

BACKGROUND

Counsel represents Jonesport Power L.P. ("JPLP"), located in Calmody County, Virginia, and Mid-Atlantic Energy Partnership ("MAEP"), located in the City of Placide, Virginia. Both entities are independent (i.e., non-public utility) power producers.

JPLP is a cogenerator. Cogeneration facilities are defined in § 201 of the Public Utilities Regulatory Policies Act (PURPA) as (in substance) facilities that sequentially produce both electrical and thermal energy from the same source. *See* 16 U.S.C. § 796(18).

MAEP is an exempt wholesale generator, which is defined in 15 U.S.C. § 79z-5a as

any person determined by the Federal Energy Regulatory Commission to be engaged directly, or indirectly through one or more affiliates as defined in section 79b(a)(11)(B) of this title, and exclusively in the business of owning or operating, or both owning and operating, all or part of one or more eligible facilities and selling electric energy at wholesale. . . .

Until recently, the generating equipment of both entities was classified for property tax purposes as machinery and tools by the respective localities. Calmody County assessed JPLP's equipment at 10% of original cost, while the City of Placide assessed MAEP's equipment at 20% of original cost.

However, as a result of certain amendments to the taxation provisions of the Virginia Code, this generating equipment is now subject to centralized assessment by the State Corporation Commission. The equipment is currently being taxed by both localities at the real estate rate, pursuant to Va. Code Ann. § 58.1-2606(A), which provides as follows:

Notwithstanding the provisions of this section and §§ 58.1-2607 and 58.1-2690, all local taxes on the real estate and tangible personal property of public service corporations referred to in such sections and other persons with

property assessed pursuant to this chapter shall be at the real estate rate applicable in the respective locality.

This has resulted in abrupt and very substantial property tax increases for both JPLP and MAEP.

Both Calmody County and the City of Placide, recognizing the financial burden this has imposed on the two independent power producers, and also recognizing that such abrupt tax increases were not an intended consequence of the switch to centralized assessment, have indicated a willingness to consider the enactment of ordinances which would create separate classifications or subclassifications, for property tax purposes, for MAEP's and JPLP's generating equipment. Upon reclassification, taxing such equipment at a lower rate would clearly be permissible under Va. Code Ann. § 58.1-2606(C), which provides that "Notwithstanding any of the foregoing provisions, generating equipment which is reported to the Commission shall be taxed at a rate not to exceed the real estate rate applicable in the respective localities."

However, the localities have questioned whether they may permissibly create a classification that would apply only to the generating equipment of independent power producers such as MAEP and JPLP, and would not apply to the equipment of large public utilities. Commonwealth Electric & Gas ("CEG") has generating facilities in both Calmody County and the City of Placide, and the taxing jurisdictions would experience a substantial revenue loss if they had to extend the more favorable tax rates to public utilities as well.

ISSUE PRESENTED

Under Virginia law, may a local taxing authority create a separate classification or subclassification, for property tax purposes, consisting of the generating equipment of independent power producers, without having to extend the favorable tax rate afforded such a classification to the generating equipment of public utilities as well?

CONCLUSION AND DISCUSSION

Virginia statutory and case law make abundantly clear that the creation of a separate classification or subclassification, for property tax purposes, consisting of the generating equipment of cogenerators and exempt wholesale generators such as JPLP and MAEP, which would not include the generating equipment of public utilities such as CEG, would be permissible.

As a general matter, Virginia allows different rates of taxation on different classes of property. Va. Code Ann. § 58.1-3008 provides as follows:

58.1-3008. Different rates of levy on different classes of property

The governing body of any county, city or town in laying levies on taxable real estate, tangible personal property and merchants' capital may impose different rates of levy on real estate, merchants' capital, tangible personal property or any separate class thereof authorized under Chapter 35 (§§ 58.1-3500 et seq.), and machinery and tools, or it may impose the same rate of levy on any or all of these subjects of taxation. Such rates shall conform to the requirements set forth in such Chapter 35.

Moreover, the Virginia Code expressly recognizes that generating equipment of the type at issue here may be separately classified for property tax purposes. *See* Va. Code Ann. § 58.1-2606(C). See also Va. Code Ann. § 58.1-3506(A)(7), which provides as follows:

§ 58.1-3506. Other classifications of tangible personal property for taxation

A. The items of property set forth below are each declared to be a separate class of property and shall constitute a classification for local taxation separate from other classifications of tangible personal property provided in this chapter:

....

7. Generating equipment purchased after December 31, 1974, for the purpose of changing the energy source of a manufacturing plant from oil or natural gas to coal, wood, wood bark, wood residue, or any other alternative energy source for use in manufacturing and any cogeneration equipment purchased to achieve more efficient use of any energy source. *Such generating equipment and cogeneration equipment shall include, without limitation, such equipment purchased by firms engaged in the business of generating electricity or steam, or both.*

(Emphasis added.)

Indeed, Va. Code Ann. § 58.1-2600 separately defines a "cogenerator" as "a qualifying cogenerator or qualifying small power producer within the meaning of regulations adopted by the Federal Energy Regulatory Commission in implementation of the Public Utility Regulatory Policies Act of 1978."

While Title 58.1 of the Virginia Code does not include any express reference to the property tax treatment of exempt wholesale generators such as MAEP, the case law makes clear that the generating equipment of exempt wholesale generators, as well as that of

cogenerators such as JPLP, may properly be separately classified from the generating equipment of public utilities such as CEG.

It has been long recognized that legislative classifications for tax purposes are constitutionally permissible, so long as the classifications are not arbitrary. *See, e.g., East Coast Freight Lines v. City of Richmond*, 194 Va. 517, 74 S.E.2d 283 (1953); *Richmond Linen Supply Co. v. City of Lynchburg*, 160 Va. 644, 169 S.E. 554 (1933) (ordinance imposing \$300 license tax on nonresident laundry doing business in city, when license tax on local laundries was \$50, not unconstitutionally arbitrary). While taxation must be uniform within a particular classification, it need not be uniform as between or among different classifications. *R. Cross, Inc. v. City of Newport News*, 217 Va. 202, 228 S.E.2d 113 (1976).

Indeed, it has been said that classifications for tax purposes "are to be sustained whenever there is any fair basis for them. . . . [E]quality in taxation . . . is a dream unrealized [and] differences in methods may be in itself a basis for classification." *Richmond Linen Supply*, 169 S.E. at 556; *accord Commonwealth v. Whiting Oil Co.*, 167 Va. 73, 187 S.E. 498, 500 (1936) (classification for purpose of taxation is lawful if it rests on "any reasonable basis"); *City of Portsmouth v. Citizens Trust*, 216 Va. 695, 698, 222 S.E.2d 532 (1976); *cf. Southern Railway v. Commonwealth*, 211 Va. 210, 176 S.E.2d 578 (1970) (fact that assessment ratios of other short line railroads were not increased to 40% at same time such ratio was imposed on plaintiff did not constitute denial of equal protection, where such assessment on plaintiff's property was not "out of line generally" with assessment of other railroad properties in Virginia at that time).

More recent cases have held that the determinative criterion is whether a "rational basis" exists for different tax treatment. *See, e.g., Chesterfield Cablevision, Inc. v. County of Chesterfield*, 241 Va. 252, 401 S.E.2d 678 (1991). "Unless a 'suspect classification' is involved, the legislature may constitutionally treat different subjects differently for the purpose of taxation (1) if the difference is real, (2) if the distinction has some relevance to the legislative purpose, and (3) if the differing treatments are 'not so disparate, relative to the difference in classification, as to be wholly arbitrary.'" 401 S.E.2d at 680 (quoting in part *City of Portsmouth v. Citizens Trust*, 222 S.E.2d at 534).

Applying the foregoing to the issue before it, the *Chesterfield Cablevision* court employed a functionality analysis in reaching its conclusion that the county acted properly, and with a rational basis, in imposing a license tax on cable television service providers for the privilege of doing business in the county, while exempting broadcast television stations from the same tax. It quoted the United States Supreme Court in *Fortnightly Corp. v. United Artists*, 392 U.S. 390, 88 S. Ct. 2084, 2089 (1968), as follows:

The function of CATV systems has little in common with the function of broadcasters. CATV systems do not in fact broadcast or rebroadcast. Broadcasters select the programs to be viewed; CATV systems simply carry, without editing, whatever programs they receive. Broadcasters procure programs and propagate them to the public; CATV systems receive programs that have been released to the public and carry them by private channels to additional viewers.

A similar rational basis test and functionality analysis were employed by the Virginia Supreme Court in *Cox Cable Hampton Roads, Inc. v. City of Norfolk*, 247 Va. 64, 439 S.E.2d 366 (1994). There, the court upheld the validity, against an equal protection challenge, to a

city ordinance imposing a 7% tax on service billings by cable television providers, which was not applicable to operators of satellite TV systems. After noting that "[i]f the methods and character of businesses differ, such differences may be a valid basis for a tax classification," 439 S.E.2d at 368, the court looked to the functional differences between the two types of television service providers:

We hold that a rational basis exists because Cox Cable and SMATV vendors utilize different transmission methods to supply their programs, and this difference justifies the tax distinction. Cox Cable's franchise enables it to use utility facilities along the City's streets in its transmission system. Thus, it can furnish television service without the necessity of the additional equipment SMATV viewers must provide upon their premises. Additionally, Cox Cable can also offer local programming through its system while SMATV vendors cannot.

In our opinion, these differences provide a rational basis for the distinction between the taxation of Cox Cable's billings to its subscribers and the nontaxation of SMATV vendors' billings to their subscribers. Accordingly, we conclude that the City's tax did not violate Cox Cable's rights under the Equal Protection Clause.

Id. at 368-69.

Unfortunately, there is little or no reported Virginia case law applying the rational basis test and the functional analysis to the taxation of independent power producers vis-a-vis taxation of public utility power producers. *Cf. Hopewell Cogeneration Ltd. Partnership v. State Corp. Commission*, 249 Va. 107, 453 S.E.2d 277 (1995) (State Corporation Commission's disallowance, in utility rate case, of consideration of certain items paid to independent power producers under power purchase contracts not governed by utility's rate schedule and not approved by Commission or FERC, while not imposing such disallowance as to contracts that were so governed or approved, was not arbitrary, capricious, or an abuse

of power); *City of Richmond v. Commonwealth*, 188 Va. 600, 50 S.E.2d 654 (1948) (upholding validity of placing real and tangible personal property of public service corporations, including electric utilities, in separate tax classification from that of properties of individuals and other private corporations).

There are cases from other jurisdictions which address this issue, although for the most part indirectly or obliquely. In *City of Idanha v. Consumer Power, Inc.*, 495 P.2d 294, 300 (Or. Ct. App. 1972), the court upheld the validity of a municipal licensing/occupational tax ordinance applicable to all public utilities supplying or selling electrical energy within the city, but expressly not applicable to other public utilities.

There are substantial distinctions between the services offered, business organization employed, and regulations imposed by other governmental agencies upon an electric utility as compared with a bus company, a telephone company or cable television company. Whether it is wise or expedient, based upon such difference, to classify an electric utility in a class by itself is a legislative question to be determined by the lawmakers.

In *Appalachian Power Co. v. State Tax Department of West Virginia*, 466 S.E.2d 424 (W. Va. 1995), the court upheld the validity, against an equal protection challenge, of an electrical generation tax which was imposed upon entities that generated electrical power for sale, but which did not apply to manufacturers who generated power strictly for their own use. After initially noting that the proper test is whether the enactment is "rationally related" to a legitimate state interest (i.e., essentially the same as the "rational basis" test in the Virginia cases discussed above), the court elaborated on its holding:

Thus, the challenged provisions impose the generation tax on all entities who generate electricity to the extent of their "net generation." As we have noted, "net generation" is determined by subtracting station use from the total

electricity generated. Plaintiffs' complaint appears to be that equal protection is denied because for some electrical producers the deductible is the same as the total amount they produce. Thus, one could argue that the deductible effectively creates a classification between companies who generate electricity for resale and companies who generate electricity strictly for their own use at the generation site. We see no troubling discrimination here. The Legislature has simply seen fit to tax one activity--generation of electricity for resale--and to not tax another--generation of electricity for self-use. This distinction is commonplace.

Id. at 446.

In *North Georgia Electric Membership Corp. v. City of Calhoun*, 450 S.E.2d 410 (Ga. 1994), the court upheld the validity of a municipal gross receipts tax imposed on secondary suppliers of electric power "which [are] not otherwise paying a franchise fee pursuant to a franchise agreement." The court concluded (without elaborating on its rationale) that this constituted a permissible subclassification.

In *In re Opinion of the Justices*, 81 So. 2d 277 (Ala. 1955), the Alabama Supreme Court opined that a bill then pending in the state legislature which provided for a tax on the gross receipts of operators of electric or hydroelectric public utilities, but which exempted distributors and sellers of electricity whose business activities were not subject to regulation by the Alabama Public Service Commission, was not presumptively violative of the Equal Protection Clause of the Fourteenth Amendment. "Statutory discrimination between classes must be presumed to be relevant to permissible legislative purpose and will not be deemed to be a denial of equal protection if any state of facts could be conceived which would support it." *Id.* at 283. Because "no factual situations are presented," *id.*, the court did not discuss the application of this general principle to any particular controversy.

Clearly, a functional analysis similar to that in the cable television and other cases discussed above would provide a sound basis for a property tax subclassification of electrical generating equipment owned by independent power producers such as MAEP and JPLP, not applicable to the equipment of public utilities such as CEG (although JPLP is a cogenerator while MAEP is an exempt wholesale producer, the functional analysis as to both, vis-a-vis CEG, is essentially the same).

Unlike CEG, JPLP and MAEP are not franchised utilities and are not subject to the regulatory jurisdiction of the State Corporation Commission. Neither of the two entities sells the power it generates at retail. Instead, they sell power and generating capacity to public utilities such as CEG pursuant to long-term, fixed-price contracts. Thus, lacking a retail customer base, they cannot pass along to such customers any part of the greatly increased property tax burden they have incurred as a result of the centralized assessment scheme. CEG and similar public utilities can generally pass along increased taxes, in whole or in part, under Virginia's statutory and administrative rate regulation scheme.

Moreover, the technical specifications of the two entities' generating equipment also differ in very substantial ways from that of CEG (we defer to counsel and his clients in providing the particulars of these technical specifications, some of which, as to JPLP, were outlined in counsel's draft letter to Jonathan L. Quincey, Calmody County Attorney).

Taken together, all these factors indicate that the instant situation manifestly meets the three-part test for a "rational basis" for separate tax classifications outlined in *Chesterfield Cablevision, Inc. v. County of Chesterfield*. The functional differences between the

independent power producers and CEG are patently "real." Those differences are not only relevant to, but are indeed the very basis of, the legislative purpose in the proposed enactment of the classification ordinances by Calmody County and the City of Placide. That is, because MAEP and JPLP do not sell their power at retail, they cannot (unlike CEG) pass along to customers any part of the increased tax burden that has resulted from centralized assessment, and thus they are disproportionately affected by the new assessment regime. Finally, enactment of such ordinances by the localities would not result in such disparate tax treatment of the independent power producers and CEG as to be "wholly arbitrary."