

STATE OF MINNESOTA
OFFICE OF ADMINISTRATIVE HEARINGS
FOR THE MINNESOTA DEPARTMENT OF REVENUE

In the Matter of Proposed Rules
Governing the Valuation and
Assessment of Personal Property of
Electric, Gas Distribution and Pipeline
Companies, Minn. Rule Chapter 8100.

REPORT OF THE
ADMINISTRATIVE LAW JUDGE

The above-entitled matter came on for hearing before Administrative Law Judge Richard C. Luis at 9:00 a.m. on May 6, 1996, at the Minnesota Department of Revenue, 10 River Park Plaza, St. Paul, Minnesota. The hearing continued until all interested persons had been heard.

This Report is part of a rulemaking proceeding held pursuant to Minn. Stat. §§ 14.131 to 14.20, to hear public comment, to determine whether the Minnesota Department of Revenue (the Department) has fulfilled all relevant substantive and procedural requirements of law applicable to the adoption of the rules, whether the proposed rules are needed and reasonable and whether or not modifications to the rules proposed by the Department after initial publication are impermissible, substantial changes.

Richard L. Walzer, Staff Attorney, Minnesota Department of Revenue, 10 River Park Plaza, Eighth Floor, St. Paul, Minnesota 55146, appeared on behalf of the Department. The Department's hearing panel consisted of Allan Whipple, Manager of the State Assessed Properties Section, and Gerald Garski, Assistant Director of the Property Tax Division. Forty persons attended the hearing. Thirty-two persons signed the hearing register. The hearing continued until all interested persons, groups or associations had an opportunity to be heard concerning the adoption of these rules.

The record remained open for the submission of written comments for twenty calendar days following the hearing, to May 28, 1996. Pursuant to Minn. Stat. § 14.15, subd. 1, five working days were allowed for the filing of responsive comments. At the close of business on June 4, 1996 the rulemaking record closed for all purposes. The Administrative Law Judge received written comments from interested persons during the comment period. The Department submitted written comments responding to matters discussed at the hearing and identifying the amendments proposed to the rules.

The Commissioner of Revenue must wait at least five working days before taking any final action on the rule(s); during that period, this Report must be made available to all interested persons upon request.

Pursuant to the provisions of Minn. Stat. § 14.15, subd. 3 and 4, this Report has been submitted to the Chief Administrative Law Judge for his approval. If the Chief

Administrative Law Judge approves the adverse findings of this Report, he will advise the Commissioner of actions which will correct the defects and the Commissioner may not adopt the rules until the Chief Administrative Law Judge determines that the defects have been corrected. In those instances where the Chief Administrative Law Judge identifies defects which relate to the issues of need or reasonableness, the Commissioner can adopt the Chief Administrative Law Judge's suggested actions to cure the defects. An alternative is provided for in Minn. Stat. § 14.15, subd. 4, to allow agencies that choose not to adopt the suggested language, if the agency submits the proposed rule to the Legislative Commission to Review Administrative Rules (LCRAR) for the Commission's advice and comment. The LCRAR was abolished, effective July 1, 1996. See Laws of Minnesota 1995, Chapter 248, Art. 2, Sec. 6 (allowing only legislative commissions approved by the Legislative Coordinating Commission to continue in existence).

If the Commissioner elects to adopt the suggested actions of the Chief Administrative Law Judge and makes no other changes and the Chief Administrative Law Judge determines that the defects have been corrected, then the Commissioner may proceed to adopt the rules and submit them to the Revisor of Statutes for a review of the form. If the Commissioner makes changes in the rules other than those suggested by the Administrative Law Judge and Chief Administrative Law Judge, then he shall submit the rules, with the complete hearing record, to the Chief Administrative Law Judge for a review of the changes before adopting them and submitting them to the Revisor of Statutes.

When the Commissioner files the rules with the Secretary of State, he shall give notice on the day of filing to all persons who requested that they be informed of the filing.

Based upon all the testimony, exhibits, and written comments, the Administrative Law Judge makes the following:

FINDINGS OF FACT

Procedural Requirements

1. On March 12, 1996, the Department filed the following documents with the Chief Administrative Law Judge:

- (a) a copy of the proposed rules, certified as to form by the Revisor of Statutes;
- (b) a proposed Notice of Hearing;
- (c) a Statement of Intent to Provide Additional Discretionary Public Notice;
- (d) a Statement of Need and Reasonableness (SONAR).

2. On March 28, 1996, the Department mailed the Notice of Hearing to all persons and associations who had registered their names with the Department for the purpose of receiving such notice and the persons who appear on the list of additional persons to receive the Notice of Hearing.

3. On April 1, 1996, the Notice of Hearing and the proposed rules were published at 20 State Register 2399.

4. On April 4, 1996, the Department filed the following documents with the Administrative Law Judge:

- (a) a photocopy of the Notice of Hearing, as mailed;
- (b) the Certificate of Mailing the Notice of Hearing and Certificate of Mailing List;
- (c) the Certificate of Additional Discretionary Notice;
- (d) the Certificate of Mailing the SONAR to the Legislative Commission to Review Administrative Rules;
- (e) a photocopy of the Notice of Intent to Solicit Outside Information or Opinions, published at 20 S.R. 176 on July 24, 1995; and
- (f) a photocopy of the Notice of Hearing and Proposed Rules, as published at 20 S.R. 2399 on April 1, 1996.

5. At the hearing, the Department filed the comments it received to that date concerning the proposed rules, including comments on meetings held prior to the Notice of Solicitation. See Exhibits 9-25.

Task Force on Proposed Rule.

6. No advisory task force was formed to assist the Department in formulating these rules. The Notice of Solicitation of Outside Opinion, published in the State Register on July 24, 1995, indicates that the reason for not doing so was the expectation that the rules would be ready for the 1996 assessment year.

Nature of the Proposed Rules and Statutory Authority.

7. Property taxes are paid to counties in Minnesota by utilities on some of the property used by the utility for the generation or transmission of electricity, petroleum, or natural gas. The taxes are determined in part by the valuation of the property subject to taxation. The Department has used a combination of cost factors and income factors to determine the appropriate valuation of each utility's property. The Department has concluded that a more accurate valuation can be achieved by changing its method of calculating the value of some utility property. Further, the Department has recognized a change in the utility industry, introducing more competition into the market for electricity. The Department has concluded that such a change requires a change in the valuation formula used for electric utilities.

8. In its SONAR, the Department cites a number of statutes supporting its authority to adopt these rules. Minn. Stat. § 270.06(14) generally authorizes the Commissioner to make rules regarding assessments under the tax laws of the State. Minn. Stat. §§ 273.33, subd. 2; 273.37, subd. 2; and 273.38 authorize the Commissioner to assess certain pipeline property and certain electrical transmission

property. The Judge concludes that the Department has the general statutory authority to adopt the proposed rules.

Cost and Alternative Assessments in SONAR.

9. Minn. Stat. § 14.131 provides that state agencies proposing rules must identify classes of persons affected by the rule, including those incurring costs and those reaping benefits; the probable effect upon state agencies and state revenues; whether less costly or less intrusive means exist for achieving the rule's goals; what alternatives were considered and the reasons why any such alternatives were not chosen; the costs that will be incurred complying with the rule; and differences between the proposed rules and existing federal regulations.

10. The Department indicates that costs for utilities arising from the rule itself will not change, but utilities will experience changes in their property taxes as a result of the rule. SONAR, at 2 The Department concluded that no fiscal impact would be experienced by the State, local public bodies, or the utilities in complying with the proposed rules and, therefore, no less costly way to comply could be devised. *Id.* Since the Department is not aware of any Federal property tax or other regulations with an effect on the Department's rules, the Department concluded there was no conflict between the proposed rules and any Federal regulation. *Id.* The Administrative Law Judge finds that the Department has met the requirements of Minn. Stat. § 14.131 relating to cost and alternative assessments.

Impact on Farming Operations

1. Minn. Stat. § 14.111 (1996), imposes an additional notice requirement when rules are proposed that affect farming operations. The proposed rules will not affect farming operations and no additional notice is required.

Assessment of Error

2. The required notice of hearing mailed to both the required and discretionary mailing lists lacked several paragraphs. Mailing an incomplete notice is a procedural error. Under Minn. Stat. § 14.15, subd. 5, the Judge must assess the agency's effort to correct the error and determine if the error is harmless, whether some additional action is needed to cure the error, or whether the rulemaking proceeding must be delayed to provide for a new notice and hearing date.

3. Upon discovering the error, the Department mailed the missing portion of the notice to the persons who had received the incomplete notice. Exhibit 26. The missing portion was mailed on May 1, 1996. The omitted paragraphs relate solely to post hearing rule proceedings. The parties involved in this rulemaking are sophisticated in their knowledge of the rulemaking process. No interested party has been denied the opportunity to participate meaningfully in this rulemaking proceeding by the Department's error. The error is harmless within the meaning of Minn. Stat. § 14.15, subd. 5.

Analysis of the Proposed Rules

4. Under Minn. Stat. § 14.14, subd. 2, and Minn. Rule 1400.2100, the Administrative Law Judge must determine whether the need for and reasonableness of the proposed rules have been established by the Department by an affirmative presentation of facts. The Department prepared a Statement of Need and Reasonableness ("SONAR") in support of the adoption of each of the proposed rules. At the hearing, the Department supplemented the SONAR in making its affirmative presentation of need and reasonableness for each provision. The Department also made written post-hearing comments.

5. The question of whether a rule is reasonable focuses on whether it has a rational basis. The Minnesota Court of Appeals has held a rule to be reasonable if it is rationally related to the end sought to be achieved by the statute. Broen Memorial Home v. Minnesota Department of Human Services, 364 N.W.2d 436, 440 (Minn. App. 1985); Blocher Outdoor Advertising Company v. Minnesota Department of Transportation, 347 N.W.2d 88, 91 (Minn. App. 1984). The Supreme Court of Minnesota has further defined the burden by requiring that the agency "explain on what evidence it is relying and how the evidence connects rationally with the agency's choice of action to be taken." Manufactured Housing Institute v. Pettersen, 347 N.W.2d 238, 244 (Minn. 1984). An agency is entitled to make choices between possible standards as long as the choice it makes is rational. If commentators suggest approaches other than a rational one selected by the agency, it is not the proper role of the Administrative Law Judge to determine which alternative presents the "best" approach.

6. In addition to need and reasonableness, the Administrative Law Judge must assess whether the rule adoption procedure was complied with, whether the rule grants undue discretion, whether the agency has statutory authority to adopt the rule, whether the rule is unconstitutional or illegal, whether the rule constitutes an undue delegation of authority to another, or whether the proposed language is not a rule. Minn. Rule 1400.2100. This Report is generally limited to the discussion of the portions of the proposed rule that received significant critical comment or otherwise need to be examined. Accordingly, the Report will not discuss each comment or rule part. Persons or groups who do not find their particular comments referenced in this Report should know that each and every submission has been read and considered. Moreover, because some sections of the proposed rule were not opposed and were adequately supported by the SONAR, a detailed discussion of each section of the proposed rule is unnecessary. The Administrative Law Judge specifically finds that the Department has demonstrated the need for and reasonableness of the provisions of the rule that are not discussed in this Report, that such provisions are within the Department's statutory authority, and that there are no other problems that prevent their adoption.

7. Where changes are made to the rule after publication in the State Register, the Administrative Law Judge must determine if the new language is substantially different from that which was proposed originally. Minn. Stat. § 14.15, subd. 3 (1996). The standards to determine if the new language is substantially different are found in Minn. Stat. § 14.05, subd. 2 (1996). Any language proposed by the Department which differs from the rule as published in the State Register and is not discussed in this Report is found not to be substantially different from the language published in the State Register.

8. The Department has proposed a definition for “earnings growth rate” be added as subpart 5a. The proposed language reads:

“Earnings growth rate” means the average increase or decrease in the five-year moving average earnings per share as computed in the annual capitalization rate study. The rate will be adjusted to normalize income to one year in the future.

9. Eugene Morabito, Attorney for Great Lakes Gas Transmission Limited Partnership (Great Lakes) asserts that the use of an earnings growth rate is irrational because earnings from the utility portion of its business have become stagnant or declined. Transcript, at 113-114; Great Lakes Reply, at 5. The Department responded that it uses the “unit value method” of assessment which treats the assessed property as part of an ongoing economic activity. Transcript, at 66-67. While the unit value method does not allocate earnings between assessed and nonassessed property, the recognition of an income factor shows that the cost of the assessed property alone is not the proper basis for taxation. No utility is being taxed upon its earnings by this rule, rather the earnings are being used to reach a more accurate valuation of the property subject to property tax. That goal is achieved more appropriately through an allocation between income and cost factors in the valuation formula.

10. The definition proposed by the Department allows for a drop in overall earnings to be reflected in a reduction in the income factor used to determine the valuation of property. To the extent that nonutility aspects of the corporate business have provided the earnings, there is an argument that such earnings should not affect utility property valuation. However, the converse, that losses in those other areas would serve to reduce the property valuation, is equally true. How a company structures its holdings is not for the Department to determine. The trend assessed for application in the assessment year for the income factor is of stock yields. A reasonable rate of return for investors is included in the rates of regulated utilities. Changes in the earnings rate of stock is a measure of income for the utility enterprise, even if nonutility activities are included in the earnings rate. It is found that assessing the trend of such a measure and extrapolating that trend into the current assessment year is reasonable to achieve a measure as close as reasonably possible to the actual value of the property being assessed.

11. The proposed definition calculates the earnings growth rate as an increase or decrease. The definition does not indicate how the increase or decrease is to be expressed. As applied in Minn. Rule 8100.0300, subpart 4, the rate is applied as a percentage. In order to function in the remainder of the rule, the definition should indicate that the rate is a percentage. Failure to do so leaves somewhat vague a critical component of the valuation calculation. The language does not constitute a defect in this instance since the persons regulated by this rule are sophisticated in utility calculations and are aware that a percentage is required. While not a defect, the Judge suggests adding “expressed as a percentage” after the words “earnings per share”. The subpart is needed and reasonable. The additional language, if adopted by the Department, is not substantially different from the rule as proposed and is likewise found to be necessary and reasonable.

12. The Department has proposed to delete subpart 17, which defines “weighted pipeline miles.” The calculation which used that figure is being deleted from the rules

Minn. Rule 8100.0200 - Introduction

13. Minn. Rule 8100.0200 describes the purpose and overall procedure in determining the valuation of utility companies operating within Minnesota. The Department originally proposed to modify part .0200 by including equalization as a task to be performed in these rules and requiring that the new rule for valuation be used for the assessments done in 1996. A number of commentators criticized the proposal to use the new system in 1996. Daniel Boris, Senior Deputy Assessor for the Minneapolis Assessor's Office, indicated that the Minneapolis assessment roll was virtually completed and a change now would have a significant budget impact due to work needing to be redone. Transcript, at 37. Kathleen Heaney, Assistant Sherburne County Attorney, suggested that the fiscal impact would be severe and that either service cuts or layoffs could result if the formula was to be used for 1996 valuations. Transcript, at 51. In response to the comments, the Department indicated at the hearing that there was no compelling need to mandate the implementation of the amendments for the 1996 assessment year. Transcript, at 27-28. Jim Duevel, Director of Taxes for Northern States Power, Inc. (NSP), strongly supported the change in valuation method occurring in 1996. Transcript, at 57. NSP asserts that, since the change in the rules was first discussed in 1994, local public bodies have had sufficient time to prepare for new standards. *Id.*

14. The assessment of costs to local public bodies done by the Department estimates no significant costs will be incurred due to this rule. Requiring the assessing authorities to redo work would result in significant costs. While utilities that would experience lower valuations (and thereby lower taxes) from the new formula are eager to see the change done as soon as possible, the burden on local public bodies renders changing the system in 1996 unreasonable, absent some compelling need. No such compelling need has been shown. At the hearing, the Department recognized that it could not meet the June 30, 1996 deadline for having this rule in place to be applied for the 1996 assessments. Therefore, the Department agreed to change the implementation to 1997. Transcript, at 98. The Department has shown that making the system effective in 1997 is needed and reasonable. The rule part, as modified, is needed and reasonable. The new language is not substantially different from the rules as proposed.

Minn. Rule 8100.0300 - Valuation

15. The only change proposed in subpart 1 of Minn. Rule 8100.0300 was the effective year for the new system. As in the foregoing rule part, the rule has been modified to apply the new system in 1997, rather than 1996 as originally proposed. The new language in subpart 1 is needed, reasonable, and not substantially different from the originally proposed rule.

Subpart 3 - Cost Approach

16. Subpart 3 of Minn. Rule 8100.0300 sets out the approach to determining the cost factor to be used in the utility valuation formula. Generally speaking, the cost factor is determined by taking the original cost of the property, subtracting depreciation,

adding the cost of improvements, and adding the cost of work in progress on the assessment date. For determining the valuation of utility property, subpart 3 established a “weight” for the cost factor, that is, what percentage of the figure arrived at would be included in the valuation formula. For electric companies, the existing weight is 85%. The current rules set the weight for gas distribution companies and pipeline companies at 75%. The sole change proposed for subpart 3 is to set the weight for electric companies at 75%.

17. Sherburne County objected to the change in allocation for electric utilities from 85% being determined by cost of the property being assessed. By Sherburne County’s calculation, the assessed value of Sherco 3 (the largest electrical generating plant in Minnesota) of Northern States Power, Inc. (NSP) is currently \$453,805,300. Transcript at 47. By reducing the cost factor to 75% of the valuation, Sherburne County estimates the valuation would be reduced to \$440,191,100, a reduction of over 13 million dollars. *Id.* Sherburne County asserts that the change in the rule, and the resulting reduction in property tax revenue from decreased valuation of utility property, has not been shown to be needed or reasonable.

18. Changes in the utility industry, particularly to introduce competition, are cited by the Department and the utilities as supporting the change in weighted allocation from cost to income. SONAR, at 4-5. Interstate Power Company (Interstate) provided a number of articles discussing competition in the electrical utility industry and a paper by the Minnesota Department of Public Service (DPS). Interstate Comment, Exhibits 1-3. The DPS paper indicates that personal property taxation is a significant cost to utilities and that enterprises that cogenerate power are partially exempt from such taxation. *Id.* Exhibit 1. Under such circumstances, utilities could be at a significant disadvantage in competition with cogenerators based on the price offered consumers. NSP indicates that the Federal Energy Regulatory Commission (FERC) and state commissions have acted to introduce competition into the electrical utility industry. NSP Comment, at 2. Nine wholesale consumers are claimed to have been lost by NSP to competition. *Id.* The rate of return set by the Minnesota Public Utilities Commission (MPUC) in the NSP 1993 electric rate case is identified as the same rate as those set for natural gas utilities. *Id.* at 3. The reason cited by NSP is the similarity of risk between the utilities, due to the introduction of competition.

19. Sherburne County asserts that no significant competition exists at the present time. The only cogenerators identified as currently operating are the NRG group and the Koch refinery. Transcript, at 48. The NRG group is a wholly owned subsidiary of NSP. Sherburne County Comment, Exhibit B, at 13. Sherburne County argues that utilities are addressing the potential for more competition by merging, thereby reducing potential competitors, and by pooling capital assets, thereby reducing the risk of capital investment. Transcript, at 50-51. For example, NSP is in the process of acquiring Wisconsin Energy Corporation, a neighboring utility in Wisconsin. Transcript, at 50; Sherburne County Comment, Exhibit A and Exhibit B, at 2.

20. The Department asserts that the 85% cost weighting for valuation was based upon the extent of regulation of electric utilities. Transcript, at 60. While the record supports the conclusion that competition is not yet pervasive in the industry, the mere opportunity for competition significantly changes the risk run by a utility in making capital investments in generating or transmission facilities. The inherent delay in

changing the standard of valuation, in this matter two years from notice of solicitation to implementation in assessing 1997 property values, also supports making the change now, rather than waiting for competition to increase and then reassessing the validity of the allocation. With the increase in risk to both the gas distribution and electric utility industries assessed to be equivalent, weighting the cost factor for both industries at the same percentage is both needed and reasonable. Subpart 3 is found to be needed and reasonable, as proposed.

Subpart 4 - Income Approach

1. Subpart 4 sets out the method of determining the income factor in the valuation calculation. The Department proposes to delete deferred taxes from the calculation, add an adjustment for the earnings growth rate, and change the weight of the income factor to 25% for electric utilities. The Department also replaced its existing examples of how the income factor is calculated with examples applying the new formula. The formula proposed takes the Net Operating Income (NOI) for each of the three preceding years and multiplies each by the square of the sum of 1 plus the earnings growth rate (expressed in decimal form). Each product of those actions is multiplied by a weighting factor (first year - 25%; second year - 35%, third year - 40%) and each product is identified as the weighted income to be capitalized. That amount is multiplied by the capitalization rate determined through the band of investment method. That method considers the utility's capital structure, its debt cost, and the yield on the utility's preferred and common stock. The resulting annual totals over the three year period are added to arrive at the total income indicator of value.

2. Prior to this rulemaking, the Department suspected that the existing three-year averaging method was not arriving at an accurate valuation for utility property income. Transcript, at 63. To determine if other methods were useful to arrive at a more accurate figure, the Department commissioned a study by Professor Timothy Nantell of the University of Minnesota's Carlson School (hereinafter "the Carlson Study"). The Carlson Study examined existing methods of valuation of railroads and utilities and concluded that the existing Department method was appropriate, particularly to achieve a "smoothing of valuations from year to year." Exhibit 30, at 8.

3. A model was developed to determine how the existing valuation methodology used by the Department compares to other methods of determining value. Exhibit 30, at 10. Based upon the results of the model and operating within the limits of policy and practicality imposed by the Department, the Carlson Study proposed that a growth estimation be included as a component of the NOI. *Id.* at 12. Simply averaging the rate of growth over the past three years results in the future growth rate being the average growth rate over the past three years. *Id.* at 12-13. To account for the extrapolation into the future, the growth rate should be squared. *Id.* at 13. The Department accepted this suggestion and incorporated the calculation in the proposed rule.

4. The Department pointed out that the earnings growth calculation method proposed in the rule is not intended to estimate closely any particular utility's earnings in the upcoming year. That would more properly be done by an individual assessment of each utility and the conditions under which it operates. Transcript, at 64. Rather, the Department intends to use a method that comes closer to the actual income of the utility

without losing the beneficial effects of stabilizing the valuation of property taxed from year to year. *Id.* This achieves the Department's dual purposes of obtaining a reasonably accurate valuation of property and establishing a stable revenue stream for local governments.

5. Interstate urged that the adjustment to NOI not include squaring the earnings growth rate plus one. Interstate Comment, at 5. The commentator maintains that multiplying one allocation factor by another can multiply error. *Id.* Squaring the growth rate plus one is a method of going beyond the mere average of the last three years to determine what the next year's income will be. The inclusion of squaring the earnings growth rate is done to conform more closely to the calculated outcome to the results already seen in utility earnings. Exhibit 30, at 12-13.

6. Great Lakes characterized the Carlson Study as a "student project" and suggested that the conclusions drawn from the Carlson Study are not reliable. The Carlson Study was performed with the assistance of two graduate students. These individuals, by definition, had already earned college degrees. They were working under the direction of a Full Professor of Finance at the University of Minnesota. None of the methodology identified in the Carlson Study by the commentator was demonstrated to be incorrect or misapplied. There is no basis in the rulemaking record to discount the Carlson Study.

7. A study by John Goodman, Vice President of AUS Consultants (hereinafter "Goodman Study"), is cited by Great Lakes and NSP as supporting their contention that the Department's proposed methodology is not reasonable. The Goodman Study relies upon numbers with a "forward looking flavor." Transcript, at 125. Particularly, the method advocated to determine anticipated earnings is to estimate next year's dividend, divide that amount by the current stock price and add estimated growth in the next year. *Id.* This methodology, a variation of the discounted cash flow (DCF) model used in determining rate of return for utility regulation purposes, presents several problems. The Carlson Study examined a similar method and rejected it since "the majority of companies are private and MDR [the Department] does not have the resources to determine an accurate forecast for each company." Exhibit 30, at 8.

8. The City of Minneapolis suggested that the averaging should necessarily use a lower capitalization rate to reflect the lower risk obtained by averaging. Transcript, at 36-37. Great Lakes criticized the calculation of the capitalization method as including historical data that was too remote to be useful. Transcript, at 120 and 124-125; Great Lakes Comment, at 3. Other than the deletion of deferred taxes from the calculation, the method used to arrive at the capitalization rate is not being proposed for change by the Department. The commentators supported the deletion. There is no defect in the proposed rule for using the capitalization method already existing in Chapter 8100.

9. The Department is relying upon historical data and using a widely accepted method of extrapolating the change in past years' earnings into the next year. The alternative proposed by Great Lakes relies upon two estimated numbers (next year's dividend and next year's growth) and one known number (current share price). Great Lakes has not identified how confidence is to be established in the estimated numbers required for its proposed formula. The Department has shown its method to be reliable,

10. The language of subpart 4 requires that net income be “adjusted for the earnings growth rate.” “Adjusted” is too vague a term to adequately describe the calculation required by the subpart. There is no express statement in the rule language as to what constitutes the adjustment required. The subpart is found to be impermissibly vague. To cure this defect, the Department can either add a sentence describing the adjustment process or replace “adjusted” with a description of the mathematical manipulations required to achieve the desired adjustment. If the Department chooses the former option, the Judge suggests the following language:

The earnings growth rate adjustment is performed by adding the earnings growth rate, expressed in decimal form, to one (1), squaring the sum of the two numbers, and multiplying the result by the net operating income figure.

Should the Department choose the latter option, the Judge suggests replacing “adjusted” with “multiplied by square of the sum of the earnings growth rate plus one.” While either suggested change is more difficult to read, the language is clearer in terms of what operations must be performed to achieve the desired mathematical calculation. When an increase or decrease is experienced, the impact on the income factor is clearly indicated. Without such a change, the example shown later in the subpart is the only statement purporting to show how the process is intended to work, but it is unclear that the example shows a calculation of the adjusted earnings growth rate. With either suggested change, subpart 4 is found to be needed and reasonable. The new language suggested to cure this vagueness defect is found, under either of the options noted above, not to be substantially different from the rule published in the State Register, and if adopted, is found to be necessary and reasonable.

Subpart 7 - Obsolescence Allowances

1. The Department proposed to delete subpart 7 of Minn. Rule 8100.0400, which set standards for “economic obsolescence.” The Department explained that the subpart was adopted to address the specific situation that could arise for pipelines transporting products from Canada if the Canadian government suspended trade in those products with the United States. Transcript, at 30-31; SONAR, at 6. The Department has concluded that there is little risk of such suspension occurring and therefore the rule is no longer necessary. The Department has identified discretionary authority on the part of the Commissioner in Minn. Rule 8100.0200 to modify assessed value where circumstances dictate the need for such action. Transcript, at 79.

2. Great Lakes suggested that other forms of economic obsolescence could occur and proposed language to allow a utility to apply for relief when property becomes functionally or economically obsolete. NSP supported the Great Lakes language, asserting that deletion of the definition would imply obsolescence is no longer a consideration in property valuation. NSP Comment, at 3. The Department declined to accept the proposed language, preferring to rely upon the Commissioner's discretion to arrive at an accurate valuation when unusual circumstances arise. Transcript, at 147. There is no suggestion from the commentators that the specific reason for adopting this provision originally remains valid.

3. Great Lakes has pointed out that the valuation provisions concerning railroads have an obsolescence provision. The commentator maintains that the Department is discriminating by not affording gas pipelines such a provision. The Department pointed out that railroads are different from gas pipelines and asserted that economic data from railroads should not form the basis of conclusions about economic valuation. Transcript, at 87. The impact of changes in the railroad industry are not clearly present in the gas transmission industry. The subjects of regulation are different between railroads and natural gas pipelines and the impact of economic and functional changes are also different. Since the two industries are not similarly situated in how changes occur, there is no discrimination demonstrated by the Department's reliance upon a different means of addressing the potential for obsolescence. The Department has demonstrated that the concerns of the commentators can be met by means of the Commissioner's discretionary authority under Minn. Rule 8100.0200. Deleting subpart 7 has been shown to be needed and reasonable.

Minn. Rule 8100.0400 - Allocation

4. The existing rule allocates the value of pipeline companies between Minnesota and other states by factoring cost, gross revenue, and weighted pipeline miles. Proposed subpart 4 of Minn. Rule 8100.0400 deletes the existing system and replaces it with allocations of cost and throughput, weighted at 75% and 25%, respectively. The allocation calculations are performed by comparing Minnesota costs to total system cost and Minnesota throughput to total system throughput. The resulting amounts are each multiplied by its respective weighting factor and the final amounts arrived at are added together to derive the percentage of property value allocated to Minnesota.

5. Great Lakes questioned how the allocation of cost and throughput was to be made. In the proposed rule as certified by the Revisor of Statutes and published in the State Register, the throughput figure was identified as a dollar amount. The Department clarified that the addition of a dollar sign was an error; the figure was to be a quantity measurement. Transcript, at 89-90. For natural gas pipelines, the measurement would be in Mcf miles (cubic feet in thousands per mile). *Id.* The Department indicated that the only utility that has expressed any difficulty with the formula was Great Lakes. Transcript, at 88. The rule part, as modified, is found to be needed and reasonable. The change to delete dollar signs conforms the rule example with the Department's intent and does not constitute a substantially different rule from that originally proposed. To clarify the rule further, it is suggested the Department add the parenthetical "(Mcf or barrel miles)" after "Minnesota Throughput" and "System

Throughput" in subpart 4. Such changes are clerical and clarifying in nature, are not substantial and are found to be necessary and reasonable.

6. The City of Minneapolis questioned what effect the rules would have on petitions challenging assessments. The Department responded that its existing policy is to defend actively such appeals when it has made a valuation required by statute but not to defend where only an advisory opinion as to value is sought by a county. Transcript, at 39. Appeals are necessarily tangential to the rule, absent specific facts to the contrary. There is nothing in the record to indicate that any part of the rule is affected by utilities appealing valuations.

7. Great Lakes urged that the Department delay implementation of the new valuation formula until a legislatively mandated study to analyze utility taxation by the Department, the Minnesota Department of Public Service, and the Minnesota Public Utilities Commission (hereinafter "Joint Study") is completed. See Minn. Laws 1996, Ch. 444 § 4 (Uncodified). No commentator has identified any particular aspect of the Department's proposed rule that would be affected by the Joint Study. As discussed above, the rulemaking process can consume a substantial period of time. The record in this matter demonstrates that the movement to competition within the utility regulatory environment has begun. Absent a mandate to delay the adoption of the proposed rules, adoption and implementation of them is within the discretion of the Department.

Based upon the foregoing Findings of Fact, the Administrative Law Judge makes the following:

CONCLUSIONS

1. The Minnesota Department of Revenue (the Department) gave proper notice of this rulemaking hearing.

2. The Department has substantially fulfilled the procedural requirements of Minn. Stat. §§ 14.14, subds. 1, 1a and 14.14, subd. 2, and all other procedural requirements of law or rule so as to allow it to adopt the proposed rules. The error in mailing the Notice of Hearing, discussed at Findings 12 and 13, is a harmless error under Minn. Stat. § 14.15, subd. 5.

3. The Department has demonstrated its statutory authority to adopt the proposed rules, and has fulfilled all other substantive requirements of law or rule within the meaning of Minn. Stat. §§ 14.05, subd. 1, and 14.50 (i) and (ii), except as noted at Finding 40.

4. The Department has demonstrated the need for and reasonableness of the proposed rules by an affirmative presentation of facts in the record within the meaning of Minn. Stat. §§ 14.14, subd. 2 and 14.50 (iii).

5. The additions and amendments to the proposed rules which were suggested by the Department after publication of the proposed rules in the State Register do not

result in rules which are substantially different from the proposed rules as published in the State Register within the meaning of Minn. Stat. § 14.15, subd. 3, and Minn. Rule 1400.2100C.

6. The Administrative Law Judge has suggested action to correct the defects cited in Conclusion 3, as noted at Finding 40.

7. Due to Conclusions 3 and 6, this Report has been referred to the Chief Administrative Law Judge for his approval pursuant to Minn. Stat. § 14.15, subd. 3 (1994).

8. Any Findings which might properly be termed Conclusions are hereby adopted as such.

9. A finding or conclusion of need and reasonableness in regard to any particular rule subsection does not preclude and should not discourage the Department from further modification of the proposed rules based upon an examination of the public comments, provided that the resulting rule is not substantially different from the proposed rules as originally published, and provided that the rule finally adopted is based upon facts appearing in this rule hearing record.

Based upon the foregoing Conclusions, the Administrative Law Judge makes the following:

RECOMMENDATION

IT IS HEREBY RECOMMENDED that the proposed rules be adopted, except as otherwise noted above.

Dated this ___ day of July, 1996.

RICHARD C. LUIS
Administrative Law Judge

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