesting that FERC now considers booked out transactions to constitute sales, most of the discussion focused on the fact that booked out transactions "relate to" or "affect" sales prices and therefore are subject to the reporting requirement contained in 16 U.S.C.A. § 824d(c).

In any event, regardless of whether FERC now regards booked out forward contracts as sales of electricity for federal regulatory purposes under the FPA, its determination is not binding upon the Department. We agree with FERC's earlier interpretation that these are simply financial transactions.

Finally, we disagree with Taxpayer's assertion that there is no inconsistency in its claim that it should be taxed on net trading gains for periods prior to June 8, 1999, the effective date of RCW 82.04.310(2), but that its gross receipts are exempt thereafter. If Taxpayer's forward contracts that do not go to physical delivery actually constituted a sale of the underlying electricity, then Taxpayer would be liable for Service B&O on the gross amounts received for periods prior to the effective date of RCW 82.04.310(2), not merely on the trading gains.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 16th day January of 2004