MINNESOTA REVENUE

11-15-2006

November 9, 2006

Legislative Reference Library
645 State Office Building
100 Rev. Dr. Martin Luther King Jr. Blvd.
St. Paul, Minnesota 55155

Re: Proposed Amendment to Rules Governing Valuation and Assessment of the Property of Utility Companies, with Proposed Repealer of certain subparts, *Minnesota Rules*, Chapter 8100

Dear Librarian:

The Minnesota Department of Revenue intends to amend rules governing valuation and assessment of the property of utility companies, with proposed repealer of certain subparts, *Minnesota Rules*, Chapter 8100. We plan to publish a Notice of Hearing in the November 13, 2006, edition of the *State Register*.

The Department has prepared a Statement of Need and Reasonableness, which is now available to the public. As required by *Minnesota Statutes*, sections 14.131 and 14.23, the Department is sending the Library a copy of the Statement of Need and Reasonableness.

If you have any questions, please contact me at (651) 556-4062.

Sincerely,

Susan E. Barry

Susan Barry, Supervising Attorney
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Enclosure: SONAR

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MINNESOTA DEPARTMENT OF REVENUE

STATEMENT OF NEED AND REASONABLENESS

Proposed Amendment to Rules Relating to Utilities; Valuation and Assessment of Electric, Gas Distribution, and Pipeline Companies, Minnesota Rules, parts 8100.0100-8100.0500; proposed new rule 8100.0800 and proposed repeal of Minnesota Rules, part 8100.0300, subpart 2; and part 8100.0500, subpart 4 and subpart 4a.

October 3, 2006

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I. INTRODUCTION

The Minnesota Department of Revenue proposes to revise rules relating to valuation and assessment of utility companies for property tax purposes. Minnesota's utility property valuation rules have been in existence since 1975. The rules were first promulgated after the Minnesota Supreme Court struck down the previous valuation method in 1973 in the case, *Independent School District No. 99 v. Commissioner of Taxation*, 211 N.W.2d 886 (Minn. 1973). This case was the impetus for the creation of the current rule. The case articulates the requirement that an approximation of market value must include consideration of all relevant factors.

Local taxing authorities appealed a Tax Court decision that affirmed the Commissioner of Taxation's ("Commissioner") reduction of a 1966 ad valorem tax valuation for utility property owned by Minnesota Power & Light Company. In addition, the taxing authorities challenged the application of a formula, original cost less depreciation ("OCLD") with a cap on depreciation, which was the sole basis for the Commissioner's valuation of the utility property. The taxing authorities claimed that the application of the formula was unreasonable as well as arbitrary and capricious. *Id* at 889.

In reviewing the lower court decision, the Court held that *Minnesota Statutes* § 273.11 (1965) applied, and required that "all property shall be assessed at its true and full value." *Id.* The Court also held that *Minnesota Statutes* § 273.12 (1965) required every property valuation for ad valorem taxation to "consider and give due weight to every element and factor affecting the market value." *Id* at 890. The Court determined that the OCLD formula used by the Commissioner "makes market value synonymous with original cost, taking into account limited depreciation, and gives no weight to other factors affecting market value." *Id.*

The Court dismissed the argument that the formula provided uniformity because there was no evidence that statutory compliance would violate the principle of uniformity. *Id* at 890. The Court also dismissed the argument that the formula provides for simplicity of administration. The court explained that no express legislative authority existed for disregarding the statutory requirement to consider and give due weight to all factors affecting market value. *Id* at 891.

The Court held that the use of the formula was arbitrary and unreasonable because it was the only factor considered in valuing the property. However, the Court made it clear that upon considering all factors, the formula could be determined to result in the closest approximation of market value. *Id.*

The case is cited in several later cases, both in Minnesota and other jurisdictions. Most of the cases cite to the court's ruling that every element and factor must be considered and given due weight when determining market value, rather than the adoption of a single approach. *See, e.g. Contos v. Herbst*, 278 N.W.2d 732, (Minn. 1979); *Northerly Centre Corp. v. Ramsey County*, 248 N.W.2d 923, (Minn. 1976). Additionally, the case is also cited for the holding that after consideration of all elements and factors, a single formula may be determined to most closely approximate market value. *See, e.g. Northwest Airlines, Inc v. Commissioner of Revenue*, 265 N.W.2d 825, (Minn. 1978); *Cleveman Realty Co. v. County of Hennepin*, (Minn.Tax Dec 03, 1982); *Jrs Investments v. County of Hennepin*, (Minn.Tax Apr 30, 1982).

The rules have been revised numerous times throughout their existence. The most recent revision occurred in 2000. However, the majority of the changes have been technical in nature. It is the opinion of the commissioner of the Department of Revenue that revisions to the rule are again necessary.

Minnesota Statutes, section 273.11 subpart 1, requires that "all property shall be valued at its market value." The statute further directs that the assessor value "each article or description of property by itself, and at such sum as the assessor believes the same to be fairly worth in money." Further, *Minnesota Statutes* section 273.12 states that "[i]t shall be the duty of every assessor ... in estimating and determining the value of lands for the purpose of taxation, to consider and give due weight to every element and factor affecting the market value thereof...."

There are three generally accepted approaches for finding market value: the cost approach, the income approach, and the market approach. The current rules are rigid, formula driven, and strictly prohibit the application of the market approach in the valuation of utility property. This is contrary to statutory and judicial requirements that all relevant data be considered. In addition, the current rules do not allow assessors to apply sound judgment throughout the appraisal process, place limitations on the consideration of depreciation; make no adjustment for contributions in aid of construction ("CIAC"); and require the assessor to use an inflexible method of correlating the indicators of value that result from each of the approaches to valuation.

The proposed changes are necessary to update the existing rule in light of current economic conditions; to ensure that a reasonable estimate of market value is derived from the consideration of all appropriate data; to allow for a balance between a prescriptive rule and sound appraisal judgment; to address concerns of predictability and stability in estimations of market value; and to ensure that utility valuation is easily understood and administered.

This document, the Statement of Need and Reasonableness ("SONAR"), has been prepared to establish the statutory authority of, need for, and reasonableness of the proposed rules. It is submitted pursuant to *Minnesota Statutes*, section 14.23, and *Minnesota Rules* part 1400.2070.

II. PROCEDURAL HISTORY

Although not part of the formal rulemaking process, the department has held periodic open forum meetings regarding utility valuation in 2001 and 2002. At those meetings utility valuation, including the possibility of rulemaking was discussed in general terms. In November of 2001 during a discussion of possible rulemaking the department announced that prior to beginning any rulemaking we would hire a consultant.

A Request for Comments, in anticipation of possible utility rules changes, was published in the *State Register* on December 8, 2003 (28 *S.R.* 758), and was mailed to the list of persons and associations who have placed their names on the Department of Revenue rulemaking mailing list as well as those on our additional notice list. The department has kept the comment period open until the Notice of Intent to Adopt Rules is published in the *State Register*.

In July of 2004 the Department of Revenue hired Brent Eyre as a consultant to prepare a report which reviewed the existing rules and made recommendations for changes. The report was published on the Department of Revenue website (http://www.taxes.state.mn) in January 2005. Two public forums were held to discuss the report and solicit additional public comments, particularly

related to the consultant's report. The first forum was held on March 9, 2005 with notice published in the *State Register* (29 *S.R.* 956). A second forum was held on July 12, 2005.

In addition, the department created a fourteen member Utility Rules Advisory Committee consisting of representatives from the utility industry, as well as representatives from host communities. An announcement soliciting members for the Advisory Committee was published in the *State Register* (30 *S.R.* 108). The following people are members of the Advisory Committee: Joseph Rheinberger (Xcel Energy, NSP), Gary Spielman (Minnkota Power Coop), Deb Eck (East Central Energy), Kevin Hafner (Southern Minn. Municipal), Kirk Nesvig (CenterPoint Energy), Rick Johnson (Enbridge Energy), Joann Wright (Northern Natural Gas Co.), Bill Peterson (Dakota County), Jim Hallstrom (Martin County), Don Holm (Clearwater County),Brad Johnson (Goodhue County), Steven W Nyhus (Flaherty & Hood, CUC), Keith Carlson (Metro Inter-County Assoc.), Kathleen Heaney (Sherburne County), Alan Whipple (DOR), Gordon Folkman (DOR), Brent Eyre (Consultant), Harriet Sims (DOR), Jack Mansun (DOR- Assistant Commissioner), Dan Salomone (DOR-Commissioner, *ex officio* member). The advisory committee has provided insight and advice regarding possible impacts to communities and businesses as a result of rule changes. The department has published announcements for advisory committee meetings in the *State Register* (30 *S.R.* 569; 30 *S.R.* 772; 30 *S.R.* 886; and 30 *S.R.*1010) and on the department website. Observers were welcome to attend all meetings. In addition, summaries of the department's tentative proposed changes to the rule, and miscellaneous documents pertaining to the revision process have all be published on the department's website. The last advisory committee meeting held on March 23, 2006 offered an opportunity for the committee to provide feedback on a draft of the proposed rule. The draft was posted on the department's website.

On May 16, 2006, a public forum was held to solicit additional informal public comment regarding the draft of the proposed rule before it was published in the *State Register.* Notice of this meeting was published at 30 *S.R.* 1196.

III. ADDITIONAL NOTICE

The Additional Notice Plan was reviewed by the Office of Administrative Hearings and approved in a November 19, 2004, letter from Administrative Law Judge George Beck. The Additional Notice Plan consists of:

(1) Electronically mailing copies of the Request for Comments and the Notice of Intent to Adopt Rules to all current county assessors and auditors;
(2) Mailing copies of the Request for Comments and the Notice of Intent to Adopt Rules to all utility companies;
(3) Mailing copies of the Request for Comments and the Notice of Intent to Adopt Rules to the President of the Real Estate Section of the Minnesota State Bar Association;
(4) Mailing copies of the Request for Comments and the Notice of Intent to Adopt Rules to all persons who have notified the department that they are interested in utility valuation;
(5) Mailing copies of the Request for Comments and the Notice of Intent to Adopt Rules to additional agencies and groups identified by the Office of Administrative Hearings as potentially interested parties. These groups are the Public Utilities Commission, Energy Division of the Department of Commerce, Residential Utilities Division of the Minnesota Attorney General's Office, Minnesota Municipal Utility Association (MMUA), Minnesota Rural Electric Association (MREA), Energy CENTS Coalition, Legal Services Advocacy Project (LSAP), Minnesota Chamber of Commerce and Suburban Rate Authority.; and

(6) Posting the Request for Comments, comments, rule drafts, Notice of Intent to Adopt Rules, SONAR, and various supplemental information on the Department of Revenue website at http://www.taxes.state.mn.us

The Notice Plan also includes giving notice required by statute. The department will mail the proposed rules and Notice of Intent to Adopt to everyone who has registered to be on the department's rulemaking mailing list under *Minnesota Statutes*, section 14.14, subdivision 1a. The department will also give notice to the Legislature in accordance with *Minnesota Statutes*, section 14.116.

IV. ALTERNATIVE FORMAT

Upon request, this Statement of Need and Reasonableness can be made available in an alternative format, such as large print, Braille, or cassette tape. To make a request, contact:

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TTY users may call the Department of Revenue at Minnesota Relay 711.

V. STATUTORY AUTHORITY

The department's authority to amend the rules is set forth in *Minnesota Statutes* section 270C.06, which authorizes the commissioner of the Department of Revenue to "make, publish, and distribute rules for the administration and enforcement of state revenue laws. The rules have the force of law." In addition, *Minnesota Statutes* section 273.33 subdivision 2, section 273.37 subdivision 2, and section 273.38 require the commissioner of the Department of Revenue to assess personal property of electric, gas distribution, and pipeline companies, as well as electric cooperatives.

VI. REGULATORY ANALYSIS

As required by *Minnesota Statutes*, section 14.131, the department considered the following seven factors:

"(1) a description of the classes of persons who probably will be affected by the proposed rule, including classes that will bear the costs of the proposed rule and classes that will benefit from the proposed rule"

Electric, gas distribution, pipeline, and integrated companies with operating property in Minnesota; electric cooperative associations; local governments of host communities; taxpayers in host communities; and the Property Tax Division of the Minnesota Department of Revenue will probably be affected by the proposed rule changes.

"(2) the probable costs to the agency and to any other agency of the implementation and enforcement of the proposed rule and any anticipated effect on state revenues"

The department could incur costs associated with additional assessment procedures during the phase-in period, increased training, and short-term increases in the number of questions from utilities and local government. The cost to administer these changes will be negligible to the state. There will be no effect on state revenues as a result of the proposed rule change; most revenue from utility property taxes goes to local units of government. In addition, overall levies are expected to remain the same regardless of valuation changes. However, there may be some shifts of tax onto other taxpayers at the county level.

"(3) a determination of whether there are less costly methods or less intrusive methods for achieving the purpose of the proposed rule"

There are no less costly or intrusive methods for achieving the purpose of the proposed rule changes. The purposes of the proposed rule changes are: to ensure that utility property tax valuations are reasonable estimates of market value; to reduce the prescriptiveness and rigidity of the current valuation process in order to achieve a reasonable estimate of market value; to provide for the use of sound appraisal judgment; to increase the ease at which the rules are understood and administered; to make editorial and grammatical changes; to correct outdated internal references; and to repeal obsolete sections.

"(4) a description of any alternative methods for achieving the purpose of the proposed rule that were seriously considered by the agency and the reasons why they were rejected in favor of the proposed rule"

There is no reasonable alternative method for achieving the purposes of the proposed rule changes as stated in item 3.

"(5) the probable costs of complying with the proposed rule, including the portion of the total costs that will be borne by identifiable categories of affected parties, such as separate classes of governmental units, businesses, or individuals"

Based on the information available to the department, the cost to all parties will be negligible. There may be some initial costs of training for assessors and company tax preparers to learn new valuation and assessment methods. The greatest change will be the change allowing assessors to use appraisal judgment in weighing the indicators of value rather than using the fixed weights prescribed in the current rule. Because information provided by the utility companies will be virtually the same as that required by the current rule we anticipate that any additional costs to gather and provide information will be minimal. We also anticipate any additional costs to audit utility company returns will be negligible because audits are performed under the existing rules. Local governments will not incur additional costs to enter the values into their property tax systems because they enter values under the current rules.

During the initial comment period after the Request for Comments in Anticipation of Possible Rulemaking and also during the advisory committee meetings, several people noted that counties could bear financial costs if a new rule resulted in lower valuations. While the department is sensitive to this issue, the costs of compliance referred to in Chapter 14 are costs that identified groups must bear in order to comply with the proposed rule. These are costs other than potential reduction of tax base which is a foreseeable consequence of compliance but not a cost to comply. Issues of the tax base of individual communities are more properly dealt with by the legislature.

"(6) the probable costs or consequences of not adopting the proposed rule, including those costs or consequences borne by identifiable categories of affected parties, such as separate classes of government units, businesses, or individuals"

The department has not identified any specific costs that will arise if the proposed rule is not adopted. However, one consequence of failure to adopt the rule changes could be increased costs resulting from additional appeals and litigation. These costs would be borne by the state, host communities and the parties contesting the valuation. During the past three years utility valuations have been challenged resulting in litigation against the department and host communities. Two cases were resolved through a mutually agreeable settlement and a third case is currently in litigation. Overall costs of settlement, expert witness fees and salaries are approximately $6.5 million dollars to date. If new rules are not promulgated the department anticipates that utilities will continue to challenge valuations under the existing rule and that litigation resulting from such challenges could be harder to settle, consequently the department and host communities will continue to incur litigation costs and those costs are likely to rise.

"(7) an assessment of any differences between the proposed rule and existing federal regulations and a specific analysis of the need for and reasonableness of each difference"

There are no existing federal regulations related to this rule. The federal government is constitutionally prohibited from administering property taxes (*U.S. Const.* Art. I Section 9). There are no federal statutes or regulations that direct the states on how to administer utility property taxes. The Federal Energy Regulatory Commission (FERC) has specific regulations regarding recordkeeping for utility companies. The proposed rule changes are consistent with FERC regulations.

VII. PERFORMANCE-BASED RULES

In drafting the proposed rules the department was aware of the statutory mandate that where feasible, agencies should develop rules that balance the needs of the agency in meeting its objectives, while maintaining some flexibility for the affected parties. (See *Minnesota Statutes*, section 14.002.) The department's primary objectives in pursuing these rule changes are to accurately and predictably estimate market value and ensure that utility valuation is easily understood and administered by reducing the prescriptiveness and rigidity of the current rule.

VIII. CONSULT WITH FINANCE ON LOCAL GOVERNMENT IMPACT

As required by *Minnesota Statutes*, section 14.131, the department has consulted with the commissioner of the Department of Finance. On August 29, 2006 the department fulfilled this requirement by sending to the Commissioner of the Department of Finance, copies of the documents sent to the Governor's Office for review and approval by the Governor's Office prior to the department publishing the Notice of Intent to Adopt. The documents included: the Governor's Office Proposed Rule and SONAR Form; draft rules; a preliminary draft of this SONAR and a letter summarizing potential local government impacts (see Exhibit A). The Department of Finance sent a reply dated September 20, 2006. The letter concluded that "Based on this information, I believe the Department of Revenue's proposed rule amendments will have a noticeable fiscal impact on local units of government. Revenue has adequately considered these possible effects through an advisory committee, a consultant's report, and public forums. In response, the Department of

Revenue has developed a plan to mitigate the fiscal impact on local units of government by implementing the proposed rule changes over three years." (see Exhibit B).

IX. COST OF COMPLYING FOR SMALL BUSINESS OR CITY

Minnesota Statutes, section 14.127, require the department to determine if the cost of complying with proposed rules in the first year after the rules take effect will exceed $25,000 for any small business or small city. A small business is defined as a business (either for profit or nonprofit) with less than 50 full-time employees and a small city is defined as a city with less than ten full-time employees. The department has considered whether the cost of complying with the proposed rules in the first year after the rules take effect will exceed $25,000 for any small business or small city.

The department has determined that the cost of complying with the proposed rules in the first year after the rules take effect will not exceed $25,000 for any small business or small city. The costs of complying with these rules for a small business is negligible because the information required under the proposed rules will be virtually the same as under the current rules. There will be no change in the cost to comply for small cities because the counties handle all administrative work on property tax assessment and collection for local governments.

The department has made this determination based on the probable costs of complying with the proposed rule, as described in the Regulatory Analysis section of this SONAR. In addition, the department asked the advisory committee members whether these costs would exceed $25,000 during the first year for any small business or city. The advisory committee members, who included a representative from a small business/city, did not indicate that the costs would exceed $25,000. The department asked each cooperative association with less than 50 employees to estimate the cost of complying with the proposed rules during the first year. No member representing a cooperative association estimated that costs would exceed $25,000. We believe that the advice received is accurate because the cooperative associations and advisory committee members were provided with a preliminary copy of the proposed amendments to the rules for review and they are in the best position to estimate their own actual costs.

In making this analysis the department of revenue assumed that costs of compliance are costs other than taxes. Costs of complying are distinct from potential tax impacts. Costs to comply are not increases in tax burden or a loss of tax base.

X. LIST OF EXHIBITS

In support of the need for and reasonableness of the proposed rules, the department anticipates that it will enter the following exhibits into the hearing record:

Exhibit A. **Letter sent to the Department of Finance Regarding Impact on Local Government**

Exhibit B. **Department of Finance Response to Letter Regarding Impact on Local Government**

Exhibit C. The Consultant's Report

The consultant, Brent Eyre, was contracted to draft a report entitled *A Review of Minnesota Rules Chapter 8100*. The report can be viewed at the Department of Revenue web site, www.taxes.state.mn.us and is also available by contacting the Department of Revenue.

Exhibit D. Valuation Projections

XI. RULE-BY-RULE ANALYSIS

In addition to the substantive changes summarized above, many of the changes involve the repeal of outdated information and duplicative language, as well as changes that bring the language of the rules in conformity with the Office of the Revisor of Statutes' *Minnesota Rules Drafting Manual with Styles and Forms*. The following is an analysis of the proposed changes to the existing rules.

A. NEED AND REASONABLENESS FOR RULE AMENDMENTS AS A WHOLE

Minnesota Statutes, Chapter 14, requires the department to explain the facts establishing the need for and reasonableness of the rules as proposed. "Need" means that a problem exists which requires administrative attention. "Reasonableness" means that there is a rational basis for the department's proposed action.

The amendments to *Minnesota Rules*, Chapter 8100 are needed because the current rules are very rigid and restrict the consideration of information that is relevant to the valuation of utility property. This is contrary to *Minnesota Statutes*, section 273.11 subpart 1, which requires that the assessor value "each article or description of property by itself, and at such sum as the assessor believes the same to be fairly worth in money."

Further, *Minnesota Statutes,* section 273.12 states that "[i]t shall be the duty of every assessor ... in estimating and determining the value of lands for the purpose of taxation, to consider and give due weight to every element and factor affecting the market value thereof...."

The current rules constrain assessor's judgment in valuing utility property. This rigidity hinders the assessor's ability to consider all relevant data pertaining to value in the valuation process, as mandated by *Minnesota Statutes,* section 273.12. The constraints also limit the assessor's ability to accurately achieve a market value, which is mandated by *Minnesota Statutes*, section 273.11 subpart 1. The inflexibility of the rules has been challenged through appeals and litigation (See discussion in section VI (6) above). The amendments remedy these problems by allowing consideration of information other than just cost and income; by removing rigid weightings in the correlation process thus allowing assessors to use their judgment to more accurately value utility property; and by removing limits on depreciation that limit the accuracy of utility property appraisals.

The amendments to *Minnesota Rules*, Chapter 8100 are reasonable because they are consistent with accepted appraisal practices. The department sought outside expertise from a consultant who provided guidance related to the valuation techniques employed in other tax

jurisdictions. See Exhibit C, Consultant's Report. The purpose of the report was to evaluate the current rule that the Department uses to value utility property in the state of Minnesota for property tax purposes and make recommendations for revisions. The consultant performed the following tasks: performed a full review of Minnesota's statutes and rules pertaining to the valuation and assessment of utility property; reviewed public comments submitted to the Minnesota Department of Revenue from utility companies, local governments, and taxpayer groups; prepared a preliminary report of initial findings and responded to specific questions raised by the Minnesota Department of Revenue (the preliminary report and the responses to those questions have been incorporated into the final report); surveyed other states concerning the methodologies employed to value and assess utility property; questioned and surveyed various national experts in the area of utility valuation; made recommendations about possible amendments to the Minnesota utility valuations rule; and prepared a sample appraisal that emulates the recommendations. Mr. Eyre's recommendations concerning the current rule are on page 6 of the Executive Summary of his report. The report also lists Mr. Eyre's credentials.

In addition, the department has solicited public comments throughout the revision process, including the formation of an advisory committee. The department has fully considered all comments received.

B. GENERAL CHANGES TO REFLECT GUIDELINES IN MINNESOTA RULES DRAFTING MANUAL

The amendments throughout the proposed rule that concern the choice of word usage involving "shall," "should," "must," and "will" are made to reflect the most recent guidelines of the *Minnesota Rules Drafting Manual with Styles and Forms*, distributed by the Office of the Revisor of Statutes. These revisions are not substantive, and are not commented on separately.

C. INDIVIDUAL SECTIONS OF RULE

8100.0100 DEFINITIONS.

Subparts 3a, 5b, 11a, 13a, 13b, and 13c.
Six subparts are added to define the terms "beta," "contributions in aid of construction," "original cost less depreciation," "relative risk," "risk-free rate," and "risk premium." These terms are terms-of-art of in the appraisal field. Providing a definition for these terms is necessary to ensure that the rule is comprehensible to non-expert readers and to make certain that there is no confusion with other meanings that the terms may have in other contexts. The definitions are reasonable because they are derived from principal appraisal texts. (See for example, *Stocks, Bonds, Bills, and Inflation Valuation Edition 200X Yearbook (SBBI)* published yearly by Ibbotson Associates, 225 North Michigan Avenue, Suite 700 Chicago, IL 60601-7676 (ISBN 1-882864-23-9))

"Contributions in aid of construction" is a factor that has been added to the calculation of total cost. (See 8100.0300 Subp. 3. Item A.) "Beta," "relative risk," "risk-free rate," and "risk premium" are all considerations that have been added to the capitalization method discussed in the income approach. (See 8100.0300 Subp. 4.). Definitions for these terms are necessary as they are terms newly added to the proposed rules and will aid the reader in understanding the rule. "Original cost less

depreciation" is the type of cost used in the cost approach, cost less depreciation method for cooperatives, and allocation. (See 8100.0300 Subparts 3 Item A. and 6; 8100.0400.) "Original cost less depreciation" requires a definition because there is often confusion, even within the industry, between historical cost less depreciation and original cost less depreciation. The definition given to original cost less depreciation in these rules is an accepted definition within the appraisal profession.

Subpart 5c.

The term "cooperative association" is defined to also include municipal power agencies and pipelines which are not common carriers. This treatment is necessary because municipal power agencies must be valued as if they were owned by private persons. *Minnesota Statutes*, section 453.54, subd. 20. Municipal Power Agencies are designed to operate at minimal cost to the consumer. Therefore they are most like cooperatives than other forms of business organizations. Pipelines which are not common carriers do not charge their customer for use of their pipelines, only for what is shipped through them. The non common carrier pipelines also operate so as to minimize cost to the consumer and therefore it is reasonable that they be treated as cooperatives. The definition is necessary to avoid confusion because for the sake of brevity the rule language refers only to cooperative associations.

Subpart 11.

The definition of "operating property" is modified to provide a more accurate explanation of the term. The word "tangible" is added to make clear that the term "operating property" refers only to physical property. The first sentence of the definition is restructured to make it clear that land is not operating property. A presumption is added to the definition as well. Property that is located on the same or contiguous parcels of land as operating property is presumed to be operating property. The presumption is necessary because the character of property located in close proximity to operating property is often questioned. The presumption resolves many of these questions. The presumption is reasonable because it can be rebutted, and taxpayers and host communities can request a determination from the commissioner. (See 8100.0300 Subp. 3. Items B and C.)

In conjunction with the creation of the presumption, lists of examples of nonoperating property (garages, warehouses, office buildings, etc.) except for land were deleted. The examples are not needed or useful because the determination of whether property is operating or nonoperating must be made on a case by case basis and the proposed rules provide enough guidance for the assessor to do so. The remaining sentence is modified to state that land is always nonoperating property. This is reasonable because it is consistent with the first sentence of subpart 11 in the current rule which states the generally accepted definition of operating property. Land is not considered to be directly associated with generation, transmission or distribution of products sold by utility companies because if all operating property of a utility were removed the land could be sold for any use.

Subpart 16.

The word "entire" is added to the definition of "unit value" to foreclose any question about whether unit value encompasses all system plant owned by a utility. This is a technical change.

8100.0200 INTRODUCTION.

The first two sentences are modified by striking superfluous language and inserting the term "unit value" instead. The stricken language defined the term "unit value". "Unit value" is defined in

8100.0100, subpart 16 so there is no need to define it again. Use of the term itself, rather than a reiteration of its definition, provides clarity.

Consistent with the overall proposed changes to the rule, the term "additional indicators of value" is added to the list of indicators for the calculation of unit value. The need and reasonableness for adding additional considerations is discussed in detail below—within the analysis of revisions to 8100.0300 subparts 4a and 5.

The word "assigned" is stricken. The word is used in conjunction with the term-of-art "allocated" which is defined in *Minnesota Rules*, 8100.0100 Subpart 2 (as "allocation"). Removal of "assigned" ensures that the proper interpretation of "allocated" is understood. The following sentence is added: "The value of property located in Minnesota that is exempt from property tax or that is locally assessed, is subtracted from the value allocated to Minnesota." This is not an addition of a new procedure, but rather a summary of the process currently described in *Minnesota Rules*, 8100.0500. The addition of the sentence is necessary to give a more accurate overview of the entire utility property assessment process.

A reference to materials from the Interstate Commerce Commission is removed because the Interstate Commerce Commission was abolished in 1996. The addition of "other publicly available sources of information regarding rates" is necessary to allow the department to use additional company and industry information that affects value. The sentence: "Finally, the value will be equalized based on sales/assessment ratios determined by the Department of Revenue." is added. This is not an addition of a new procedure, but rather a summary of the process currently described in *Minnesota Rules*, 8100.0700. The addition of the sentence is necessary to give a more accurate overview of the entire utility property assessment process.

The second to last paragraph which deals with methods, procedures and indicators of value is deleted because it contains unnecessary and repetitive language, and it is outdated. Correct dates are added in later parts of the rule. (See 8100.0800) The last paragraph is edited to remove the first phrase because it is colloquial and unnecessary. The term "his or her judgment" is replaced by "discretion." This is necessary in order to make the sentence consistent with the paragraph and the rule in general, which uses "discretion" rather than "judgment." Specific constraints are added to the commissioner's use of discretion to prevent an unfettered grant of discretion. See discussion under Rule 8100.0300, subpart 4a.

8100.0300 VALUATION.

Subpart 1. General.

The first paragraph provides an introduction to the discussion of valuation in the rule. The language referring to "stringent government regulations over operations and earnings" is struck because 1). It is unnecessary in the introduction and 2.) the utility industry has been deregulated to some extent. Language stating that the traditional approaches to valuation are modified for utility companies is retained to explain to the reader that utility property must be valued differently from other properties. The reference to the year 2000 and subsequent years is struck because it is outdated. Effective dates are added in later parts of the rule. (See Parts 8100.0800 and 8100.0900). The second paragraph is added to indicate that the rule will require a less rigid formula and will allow the assessor

to use all reliable indicators of value. This is necessary because it allows for a more accurate estimation of value by considering all relevant data pertaining to value in the valuation process, as mandated by *Minnesota Statutes* section 273.12. It also facilitates a more accurate determination of market value, which is mandated by *Minnesota Statutes*, section 273.11 subpart 1. This is reasonable because it allows the commissioner to include additional information that is demonstrated to be reliable and of value. The reduction in rigidity also furthers the legislative goal of performance based rules as described in *Minnesota Statutes*, section 14.002. (Refer to 8100.0300 Subparts 4a and 5 for further discussion of the need for and reasonableness of specific components of this approach to value.). This treatment is consistent with the discussion and recommendations regarding allowing appraisal judgment versus strict adherence to a rule or statutory formula contained in *A Review of Minnesota Rules Chapter 8100,* pages 15 -17 and 32. (Exhibit C)

Subp. 2. Market Approach.

This subpart is repealed because the market approach is no longer strictly prohibited. (See 8100.0300 Subp. 4a.) The market approach is added as an additional indicator of value that can be used at the commissioner's discretion. (Refer to discussion of 8100.0300 Subpart 4a below further analysis.)

Subp. 3. Cost Approach.

The paragraphs in this subpart are divided into items A through E to make this subpart easier to read. Item B, which corresponds to the second paragraph of the current part 8100.0300 has not been changed other than being re labeled. A new paragraph C is added.

Item A.

The words "the cost of" are added to clear up ambiguity regarding how improvements to system plant are to be considered. Two additional phrases describing construction work in progress are necessary. First, "all types" is necessary to indicate that both 'replacement' and 'expansion' construction work in progress are included. Second, "installed" is added to indicate that materials for construction are not part of construction work in progress until the materials are installed. Property held for future use and contributions in aid of construction are added to the list of factors that affect cost. This is necessary because a main principle of property valuation is that all property owned or used by the utility should be included. *Minnesota Statutes*, section 273.12. This is reasonable because property held for future use is usually land with attached buildings that the utility intends to use at a future time. The addition of contributions in aid of construction is reasonable because it is property used in the business, even though it is paid for by a customer or another utility, so it must be included in the valuation.

New language states that original cost less depreciation is presumed to be equal to historical cost less depreciation. As discussed in the analysis of revisions to 8100.0100 Subp. 11a, above there is often confusion between the definitions of historical cost less depreciation and original cost less depreciation. Although the two terms have different definitions, they often have the same value. The proposed rule recognizes this. "Original cost" is often defined as the cost of the asset when first placed in service. "Historical cost" is often defined as the cost of the asset to the current owner. This will almost always be the same value. Proposed language in 8100.0100 subpart 11a defines original

cost less depreciation as "original cost of the property to the present owner, minus any depreciation attributable to the property." This treatment is consistent with the discussion of the cost approach in *A Review of Minnesota Rules Chapter 8100,* pages 17 – 19 (Exhibit C).

The presumption is necessary in order to minimize any confusion that may still exist regarding the definition of historical versus original cost. In addition, some companies may keep their books using the historical cost less depreciation method. Those companies would not need to redo their calculations. The presumption that original and historical cost less depreciation are equal is reasonable based on the way that the two terms are usually defined. It is reasonable to express this in the rule as a presumption that can be rebutted because if the valuations actually differ the correct value may be used.

It is also reasonable to require that rate-based utility companies use the same type of cost that is used in the rate base calculation because the utility companies already have these figures.

Item C.

As discussed in the analysis of revisions to 8100.0100 Subp. 11, the character of property located in close proximity to operating property is often questioned. The proposed new paragraph C allows assessors or utility companies to request a determination by the commissioner concerning the character of property as operating or non operating property. (See proposed revision to 8100.0100, subp.11 and analysis above). The ability to request a determination is necessary to allow utility companies and assessors to clarify the character of property and to ensure that property is being characterized on a uniform basis. As the presumption in 8100.0100 subpart 11 that property located on the same or contiguous parcel of land as operating property is operating property is a rebuttable presumption, it is necessary and reasonable to allow utility companies or assessors a venue in which to rebut the presumption.

Item D.

Limits on depreciation are removed. This is necessary because the current rule creates an artificial limit on the consideration of all depreciation, which in turn makes it difficult to achieve an accurate estimate of market value. The limit on depreciation results in an inaccurate method of arriving at value. Valuation methods which incorporate a limitation on actual depreciation have not been found to be part of any generally accepted method of valuation. The decision to remove the limit on depreciation is consistent with the analysis expressed in *A Review of Minnesota Rules Chapter 8100,* pages 29, 30, 46 and 47. (Exhibit C)

This change is reasonable because it allows assessors to consider all relevant information. This change is also reasonable because it reduces the prescriptiveness and rigidity of the rule, which furthers the legislative goal of performance based rules as described in *Minnesota Statutes,* section 14.002. See Minnesota Statutes §§ 273.11, 273.12 and discussion under Section XI. A of this document (Need and Reasonableness for Amendments as a Whole).

The prescribed weightings of the cost approach are eliminated. A new method for correlating the various indicators of value is created that allows for assessors to use sound discretion. (See discussion under Rule 8100.0300 subpart 5 below for further analysis.) This change is reasonable

because it reduces the prescriptiveness and rigidity of the rule, which furthers the legislative goal of performance based rules as described in *Minnesota Statutes*, section 14.002 and effects the statutory requirements of Minnesota Statutes §§ 273.11 and 273.12 (requiring that all property be valued at its market value and that assessors consider all relevant data pertaining to value).

Item E.

The example is modified to reflect the changes made in items A, C, and D. An example remains necessary in order to provide a graphic and understandable explanation of how to compute the cost indicator. It is reasonable to include additional lines for the changes made to the cost indicator so that the example reflects the correct way to calculate this indicator.

Subp. 4. Income Approach.

Utility companies will be allowed to request that non recurring items or income or expense be removed from the calculation. The deduction is necessary and reasonable because a purchaser would not expect continuing income from these items and would not figure them into the price it is willing to pay for the utility company. It is reasonable to require that the commissioner must determine whether the items should be removed upon request. Most items of income and expense should be included in determining value under the income approach and it would normally not be apparent to the assessor which items are recurring. The utility company has the best information concerning which items are expected to be recurring items. Requiring the commissioner to ultimately make the determination helps insure that all utilities are valued on a uniform basis.

Additional factors are added to the list that the commissioner will use in determining the capitalization rate. Risk-free rate, beta, relative risk, and risk premiums are added to considerations for the band of investment method for capitalizing income. The additions are necessary to make the process consistent with accepted appraisal practices and to allow the assessor to use a wider range of relevant information, specifically the Capital Asset Pricing Model. "Capitalization" is added to clarify the type of rate being referred to. The prescribed weighting of the cost approach is eliminated. (See 8100.0300 subpart 5 below for further explanation of the need for and reasonableness of eliminating prescribed weightings). The words "natural gas systems" and "fluid" have been added before pipelines to clarify that this subpart applies to natural gas transmission and fluid pipeline companies. The department does not consider this to be a substantive change as the rule has been interpreted to include companies which operate natural gas transmission and fluid pipelines within the commonly understood definition of "pipeline company" within the industry. The years noted in the example have been changed to simply refer to "year 1, "year 2' and "current year" to make it clear that the example applies to all years.

Subp. 4a. Additional indicators of value.

This new subpart allows for the consideration of the market indicator, or other additional indicators that are reliable and indicative of the value of a utility company. The use of any additional indicator of value requires express findings that the deviation from the default weightings is

necessary. The addition of this subpart is central to reducing the rigidity of the rule and the limitations placed on assessors in considering all relevant information that affects value.

This change is necessary: to ensure that a reasonable estimate of market value is derived; to allow for a balance between a prescriptive rule and sound appraisal judgment; to address concerns of predictability and stability in estimations of market value; and to ensure that utility valuation is easily understood and administered. Minnesota Statutes §§ 273.11 and 273.12 require respectively that all property be valued at its market value and the assessors must consider all relevant data pertaining to value. It is not possible for an assessor to properly value property at its market value if he or she cannot consider all relevant indicators of value.

Subpart 4a is reasonable because it allows additional considerations only when they are reliable and applicable. This change is also reasonable because it reduces the prescriptiveness and rigidity of the rule, which furthers the legislative goal of performance based rules as described in *Minnesota Statutes*, section 14.002. See analysis in the introduction to this document and in discussions under part 8100.0300 subpart 1, above.

Paragraph A explains that if the market indicator can be quantified, is reliable and indicative of value for a company the commissioner may adjust the default weightings in the unit value computation (see discussion under 8100.0300, subpart 5) by up to 5 percent to account for the market indicator. The market approach is one of the three commonly used indicators of value. This approach generally relies on a calculation of stock and debt but as utility companies are rarely sold this is usually not a good indicator of value. Also, utility companies are often owned by larger parent companies. It can be difficult to factor out the parent company's stock and debt value from the subsidiary's and this indicator is especially unreliable if the parent company is in a different business than the subsidiary. However, in some circumstances, such as when a utility is a major part of a publicly traded parent the stock and debt approach could be indicative of value. Language limiting use of the market factor to situations where it can be quantified and is reliable is necessary because of the inherent problems in using the market indicator of value.

Paragraph B allows the commissioner to adjust the weightings for economic obsolescence or other forms of obsolescence as well as other adjustments consistent with the rules or Minnesota Statutes. This is necessary to insure that assessors can arrive at a reasonable measure of market value. This treatment is consistent with the views on economic obsolescence expressed in *A Review of Minnesota Rules Chapter 8100,* pages 37-40 and 54 (Exhibit C).

Paragraph C requires that if the commissioner uses additional indicators of value or forms of depreciation he or she must make specific findings. It is reasonable to require that if additional indicators of value (including the market indicator) are used that the commissioner must make specific findings and state them in writing. If the commissioner deviates from the default weightings, the utility companies and host communities must be assured that the deviation is based on specific, articulable market factors. This helps to insure that assessments accurately reflect market value. Therefore it is necessary to require that the commissioner identify specific findings in order to assure that all indicators of value are properly considered and that valuations are consistent for similarly situated taxpayers.

Subp. 5. Unit value computation.

This subpart is revised to reflect changes made to 8100.0300 Subpart 3, 4, and 4a. The added language gives the assessor discretion in determining the unit value and eliminates the previously prescribed weightings from the cost and income approaches. The proposed language includes default weightings to give assessors a 'starting point' for each assessment. It is presumed that cost and income have an equal impact on value. Thus the 50/50 starting point is a neutral position from which the assessor can justify deviations if necessary. The market indicator has an initial default weighting of zero because it has not been shown to be indicative of market value for most utilities. However, the assessor can give the indicator weight in accordance with the provisions of 8100.0300 Subpart 4a. The example of a unit value computation is modified to reflect consideration of the market approach as an additional indicator of value.

The revisions are necessary: to allow the assessor to calculate a reasonable estimate of market value; to allow for a balance between a prescriptive rule and sound appraisal judgment; to address concerns of predictability and stability in estimations of market value; and to ensure that utility valuation is easily understood and administered.

These revisions are reasonable because they reduce the prescriptiveness and rigidity of the rule, which furthers the legislative goal of performance based rules as described in *Minnesota Statutes*, section 14.002. The proposed revisions make it more likely that an assessor can arrive at an accurate calculation of market value because he or she will be able to consider all relevant factors and assign appropriate weight to the factors based on appraisal judgment. On the other hand the specific guidance in the proposed language imparts predictability and stability.

Subp. 5a. Valuation election for cooperative associations.

This subpart is added to allow for cooperatives to elect their valuation method. This election is present in the existing rules, but revisions to 8100.0300 Subp. 6. necessitate revisions to the election process. For assessment year 2007, the first year that the proposed rules will be in effect, cooperatives must be valued under the same method as they currently are valued. This is necessary to allow all parties to a chance to evaluate the effect of the new rules on each cooperative before any irrevocable election is made. It is necessary that the election to change valuation methods is irrevocable to prevent cooperatives from switching back and forth between valuation methods depending on their current financial situation. Constant vacillation between the two valuation methods would cause an enormous administrative burden for the department and uncertainty for the host communities.

Subp. 6. Cost less depreciation method of valuation for utility property of cooperative associations.

The reference to historical cost has been replaced with cost less depreciation to be consistent with changes discussed below. The existing language of this subpart is divided into items A through C in order to make it easier to read.

Item A.

Historical cost method is replaced with original cost (see analysis of historical cost and original cost methods, in the discussions of 8100.0100 Subp. 11a. and 8100.0300 Subp. 3, item A above). The depreciation limit is increased to seventy-five (75) percent in order to allow a more accurate estimation of market value. However, the department of revenue anticipates that very few parcels will actually attain a seventy-five per cent depreciation rate. Nevertheless, the limit on depreciation is not completely removed because doing so may result in a value of zero for a cooperative. While this might be technically correct for a book value, it is unlikely that the cooperative would also have a market value of zero. The revised limit is a reasonable balance between an artificial limit and allowing book value to distort market value to zero. The use of the average depreciation level instead of specific depreciation rates is reasonable because it reduces the administrative burden placed on cooperatives by simplifying the calculation of the value of retirements.

Item B.

The orderly transition of companies changing from the cost less depreciation method is necessary and reasonable in order to allow the department of revenue staff time to do the work required. Requiring companies changing from one method to the other to file an election ensures that the department of revenue staff will have time to change data files.

Item C.

The example of the cost less depreciation computation is modified to reflect the revisions made to this subpart. It is necessary to include an example due to the complex nature of the calculations. This particular example is reasonable because it accurately explains how to calculate cost less depreciation according to the revised subpart B.

Subp. 8. Retirements.

The language in this subpart beginning with the third sentence in paragraph B is broken into paragraphs C through E for clarity (paragraphs A and B are retained). "Real" was added before "property" in the newly formed paragraph D to clarify that utility real property is referred to. This is necessary because only real property is taxed ad valorem. Other changes concerning the choice of word usage are made to comply with Revisor Guidelines. The changes are merely editorial and not substantive.

8100.0400 ALLOCATION.

Subpart 1. General.

The second sentence, which defines the term "allocation" is removed because it merely repeats the definition of "allocation," which is already defined in part 8100.0100, subpart 2. The last paragraph is removed because there is no need to state that the factors to be considered in making allocations of unit value are specified in the rule.

Subp. 3. Gas distribution companies.

The only changes concern the choice of word usage to comply with Revisor Guidelines. The changes are merely editorial and are not substantive.

Subp. 4. Pipeline companies.

The only changes concern the choice of word usage to comply with Revisor Guidelines. The changes are merely editorial and are not substantive.

8100.0500 ADJUSTMENTS FOR NON-FORMULA-ASSESSED OR EXEMPT PROPERTY.

Subp. 1 Deduction for exempt of non-formula-assessed property

The only changes concern the choice of word usage to comply with Revisor Guidelines. The changes are merely editorial and are not substantive.

Subp. 2 Valuation formula not applicable to certain utility property.

The only changes concern the choice of word usage to comply with Revisor Guidelines. The changes are merely editorial and are not substantive.

Subp. 3. Deduction for cost of land and rights of way; application to nonoperating property.

This subpart has been modified to conform to changes made in part 8100.0300, subparts 3 and 5. See analysis of need and reasonableness in discussion regarding those sections above.

Subp. 4. Deduction for cost of land and rights of way; application to nonoperating property.

This subpart is repealed because the process has been incorporated into 8100.0500 Subpart 3. Thus the language of this subpart is redundant.

Subp. 4a. Deduction of exempt or non-formula-assessed property of cooperatives electing to be valued under part 8100.0300, subparts 3 to 5.

This subpart is repealed because the process has been incorporated into 8100.0500 Subpart 3. Thus the language of this subpart is redundant.

Subp. 5. Burden of proof and responsibility of utility company.

The only changes concern the choice of word usage to comply with Revisor Guidelines. The changes are merely editorial and are not substantive.

8100.0800 PHASE-IN.

Subp. 1. Phase-in of valuation changes.

This new rule provides that the changes in valuation resulting from the proposed rule amendments in parts 8100.0100 to 8100.0500 are phased in over three years with the changes being fully effective in the third year. For assessment year 2007, the first year that the proposed changes would take effect, twenty per cent of the difference in value between the value derived under the current rule and the proposed changes would be added to the assessed value for 2007 regardless of whether the addition is a positive of negative sum. For assessment year 2008, the second year that the proposed changes would take effect, fifty per cent of the difference in value between the value derived under the current rule and the proposed changes would be added to the assessed value for 2008 regardless of whether the addition is a positive of negative sum. For assessment year 2009 and all subsequent years the full value derived under the proposed changes would be the assessed value.

The proposed changes in the methodology used to value utility property under Minnesota Rules Parts 8100.0100 to 8100.0500 are necessary and reasonable. See discussion of need and reasonableness under changes to rules parts 8100.0100 to 8100.0500 above. The Department of Revenue estimates that implementation of all valuation changes will result in a total reduction in valuation of approximately $1.3 billion and a reduction of taxes to the host communities of slightly less than $50 million overall. Each host community will be impacted differently. See charts in Exhibit D. School aids and property values are directly related to a community's tax base. In addition it is highly likely that bond ratings would be affected. Some values may decrease sharply enough have a serious impact upon school aids. The effect of lower valuation could result in host communities making decisions to shift taxes to other classes of taxpayers. The proposed phase in accommodates increases as well as decreases in value. While it is theoretically possible that some communities could experience an increase in property values, department of revenue projections do not show any possible increases.

Although the proposed changes in valuation methodology are necessary in order to comply with Minnesota Statutes and accepted appraisal practices, the aforementioned practical considerations must also be considered. Tax base changes will require host communities to make decisions regarding how they will fund essential services and how they will allocate the tax burden. Allowing these changes to take place in a more gradual manner over three years will allow host communities time to absorb the costs and make any required changes in an orderly and reasonable fashion. The phase-in also gives the legislature time to review any possible impacts of the rule changes act accordingly. The department believes that the goal of achieving correct market values must be weighed against the projected level of disruption to the tax bases of the host communities. Utility company valuation has been "incorrect" for decades in that the current rule did not allow assessors to arrive at true market value. We believe that two years is a reasonable period of time to work toward achieving the correct market value. *Minnesota Statutes*, section 14.002 states that one of the state's regulatory policies is that wherever feasible the rules must meet the agency's regulatory objectives while achieving maximum flexibility for the regulated parties.

Thus a phase-in is a reasonable way to implement the proposed changes in valuation methodology and at the same time mitigate decreases the tax base of host communities.

Subp. 2. Examples of phase-in valuations

This subpart is added to provide examples of how the phase-in, as described in 8100.0800 Subp. 1, is to be implemented. It is necessary to include an example due to the complex nature of the calculations. This particular example is reasonable because it accurately explains how to calculate phased in values regardless of whether the values are lower or higher under the proposed changes.

XII. LIST OF WITNESSES

These rules will go to a public hearing. At the hearing, the department anticipates having the following witnesses testify in support of the need for and reasonableness of the rules:

1. Mr. Alan Whipple, manager, State Assessed Property Section, Property Tax Division, Minnesota Department of Revenue, will testify about the development and the content of the rules, as well as the need for the proposed changes to the current rules.

2. Mr. Brent Eyre, consultant, retained by the Minnesota Department of Revenue to evaluate and make recommendations for revision of the current rules, will testify about the need and reasonableness of the proposed revisions, as well as utility assessment practices utilized by other jurisdictions.

3. Other Department of Revenue employees, as deemed necessary or appropriate.

XIV. REFERENCES

Stocks, Bonds, Bills, and Inflation Valuation Edition 200X Yearbook (SBBI) published yearly by Ibbotson Associates, 225 North Michigan Avenue, Suite 700 Chicago, IL 60601-7676 (ISBN 1-882864-23-9))

XV. CONCLUSION

Based on the foregoing, the proposed rules are both needed and reasonable.

10/30/06
Date

Daniel A. Salomone, Commissioner
Minnesota Department of Revenue