



STATE OF CALIFORNIA  
**FRANCHISE TAX BOARD**  
**Legal Branch**  
 PO Box 1720  
 Rancho Cordova, CA 95741-1720  
 (916) 845-5245 Fax (916) 845-3648

KATHLEEN CONNELL  
 Chair

DEAN ANDAL  
 Member

B. TIMOTHY GAGE  
 Member

July 28, 2000

Chief Counsel Ruling  
 2000-02

\*\*\*\*\*

Dear \*\*\*\*\*:

Your joint letter of \*\*\*\*\*, requesting a legal ruling, has been referred to me for response.

**ISSUE**

Should electricity procured through the California Power Exchange (PX) solely on behalf of California default electrical consumers (described below), required to be sold at the PX price without a profit markup, be treated as a purchase and a subsequent resale of electricity to those consumers?

**FACTS**

\*\*\*\*\* (the ruling requestors) are public utilities regulated by the California Public Utilities Commission (Regulated Public Utilities, or RPU).

\*\*\*\*\* . Either or both of the requestors may have one or more entities in their respective affiliated groups which also sell electricity, but which are not RPUs. Those entities are not the subject of this ruling.

Under the new electric utility market structure that took effect April 1, 1998, RPUs were required by law to implement retail choice in their historical customer territory by giving consumers the ability to procure electricity directly from competitive electrical energy providers. Pursuant to Assembly Bill 1890, which established the legal framework for restructuring California's electric market, RPUs were required to divest themselves of all but a few of their regulated utility electricity generating properties. The RPUs are required to sell all generated electrical power from their remaining regulated plant facilities through the California PX until March 31, 2002. In addition, the RPUs are required to procure electricity through the PX and distribute it through their distribution lines to their former customers that have not elected a specific electrical energy provider (default electrical consumers). The RPUs do not specifically act as an agent for their default electrical consumers in that a purchase demand bid price for electricity is made by the RPU itself, and the RPU takes title to purchased electricity in bulk which is then transferred to its default consumers.

\*\*\*\*\*

\*\*\*\*\*

July 28, 2000

Page 2

The PX is a not-for-profit California public benefit corporation that administers an auction for the sale and purchase of electricity. It receives demand and supply bids, determines market clearing prices, serves as a scheduling coordinator, settles trades in the PX market, and prepares and sends invoices and facilitates funds transfer services for settlement and billing. The PX also establishes hourly spot prices for electricity. As an electricity exchange, the PX brings together qualified buyers and sellers but does not itself take title to the power, nor does it take any financial position in the marketplace.

The sellers into the PX system include unregulated energy providers, regulated energy providers not subject to regulation by the California Public Utilities Commission, as well as RPUs. While some sellers have specifically identified customers that have contracted to acquire power through the PX, power is also commonly sold to the default electrical consumers. Default electrical consumers acquiring power through the PX have no way of knowing the generation source of their electric power. Electricity billings such consumers receive do not identify a specific energy provider, although the RPUs will usually handle the energy delivery to the default electrical consumers through their power lines and do billing services.

Until at least March 31, 2002, the price that is charged to the default electrical consumer for its electricity consumption is the PX auction price; the RPUs cannot mark up the price of electricity. The RPUs receive a fee for energy delivery and billing services, for which the end consumer is separately charged. The RPUs are compensated for the cost of line loss and the uncollectible accounts of their default electrical consumers by means of PUC approved tariffs, which are added to the RPU's energy charges to their respective default consumers. The RPUs are compensated for the costs of billing and collection with no profit margin built into that function. Under PUC rules, the RPUs cannot use the default billing statements as a means of customer solicitation (e.g., by the use of advertising inserts) for other goods and services offered by the utility or its affiliates, unless it provides similar access to all.

## LAW AND ANALYSIS

Taxpayers who have income from business activities that are taxable both within and without the state must allocate and apportion their net income as provided in the Uniform Division of Income for Tax Purposes Act (UDITPA) contained in Revenue and Taxation Code sections 25120-25139. (Rev. & Tax. Code, § 25121.) Ordinarily, the business income of such a taxpayer must be apportioned to this state by multiplying the business income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four. (Rev. & Tax. Code, § 25128, subd. (a).)

The sales factor is defined in Revenue and Taxation Code section 25134 as

a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year.

\*\*\*\*\*

\*\*\*\*\*

July 28, 2000  
Page 3

Revenue and Taxation Code section 25120 defines the term “sales.” It states, in pertinent part:

(e) “Sales” means all gross receipts of the taxpayer not allocated under Sections 25123 through 25127 of this code.

Section 25137 provides, in part:

If the allocation and apportionment provisions of [UDITPA] do not fairly represent the extent of the taxpayer’s activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer’s business activity, if reasonable:

\*\*\*

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer’s income.

While sales of electricity by the RPU’s into the PX market are not sales to the PX, they are nevertheless sales to some end purchaser or consumer. Thus, they are properly considered in the sales factor denominator.

If sales of electricity by the RPU’s to their default electrical consumers could be marked up to provide a profit component at the customer level, or could otherwise be used to provide a market advantage, then sales by the RPU’s into the PX might be the equivalent of a wholesale market for electricity, with sales to the default consumers as the equivalent of a retail market. In such case, both kinds of sales might appropriately be in the sales factor. However, even in that event, sales into the PX in an amount equal to the purchases from the PX for resale to the RPU’s customers might be appropriate for something like intercompany transaction treatment.

However, in the present California regulated electricity environment (operative until March 31, 2002), the normal incidents of a sale, especially the benefits of profit, and risk of loss, are substantially absent with respect to the RPU’s default electrical consumers. In addition, there does not appear to be any significant potential for indirect economic benefit from such activity (e.g., special access to customers for solicitation of other products or services). Accordingly, we have concluded that under authority of section 25137, the electrical energy purchase by the default electrical consumer (as opposed to energy delivery and billing fees charged to that customer) will not be considered a sale of the RPU’s under Revenue and Taxation Code section 25120, subdivision (e), and should not be reflected as a sale for purposes of the sales factor described by section 25134.

HOLDING

\*\*\*\*\*

\*\*\*\*\*

July 28, 2000

Page 4

Under authority of section 25137, electrical power acquired for default electrical consumers through the California Power Exchange, at no markup and with no risk of loss, is not considered a purchase by the RPU of electricity and a resale of electricity by the RPU to the default electrical consumers for purposes of section 25120, subdivision (e), and section 25134.

Please be advised that the tax consequences expressed in this letter are applicable to the named taxpayers only and are based upon and limited to the facts submitted in the letter of \*\*\*\*\*, and in subsequent meetings and submittals. This ruling is contingent upon the accuracy of the facts as represented, and those facts are subject to verification by audit examination. As this ruling relates to circumstances which are subject to change as of March 31, 2002, this ruling is effective only until that date.

In the event of a change in relevant statutory, judicial, or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of Revenue and Taxation Code section 21012, subdivision (a)(1).

Sincerely,

Michael E. Brownell  
Tax Counsel IV