

COMMENTS OF RICHARD G. SMITH¹
ON BEHALF OF NORTHWESTERN ENERGY

Before the Revenue and Transportation Interim Committee
September 14, 2017

I have been representing centrally assessed taxpayers in Montana for about 20 years, in cases before the Tax Appeals Board, the district courts and the Supreme Court. I have done work for many taxpayers in similar forums in most of the other Western States, and am familiar with the methods of valuation and in general with the levels of taxation in those states.

I offer testimony today on four related topics:

1. How Montana stands out among states for the high effective tax rates for centrally assessed taxpayers and particularly for the rates used for electric utilities and related taxpayers. These rates are a function of the assessment ratio and valuation methods.
2. How Montana stands out among states for the assessment ratios used to value centrally assessed taxpayers.
3. How Montana stands out among states for the methods used to value centrally assessed taxpayers.
4. What alternatives are available to the legislature to address these issues?

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I. Montana's Tax Rates for Utilities are Extraordinarily High

- Northwestern's effective tax rate for 2016 for property taxes on its Montana property was 5.6%. That rate is far higher than most other taxpayers in Montana.
- For other states in which Northwestern operates the rates are much lower: Nebraska, a still-high 2.4%; and South Dakota, 1.9%
- Other states in the West are generally much lower than Montana. Idaho's average tax rate is 1.32% in 2016 for all classes of property. I understand that rates for electric utilities in other Western states are in a range around Idaho's.

II. What are the Reasons for High Rates?

- Assessment ratio of 12%
 - This rate is double the next highest ratio in Montana.
 - Most states do not have separate classifications for property and those that do are not as dramatic in the variation of ratios.
 - Penalizes heavy users of electricity – since the utility passes on higher taxes to ratepayers, it is the ratepayers who pay most of the higher taxes.
 - Penalizes utility stockholders – state law allows only a 60% pass-through in the property tax “tracker” mechanism, running the risk that shareholders don't get a full recovery of costs.
- Valuation Methods that Drive High Values
 - Cost approach with no recognition for obsolescence beyond what is included in accounting depreciation. Many states adjust for obsolescence or, if not, do not give the cost approach any weight. At least two states (Utah and California), deduct the Deferred Income Tax account balance for regulated utilities, since it is a deduction required by public service commissions to determine the

investment base (i.e., rate base) on which customer rates are determined.

- Income method focused on stock market returns to determine capitalization rates (known as “direct capitalization”)
- Market approach that also focuses on stock market values (known as “stock and debt”)
- Emphasis on stock market prices introduces value considerations separate from the value of the underlying operating property
- All these methods provide consistently higher values than the methods used in most states
- Montana courts have largely validated DOR’s choices of methodology, so the choice now is primarily a legislative one

III. Alternatives for Moderating Higher Taxes

- Lower the 12% assessment ratio – Arizona has recently lowered the ratio applicable to utilities from 25% to 18%
- Mandate certain valuation methods, or prohibit certain others
 - Examples – Idaho, Utah
- Require lower weightings in the final correlation of values to the less reliable methods – cost, direct cap and stock and debt
- Require or encourage consistency in the weightings from year to year, so that there can be more predictability

Idaho – see below, enacted in 2015:

63-205B. ASSESSMENT OF OPERATING PROPERTY OF RATE-REGULATED ELECTRIC UTILITY COMPANIES.

(1) In the assessment of the operating property of rate-regulated electric utility companies, the market value shall be determined by the state tax commission by applying applicable law, statutes, property tax administrative rules and the following criteria:

(a) Depending on the weighting placed on the income approach, as described in paragraph (d) of this subsection, no more than twenty percent (20%) weight shall be placed on the cost indicator when utilizing the historic cost less depreciation (HCLD) method in the system value correlation.

(b) In the income approach, income to be capitalized will be normalized, utilizing the gross domestic product implicit price deflator from the United States department of commerce, bureau of economic analysis, by using an average of at least the previous four (4) years' net operating incomes and by adjusting each year's net operating income for unusual nonrecurring items.

(c) In the income approach, a market discount rate will be determined, and to that rate a flotation cost component of twenty hundredths of one percent (0.20%) will be added.

(d) A weighting between eighty percent (80%) and one hundred percent (100%) will be placed on the income approach in the system value correlation.

(e) Within the market approach, a sales comparison approach may be used if reliable data is available and appropriate comparison adjustments can be made. No weight will be placed on a stock and debt approach in the system value correlation.

(f) For rate-regulated electric utility companies, the weightings prescribed in this section shall control the weightings used in the system correlation or reconciliation.

(2) Subsection (1)(a) of this section shall be construed to mean that the use of no more than twenty percent (20%) weight placed on the cost indicator, when utilizing the HCLD method to calculate the cost approach, accounts for any and all forms of depreciation, including any and all forms of obsolescence, and the appraiser shall not consider any further obsolescence.

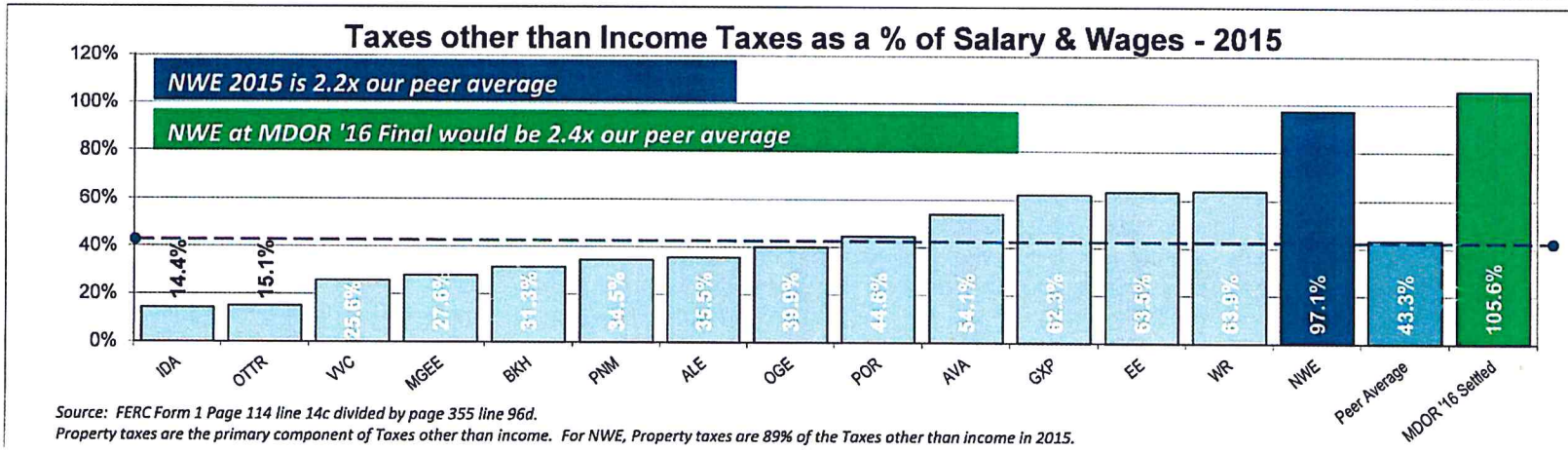
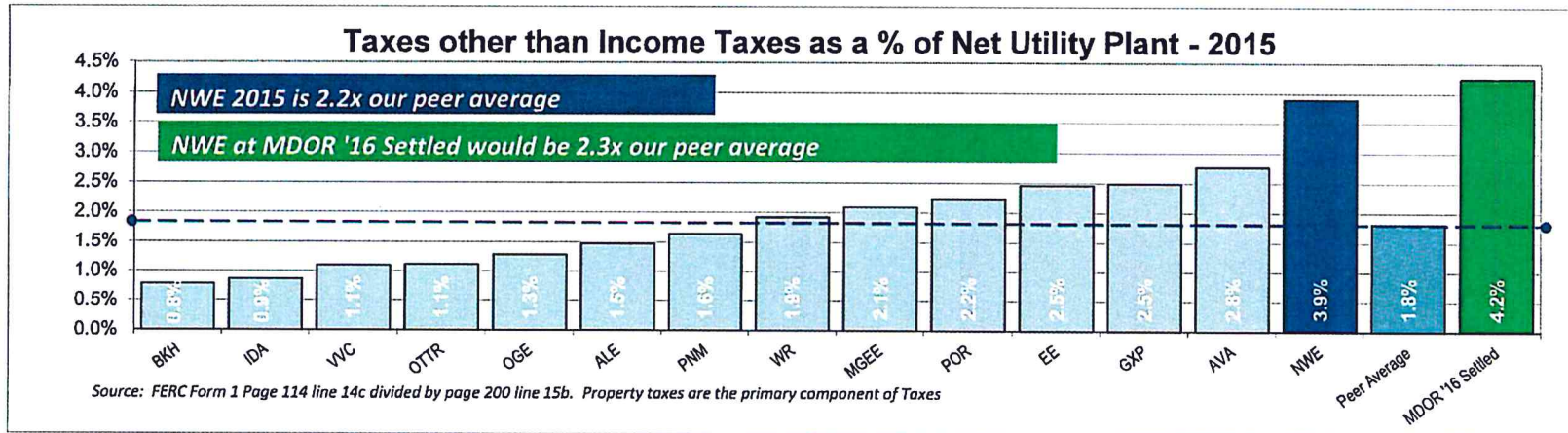
(3) The state tax commission is hereby authorized to promulgate rules to implement the provisions of this section.

Utah:

Utah Tax Commission Rule 62 was promulgated in 1999 and requires the following:

- Preferred valuation indicators:
 - HCLD cost indicator, with deferred income tax deduction for regulated utilities; focus on rate base, with other adjustments required to align cost approach to the investment base on which earnings can be derived
 - Yield capitalization income approach, with mandated parameters for determining capitalization rates
 - Disfavors stock and debt and direct capitalization methods

NorthWestern Energy - Property Tax
NWE Property Tax Metrics versus Peer Group



NorthWestern Energy Peer Group: ALLETE, Inc. (ALE); Avista Corporation (AVA); Black Hills Corporation (BKH); El Paso Electric Company (EE); Great Plains Energy Inc. (GXP); IDACORP, Inc. (IDA); MGE Energy, Inc. (MGEE); OGE Energy, Inc. (OGE); Otter Tail Company (OTTR); PNM Resources, Inc. (PNM); Portland General Electric Company (POR); Vectren Corporation (VVC); and Westar Energy, Inc. (WR)