Cite as Det. No. 06-0225, 26 WTD 175 (2007)

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. 06-0225
. . .	)	
	)	Registration No. . . .
	)	FY. . ./Audit No. . . .
	)	Docket No. . . .
	)	

[1] RULE 179; RCW 82.16.010: PUBLIC UTILITY TAX – WHOLESALE SALES OF ELECTRICITY NOT EXEMPT. Under the Washington public utility tax, the gross income of a light and power business is made up of those amounts derived directly from, or incidental to, "the business of operating a plant or system for the generation, production or distribution of electrical energy for hire or sale and/or for the wheeling of electricity for others." The statute does not distinguish between wholesale and retail business operations, and Rule 179(3)(e) does not support the assertion that only income derived from retail business operations are subject to the tax. Wholesale business operations of a light and power business are not exempt from the public utility tax simply by virtue of being wholesale in nature. Thus, gross income from wholesale business operations is subject to the PUT unless a specific exemption or deduction applies.

[2] RULE 179; RCW 82.16.010(12): PUBLIC UTILITY TAX – DEFINITION OF GROSS INCOME – AMOUNTS DERIVED FROM OPERATIONS INCIDENTAL TO THE PERFORMANCE OF LIGHT AND POWER BUSINESS OPERATIONS – SALE OF SCHEDULING SERVICES. A light and power business is subject to the public utility tax on its gross income derived from the performance of its light and power business operations, including operations incidental thereto. Scheduling services are incidental to the operations of a light and power business and amounts received from providing scheduling services qualify as gross income subject to the public utility tax.

[3] RULE 179; RCW 82.16.050(9): PUBLIC UTILITY TAX – DEDUCTION ALLOWED IN COMPUTING THE TAX FOR AMOUNTS DERIVED FROM THE PRODUCTION, SALE, OR TRANSFER OF ELECTRICAL ENERGY FOR RESALE – PROOF REQUIRED. RCW 82.16.050(9) authorizes a deduction in computing the public utility tax for amounts "derived from the

production, sale, or transfer of electrical energy for resale within or outside the state or for consumption outside the states." To qualify for the deduction, the taxpayer is required to show that the gross income in question was (1) derived from the production, sale, or transfer of electrical energy, and (2) the electrical energy produced, sold or transferred was acquired for resale or for consumption outside this state.

[4] RULE 179; RCW 82.16.010(12): PUBLIC UTILITY TAX – DEFINITION OF GROSS INCOME – AMOUNTS DERIVED FROM OPERATIONS INCIDENTAL TO THE PERFORMANCE OF LIGHT AND POWER BUSINESS OPERATIONS – SALE OF EXCESS OPERATING CAPACITY RESERVE. A light and power business is subject to the public utility tax on its gross income derived from the performance of its light and power business operations, including operations incidental thereto. Maintaining or having access to excess operating capacity is incidental to the operations of a light and power business, and amounts received from selling excess operating capacity qualify as gross income subject to the public utility tax.

[5] RULE 179; RCW 82.16.010(12): PUBLIC UTILITY TAX – DEFINITION OF GROSS INCOME – AMOUNTS DERIVED FROM OPERATIONS INCIDENTAL TO THE PERFORMANCE OF LIGHT AND POWER BUSINESS OPERATIONS – SALE OF EXCESS TRANSMISSION CAPACITY. A light and power business is subject to the public utility tax on its gross income derived from the performance of its light and power business operations, including operations incidental thereto. Maintaining or having access to transmission capacity is incidental to the operations of a light and power business, and amounts received from selling excess transmission capacity qualify as gross income subject to the public utility tax.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

Zalesky, A.L.J. – A public utility district that operates a "light and power business" disputes the assessment of public utility tax on certain income it received that was not directly associated with the generation, distribution, or sale of electric power. . . . We conclude that the disputed income from "scheduling services," "operating reserves," . . . and "sale of transmission capacity" were all from operations incidental to taxpayer's light and power business operations and that public utility tax was correctly assessed on that revenue. . . .[1]

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

ISSUES

1. Does WAC 458-20-179(3)(e) exempt gross income derived from wholesale business activities from the public utility tax?

2. Is public utility tax due on income received by a light and power business from the sale of "scheduling services"?

3. Is public utility tax due on income received by a light and power business from the sale of "excess operating capacity reserve"?

4. . . .

5. Is public utility tax due on income received by a light and power business from the sale of transmission capacity acquired from [an entity]?

. . .

FINDINGS OF FACT

[Taxpayer] is a vertically integrated electric utility with its business offices in . . . Washington. Taxpayer owns and operates . . . dams . . . . Taxpayer also owns and operates . . . hydroelectric generating facilities . . . . Electricity generated from these hydroelectric plants is sold on a retail basis . . . .

In addition to its power generation and retail power transmission and distribution operations, the Taxpayer also sells power on a wholesale basis. Taxpayer describes its wholesale power operations as follows:

> As a result of long-term power sales contracts entered into . . . [Taxpayer] retains 36.5 percent of the power generated . . . . The remaining 63.5 percent is sold at cost to 12 other utilities . . . .

Taxpayer is a "[l]ight and power business" as defined in RCW 82.16.010(5). As such, it is subject to the Washington public utility tax (PUT). Taxpayer is also subject to the Washington business and occupation (B&O) tax on its receipts from business activity not subject to the PUT, as well as Washington use tax on tangible personal property it uses or consumes in its business operations.

In 2005 the Department's Audit Division conducted an audit of Taxpayer's books and records for the January 2001 though September 2004 taxable periods. The audit resulted in an assessment . . . .

The adjustments made by the Audit Division were detailed in Audit Schedules . . . . Taxpayer has agreed to the adjustments contained in most of those Audit Schedules. However, Taxpayer disputes [some of] the adjustments . . . . [One of the schedules] calculates the PUT on revenue derived by the Taxpayer from power transmission "scheduling services," the sale of power generation "operating reserves," . . . and the receipt of income from the sale of Taxpayer's contractual right to transmission capacity . . . . The Taxpayer contends that the audit staff incorrectly characterized the amounts listed in [the schedules] as gross income subject to the PUT. A brief description of each of these amounts is set out below:

- Scheduling. The electric power transmission grid is made up of various "control areas." Taxpayer manages a control area and is connected at various points to other control areas. If power is to be transferred from one control area to another there must be a "schedule" that allows both control areas to know how much power is being transferred in or out at specific times. Electric power cannot be moved without this scheduling component. For a fee, Taxpayer will provide this scheduling service to third parties that do not have the ability to do their own scheduling.

- Operating Reserves. In order to maintain the integrity of the power supply system there is a need to have power generation capability kept in reserve to be made available within a short period of time when circumstances warrant. At times during the year the Taxpayer will have excess reserve generating capacity that is not needed to fulfill its own generation reserve requirements. On occasion the Taxpayer will sell some of its excess reserve capacity to other utilities to help them fulfill their reserve requirements.

- . . .

- Sale of Excess Transmission Capacity. In addition to its own high voltage transmission lines, the Taxpayer has a contract with [an entity] that gives Taxpayer the right to use [that entity's] transmission lines. The contract allows Taxpayer to move a specified amount of electrical energy over [that entity's] transmission system. When the Taxpayer does not have the need for all of the transmission capacity it has acquired, it can sell the excess capacity to other utilities . . . .

With respect to . . . the disputed income from scheduling, operating reserves, . . . and sale of transmission capacity, Taxpayer's primary contention is that the public utility tax (PUT) only applies to "retailing activities" and since the amounts in dispute were derived from what Taxpayer characterizes as its "wholesale activities," no PUT is due . . . . Alternatively, Taxpayer argues that (1) the disputed amounts do not meet the definition of "gross income" as defined in RCW 82.16.010(12), and (2) even if the amounts are "gross income," they are deductible under RCW 82.16.050(9). . . . We will address each of these arguments in turn.

ANALYSIS

A. Overview of the Public Utility Tax.

The PUT is imposed for the act or privilege of engaging within this state in any of the public service or transportation businesses listed in RCW 82.16.020, including a "light and power business." RCW 82.16.020(1)(b). A "light and power business" is defined as "the business of operating a plant or system for the generation, production or distribution of electrical energy for hire or sale and/or for the wheeling of electricity for others." RCW 82.16.010(5).

The tax is computed by multiplying the "gross income of the business" by the rate specific to the particular type of business being taxed. For instance, the gross income of a light and power business is currently taxed at the rate of 3.873%. RCW 82.16.020(1)(b) and (2). The term "gross income" is defined in RCW 82.16.010(12) as follows:

> "Gross income" means the value proceeding or accruing from the performance of the particular public service or transportation business involved, including operations incidental thereto, but without any deduction on account of the cost of the commodity furnished or sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

To be subject to the PUT, the gross income must be derived from the operations of the public service or transportation business at issue. In effect, the statutory definition makes a distinction between operating income and nonoperating income. *See* Det. No. 00-080, 20 WTD 204 (2001); *King County Water Dist. No. 68 v. Tax Comm'n*, 58 Wn.2d 282, 285-86, 362 P.2d 244, 245-46 (1961). Operating income, which includes revenue from operations incidental to the performance of the public service or transportation business, is subject to the PUT while nonoperating income is not.[2]

The operating income of a light and power business is made up of those amounts derived directly from, or incidental to, "the business of operating a plant or system for the generation, production or distribution of electrical energy for hire or sale and/or for the wheeling of electricity for others." The definition of a light and power business set out in RCW 82.16.010(5) does not distinguish between wholesale and retail business operations. However, as we will discuss at greater length in Part C of this Analysis, RCW 82.16.050(9) does provide a deduction from the PUT for "[a]mounts derived from the production, sale, or transfer of electrical energy for resale within or outside the state or for consumption outside the state."

B. WAC 458-20-179(3)(e)(Rule 179(3)(e)) does not Support Taxpayer's Claim that Wholesale Business Activities are Exempt from the PUT.

[1] Taxpayer argues that the Department has historically limited the PUT to only the gross income derived from the retail sale of power. . . . According to the Taxpayer, wholesale power operations such as the sale of scheduling services, sale of operating capacity reserve, . . . and sale

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[2] In most cases the gross income of a public service business or transportation business that is characterized as nonoperating income for purposes of the PUT will be subject to the Washington B&O tax. *See* RCW 82.16.060 (persons liable for the PUT are not thereby exempt "from tax under any other chapters of this title with respect to activities other than those specifically within the provisions of this chapter."); *City of Kennewick v. State*, 67 Wn.2d 589, 594, 409 P.2d 138, 140-41 (1965) (gross income of a utility that falls outside the public utility tax is subject to the B&O tax.).

of transmission rights, are exempt. Taxpayer relies primarily on Rule 179(3)(e) to support its assertion that wholesale activities are exempt. That administrative rule provides in part:

> (e) Income from activities which are incidental to a public utility activity are generally taxable under the public utility tax when performed for an existing customer. This includes charges for line extensions, connection fees, line drop charges, start up fees, pole replacements, testing, replacing meters, line repairs, line raisings, pole contact charges, load factor charges, meter reading fees, etc. However, if any of these services are performed for a customer prior to sale of a public utility service to the customer, the income is taxable under the business and occupation tax. . . .

[3] Taxpayer asserts that the list of activities set out in the second sentence of Rule 179(3)(e) all relate to services provided to retail customers. Therefore, according to the Taxpayer, income from activities incidental to a light and power business do not include "activities or services related to the distribution of power to other power entities or power marketers for resale." . . . We respectfully disagree. First, it is relevant to note that Rule 179(3)(e) is a rule of general application within the PUT. It is not specific to light and power businesses. Furthermore, the rule specifies that incidental activities "include" those activities listed. The word "includes" is generally . . . not intended to limit the scope of a statute or rule by excluding those items not listed thereafter. *Brown v. Scott Paper Worldwide Co.*, 143 Wn.2d 349, 359, 20 P.3d 921, 926 (2001). After careful consideration, we cannot interpret this general rule with its list of **included** services as exempting from the PUT the entire class of wholesale light and power distribution services. *See Budget Rent-A-Car, Inc. v. Department of Rev.*, 81 Wn.2d 171, 500 P.2d 764 (1972) (exemptions from tax are to be narrowly construed.).

Moreover, the real import of Rule 179(3)(e) is to apply the "existing customer" versus "new or prospective customer" dichotomy established by the Washington Supreme Court in *King County Water Dist. No. 68 v. Tax Comm'n*, 58 Wn.2d 282, 365 P.2d 244 (1961), and *Kennewick v. State*, 67 Wn.2d 589, 409 P.2d 138 (1965).

In *King County Water Dist. No. 68*, the Supreme Court was called upon to determine whether payments received by a water distribution utility as reimbursements for capital expenditures needed to hook up new customers to its water distribution system were gross income subject to the PUT. In holding that the payments were excluded from the PUT, the Court stated:

> The issue posed requires that we determine whether the statute makes a distinction between nonoperating and operating revenue of a water utility business. The [King Count Water District] argues first, that the transactions in the instant case were not within the operation of a water distribution business as defined under [the PUT statute]. We agree. The statute specifically provides that a "'Water distribution business' means the business of operating a plant or system for the distribution of water for hire or sale." This presupposes the existence of a plant to operate. Construction, installing, and inspecting facilities for the purpose of operating a plant do not constitute operations of such facilities as expressly

> provided for under this statutory definition. Thus, it follows that money received as reimbursement for the cost of construction, installing, and inspecting facilities for the purpose of operating a water distribution system would not be within the operation of the Water District's distribution business.

Id. at 285-86, 365 P.2d at 245-46. The Court went on to explain that "the persons making the payments in question were not in the same category as that of water users, and they were not capable of becoming water users . . . until these additions or installations to the District's system were complete." *Id.* at 287, 365 P.2d at 246.

A few years latter, in *Kennewick v. State*, the Supreme Court was again faced with a water distribution service provider that was appealing the imposition of the PUT on amounts it received as reimbursement for capital improvements. This time, however, the amounts in dispute were received from existing water users.[3] In upholding the imposition of the tax, the Court distinguished its prior holding in *King County*. According to the Court, *King County* "involved reimbursements to the water district for installation costs which arose prior to the time any water was delivered or sold to the users. These reimbursements were not income from the operation of the 'business.'" *Kennewick* at 591-92, 409 P.2d at 139. By contrast, "[i]n the present case, the operation of the water system by the city is clearly within the purview of the public utility tax" in that the tax "is predicated upon the gross income received from the consumers for the utility service rendered." *Id.* at 592, 409 P.2d at 139.

King County and *Kennewick* stand for the proposition that capital improvements and similar activities may be included in the PUT if performed for an existing customer, but are outside the purview of the PUT if performed for someone who is not yet receiving the operating services of the utility. As we explained in greater detail in Det. No 00-080, 20 WTD 204 (2001):

> *King County* . . . held that gross income of a utility does not include payments for the purchase of access to a service (hook ups or extension lines) by a new customer or an old customer in a new location, or for amenities collateral to a service such as replacing overhead wiring with underground wiring. Such payments are paid in full by customers who vote for or request the specific enhancement and are not paid by all ratepayers as a whole. In those instances the utility is not receiving income for providing water.
>
> In contrast, charges for the construction of, or improvement to, the general distribution system . . . are part of providing water service. *Kennewick* held that revenues paid by the ratepayers which was enough to pay back not only the cost of operating and maintaining a water system but also enough to pay the principal

[3] The case involved three issues: (1) whether the utility owed PUT on amounts paid by existing water users for capital contribution; (2) whether the utility owed B&O tax on amounts paid by "prospective water users" for capital contributions; and (3) whether the utility owed B&O tax on amounts paid for sewer service. For purposes of this Determination we are concerned only with the first issue.

> and interest on bonds for capital construction were part of the consideration for purchasing water.

Id. at 209-10.

Rule 179(3)(e) was promulgated to recognize and implement the holdings of *King County* and *Kennewick*. With those cases in mind, it is evident that the items listed in the second sentence of that Rule ("line extensions, connection fees, line drop charges, start up fees, pole replacements, testing, replacing meters, line repairs, line raisings, pole contact charges, load factor charges, meter reading fees, etc.") are examples of the type of improvements to the distribution system that will generate gross income subject to the PUT when paid for by existing customers but not when paid for by new customers. Taxpayer's assertion that Rule 179(3)(e) was intended to create as distinction between "retail" services and "wholesale" services is simply not supported by the case law upon which the Rule was based. Therefore, we reject Taxpayer's claim that Rule 179(3)(e) exempts from the PUT the entire class of wholesale power distribution services.

C. Disputed Audit Adjustments . . .

As an alternative argument, Taxpayer asserts that the disputed amounts [related to income received by Taxpayer (1) from the sale of scheduling services; (2) from the sale of excess operating capacity reserve; . . . and (4) from the sale of excess transmission capacity . . .] are either not "gross income" subject to the PUT, or are deductible under RCW 82.16.050(9). . . . While there is considerable overlap relating to the proper tax treatment of each type of income . . . , the issues are diverse enough to prevent us from lumping them all together in a global analysis. As a result, we will analyze each separately.

1. Scheduling Services.

a. <u>Introduction.</u>

Taxpayer's transmission facilities constitute a control area that is connected at various points to other control areas. Taxpayer manages its control area from its dispatch center. One of the primary purposes of a dispatch center is the "scheduling" of power flowing into and out of the control area. The scheduling of power between connected control areas is a key ingredient in the wholesale transmission of electric power. As more fully explained by Taxpayer:

> If power is to be delivered from one control area to another, there must be a schedule. The schedule allows the two control areas to know how much power is being delivered at specific times. As each control area is responsible to match loads or power demands to power resources, transfer of power in and out of each control area must be exactly accounted for at all times.

. . . There are participants in the wholesale power market that do not own or manage a control area and have no ability to schedule power on their own behalf. These market participants must acquire scheduling services from utilities such as Taxpayer. In fact, scheduling is one of the enumerated "ancillary services" that must be offered as part of the open access to transmission facilities under Federal Energy Regulatory Commission (FERC) Order No. 888. *See* FERC Order No. 888, 61 Fed. Reg. 21,540, 21,581-82 (1996).[4] While Taxpayer is required to provide scheduling services, it is also permitted to charge nondiscriminatory rates for this service. The scheduling service income is recorded by Taxpayer under FERC operating revenue account number 451, miscellaneous service revenue. Taxpayer treats the income from scheduling services as exempt from the PUT. The audit staff has recharacterized this income as incidental to Taxpayer's light and power business activity. As such, the income is subject to the PUT.

b. <u>Scheduling is incidental to the wheeling of electricity and, as a result, is part of the gross income of a light and power business.</u>

[2] Gross income for purposes of the PUT is defined as "the value proceeding or accruing from the performance of the particular public service . . . business involved, including operations incidental thereto." RCW 82.16.010(12). A light and power public service business is defined as "the business of operating a plant or system for the generation, production or distribution of electrical energy for hire or sale and/or for the wheeling of electricity for others." RCW 82.16.010(5). "'Wheeling' is the activity of delivering or distributing electricity owned by others using power lines and equipment of the person doing the wheeling." Rule 179(3)(a).

Scheduling is not specifically listed as part of a light and power business. However, scheduling is a necessary component of the wheeling of electricity. *See* W.M. Warwick, *A Primer on Electric Utilities, Deregulation, and Restructuring of U.S. Electricity Markets: Version 2.0*, (May 2002) (hereinafter "*Primer*") at ¶ 4.1.1 (Wheeling power . . . needs to be managed so that power can be tracked as it flows from utility to utility across the grid.").[5] The wheeling of electricity could not be accomplished without accurate scheduling. If the scheduling service was bundled and sold as part of the wheeling of electricity taking place within Washington, it would be included as gross income of the utility doing the wheeling. We see no reason why the same service, when unbundled and sold as a stand alone "ancillary service" should be treated

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[4] Interstate transmission of power is regulated by the Federal Energy Regulatory Commission. The FERC was created by Congress in 1977 and is authorized to regulate the "transmission of electric energy in interstate commerce and . . . the sale of electricity at wholesale in interstate commerce." 16 U.S.C. § 824(b)(1). In 1996 the FERC issued Order No. 888, 61 Fed. Reg. 21,540 (1996). The stated goal of Order No. 888 was to "remove impediments to competition in the wholesale bulk power marketplace and to bring more efficient, lower cost power to the Nation's electricity consumers." FERC Order No. 888, 61 Fed. Reg. at 21,541. To achieve this goal, "FERC ordered 'functional unbundling' of wholesale generation and transmission services" and open access to transmission facilities. *New York v. F.E.R.C.*, 535 U.S. 1, 11, 122 S.Ct. 1012, 1019 (2002). According to the FERC, functional unbundling and open access were vital to a competitive marketplace. As part of Order No. 888, the FERC set out six categories of "ancillary services" that must be offered as part of the open access to transmission facilities. These six categories of ancillary services are (1) scheduling, system control, and dispatch services, (2) reactive supply and voltage control from generation sources service, (3) regulation and frequency response service, (4) energy imbalance service, (5) operating reserve – spinning reserve service, and (6) operating reserve – supplemental reserve service. FERC Order No. 888, 61 Fed. Reg. at 21,581-82.

[5] The *Primer* was published by the Pacific Northwest National Laboratory for the U.S. Department of Energy, Federal Energy Management Program. It is available on-line at http://pnnl-utilityrestructuring.pnl.gov/publications/Primer/primer.pdf.

differently. Thus, we conclude that scheduling is an activity incidental to the wheeling of electricity for others and if the service is conducted within this state it must be included within the gross income of a light and power business.

c. Taxpayer has not met all the elements necessary under RCW 82.16.050(9) to prove that the scheduling income is deductible.

[3] Having determined that scheduling is an activity incidental to the wheeling of electricity for others and that scheduling income constitutes "gross income" of a light and power business, we must next decide whether those receipts are deductible under RCW 82.16.050(9). That section provides that in computing the PUT "there may be deducted from the gross income . . . [a]mounts derived from the production, sale, or transfer of electrical energy for resale within or outside the state or for consumption outside the state."

Deductions from a tax statute are a matter of legislative grace and the person claiming the deduction bears the burden of proving that he or she qualifies. *Group Health Coop. v. State Tax Comm'n*, 72 Wn.2d 422, 433 P.2d 201 (1967). In the present case, Taxpayer must prove that the income it received from its scheduling activities was (1) derived from the production, sale, or transfer of electrical energy, and (2) the electrical energy produced, sold or transferred is acquired for resale or for consumption outside this state.

The record does not provide any evidence as to how the electrical energy being "scheduled" was put to use by the purchaser. In other words, there is no evidence that the scheduled electrical energy was purchased for resale or for consumption outside the state. Thus, Taxpayer has not met the second element necessary under RCW 82.16.050(9).[6] Therefore, no deduction can be allowed. *Group Health*, supra.

2. Operating Reserves.

a. Introduction.

[4] In order to maintain the integrity of the power supply system there is a need to have power generation capability kept in reserve. There are two different types of reserve: (1) operating capacity reserve (also known as "spinning reserve"), and (2) installed capacity reserve (also known as "supplemental reserve"). Installed capacity reserve "is usually supplied by power plants that are available for operations, but sitting idle." *Primer* at ¶ 4.1.4. Operating capacity reserve, on the other hand, is "provided by power plants that are actually operating, but at less than full capacity, hence the generators . . . are 'spinning'" at less than full speed. *Id.*

Operating capacity reserve is available on relatively short notice to add power to the power grid when necessary to meet unexpected demand, regulate voltage and frequency, or to provide other ancillary services necessary for the stable supply of electric power.

[6] We make no finding as to whether Taxpayer has met the first element required under RCW 82.16.050(9).

There is, as we understand it, an active market for operating capacity reserve. Taxpayer is a participant in this market, meaning that if Taxpayer has more operating capacity reserve than it needs for its own operations it can sell that excess reserve to other utilities that have a deficient reserve. The income received by Taxpayer from the sale of excess operating capacity reserve is reported as miscellaneous service revenues. Relying on its understanding that the PUT only applies to retail sales of electricity, Taxpayer treats this income as exempt from the PUT. The audit staff disagrees, finding that this income is incidental to Taxpayer's light and power business activity. We agree with the audit staff.

b. <u>Operating capacity reserve is incidental to the generation of electricity and is part of the gross income of a light and power business.</u>

In order to be considered "gross income" under RCW 82.16.010(12), income from the sale of operating capacity reserve must be directly or incidentally derived from the performance of Taxpayer's "business of operating a plant or system for the generation, production or distribution of electrical energy." There is no disputing the fact that operating reserves are of paramount importance to maintaining the reliability of the power supply system. In addition, operating reserves, both "spinning" and "supplemental," are listed in FERC Order No. 888 as two of the six ancillary services that must be offered on a competitive basis within the wholesale power market. *See* FERC Order No. 888, 61 Fed. Reg. at 21,580 (listing "Operating Reserve—Spinning Reserve Service" and "Operating Reserve—Supplemental Reserve Service."). Moreover, Taxpayer acknowledges that "[o]perating reserves are considered in the power industry to be a 'power product'" that can be sold "to other utilities or similar entities." . . . There is, in effect, a bona fide business purpose for producing and selling this "power product." Finally, without its electric power generation facilities, Taxpayer would not have excess reserve that it could sell on the wholesale market as a "power product."

After carefully considering the facts and circumstances surrounding the sale of excess operating capacity reserve, we conclude that it is a product or service that is incidentally connected to the production and distribution of electrical energy. As such, it is part of the Taxpayer's "gross income" for purposes of the PUT.

c. <u>Taxpayer has not proved that the income received from the sale of its excess operating capacity reserve is deductible under RCW 82.16.050(9).</u>

RCW 82.16.050(9) authorizes the deduction of amounts "derived from the production, sale, or transfer of electrical energy for resale within or outside the state or for consumption outside the state." Taxpayer must prove that the income it received from the sale of its excess operating capacity reserve is (1) derived from the production, sale, or transfer of electrical energy, and (2) the electrical energy produced, sold or transferred is acquired for resale or for consumption outside this state.

The record does not indicate how much, if any, of the excess operating capacity reserve sold by Taxpayer during the periods at issue was for resale by the purchaser or for consumption by the purchaser outside Washington. Thus, Taxpayer has not met its burden of proving the second element required under RCW 82.16.050(9).[7] For this reason, no deduction can be allowed.

3. . . .

4. Sale of Excess Transmission Capacity.

a. Introduction.

[5] Taxpayer enters into "Service Agreements" with [an entity] for access to [the entity's] transmission lines. . . . The Service Agreements specify, among other things, the amount of transmission capacity (*i.e.*, the amount of electricity that can be moved across the [entity's] transmission lines) and the rate charged for the service. For the two year period commencing October 1, 2001, the Taxpayer paid roughly $. . . to the [entity] under the terms of its Service Agreement with the [entity]. . . .

Taxpayer acquires transmission capacity from the [entity] for three primary reasons:

(1) To deliver power purchased from the [the entity] to Taxpayer's transmission and distribution system.
(2) To transport power from the Taxpayer's power generation facilities to its transmission and distribution system.
(3) To transport power purchased or sold on the open power market.

The contracts with the [entity] are tantamount to the pre-purchase of transmission capacity. The Taxpayer buys sufficient transmission capacity to provide for the transport of power for the highest capacity needed at any given time. Due to seasonal variances in supply and demand, the Taxpayer does not always need this full transmission capacity and is able to sell its excess capacity to third parties. Taxpayer accounts for the income from the sale of its excess transmission capacity as "other electrical revenue" (FERC operating revenue account number 456) which it excludes from the PUT. The audit staff recharacterized this income as "wheeling" income earned from Taxpayer's light and power business operations. While we do not believe the income in question is from "wheeling" as that term is defined in Rule 179(3)(a), we do find that the sale of excess transmission capacity is an activity incidental to Taxpayer's light and power business operations and uphold the audit staff on that basis.

b. The sale of excess transmission capacity acquired from the [Entity] is incidental to the distribution of electrical energy.

A significant part of Taxpayer's light and power business operations is the distribution of electricity to retail customers located in . . . County. Electricity sold by Taxpayer to its retail customers must first be transported from its source, across the transmission grid, to substations connected to Taxpayer's distribution facilities. Much of this electricity is wheeled across

[7] We make no finding as to whether Taxpayer has met the first element necessary for the deduction.

transmission lines owned by the [entity]. Taxpayer pays upwards of $. . . per year for what amounts to pre-paid transmission capacity from which it can receive electricity that has been wheeled across the [the entity's] transmission lines. Access to this transmission capacity is an essential part of Taxpayer's retail electric power distribution business.

Because electrical energy is difficult to store, and because it is difficult to plan for the exact amount of electricity needed at any given time, Taxpayer has contracted with the [entity] for sufficient transmission capacity to meet the highest capacity needed at any given time. When Taxpayer has more capacity than is needed, it is able to sell that excess capacity to third parties. There is no question that acquiring sufficient transmission capacity to meet its needs is an integral part of Taxpayer's power distribution operations. Further, we conclude that selling excess capacity is a natural and recurring consequence of Taxpayer's relationship with the [the entity] and the manner in which transmission capacity is procured. Because of this correlation between the need to acquire sufficient capacity and the ability to sell excess capacity, we find that income generated from the sale of excess transmission capacity is incidentally connected to Taxpayer's distribution operations. As such, it is part of the Taxpayer's "gross income" for purposes of the PUT.

c. <u>Taxpayer has not proved that income received from the sale of excess transmission capacity is deductible under RCW 82.16.050(9).</u>

As we have previously noted, RCW 82.16.050(9) authorizes the deduction of amounts "derived from the production, sale, or transfer of electrical energy for resale within or outside the state or for consumption outside the state." The deduction does not clearly apply to income derived from the sale of excess transmission capacity. The income at issue was not derived from the production, sale, or transfer of electrical energy. Rather, it was derived from the sale of a contractual right to use transmission facilities belonging to the [entity].

Furthermore, we have been presented with no evidence to suggest that the income from the sale of excess transmission capacity is being tax under the PUT more than once or that it is generated from the interstate sale or transfer of electrical energy. Because income generated from the sale of excess transmission capacity does not clearly come within the purview of RCW 82.16.050(9), no deduction can be allowed. Det. No. 02-0134, *supra*. . . .

DECISION AND DISPOSITION

Taxpayer's Petition is denied . . . .

Dated this 15th day of September, 2006.