State of Minnesota
Department of Revenue

In the Matter of the Proposes Rules of the Department of Revenue Governing the Valuation and Assessment of Electric, Gas Distribution and Pipeline Companies (Utility Companies)

STATEMENT OF NEED AND REASONABLENESS

The above-captioned rules are being proposed in order to update and revise the current Rules of the Department of Revenue Relating to Ad Valorem (Property) Taxes. The current rules have been in effect since 1975. They have been revised many times. Once in 1976, 1979, 1982, 1983, 1984, 1985, 1986, 1987, and again in 1988; however, it is the announced intention of the Department of Revenue to revise the rules whenever conditions, economic or otherwise, dictate a need for revision. It is now the opinion of the Commissioner of Revenue that the rules should be revised.

This document has been prepared as a verbatim affirmative presentation of the facts necessary to establish the statutory authority, need for, and reasonableness of the proposed new rules. It is submitted pursuant to Minn. Rule 1400.0500 requiring a Statement of Need and Reasonableness.

A Notice of Intent to Solicit Outside Information or Opinions in the preparation of these proposed rules was published in the State Register on February 21, 1989 (13 S.R. 2050). Additionally, an open forum type discussion meeting was held on February 23, 1989. This meeting was attended by members of the Department of Revenue together with county representatives and representatives of various utility companies. A list of those in attendance, the agenda, and meeting notes relative to this meeting is available in the Department of Revenue. Various suggestions and comments made at this meeting were received and duly considered by the agency.

Authority to Adopt Rules

Minn. Stat. 270.06(14) states that the Commissioner of Revenue shall: .."promulgate rules having the force and effect of law, for the administration and enforcement of the property tax;" The above captioned rules are encompassed within this authority.

Further, Minn. Stat. 270.11, Subd. 1 and 6 gives the Commissioner of Revenue the authority to review, modify, revise, raise or lower the assessed valuation of any real or personal property of any individual, co-partnership, company, association or corporation. The Commissioner of Revenue is also charged with the responsibility under Minn. Stat. 273.33, Subd. 2; 273.37, Subd. 2; and 273.38 of assessing the... "personal property, consisting of the pipeline system of mains, pipes and equipment attached thereto, of pipeline companies and others engaged in the operations or business of transporting natural gas, gasoline or other petroleum products by pipelines... transmission lines of less than 69kv, transmission lines of 69kv and above located in an unorganized township and distribution lines, (of electric companies) and equipment attached thereto, having a fixed situs outside the corporate limits of cities... the distribution lines, and the attachments and appurtenances thereto, (of electric companies)". Such assessments are best discharged through the promulgation of such rules as are being proposed here.

Adoption of Proposed Rules
Need and Reasonableness

The agency is currently proposing five revisions to the existing body of the ad valorem rules for utility property. These revisions concern Minn. Rules 8100.0300, Subp. 3, Cost approach, Minn. Rules 8100.0300 Subp. 4, Income approach, Minn. Rules 8100.0400 Subp. 2, Electric Companies, Minn. Rules 8100.0500 Subp. 4, Deduction of exempt property and Minn. Rules 8100.0600, Apportionment.

The first proposed change in the rules concerns the amount of depreciation which will be allowed as a reduction of the cost of the utility's property. There are several types of cost which are used in the appraisal of utilities:

1. Original Cost - Original cost is the actual cost of a property when it was first acquired or constructed.
2. Book Cost - Book cost is the original cost of a property less accrued depreciation.
3. Reproduction Cost - Reproduction cost is the present dollar cost to reproduce a replica of the existing property, i.e. what the property would cost today. Reproduction cost is obtained by trending known costs up or down, depending on whether current construction costs are greater or less than when the property was first constructed.
4. Replacement Cost - Replacement cost is the present dollar cost to replace a property with one having similar or equal usefulness.

The estimation of value by use of the cost approach requires the use of the proper type of cost, and then computing the loss in value due to depreciation.

Depreciation is made up of three factors:

1. Physical deterioration, which is the loss in value from original cost caused by normal use and wearing out of the property.
2. Functional obsolescence, which is a loss in value because of functional deficiencies or inadequacies within the property itself. Normally, functional obsolescence would result from technological changes which result in better, more efficient techniques.

3. Economic obsolescence, which is a loss in value caused by factors outside the property itself.

In the case of electric utilities the various elements of depreciation are considered by the Federal Energy Regulatory Commission which then specifies what rates of depreciation are to be used by the various utilities for different classes of assets.

The four major electric utilities operating within Minnesota are currently at the following depreciation level:

Original Cost of Plant in Service	$7,164,589,653
Accrued Depreciation	2,177,607,898
Net Cost of Plant in Service	4,986,981,755
Ratio of Depr. to Original Cost	(Approx.) 30%

The rules now in effect allow the electric companies a maximum of 20% depreciation plus 30% of any excess depreciation over the 20% maximum. The proposed rule would give the companies an allowance of 40% of the excess depreciation over the 20% maximum for assessment year 1990 and 50% of the excess for 1991 and subsequent assessment years. The difference between the companies' actual book depreciation and the maximum depreciation rate of 20% plus 40% or 50% of the excess depreciation is the agency's method of calculating a replacement cost for the utilities' property and also a hedge against inflation. This method of allowing depreciation also provides a reasonable residual value of 40% of cost even if the property is totally depreciated for regulatory rate setting.

Minn. Stat. 273.11, Subd. 1 requires that ..."all property shall be valued at its market value." With most types of property the concept of market value equates to replacement cost. The owner of a 22 year old three bedroom, 1000 square foot rambler does not have his property valued by the local assessor at the original cost of $20,000; neither does the assessor use book cost. The assessor would use some form of either reproduction or replacement cost. When the house was built in 1967 construction costs must have been approximately $20 per square foot; hence, the selling price, (market value, original cost) of $20,000. Today, inflation has pushed these same construction costs to $75 per square foot, so the market value or replacement cost of the property is $75,000.

The agency recognizes that a multimillion dollar utility does not sell in the same way a three bedroom rambler might. It also recognizes that in most instances the utility is limited in its earnings by its rate base; (rate base is normally original cost less depreciation). However, it is readily apparent that because of inflation the cost of replacing the facilities at today's prices would be more than the original cost at the time of installation. Our holding of the depreciation at a specified maximum attempts to recognize both the wearing out and obsolescence of the facilities together with the fact that to replace or reproduce the facility would produce more value. The agency believes that the proposed maximum depreciation allowance is a reasonable and viable method of accomplishing both these objectives.

The major pipeline and gas distribution companies have the following depreciation levels.

Original Cost of Plant in Service	$5,957,787,623
Accrued Depreciation	2,751,263,696
Net Cost of Plant in Service	3,206,523,927
Ratio of Depr. to Original Cost	(Approx.) 46%

The rules now in effect allow pipeline and gas distribution companies a maximum of 50% depreciation. We propose to retain this maximum but once more allow 40% of the excess depreciation over the 50% maximum for assessment year 1990 and 50% of the excess for 1991 and subsequent assessment years to be used as a reduction of the original cost of the plant in service. As with electric utilities, this is the agency's method of calculating a replacement cost for the utilities' property and also a hedge against inflation. This method also provides for a 25% residual value for fully depreciated property. The agency is aware of the difference between the depreciation allowed to electric companies and gas distribution and pipelines. We believe that because of the dissimilarity between the industries that the depreciation rates are proper. The electric industry is constantly updating and replacing its property so that overall depreciation rate is fairly low. In the pipeline industry, on the other hand, it is common practice to build a line and leave it in place for years. Since the pipes are normally buried they are not easily accessible as are electric wires. In addition, the state of the art in the pipeline industry changes much more slowly than in the electric industry. There are only so many ways you can design a pipe, while new and different ways for transmitting electricity are regularly being discovered. (Witness the change from transmitting electricity in A.C. form to the D.C. mode.) There is very little replacement and updating in the pipeline field. Minnesota has operating pipelines which were built in the 1940's. Most of the pipeline construction has been repair of existing lines or the addition of additional lines to increase capacity. Because of this longer life span of pipeline property, a larger depreciation allowance is necessary to adequately reflect the loss in value of the property. The same rationale holds true in most instances for gas distribution companies.

There are further considerations to be looked at as well. In recent years there has been more competition in the energy industries. Electricity competes with energy conservation measures that are becoming more common. Petroleum and natural gas competes with not only energy conservation but deregulation. Prices and supplies are being deregulated and must be more competitive making higher volumes necessary to warrant the same value for a pipeline. The larger depreciation allowance given is one of the agency's methods of recognizing this fact. We believe the proposal to be reasonable in its concept, and necessary if we are to find a realistic estimate of market value for these types of utilities.

The second change in Minn. Rules 8100 concerns adjusting electric utility property to take into account the effect of inflation on property values. This change is aimed at a specific type of electric utility asset, the major generating plants. The adjustment was accomplished through the use of a special study called the "Average Cost per Kilowatt of Installed Capacity."

The "Average Cost per Kilowatt of Installed Capacity" is a method of replacement cost which computed the national average cost of building a major generating plant. This average is then applied to all major plants operated by a utility. If the national average was higher than the original cost of the plant the original cost was increased to that of the average; if the national average was lower no adjustment was made.

While the "Average Cost per Kilowatt of Installed Capacity" is a method of computing replacement cost it does not consider the total cost of producing electricity. In some cases a plant that has a low "Average Cost per Kilowatt of Installed Capacity" will have a high average cost to generate a kilowatt hour of electricity. In addition the source of information used in computing the national average cost per kilowatt of installed capacity does not include all power plants to which the added value has been assessed. Therefore, we must consider the computation less reliable than it once was. We believe the proposal to repeal this part of the rule to be reasonable in its concept and necessary if we are to find a realistic estimate of market value for these types of utilities.

The third change in Minn. Rules 8100 is a change to the wording of the income indicator of value. The income indicator of value estimates the value of property by using the value of the various forms of capital of the utility. The "Income indicator of value" is estimated by weighting the earnings of the utility company for the most recent three years as follows: Most recent year, 40 percent; previous year, 35 percent; and final year, 25 percent. This value is then capitalized using a rate computed considering conditions that may exist in the future that may affect the present annual return. As presently written, the capitalization rates are recomputed each year and the resulting rates specified in the rules for electric companies, gas distribution companies and pipelines.

In the past the agency has used the capital structure of the utility, interest rates, yield of preferred stock and common stock and deferred taxes to compute the capitalization rate.

The agency does not intend to change the method of computing the capitalization rate. The language of the rule is updated to delete reference to the capitalization rates used in 1988 and specifies that a separate rate will be computed for each of the three types of companies. We believe this will aid in the understanding of the valuation methods and is reasonable and necessary to continue our equitable defensible valuation.

The fourth change in Minn. Rules 8100 is a clarification of our language requiring the inclusion of construction work in progress in the cost indicator of value. Costs associated with constructing utility property are not taxable until the parts are installed to the utility property. For instance pipe for a pipeline may be ordered and paid for before delivery to the construction site and after delivery it may be stored for a period of time before being physically installed in the pipeline by welding. The pipeline will not be considered taxable as a part of the utility until the pipe is actually welded to the pipeline and set in place in or on the ground. We believe the proposal is reasonable and necessary to provide for equitable valuations.

The fifth change in Minn. Rules 8100 is a change in the method of apportioning the Minnesota portion of the unit value to the taxing districts in Minnesota. The Minnesota portion of the unit value as adjusted under Part 8100.0500 is apportioned to the taxing districts using the original cost of the property. The rule 8100.0600 Subpart 2 specifies that certain information is required to be filed each year by the companies. Some of the information formerly required is no longer needed. Therefore, to eliminate unnecessary reporting we believe it is reasonable and necessary to delete references to information we no longer require.

In addition, we are proposing to change the calculation of apportioning value to the taxing districts. In computing the value to be apportioned to each taxing district the agency has used a complex calculation. This compares; (A) The last years market value plus the original cost of additions, minus the last market value of retired property to; (B) The last year original cost plus additions, minus retirements at cost multiplied by a percentage which specified in the rule and was 92.5% in 1988 and would have been 95% in 1989. The greater of (A) or (B) is added and divided by the Minnesota portion of the unit value as adjusted. This results in a percentage which is multiplied by (A) or (B) whichever is greater.

A review of the apportionment computer printouts shows that method (A) was used very little. This method had the effect of delaying a reduction in unit value if large retirements took place, or apportioning additional value to a property if additions greatly exceeded the prior years cost. Method (B) was used for almost all apportionment calculations. We believe that in order to fairly reflect the value of property in a taxing district the current original cost should be used and is a reasonable method to apportion value.

The Department of Revenue has determined that no business entity whose property is valued under these rules will qualify as a small business as defined by M. S. 14.115. The proposed rule changes will therefore not affect small businesses defined in this section of the Minnesota Statutes.

(8-14-89)