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STATE OF MINNESOTA
DEPARTMENT OF REVENUE

IN THE MATTER OF THE PROPOSED RULES OF THE DEPARTMENT OF REVENUE GOVERNING THE VALUATION AND ASSESSMENT OF RAILROAD OPERATING PROPERTY)	Statement of Need and Reasonableness

The above-captioned rules are being revised in order to fulfill the charge given to the Department of Revenue by the 1979 Minnesota Legislature. Article VII of the Omnibus Tax Bill passed by the 1979 Legislature deals with the ad valorem (property) taxation of railroads. Part of Article VII, codified as Minn. Stat. 270.81, Subd. 5, instructs the Commissioner of Revenue to promulgate both temporary and permanent rules necessary to implement the various provisions of Article VII. This task has been accomplished.

Temporary valuation rules were approved for use by the Attorney General's Office on March 6, 1980; and permanant valuation rules were approved, after hearing, by the Attorney General's Office on October 15, 1980. In addition, rules governing the apportionment of the value of railroad operating property to taxing districts were adopted without a public hearing pursuant to Minn. Stat. § 15.0412, Subd. 4-4f during 1981.

The agency now finds it necessary to revise the valuation rules which are over two years old. Valuation techniques, particularly in the dynamic economic condition of today, are constantly changing. The agency acknowledges a need for revision when conditions warrant change, and now, in the opinion of the Commissioner of Revenue these conditions are present.

This document has been prepared as a verbatim affirmative presentation of the facts necessary to establish the statutory authority, need for, and reasonableness of, the proposed revision. It is submitted pursuant to 9MCAR § 2.104 requiring a Statement of Need and Reasonableness.

A Notice of Intent to Solicit Outside Opinion Regarding the Method of Valuation of Railroad Operating Property was published in the State Register prior to the preparation of these revised rules on March 14, 1983, Volume 7, Number 37, page 1296. (7 S.R. 1296) An open forum-type discussion meeting was held on January 20, 1983. This meeting was attended by members of the Department of Revenue, county assessors, city assessors, representatives of the railroad industry and employees of various railroads. A list of those in attendance, the agenda, meeting notes and correspondence relative to the meeting is available in the Department of Revenue and is available for inspection by interested parties. Various suggestions and comments made at this meeting were received and duly considered by the agency.

Authority to Adopt Rules

Minn. Stat. § 270.06 (14) states that the ..."Commissioner of Revenue may promulgate rules and regulations for the administration and enforcement of the property tax. Such rules and regulations shall have the force and effect of law..." Clearly, the above rules are encompassed within this authority.

Further, Minn. Stat. § 270.11, Subd. 1 and 6 give the Commissioner of Revenue the authority to review, modify, revise, raise or lower the assessed valuation of the real or personal property of any individual, copartnership, company, association or corporation. This authority certainly would include railroad property.

Specifically, Minn. Stat. § 270.81, Subdivision 1 states that, "The operating property of every railroad company doing business in Minnesota shall be valued by the commissioner..." In addition, Subd. 5 requires the commissioner to "...exercise temporary rule-making authority...solicit information and opinions from outside his department," and adopt permanent rules pursuant to Chapter 15 in order to implement the provisions of this act. This statute therefore not only gives the commissioner the authority to adopt rules but also the duty and responsibility to do so.

Adoption of Proposed Rules
Need and Reasonableness

The agency is currently proposing only one revision to the existing body of ad valorem rules for railroad operating property. That revision concerns 12MCAR § 1.0024 Valuation C. Income approach to valuation.

The income approach to valuation is based on the simple axiom that a property is worth what it can earn. This concept has been upheld any number of times by various courts throughout the United States. A hotel built in the middle of a desert would most likely have a much lower value or selling price than a hotel built on a Florida beach, because the earning power of the Florida property is higher. The task, therefore, in the income approach to value, is to estimate what future earnings a prospective buyer could anticipate. This is accomplished by capitalizing the earnings of the railroad. The capitalization process is composed of two parts, the income to be capitalized, or income stream, and the capitalization rate.

Estimating future earnings is a difficult process. One of the best methods of estimating what will happen in the future is to look at what occurred in the past. For this reason, the agency has decided to look at the past earnings of the railroad being valued. Because railroad earnings are cyclical, going up and down in approximately three to four year cycles, the agency has opted to use a five year average of earnings in order to encourage a stable income stream without peaks and valleys. This stability benefits not only the railroads but also the taxing districts which will be the recipient of the taxes paid by the railroads. Both are ensured of a relatively constant base from which to plan budgets, expenditures and revenues. The income to be capitalized will be Net Railway Operating Income. This term represents income of a specific nature as defined by the Interstate Commerce Commission. Net Railway Operating Income is basically operating revenue, less operating expenses and taxes. It is a common figure easily obtainable by each railroad and easily audited by various regulatory bodies.

The use of this income for the income stream is not unique to Minnesota. Most states which use the unit method of valuing railroads capitalize Net Railway Operating Income or a variation of it.

The second portion of the income approach to valuation involves the establishment of a capitalization rate to be applied to the income stream. It is most important to match the proper capitalization rate to the income being capitalized. There are three basic approaches which can be used to establish a capitalization rate: the

Summation Method, the Comparative Method and the Band of Investment Method. Without going into a technical explanation of each, the summation method is a method whereby a rate is built by starting with the "safe rate" (government bonds) and adding to it increments which would be required to reflect the lesser desirability (risk) of a given investment. The comparative method recognizes the reaction of the market to a specific investment; that is, it compares the known selling price and known income of investments to the investment under examination. It is commonly shown by the following equation:

$$\frac{\text{Income}}{\text{Selling Price}} = \text{Indicated Capitalization Rate}$$

The band of investment method is a synthesis of mortgage and equity rates which market data disclosed as applicable to comparable properties. The rate developed is a weighted average, the weighting being for percentages of the value which would be occupied by the mortgage and equity position, or bands of investment.

The agency has chosen the Band of Investment method to develop a capitalization rate. The numerical development of this rate is shown in Exhibit I attached to this Statement.

The revision proposed by the agency is occasioned by the fact that the original calculation of the capitalization rate in 1980 - using exactly the same sources and methodology - resulted in an 11% capitalization rate. As is evidenced by our Exhibit the data now results in the calculation of a 12% capitalization rate.

The method employed again uses averages, just as the income stream does, to insure stability. The agency has developed one capitalization rate for all railroads doing business within Minnesota. We believe this is reasonable in that it follows the practice of both the legislature and the courts in Minnesota of treating all members of one class of property alike. The classification system is a good example: Minnesota has many different classifications of property. Some classes of property are assessed at a higher rate than others, but all property within one class is assessed at the same rate. This is analogous to what the agency has attempted to do within the framework of these proposed rules: treat all property owners of one class, i.e., railroads, alike. For this reason we have not developed individual capitalization rates, one for each road, but an average rate to be applied to all roads.

The agency believes that using the income approach to value is both necessary to arrive at a fair determination of value and reasonable in its application through the use of matched income streams and capitalization rates. Since we followed this rationale in 1980 when the available data resulted in the calculation of an 11% capitalization rate we now believe it is only reasonable, consistent and necessary to revise the rules when the available data reflects a 12% capitalization rate.

While the agency is limiting its proposed revision at this time to only one area we will continue to be responsive to changing economic conditions, valuation techniques and assessment policies. Revision will continue to be proposed to the existing rules whenever they are warranted.

EXHIBIT I

STATEMENT OF NEED AND REASONABLENESS

CAPITALIZATION RATE WORK-UP

A. The figures used in the study on the capitalization of the average railroad (left side of the worksheet) were obtained from the I.C.C. and represent historic face value figures. The results showed a make-up of 63% debt and 37% equity for the average railroad.

B. The rates used in the Cost of Money Study represent the average of four different railroad bonds. Aaa, Aa, A, Baa. This study considered the imbedded debt of railroads and calculated a rate of 8.78%.

C. The indicated rates shown in the Common Stock Yield Study (lower right corner of worksheet) represent yields obtained by adding the dividend yield to the percent of earnings per share increase over a five-year moving average. This study not only considers dividend yield but appreciation in per share prices. The average indicated rate was calculated to be 17.90%.

D. The resulting capitalization rate calculation (upper right hand corner of worksheet) was obtained bv adding a weighted debt cap rate percentage and a weighted equity cap rate percentage.

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CAPITALIZATION OF AVERAGE RAILROAD

10-YEAR STUDY - HOW THE AVERAGE RAILROAD IS CAPITALIZED

YEAR	FUNDED DEBT (MILLIONS)	EQUITY (MILLIONS)	TOTAL (MILLIONS)
1972	7,063	5,905	12,968
1973	7,198	5,894	13,092
1974	7,088	5,870	12,958
1975	7,633	5,840	13,473
1976	8,870	5,106	13,976
1977	9,810	4,971	14,781
1978	9,586	4,159	13,745
1979	9,914	4,289	14,203
1980	10,570	4,515	15,085
1981	10,363	4,606	14,969

YEAR	PERCENT OF DEBT TO TOTAL	PERCENT OF EQUITY TO TOTAL
1972	54.46%	45.54%
1973	54.98%	45.02%
1974	54.70%	45.30%
1975	56.65%	43.35%
1976	63.46%	36.53%
1977	66.37%	33.63%
1978	69.74%	30.26%
1979	69.80%	30.20%
1980	70.06%	29.94%
1981	69.23%	30.77%
AVERAGE	62.95%	37.05%
ROUNDED AVERAGE	63%	37%

Source:

Transport Statistics in the U.S.
Interstate Commerce Commission

15 YEAR STUDY
COST OF MONEY

YEAR	%
1967	5.89%
1968	6.77%
1969	7.46%
1970	8.77%
1971	8.38%
1972	7.99%
1973	8.12%
1974	8.98%
1975	9.39%
1976	8.85%
1977	8.13%
1978	8.64%
1979	9.60%
1980	11.48%
1981	13.22%
Average	8.78%

Source:

Moody's Transportation
Manual

COMPUTATION OF AVERAGE CAPITALIZATION RATE

1.	Average Railroad Debt Cost	8.78%
2.	Average Funded Debt % of Capitalization	63%
3.	Weighted Debt Cap. Rate Factor	5.53%
4.	Average Railroad Equity Return	17.90%
5.	Average Equity % of Capitalization	37%
6.	Weighted Equity Cap. Rate Factor	6.62%
7.	Average Railroad Cap. Rate (Line 3 + Line 6)	12.15%
8.	Capitalization Rate Rounded To	12%

5-YEAR RAILROAD COMMON STOCK YIELD STUDY

YEAR	AV MKT PRICE	DIVIDENDS PER SHARE	DIVIDEND YIELD %	EARNINGS PER SHARE	5 YR MOVING AVER. E. PER S	% OF E/S INCREASE	INDICATED RATE
1977	49.94	2.49	4.99%	6.25	5.32	9.92%	14.91%
1978	45.35	2.64	5.82%	6.65	5.79	8.83%	14.65%
1979	51.74	2.85	5.51%	9.65	6.59	13.82%	19.33%
1980	75.57	3.23	4.27%	10.65	7.78	18.06%	22.33%
1981	93.09	3.58	3.85%	11.30	8.90	14.40%	18.25%
AVERAGE	63.14	2.96	4.89%	8.90	6.88	13.01%	17.90%

Source: Standard & Poors Statistical Service Security Price Index Record