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MINNESOTA Department of Revenue

March 28, 1996

Maryanne V. Hruby, Director
Legislative Commission to Review Administrative Rules
55 State Office Building
St. Paul, Minnesota 55155-1201

Re: Proposed Rules of the Minnesota Department of Revenue Governing Valuation and Assessment of Electric, Gas Distribution and Pipeline Companies (Utility Companies); *Minnesota Rules*, parts 8100.0100 to 8100.0400

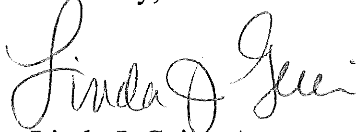
Dear Ms. Hruby:

The Minnesota Department of Revenue plans to publish a Notice of Hearing with regard to the above-referenced proposed rules in the April 1, 1996 edition of the *State Register*.

As required by Minn. Stat. §14.131, the department has prepared a Statement of Need and Reasonableness (SONAR). A copy of this SONAR is enclosed with this letter.
For your information, we are also enclosing a copy of the Notice of Hearing in this matter.

Please contact me if you have any questions.

Sincerely,



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Enclosures

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State of Minnesota
Department of Revenue

In the Matter of the Proposed 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

General Statement

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. The rules have been revised many times, the last time in 1990. 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 presentation of the facts necessary to establish the statutory authority, need for, and reasonableness of the proposed amendments to the rules. It is submitted pursuant to *Minnesota Rules,* part 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 July 24, 1995 and was mailed to the list of persons and associations who have requested, pursuant to *Minnesota Statutes*, sections 14.14, subd. 1a, and 14.22 or 14.30, that their names be placed on the State Department of Revenue rulemaking mailing list. In addition, on July 24, 1995 a copy of the notice was mailed to all utility companies whose values are determined by these rules and all county assessors in order to give notice to all persons affected by the changes.

Statutory Authority to Adopt Rules

Minnesota Statutes, section 270.06(14) authorizes the Commissioner of Revenue to "... make, publish, and distribute rules for the administration and enforcement of assessment and fees administered by the commissioner and state tax laws."

Further, *Minnesota Statutes,* section 270.11, subdivisions 1 and 6 give 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. In addition, the Commissioner of Revenue is charged with the responsibility under *Minnesota Statutes,* sections 273.33, subdivision 2; 273.37, subdivision 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, crude oil, or other petroleum products by pipelines . . ."(Minn. Stat. § 273.33, subd. 2); ". . . [t]ransmission 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. . ."(Minn. Stat. § 273.37, subd. 2). Such assessments are best discharged through the making, publishing and distribution of such rules as are being proposed here.

Minnesota Statutes, Section 14.131 Requirements

(1) Minnesota Rules, parts 8100.0100 through 8100.0700 provide for the valuation and assessment of the operating property of utility companies. These utility companies include electric companies, gas distribution companies, and pipelines. The proposed rules change the values set for property tax purposes and, therefore, change the amount of property tax assessed to the utility companies. The proposed rules will indirectly affect the property taxes assessed to other property owners in each local taxing district in which the property is located. The proposed rules will not change the method of computing the property tax values for operating property of electric cooperative companies. Some of the proposed rules will reduce the property tax for certain companies and others will increase the property tax for some companies.

(2) The Department of Revenue will not incur additional costs in enforcing the proposed rules. The Department of Revenue does not contemplate any other agency being affected by the proposed rules.

(3) & (4) The purpose of the proposed rules is to estimate the value of the operating property of the utility companies. Since we do not anticipate any additional costs to any utility company, the Department of Revenue, or to any local unit of government in order to administer these rules, there is not a less costly way to achieve the purpose of the proposed rules. The present economic conditions were considered and the Department of Revenue deems the proposed rules to be necessary based on those economic conditions.

(5) There will be no additional costs to the utility companies to comply with the proposed rules. The only change will be a shift in property taxes. This shift in property tax will vary from company to company.

(6) Since the Federal Government does not have a property tax, there are no Federal Regulations setting values of property. To the knowledge of the Commissioner these rules do not conflict with any federal law regarding limits on taxation.

Additional Notice

In order to disseminate information on the proposed rules to all interested parties, in addition to sending the information to the Department of Revenue's agency rulemaking mailing list, the Department of Revenue will also send the information to all county assessors, all utility companies whose property is valued under these rules, and to an additional list of persons who

have expressed interest in the valuation of utility property. In addition, it is the department's understanding that the county assessors will disseminate the information to other interested parties in the local governments.

Witnesses

If adoption of these rules requires a public hearing, the witnesses listed below may testify on behalf of the Department in support of the need for and reasonableness of the rules. The witnesses will be available to answer questions about the development and the content of the rules.

Alan G. Whipple, Manager
State Assessed Property Section
Property Tax Division
Minnesota Department of Revenue
10 River Park Plaza
St. Paul, MN 55146-3340

Any other employee of the Department of Revenue

Rule-by-Rule Analysis

Minnesota Rules, parts 8100.0100 through 8100.0700 are used to set the value of utility operating property for property tax purposes. Periodically, the Department of Revenue reviews the rules and the economic conditions of the industries valued by these rules to determine if they still result in a reasonable value. At this time the following changes are deemed reasonable and necessary by the Commissioner in order to bring the assessment of utility properties in line with economic conditions under which they currently operate.

- **Changes to Definitions.** The first change is to update the definitions in *Minnesota Rules,* part 8100.0100. A new subpart 5a is added to define "Earnings Growth Rate," which is used in *Minnesota Rules,* part 8100.0300 in the development of the income indicator of value. *Minnesota Rules* 8100.0100 subpart 17, the definition of "Weighted Pipe Line Miles" is repealed in these amendments. This definition is no longer needed because of the change in allocation of pipeline value in *Minnesota Rules,* part 8100.0400, subpart 4. Upon adoption of these rules, the Department will no longer use weighted pipeline miles to allocate value. These changes to definitions are reasonable and necessary in order to be consistent with other changes made to the rules.

- ***Minnesota Rules,* part 8100.0200. Introduction.** This provision is revised to state the effective date of the changes -- assessment year 1996, and also provides an explanation of what the rules do. The changes are needed and reasonable to state the purpose and date of the rule changes.

- *Minnesota Rules*, **part 8100.0300, subparts 3 and 4.** The weighting of the cost indicator of value for electric companies should be changed from 85% to 75% due to changes in the industry. Also, a change to *Minnesota Rules,* part 8100.0300, subpart 4 is made to change the weight of the income indicator of value from 15% to 25%. These two changes must be made together. This rule change is proposed due to changes the Department has observed in the electric industry. Competition is and will be increasing in the electric industry due to changes mandated by Federal Legislation.

  The following explanation is provided by Robert J. Dolan of Northern States Power Company in a letter dated October 3, 1994 regarding the change in the electric industry:

  "Federal legislation has mandated competition between energy suppliers virtually eliminating the monopoly status previously enjoyed by the utility industry. The price utilities had to pay for the privilege of having a monopoly was regulation. While operating under a monopoly status the utility was not allowed to set the price of their product that would produce the greatest economic return while managing to keep the cost of energy at its lowest possible level but had to comply with the regulatory agencies who ultimately determined the price structure.

  While utilities remain regulated at both state and federal levels it no longer enjoys the economic benefits of a monopoly. The price structure remains determined by state agencies despite the inevitable and increased competition. Electric utilities face the prospect of lowering their prices in a time of escalating costs in order to retain customers. "Over the past five years, however, the region's (Minnesota, the Dakota's, Iowa, Missouri, Nebraska and Kansas) electric rates have fallen nearly 1 percent -- making it the only region to see such a decline in overall electric rates in that period."[1]

  The effect of competition, while still being regulated, has and will continue to have a negative impact on a utility's Net Operating Income. Erosion of a utility's revenue stream, according to Mr. Daniel Scotto, senior managing director of corporate bond research of Bear Stearns & Co., "is sufficient to warrant a ratings downgrade, since utilities traditionally have enjoyed lower credit scores vis-à-vis industrial companies because of the revenue 'assurance' conveyed by regulations."[2] A credit rating reduction resulting from loss of income, of course, has a serious impact on the value of a utility.

  Since 1987, investment in utility plant and equipment at Northern States Power Company (NSP) has been reduced significantly because of conservation and more accurate energy forecasts. The effect of the reduction in capital expenditures over the past few years has reduced the level of difference between Cost and Income that had for many years been the norm.

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[1] Fortnightly, June 15, 1994
[2] Fortnightly, June 15, 1994

NSP, like the utility industry, continues to be a capital intensive company, but the difference between Cost and Income has never been less pronounced. As mentioned previously, Market Value based on Income is what a prudent investor will spend to gain control of a stream of Income. A prudent investor will only invest in property if he can be assured of a reliable, stable and predictable income stream."

Another change which has been discussed by federal and state regulators is open competition. This would primarily have an effect on companies that are large energy users and able to bid on large amounts of electricity. When this action is in effect competition could reduce the income of electric companies. Other trends in the electric industry is that companies other than electric utilities are now building electric generating plants. These plants make the electricity generated available to electric utilities or other purchasers depending on circumstances. Some companies are building generating plants for internal use and if there is excess generation they sell it. An electric generating plant which generates electricity for internal use and not for sale to others is not subject to property tax.

Due to the these changes in the economic climate of electric companies we deem it necessary and reasonable to amend the weightings of the income and cost indicators of value for electric companies.

- A second change to ***Minnesota Rules*, part 8100.0300, subpart 4,** is the addition of the Earnings Growth Rate in computing the Income indicator of value. As explained in the definition, the Earnings Growth Rate is the average growth in earnings over the last five years of the industries covered by the capitalization rate study.

In computing the capitalized earnings indicator of value we use the last three years income from operations. This net income is weighted at 40% for the latest year, 35% for the second year, and 25% for the third year. In choosing an income stream to capitalize, most experts recommend using an estimate of future income. Differences between historical income and any estimate of future income often exist. One of the reasons for the difference is, "construction in progress". Regulated utility companies are not allowed to earn on "construction in progress".

The Department of Revenue recently had the Finance Department of the Carlson School of Business, University of Minnesota study the valuation of Railroads and Utility companies for property tax purposes. The report issued as a result of this study made one recommendation regarding the capitalization of income. This recommendation is to add an "earnings growth rate" to the capitalization of income. The earnings growth rate is a method to bring historical earnings more closely to the estimate of future earnings. In order to convert the last three years income into an estimate of next year's income we take the earnings growth rate and square it, and add 1 times the weighted income from each of the three years. The result if it had been applied to the 1995 assessment would have been an increase in value of approximately .15%. Because we use historical income it is reasonable and necessary to use the earnings growth rate to convert the income to the estimate of future income.

It will be possible for the earnings growth rate to be either positive or negative. If utility company earnings in general decrease, the earnings growth rate will be negative and conversely as earnings increase, the growth rate will be positive.

This rule will have a small effect, as related above (.15% increase in value if this change had been in effect for the 1995 assessment year), on all the companies for which the unit valuation method is being used and the counties receiving the values, except for the few companies with a negative income indicator of value. The example of the income indicator at the end of this subpart is changed to reflect the addition of the earnings growth rate.

- Another change to ***Minnesota Rules*, part 8100.0300, subpart 4** is the repeal of Deferred Taxes from the computation of the capitalization rate. We have chosen to delete this component of the capitalization rate.

- The next change to ***Minnesota Rules,* part 8100.0300, subpart 4** is to change the weighting of the income indicator for electric companies to 25%. This is concurrent with the change to *Minnesota Rules*, part 8100.0200 that changes the cost indicator for electric companies to 75%. The need and reasonableness for this change is the same as the change to the weighting of the cost indicator.

- ***Minnesota Rules,* part 8100.0300, subpart 7** is being repealed. This provision was enacted because of the threatened cut-off of crude oil and natural gas from Canada. The cut-off did not happen and the threat was revoked. Because the threat is no longer in effect, it is reasonable and necessary to repeal this rule.

- ***Minnesota Rules,* part 8100.0400, subpart 4, Allocation of Value of Pipeline Companies.** The pipeline industry has undergone changes in the way they do business. These changes include a requirement that pipelines that formerly were merchants of products such as natural gas are now almost solely transporters of the gas for others. This change was required by the Federal Energy Regulatory Commission. Our current allocation of pipeline company value is 75% cost, 5% revenue and 20% pipeline inch miles. These factors appeared to be viable when pipelines were merchants but are not as relevant when the pipelines are mostly transporting product for others.

In order to determine if the allocation factors should be changed we have looked to various papers and manuals relating to unit valuation and allocation of the value among the various states. One reference source is the "Appraisal Handbook" published by the Western States Association of Tax Administrators, Committee on Centrally Assessed Property. This handbook provides the following guidance on allocation value.

There were originally five guidelines published in 1949 intended for use primarily for the allocation of railroad property. In 1960, a sixth guideline was added to make them relevant for

public utility property also. The guidelines, taken from the "Appraisal Handbook," are as follows:

1.) "That a workable formula suitable for application in all states is desirable, to the end that the aggregate of the allocation percentages of a system (the parts in the various states) should equal 100%.

2.) That a precise and theoretically correct formula of allocation is probably not ascertainable.

3.) That a formula should be simple of application and should not require unreasonable burdensome calculations.

4.) That it should be based on data that is readily available from the taxpayer's existing records and statistics.

5.) That the factor and weighting chosen should lead to a plausible conclusion that the allocation formula divides the system value in proportion to the contributions of the several states to such value.

6.) Allocation factors 'in themselves' should not be allocations. Any factor which has been derived from another factor is objectionable in that it accumulates error and may become entirely unrealistic."

Many other valuation experts have written and spoken about similar guidelines over the years. The guidelines may be worded differently but in general, the meaning of the guidelines is the same.

When selecting factors to be used to allocate the value, there are 'use' factors and 'property' factors. Examples of use factors in pipelines are throughput and revenue. Examples of property factors are cost or pipeline miles. Recommendations for the weighting of the factors are: 75% to 90% property factor, and 10% to 25% use factor.

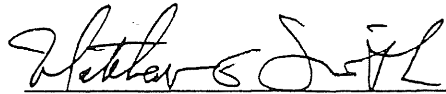
The Department of Revenue has, in the past, used revenue, which largely is assigned based on delivery point. However, due to the changes in the operation of pipelines from merchants to providing a transportation service, the Department has chosen to use an allocation use factor which reflects more accurately the value of transportation service.

After considering all of the above factors the Department is asking that the pipeline allocation be changed to 75% cost and 25% throughput. In the Department's judgment, the throughput factor will meet all of the suggested requirements for allocation of value. This change is necessary to reflect changes in the operations of pipelines and reasonable because it reflects actual use of a pipeline.

Conclusion

Based on the foregoing, the Department of Revenue's proposed rules are both necessary and reasonable.

3/27/96
Date



Matthew G. Smith, Commissioner
Minnesota Department of Revenue