Review of Utility and Pipeline Valuation:

Project Stakeholder Engagement Update

4/24/2023

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Introduction

A 2021 law directed the Department of Revenue to review the process and rules for valuations of utility and pipeline operating property.[1] Revenue values this property under Minnesota Rules, Chapter 8100 (Rule 8100). We certify the values to counties, which calculate, bill, and collect property taxes.

As part of this review, Revenue held a series of public meetings to gather feedback. These listening sessions and workgroup discussions included local government officials, representatives of utility and pipeline companies – including lobbyists and attorneys – state regulators, and other stakeholders.

This report provides an overview of the valuation process for utility and pipeline property in Minnesota, and outlines the process, findings, and potential changes from our discussions with stakeholders.

On April 17, 2023, we shared a draft version of this report to members of the working group and asked for feedback. We did not receive any response.

Utility and Pipeline Valuation

In Minnesota, all property must be valued at its market value and must be separately and independently valued. Generally, property is valued and assessed by the local taxing authorities. The Legislature created several exceptions to this arrangement of local valuation, one of which is the valuation of utility and pipeline systems.

The Department of Revenue must annually list and assess the personal property of utility and pipeline systems as of January 2 of the assessment year. Revenue then must provide these values to the various taxing jurisdictions in which the property is located.

Instead of providing an individualized valuation, the Legislature has adopted a unit-value method for the valuation of the property of railroads, utilities, and pipelines for tax purposes. The unit-value method values the entirety of a business, including all property, as a going concern when the business enterprise is located within more than one jurisdiction.

Revenue promulgated Rule 8100 regarding the ad valorem taxation of utility and pipeline systems. The rule lays out a four-step valuation and allocation process. Under this process, each year Revenue:

1. Establishes an estimate of the unit value for each utility company. For details on this step, see Capitalization Rates and Unit Value on the next page.
2. Allocates a portion of the unit value to Minnesota.
3. Subtracts the value of property in Minnesota that's exempt from property tax or locally assessed.
4. Apportions the remaining Minnesota value to the various taxing districts where the utility or pipeline property is located and certifies these values to the districts.

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[1] Minnesota Session Laws 2021, 1st Special Session, Chapter 14, article 6, section 20 – Review of Utility and Pipeline Valuation Process. The law reads: *The commissioner of revenue shall initiate a review of the framework for valuations of property described in Minnesota Statutes, sections 273.33, 273.35, 273.36, and 273.37, including the methodology for valuations prescribed in Minnesota Rules, chapter 8100.*

As part of this process, Revenue sends an Order of Value to each utility and pipeline valued under Rule 8100 setting its apportionable value as of January 2. With the order, we include a report that explains how we calculated the apportionable value using the formula in Rule 8100.

Capitalization Rates and Unit Value

To determine a utility or pipeline company's unit value, Revenue relies primarily upon a mix of the cost and income methods of property valuation.

To estimate a value under the cost approach, Rule 8100 uses original cost less depreciation plus the cost of improvements and other costs to the system, as provided for in the rule.

To estimate value under the income approach, Rule 8100 starts by calculating the utility's net operating earnings based on its earnings from the last three years before the assessment date. Next, the net operating earnings is capitalized into a value by applying a capitalization rate that's computed by using the band of investment method.[2]

Revenue publishes the [Capitalization Rate Study] to document the rates and show how they were calculated for all utility and pipeline companies operating in Minnesota. We release an initial draft of the study in March to allow public review and comments before finalizing the study. We typically host a Spring Forum where Revenue staff, stakeholders, and others gather to discuss the draft study. We also accept written comments and concerns.

Before finalizing the Capitalization Rate Study, Revenue reviews and considers the public's comments. The final study lists the public's comments and concerns and, where appropriate, adjusts the final rates.[3]

To arrive at a unit value for each company, Revenue weights the income and cost approach indicators of value equally. Rule 8100 allows us to adjust the weightings and make other adjustments within the process as needed to determine the market value.

Administrative Appeals

If a utility or pipeline company does not agree with the Department of Revenue's Order of Value, they may appeal. These taxpayers may appeal administratively to Revenue or directly to the Tax Court.

Until a law change in 2017, Revenue was unable to enter into binding settlement agreements with taxpayers during an administrative appeal.[4] The current administrative appeals process began in 2018.

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[2] Minnesota Rule 8100.0300, subpart 4(E), directs Revenue to annually compute capitalization rates using the band of investment method. This method considers the: capital structure of utilities; cost of debt or interest rate; yield on the preferred and common stocks of utilities; and the risk-free rate, relative risk, and risk premiums for public utility companies. Capitalization rates are calculated for electrical, gas distribution, and fluid pipeline companies, and for natural gas transmission systems. (Retrieved from https://www.revisor.mn.gov/rules/8100.0300)

[3] See Appendix A for a more-detailed description of how Revenue determines capitalization rates.

[4] Minnesota Session Laws 2017, 1st Special Session, Chapter 1, article 15, sections 20-23. (Retrieved from https://www.revisor.mn.gov/laws/2017/1/Session+Law/Chapter/1/)

For details and context of the changes, see Minnesota Department of Revenue's 2017 Property Tax Law Summary (pp 16-19), available online at https://www.revenue.state.mn.us/sites/default/files/2018-11/lawsummary_17.pdf.

Since the change, the number of appeals to Tax Court has dropped significantly. We've been able to resolve far more of these cases in an administrative appeal now that Revenue has authority to settle these matters, as shown in Figure 1 on the next page.

Figure 1: Valuations and Appeals – 2016-2022

Assessment Year	Rule 8100 Valuations	Administrative Appeals	Tax Court Appeals
2016	102	18	11
2017	103	15	12
2018	102	14	14 (8 did not first administratively appeal)
2019	104	19	7 (3 did not first administratively appeal)
2020	104	19	4 (1 did not first administratively appeal)
2021	105	19	3
2022	105	20	4 (1 did not first administratively appeal)

Stakeholder Engagement

To ensure this review of utility and pipeline property valuations was as meaningful as possible, the Department of Revenue partnered with the Office of Collaboration and Dispute Resolution (OCDR) within the Department of Administration. OCDR helped facilitate and gather feedback from our discussions with members of local government, representatives of utility and pipeline companies, including lobbyists and attorneys, state regulators, and other stakeholders.

The review of Rule 8100 was conducted in two phases:

1. **Listening Sessions (October – December 2021):** Virtual listening sessions with stakeholders to gather feedback, enhance mutual understanding, and discuss Rule 8100 and related statutes. These sessions focused on stakeholders' values, principles, and priorities.

2. **Workgroup Discussions (June -October 2022):** Workgroup discussions with stakeholders that reviewed the administrative processes and methodology.

Phase 1: Listening Sessions

The Department of Revenue invited more than 400 stakeholders to participate in listening sessions to help us better understand their interests. The listening sessions helped inform our review and next steps as Revenue continues the process.

We held seven 90-minute listening sessions in October and November 2021 and one supplemental 60-minute listening session in January 2022. Each session included 15-20 public- and private-sector stakeholders. About 100 individuals participated in at least one listening session, including:

- 55 stakeholders representing 31 pipeline and utility companies, cooperatives, and associated lobbyists and law firm representatives

- 47 stakeholders representing local governments, local government associations, and the Legislature

Representatives from some utility companies and local governments participated in more than one session.

Revenue and OCDR developed the session agendas by topic areas that were identified as of interest to stakeholders: aspects of the current valuation system that are working well, aspects that could work better, the timing of the valuation process, and resources required from stakeholders.

Findings

Stakeholders shared things they like and dislike about the valuation process, and they were asked to rate the relative importance of core tax principles in relation to that process.

Valuation Process

Stakeholders mentioned several strengths – and some possible improvements – with Rule 8100 and Revenue's administration of the rule. These include the administrative appeals process, discretion, communication, and timeline.

- **Administrative Appeals Process**: Overall, stakeholders express positive views of the current administrative appeal process, after it was strengthened by law changes in 2017. They appreciate the process and its ability to solidify valuations within the assessment year. However:
    - Timing of the appeal process is still concerning to local governments – especially those where utility and pipeline property make up a large share of the total tax base.
    - A few utility and pipeline companies shared a desire for additional information on unprincipled settlements that result from the appeal process.
- **Discretion:** Stakeholders see the discretion for valuing pipeline and utility property provided in Rule 8100 as both a strength and a weakness. The discretion provides flexibility to allow for the most accurate assessment of value, but also can be a point of disagreement between Revenue and utilities.
- **Communication:** Generally, stakeholders appreciate the different communication channels Revenue has developed over the years to keep companies and local governments informed. These include:
    - Revenue's annual fall and spring forums to discuss topics related to state assessed property. These programs are open to everyone, but some stakeholders did not know about the events.
    - Revenue's online Virtual Room to securely share updated company valuations during the appeal process so counties can monitor for potential tax base implications. We worked with local governments to develop this application in 2019.
- **Timeline:** Competing deadlines create a tension between valuing utility and pipeline property and the administrative appeals process. Companies want more time to file with Revenue, but local governments have statutory deadlines to send Truth in Taxation notices. The timeline to complete all of this work does not provide additional space and can create stress for all parties.

Tax Principles

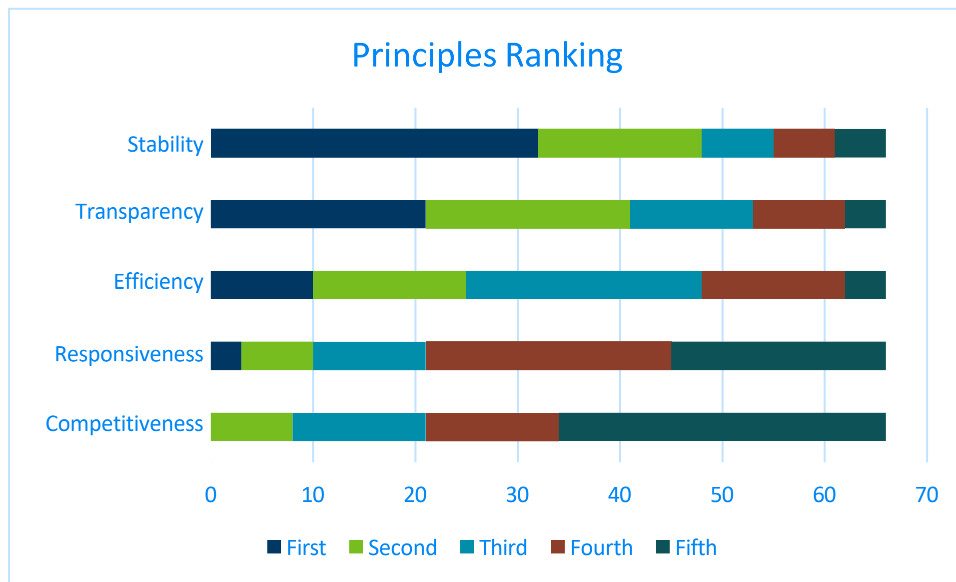
At each listening sessions we asked stakeholders to rate five tax principles from most to least important:

- **Stability:** The tax should provide stable revenues over the economic life cycle. Significant unexpected changes in tax laws, tax bills to taxpayers, and revenues to governments should be minimized.
- **Transparency:** Taxpayers should understand how their tax is determined, which governmental unit is responsible for the tax, and what services are funded by the tax.

- **Efficiency:** The tax should maximize voluntary compliance and minimize administrative costs, compliance costs, and economic distortions caused by tax-motivated behavior.
- **Responsiveness:** Tax due should change with changes in value. Lags in the system between a market change and a corresponding tax change should be minimized.
- **Competitiveness:** The tax should improve the competitiveness of Minnesota relative to other states and nations.

Participants ranked stability and transparency as the two most important principles for the valuation process. Local governments and companies both value a tax system that prioritizes stability for valuations from year to year. Figure 2 shows the full rankings from the 66 listening session attendees who participated in the survey.

Figure 2: Tax Principles Ranking



Phase 2: Workgroup Discussions

The Department of Revenue and Office of Collaboration and Dispute Resolution (OCDR) held workgroup discussions with stakeholders to further review the valuation of utility and pipeline property and to discuss the feedback shared during the listening sessions.

Two workgroups were formed to focus on the valuation process and the methodology prescribed by Rule 8100. The workgroups met every two weeks for 90 minutes.

Participants included representatives from Xcel Energy, CenterPoint Energy, Enbridge Inc., Association of Minnesota Counties, League of Minnesota Cities, Minnesota Association of County Officers, Coalition of Utility Cities, and other stakeholders. The Minnesota Rural Electric Association declined to participate.

Process Workgroup

The goal of the process workgroup was to understand various perspectives and interests related to the valuation timeline, administrative appeals process and timeline, and other administrative aspects identified in Phase 1.

Valuation and Appeals Timeline

Stakeholders and Revenue shared the same desire to have information sooner and general resource management constraints under the valuation and appeals timeline, shown in Figure 3.

Figure 3: Key Dates in the Timeline

Utility and Pipeline Assessment – Important Dates	
November – December	Revenue sends updated property record reports to companies to complete for the assessment.
January – May	The assessment date for property in Minnesota is January 2. Revenue completes the Capitalization Rate Study. We post the draft study with an open comment period in early March. The Spring Forum is held around the midpoint of the comment period.
March 31	Deadline for companies to submit the Utility and Pipeline Market Value Report and Utility and Pipeline Property Record Report; they may request up to a 15-day extension if they can show good cause. Revenue uses information from these reports to complete each company's valuation and allocate its taxable property within Minnesota.
March - July	Revenue completes and sends property valuations and apportionment information to companies. **Note:** We send Cost Less Depreciation Valuations earlier because they are often filed earlier and do not use an income approach (and thus do not need a capitalization rate, unlike unitary valuations which cannot be finished until after the Capitalization Rate Study).
July 15	Revenue sends Utility and Pipeline Equalized Orders to county auditors and assessors. These corrected certified values include the parcel-specific changes as well as changes related to administrative appeals.
October 1	Revenue sends corrected utility and pipeline values to counties.
December 31	Revenue issues corrections to utility and pipeline values for clerical errors.

Local governments would like to receive the certified values from Revenue sooner. However:

- To accomplish this, Revenue would need utility and pipeline companies to file their Market Value and Property Record reports sooner. (We use these reports to complete the valuations.)
- To complete their Market Value and Property Record reports, companies need information from their other regulatory filings and financial reports.

These constraints in the timeline make it difficult for either Revenue or utility and pipeline companies to complete their work any earlier than they do now.

Workgroup participants brainstormed potential options for adjusting the timeline, including:

1. Shortening the appeals timeline
2. Adjusting county property tax deadlines
3. Extending the timeline by 1 year

Shortening the Appeals Timeline

Under the current timeline, Revenue completes and sends the Order of Value notices to the companies between March and July. A company can request an administrative appeal within 30 days of the date of their valuation notice. If requested, Revenue may grant an extension to file an appeal for up to 15 days.

When a company requests and administrative appeal, an appeal conference is held within 20 days from their request. We then either reach a settlement or Revenue issues an appeal determination within 30 days of the conference. The goal is to finish this work by the end of September.

In 2019, Revenue created an online virtual room to share information with local governments on which companies were in administrative appeal and on any resulting valuation adjustments. This is a useful resource for local governments that use it, though the usage has been lower than we'd hoped.

Local governments depend on the certified values the receive from Revenue to figure their preliminary property tax capacity as they begin to set their budgets. Shortening the time to file an administrative appeal from 30 to 20 days would help local governments receive the final certified values sooner.

However, in discussions with companies, some of them need the full 30 days to file an administrative appeal because of staffing resources. Shortening this timeline could have the unintended consequence of companies not being able to resolve their valuation differences in administrative appeal and instead directly appealing to the Tax Court.

The administrative appeal timeline is set in Minnesota law, so legislation would be required to make any changes to the timeline.

Adjusting County Property Tax Deadlines

Each county, city, town, special taxing, and school district must certify its proposed property tax levy to the county auditor by September 30. Counties then certify rates for taxing districts located in two or more counties. County officials must send Truth in Taxation notices to their taxpayers in November. The local governments are then required to hold a meeting to review their preliminary budgets and levies.

Local government stakeholders shared concerns about how tight this timeline is, the additional pressures that come from completing their work, and some of their resource constraints. For example:

- Many counties have staff doing both property tax and election work, with some of those duties overlapping throughout the year.
- Counties may have limited options to print and mail Truth in Taxation statements; if they do not turn the statements in with ample time before the deadline, the notices may go out too late.

Delaying the deadline for setting preliminary budgets and sending Truth in Taxation statements would only create a greater time crunch at the end of the year. Local government stakeholders were not in favor of pushing back those dates.

Extending the Valuation Timeline by One Year

After seeking ways to minimally adjust the timeline to address stakeholder needs, the work group then discussed a larger change: Changing to a full-year valuation process to provide more time. Hypothetical adjustments to make this change are shown in Figure 4 on the next page.

Figure 4: Full-Year Valuation Timeline with Proposed Changes

Note: Strikethroughs indicate removing steps from the current timeline. Italics indicate a new step or change.

Utility and Pipeline Property Valuation Timeline – Lag Year Proposal	
~~**November – December**~~	~~We send updated property record reports to companies to complete for the assessment.~~
January 2	Assessment date.
January	*Revenue posts utility and pipeline property records in e-Services for companies to consult with counties and make updates (additions, retirements, corrections, etc.).*
January – May	Revenue completes the [Capitalization Rate Study.]
~~**March 31**~~ ***April 30***	Deadline for companies to submit the [Utility and Pipeline Market Value Report] and [Utility and Pipeline Property Record Report].
April – June	*Counties review and certify accuracy of utility and pipeline property record information.*
~~**March – July**~~ ***May – August***	Revenue completes and sends utility and pipeline property valuations and apportionment information to companies.
June – October	Revenue holds administrative appeals conferences for utilities and pipelines.
November	All utility and pipeline administrative appeals resolved by agreement or determination.
~~**July 15**~~ ***December 31***	Revenue sends Utility and Pipeline Equalized Orders to county auditors ~~and assessors~~.
~~**October 1**~~	~~Revenue sends corrected utility and pipeline values to counties.~~
~~**December 31**~~	~~Revenue issues corrections to utility and pipeline values for clerical errors.~~

Stakeholders discussed benefits, drawbacks, and risks associated with this proposal. Everyone agreed that additional time for filing, valuing, and appealing could benefit all stakeholders. Each stakeholder is constrained to complete their work within the current timeline and this option would create additional time.

The work group did not identify any immediate drawbacks to this proposal, but there are risks for all parties that – if not carefully vetted – could result in unintended consequences.

The biggest risk is determining how to transition to the year delay with minimal negative consequences for utility and pipeline companies, and local governments. One possibility is to duplicate one year's tax liability, but this would raise concerns about equalization and equitability across taxing jurisdictions.

Another concern is that having railroads on a different assessment timeline than utilities and pipelines could affect property tax-related local aid programs. (Revenue assesses railroads under Minnesota Rules, Chapter 8106. They are currently on the same appeal timeline as utilities and pipelines.)

Finally, changing the valuation timeline in this way would not remove the potential for refunds without also updating Tax Court statutes. It can take 18 months or more for a Tax Court case to be heard and longer to get a final order.[5]

The timeline can be even longer – and outside Revenue's control – if a party to the appeal seeks to consolidate appeals for multiple years. Currently, a taxpayer appealing the Order of Value is not required to provide their opinion of value until several months or years into the Tax Court appeal process.

Reporting Requirements and Engagement/Education

Stakeholders identified no significant issues around reporting requirements. Industry representatives notes that the required reporting is tedious and time-consuming everywhere, especially regarding local allocation details. Reporting issues are not a core issue and time-related rather than process-related.

Revenue presented about current opportunities for education and engagement with stakeholders throughout the year. Stakeholders appreciated the options provided and expressed that Revenue is responsive to their questions; Revenue's current offerings meet their needs for education and engagement.

Methodology Workgroup

Prior to working group meetings to discuss the methodology for valuations prescribed in Rule 8100, stakeholders first identified what they wanted to achieve with these discussions. All stakeholders agree the uncertainty surrounding possible paying refunds when a valuation is reduced through a Tax Court appeal is a core issue.

Utility and pipeline stakeholders mentioned a solution seen in other states which involves the taxpayer paying the undisputed amount into escrow. Under this solution, local taxing authorities would pay refunds only if the Tax Court appeal resulted in a value even lower than the undisputed amount that the taxpayer identifies.

Industry participants led with a presentation that illustrated where there is discretion within Rule 8100 – focused on the weightings for income and cost and the Capitalization Rate Study.

These valuation issues generate significant debate when a utility or pipeline challenges its value in Tax Court. The issues are the subject of expert witness testimony at trial, and the court's decisions on them can vary. Tax Court decisions have included some variation in approach and each case is decided on specific facts in that case.

Capitalization Rates

Stakeholders from the utility and pipeline industry believe that improvements could be made to Revenue's cost of equity. They highlighted how their cost of equity/rate of return/system unit value determinations made by other states compare to Minnesota.

One suggestion was that Minnesota follow the capitalization rates used by other states and the work group discussed what industry sees elsewhere. Many states do not publish a capitalization rate study, though others do, such as Colorado and California. Colorado specifically is seen by industry stakeholders as producing more stable calculations; however, its model is forward-looking blended with historical data.

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[5] See Minnesota Senate Hearing on Confirmation of the appointments of Jane N. Bowman and Wendy S. Tien to the Office of Minnesota Tax Court before the Senate Committee on Taxes, 93rd Minn. Leg., Reg. Sess. (Jan. 24, 2023). (Retrieved from https://mnsenate.granicus.com/player/clip/9880?view_id=1&redirect=true&h=c73f68b0a173e60d8b99102a1d5a8e0c)

The work group discussed if changing Rule 8100 to prescribe a specific model – rather than directing Revenue to calculate a capitalization rate each year based on several factors – would be an agreeable solution.[6]

Industry stakeholders are amenable to developing this idea, but caution that a deeper review is needed to develop it further. Further discussion focused on the discretion in Rule 8100, where multiple models are used and the degree of reliance on different models will vary.

Revenue's capitalization rates are seen to be below historic norms because of the Federal Reserve pushing interest rates down. Stakeholders suggested less reliance on the risk-free rate because of the recent variability. The language in this subpart of Rule 8100 is seen as guidance rather than prescriptive and allows Revenue to make these changes.

The work group also explored the idea of using the allowed rate of return for a rate-regulated utility to capitalize its income, rather than developing an independent capitalization rate study, for assessment purposes. Industry stakeholders were not aware of any jurisdictions that incorporate authorized rates of return into their income models for assessment purposes. They noted, however, that other Minnesota agencies are calculating a rate of return – using similar calculations to Revenue – with different results and more stability.[7]

Economic Obsolescence, Market Value, Rate Base, and Income Approach

Industry stakeholders want an automatic deduction for external (or economic) obsolescence included in the valuation process; they believe it would lead to fewer disputes. External obsolescence is a loss in value caused by something external to the property that is almost always incurable. This loss is sometimes treated as a form of depreciation in the cost approach to value.

Rule 8100's current methodology allows Revenue to adjust the weightings or make other adjustments to the value for the presence of external obsolescence. But the rule does not make an automatic reduction in value unless there is market evidence that something external to the utility or pipeline is causing its value to go down. The utility or pipeline has the burden of showing by a preponderance of the evidence at trial that its property suffers from external obsolescence. Industry stakeholders believe an automatic adjustment for external obsolescence would result in fewer appeals.

One possible solution presented to the work group to resolve the external obsolescence concerns was using a rate-based model in the cost approach. This model would only consider operating property in the taxpayer's rate base – which is different from the original cost of the company's whole system less book depreciation, currently required under Rule 8100.

In the cost approach, a rate-regulated company's regulatory rate base is the part of its system on which regulators allow it to earn a return. Industry stakeholders recognized that rate base is not the same as market value but believe Revenue should move closer to a rate-based approach. They noted that some states only use the income approach to value utilities and do not perform a cost approach.

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[6] Under Rule 8100, subpart 4(E), Revenue annually computes capitalization rates using the band of investment method – which considers several factors – for each type of utility. (Retrieved from https://www.revisor.mn.gov/rules/8100.0300)

[7] See Direct Testimony of Craig Addonizio dated October 3, 2022, *In the Matter of the Application by Northern States Power Company, D/B/A Xcel Energy, For Authority to Increase Rates for Electric Service in the State of Minnesota*, Docket No. E002/GR-21-630. (Retrieved from https://efiling.web.commerce.state.mn.us/edockets/searchDocuments.do?method=showPoup&documentId={10489F83-0000-CC12-AA57-11DBDA6C3096}&documentTitle=202210-189482-01)

Response/Feedback from Counties

Counties were clear to speak up against the idea of using regulatory ratemaking principles to value utility and pipeline properties for property tax purposes. Counties want these properties valued at market value, as currently required by Minnesota law.

Counties contend that using a company’s regulatory rate base in place of the original cost less deprecation of its system as a value under the cost approach is not an accurate measurement of market value. Counties likewise contend that using the company’s regulatory rate of return rather than Revenue’s capitalization rate to estimate value under the income approach will not lead to the market value of the property.

Counties correctly pointed out during the working group discussion that the work of the regulators in setting the company’s rates is a different exercise driven by different goals and laws than estimating the value of the operating property of the company for property tax purposes. These are very different goals and should not be conflated.

Local Government Perspectives

The next working group session was dedicated to hearing from counties. There were two large topics that were discussed: local government perspectives on the current valuation approach and impacts to local governments on alternative calculation methods.

It was recognized that Revenue has a tough job assessing utility and pipeline property and gets pushback from both the taxpayers and counties. However, some counties believe a central assessment is the only sensible model to do these valuations, and that Revenue is best positioned to do them because local officials do not have the expertise to value these systems.

Importance of Reactivity and Stability

Counties were asked to share their perspectives if valuation methodology was changed from a market value model to one that only considers the income approach. This change would not be able to reflect additions or subtractions to utility and pipeline property in a timely way.

For example, the income approach would not reflect income from newly installed plant – like an extension of a pipeline system – for several years. By contrast, the property taxes the taxpayer would pay under the current methodology would reflect the newly installed pipeline in the cost approach and, by extension, allow a local government to allocate more resources accordingly.

Due to this difference in timing, counties questioned if an income-only approach would reflect true market value, as required by state law. Counties questioned the fairness of making this kind of shift only for utilities and pipelines when all other taxpayer' share of the levy is based on the fair market value of their properties.

Overall, counties are less concerned about a lag in time to pick up property taxes from additional plant than when the value for the property is finalized. For them, a lag in taxes is manageable if the final value is known with no opportunity for it to change and require refunds to be paid out. Certainty and finality are of the utmost importance to counties.

Counties were asked for their perspective if a new methodology resulted in less tax base for local taxing jurisdictions but more certainty in valuations. Again, the responses indicated counties prefer – and state law currently requires – fair market value.

Counties also expressed concern that the administrative appeals process typically results in a lower value. They questioned whether it might be better if counties did not receive preliminary values from Revenue, so they would not have to make changes when they receive the final apportioned and equalized values from Revenue.

Some counties felt strongly that it would not be acceptable or fair to value these properties lower than fair market value just to ensure certainty. The reliability of estimates is significant, and counties want that. But the tax system is based on the expectation that all properties will be at full market value.

Counties were asked about certainty given that market values change every year, and Tax Court challenges can take several years to be finalized. Counties were clear that refunds are the most significant budgeting concern.

If there is a Tax Court challenge to locally assessed property – such as residential or commercial – the valuations are generally lower. A county can more easily plan to handle these refunds, often absorbing the cost from its general fund. But utility and pipeline valuations tend to be much higher, resulting in larger refunds if those valuations are reduced by the court. Counties are looking at ways to pay those larger refunds without having to make a cash payment, such as applying the refund to future tax liability.

Counties can also be impacted by changes in the assessed value from administrative appeals for utility and pipeline property. While administrative changes do not result in refunds, they can affect the accuracy of Truth in Taxation notices that counties send to taxpayers in November. Once the notices are sent, local governments cannot increase their levy amounts.

There are multiple ways to update Truth in Taxation notices but doing so can cause questions and concerns from the public. In addition, many counties outsource their printing, and the necessary lead times can make it difficult to update the notices before the mailing deadline set in state law.

Alternative Solutions, Previous Legislative Proposals, Transition Aid

Revenue presented to the work group on possible alternative valuation methods such as a production-based tax, or state collection of property tax for utility and pipeline property. Stakeholders saw are strengths and weaknesses in alternative models.

Work group participants acknowledged that Revenue and stakeholders did a lot of work on previous legislative attempts to amend valuation. One change to Rule 8100, which occurred in 2007, included some transition aid.

Production-based value can potentially be more predictable but requires more information and complex variables to produce similar results to current valuations. Legislators have considered this approach before, most recently in 2015 and 2017.[8] Since then, the situation of powerplants and the future of energy production have changed substantially– and any consideration now would require a thorough review and new discussions.

Utilities appreciate the predictability of production-based valuation but there are strong concerns with transitioning to this model. It would be difficult to fully predict and anticipate all the impacts for all stakeholders.

Another suggestion was that Revenue continue to assess utility and pipeline property at fair market value, but have the state collect the tax and send it local governments. Any refunds due to reduced valuations would be paid by the state general fund, addressing one of the key concerns for counties.

However, Revenue would need to certify levies and tax rates by on a parcel-by-parcel basis for these properties to collect the tax. The complexity and number of separate calculations would be a significant burden for the state.

Revenue asked if stakeholders have any interest in exploring a formulaic method for assessing utility and pipeline property. Industry stakeholders in the work group were not opposed in principle, but they indicated that more

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[8] See Senate File 1636, 89th Legislature (https://www.revisor.mn.gov/bills/bill.php?b=Senate&f=SF1636&ssn=0&y=2015) and House File 1985, 90th Legislature (https://www.revisor.mn.gov/bills/bill.php?b=house&f=HF1985&ssn=0&y=2017).

utilities would need to weigh in. They noted that industry is willing to sit down and talk about anything but obviously the details would need to be worked on before they could commit support.

Notice and Disputed Amount

Industry representatives presented the idea that an escrow account be established for the amount in controversy when a utility or pipeline assessment is challenged in Tax Court. This would help avoid counties having to issue large refunds when an assessment is reduced in Tax Court after the property taxes have already been paid.

Counties were open to this idea as well. There is at least one recent bill that would have established this.[9] However, in further discussions with counties it became clear that the ability to plan for potential refund situation was essential for this approach to work for them. If the county knows the amount in dispute, the county may be able to plan their budget for a Tax Court challenge.

To avoid counties having to pay out large refunds and give them the ability to redistribute the levy when there is a Tax Court appeal, Revenue suggests amending the statutes that govern appeals by utility and pipeline companies and their payment of taxes that are in dispute.[10] These suggested changes include:

- Require these companies to provide notice of what they believe their Minnesota apportionable value should be when filing an appeal to Tax Court. The current system does not require companies to provide this opinion of value until later in the Tax Court appeal process, which can take several months or years. This notice would be shared with counties and could be sent electronically, such as by email.[11]

- Allow the disputed tax amount for these companies to be placed in an escrow account until their Tax Court appeal is decided. If their Minnesota apportionable value is reduced, any resulting refund would be paid from the escrow account, rather than from the county's current budget.

Alternative Tax

The Legislature, Revenue, counties, and utility and pipeline industry have explored an alternative tax for generation systems in the past. Shifting to a production-based tax, rather than a market value-based property tax, would be complex and require all parties to work together to address the issues.

One significant barrier is that some counties and other jurisdictions would lose some of their current property tax base, which would shift more tax responsibility to other taxpayers. It's possible to create an aid to help jurisdictions who lose tax base – but this aid would be paid by other taxpayers across the state.

Any potential shift to a production-based model would need thorough review, vetting, and support from all stakeholders.

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[9] See Senate File 2131, 91st Legislature (https://www.revisor.mn.gov/bills/bill.php?b=senate&f=SF2131&ssn=0&y=2019).

[10] These include Minnesota Statutes, sec. 273.72, subd. 2 and 3 (Proceedings and Appeals; Utility or Railroad Valuations). (Retrieved from https://www.revisor.mn.gov/statutes/cite/273.372)

[11] Sharing the company's apportionable value opinion with counties and allowing it to be sent electronically are key parts of this suggested solution. Under current law, a taxpayer could receive an appealable order on September 30 and then have up to 60 days (November 29) – or 90 days if granted an extension (December 29) – to file their appeal with the Tax Court.

Conclusion

The Department of Revenue's listening sessions and work group discussions with representatives from local government, the utility and pipeline industries, and other stakeholders contributed a lot to our review in Minnesota. Participants brought an open mind and rich insights to these conversations, which helped all stakeholders better understand each other's positions and concerns.

Participants discussed many potential changes to Rule 8100 and the valuation of utility and pipeline property. Assessing these properties is a complex process. There are no easy ways to simplify the process that will please all stakeholders. Further discussion – and some compromises – will be necessary to make meaningful improvements.

Appendix A – Summary of the Capitalization Rate Study Process

The Minnesota Department of Revenue determines the estimated market value for utility, pipeline, and railroad operating property as of January 2 each year. We determine the unit value of the entire system to estimate the market value of these properties, in part, with the income approach to valuation. This approach measures the present value of the anticipated future benefits of property ownership.

For each market segment, the study derives:

- A yield capitalization rate (yield rate)
- A direct capitalization rate (direct rate)
- An implied growth rate
- A short-term growth rate
- A long-term growth rate
- An implied inflation rate

The market segments are:

- Electric
- Gas distribution
- Gas transmission pipeline
- Fluid transportation pipeline
- Railroad

We calculate yield and direct rates using the band of investment method. This method considers equity and debt financing and is the weighted rate of the cost of debt combined with the weighted rate for the cost of equity.

Each year, Revenue analyzes extensive market data to complete the study. More specifically, we:

- Select guideline companies for each market segment.
- Review companies' standard industrial classification codes and companies classified in specific markets by third party sources.
- Review each company's website to ensure fit as a guideline company.
- Determine if the company recently announced, is in the middle of, or recently completed a merger, as those companies would not be used as guideline companies.

Out of the approximately 150 companies reviewed as potential guideline companies, Revenue ultimately selects approximately 50 companies as guidelines. While many of the companies are used as guidelines in consecutive years, we complete a new analysis each year to determine if each company is still a good fit as a guideline company or if a company that was not used is now a good fit.

Next, Revenue gathers market data (approximately 35 different data points) from several resources (over five different sources) for each guideline company (and each individual guideline company's Securities and Exchange Commission form). We then gather market data that is applicable to each guideline company, including reviewing several sources to determine the average expected growth rate of the U.S. economy, each market segment's average expected growth rate, equity risk premium estimates, and risk free rate.

We then complete the following calculations and models:

- Unlever and relever each guideline company's beta, to use in the beta analysis.
- Beta analysis, using each guideline company's beta and unlevered/relevered beta to determine the overall riskiness of the market segment, used in the capital asset pricing model.
- Direct equity component, analyze each guideline company's price to equity ratio to determine the overall price to equity ratio of the market segment.
- Three-stage dividend growth model for each guideline company, using the company's current stock price, expected dividends, and an estimate of expected growth rate in dividends. Using three different stages of growth, determine the implied cost of equity for the market segment.
- Two-stage dividend growth model for each guideline company, using the company's dividend yield, short-term growth estimate, and the stable growth rate of the U.S. economy, apply growth rate in two stages to determine the implied cost of equity for the market segment.
- Single-stage dividend growth model using each guideline company's current dividend yield and projected short-term growth rate in earnings per share and in dividends to determine the implied cost of equity for the market segment.
- Capital asset pricing model and empirical capital asset pricing model, using an estimate of the equity risk premium from over 5 different sources (including one estimate calculated by the department using a three-stage model), the industry beta, and the risk-free rate to estimate the implied cost of equity for the market segment.
- Cost of debt, using the indexed debt rate based on each guideline company's debt rating and published yield rate to estimate the cost of debt for the market segment.[12]
- Capital structure, analyzing each guideline company's financing decisions of how much the company funds its operations with debt and how much with equity to determine the market segment's capital structure.
- Determine the best estimate of cost of debt and cost of equity and apply to the capital structure, to develop both the yield and direct rates.

Each year, Revenue evaluates models and data sources to determine if changes are needed. In several instances, we publish new models for feedback prior to relying heavily on the new model or data source.

Once the study is completed, Revenue posts a draft study welcoming comments from interested parties. We review the comments and incorporate the feedback, often adjusting the overall rates, before publishing the final study with the rates used in the valuation of utility, pipeline, and railroad companies with operating property in Minnesota.

[12] When time allows, we review recent debt issuances by each guideline company and completes yield to maturity calculations.