

PROPOSED STUDY PLAN FOR AN INTERIM STUDY TO ANALYZE THE PROPERTY TAX VALUATION METHODS OF ELECTRICAL GENERATION PROPERTY

Prepared for the Revenue and Transportation Committee

by

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INTRODUCTION

Senate Joint Resolution No. 29, passed by the 58th Legislature, requests that an appropriate interim committee study the taxation of centrally assessed properties, with a focus on utilities and utility properties. The preamble of the resolution describes the rationale for the study:

- Electric deregulation at the wholesale level has had a dramatic effect on electric markets.
- Some electrical generation facilities in Montana have been sold and are now dedicated to the unregulated market.
- Other electrical generation facilities in Montana are owned by regulated, vertically integrated utilities.
- Major electrical generation companies in Montana have repeatedly filed appeals on their property taxes.
- The rationale for the taxing of existing electrical generation was predicated on a vertically integrated utility system.

The body of the resolution directs the appropriate interim committee (or staff):

- to study the taxation of centrally assessed properties, with a focus on utilities and utility properties; and
- to examine the Department of Revenue's method for valuating electrical generation property and gather enough information to determine whether methods differ among regulated utilities, exempt wholesale generators, and other centrally assessed properties.

BACKGROUND

Historical events, federal and state legislation, the Federal Energy Regulatory Commission (FERC), technological innovation, and a renewed optimism in competitive markets have led, by fits and starts, to the restructuring of the electric utility industry from a heavily regulated, vertically integrated natural monopoly to a more competitive industry. One of the more

significant features of restructuring in those states that provide for some level of competition is the functional separation, or divestiture, of electrical generation property from transmission and distribution property. Restructuring has caused many analysts to reconsider whether methods for determining fair market value of utilities under cost-of-service regulation for property tax purposes are appropriate for generation facilities primarily selling power in competitive markets.

Montana was among the first states to restructure the electric utility industry with the enactment of Senate Bill No. 390 (Ch. 505, L. 1997), the Electric Utility Industry Restructuring and Consumer Choice Act. Although about half the states now have some form of electrical utility restructuring, several states, including Arkansas, Montana,¹ Nevada, New Mexico, Oklahoma, and West Virginia, have delayed either the restructuring process or the implementation of retail access; California has suspended restructuring.²

Restructuring and customer choice applied primarily to the then-Montana Power Company service territory. Rural electric cooperatives were allowed to determine whether their customers would be offered a choice of electricity supplier. Because North Dakota is the primary service territory of Montana-Dakota Utilities, the utility was allowed to defer customer choice until July 1, 2006. (Under current law, MDU may essentially defer customer choice indefinitely.) Some of the salient features of the original restructuring legislation included:

- allowing large electric utility customers the choice of electricity supplier by July 1, 1998;
- providing all other electric utility customers the choice of electricity supplier by July 1, 2002;
- requiring the functional separation (but not the divestiture) of a vertically integrated public utility's electricity supply, retail transmission, and distribution;
- requiring that energy supply charges, transmission and distribution charges, transition costs, and universal system benefit charges be shown separately on a customer's bill;³
- imposing a rate moratorium on electric supply-related costs through June 30, 2002; and

¹Montana's restructuring laws were significantly revised by House Bill No. 474 (Ch. 577, L. 2001) and, after voters rejected the measure in November 2002, by House Bill No. 509 (Ch. 565, L. 2003). Under HB 509, the transition period to customer choice was extended to July 1, 2027. After July 1, 2010, the Montana Public Service Commission is required to monitor whether workable competition has developed for small customers and, if workable competition exists, make recommendations for legislative implementation of customer choice (69-8-403, MCA).

²Energy Information Administration, *Status of State Electric Industry Restructuring Activity* (December 2002), pp. 1-2, at http://www.eia.doe.gov/cneaf/electricity/chg_str/regmap.html.

³House Bill No. 642 (Ch. 570, L. 2003) allows a public utility to separately disclose in a customer's bill the amount of state and local taxes and fees assessed against the public utility that the customer is paying.

- continuing the Public Service Commission's regulation of transmission and distribution services.

The legislation also directed the then-Revenue Oversight Committee to "analyze the amount of state and local tax revenue derived from previously regulated electricity suppliers that will enter the competitive market . . ." and to "recommend legislative changes, if any, to address the establishment of comparable state and local taxation burdens on all market participants in the supply of electricity".

Also during the 1997 legislative session, the Montana Legislature enacted Senate Bill No. 396 (Ch. 506, L. 1997), the Natural Gas Utility Restructuring and Customer Choice Act. That legislation also directed the Revenue Oversight Committee to:

- analyze the amount of state and local tax revenue derived from previously regulated natural gas suppliers that will enter the competitive market and report to the Legislature annually on how revenue to the state or local government is changed by restructuring and competition; and
- recommend legislative changes, if any, to address the establishment of comparable state and local taxation burdens on all market participants in the supply of natural gas. Any legislation recommended by the Revenue Oversight Committee should place comparable state and local taxation burdens upon all market participants.

In the course of adopting the study plans for the tax analyses of the electrical utilities and natural gas suppliers, the Committee decided during the 1997-98 interim to combine the studies and expand the scope of the study to include telecommunications property. The study focused on property tax rates in the context of restructuring and competition and included the impact of any changes to the taxation of centrally assessed property on property class twelve (railroad and airline property⁴). Although a review of valuation methods was part of the study plan, not much time was devoted to this function of the Montana Department of Revenue.

The Committee recommended revising the property taxation of most electrical utility property. This was accomplished by reclassifying class nine electrical utility property, including generation, transmission, and distribution property (taxed at 12% of market value), as a new property class thirteen (taxed at 6% of market value).

The Committee also recommended that a kilowatt hour tax be imposed on electric utility customers to offset the anticipated loss in property tax revenue associated with the reclassification and rate reduction. The recommendations were presented in House Bill No. 174

⁴The tax rate applied to class twelve property is based on the taxable value of all other commercial property.

(Ch. 556, L. 1999).⁵ The 1999 Legislature revised the proposal to include just generation property in the new class of property and rejected the kilowatt hour tax. Instead, the Legislature imposed a wholesale energy transaction tax to offset a portion of lost property tax revenue associated with the rate reduction. The Legislature expected that the fiscal impact of the rate reduction on generation property would also be mitigated by an anticipated sales price for Montana Power's generation facilities in excess of book value (see below). The tax is imposed at a rate of 0.015 cent a kilowatt hour of electricity transmitted by a transmission services provider in the state (see Title 15, chapter 72, MCA).⁶

Class thirteen property includes electrical generation facilities of centrally assessed electric power companies; electrical generation facilities of exempt wholesale generators or entities certified as exempt wholesale generators, pursuant to the Public Utility Holding Act of 1935; and noncentrally assessed generators.⁷ Class thirteen property does not include qualifying facilities, as defined in 16 U.S.C. 796, that are taxed under property class four (land and improvements) and class eight (business equipment). Class thirteen property also does not include generation facilities that are exempt from taxation under 15-6-225, MCA.

The Montana Power Company took the functional separation requirement of Senate Bill No. 390 one step further by divesting itself of its electrical generation property. In October 1998, the Montana Power Company announced the sale of most of its generation assets to Pennsylvania Power & Light Global Resources. The sale was completed in December 1999. A subsidiary, PPL Montana, acquired most of the Montana Power Company's generation assets in late 1999 for \$757 million. In tax year 2000, the first year property taxes were assessed on PPL Montana, the assessed market value of the generation property was \$732.4 million compared to \$524.5 million in the previous tax year. The assessed market value of the property in tax years 2001 and 2002 was \$838.5 million and \$822.9 million, respectively.

Property in Montana is taxed on the basis of fair market value. Section 15-8-111, MCA, provides in part that:

- (1) All taxable property must be assessed at 100% of its market value except as otherwise provided.
- (2) (a) Market value is the value at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.
- (b) If the department uses construction cost as one approximation of market value, the department shall

⁵The Committee also recommended in separate legislation that the property tax rate on telecommunications property be reduced from 12% to 6% and that the telephone company tax be replaced by a retail telecommunications excise tax. The recommendations were adopted in House Bill No. 128 (Ch. 426, L. 1999). See footnote 7. The Committee did not recommend any changes to the taxation of natural gas property.

⁶The replacement revenue from the wholesale energy transaction tax did not replace the entire amount of lost local property tax revenue because the lost property tax revenue associated with the tax rate reduction applied to railroad and airline property was not reimbursed. Senate Bill No. 184 (Ch. 584, L. 1999), which revised the property tax limitation laws, provided a general mechanism to reimburse local governments for lost revenue from a variety of bills enacted in 1999.

⁷Class thirteen property also includes allocations of centrally assessed telecommunications services companies.

fully consider reduction in value caused by depreciation, whether through physical depreciation, functional obsolescence, or economic obsolescence.

(c) If the department uses the capitalization of net income method as one approximation of market value and sufficient, relevant information on comparable sales and construction cost exists, the department shall rely upon the two methods that provide a similar market value as the better indicators of market value.

Section 15-23-101, MCA, directs the Department of Revenue to centrally assess each year:

(1) the railroad transportation property of railroads and railroad car companies operating in more than one county in the state or more than one state;

(2) property owned by a corporation or other person operating a single and continuous property operated in more than one county [**applies to the valuation of PPL Montana**] or more than one state, including but not limited to telegraph, telephone, microwave, and electric power or transmission lines; natural gas or oil pipelines; canals, ditches, flumes, or like properties and including, if congress passes legislation that allows the state to tax property owned by an agency created by congress to transmit or distribute electrical energy, property constructed, owned, or operated by a public agency created by congress to transmit or distribute electrical energy produced at privately owned generating facilities, not including rural electric cooperatives;

(3) all property of scheduled airlines;

(4) the net proceeds of mines;

(5) the gross proceeds of coal mines; and

(6) property described in subsections (1) and (2) that is subject to the provisions of Title 15, chapter 24, part 12.

In Montana, the unit value approach is used for valuing centrally assessed property. This approach uses companywide information regardless of location of assets or customer base to determine the market value of the business entity and allocates a proportionate share of the total value to the state and to political subdivisions within the state. There are three indicators to determine the market value of the entity: cost, market, and income.

In Montana, the cost indicator is original cost, less depreciation, and is used as the basis for determining value. The income indicator uses the business entity's present value net income stream. Changing market conditions (e.g., risk, price, and market share) will affect valuation under this approach. The market indicators include such factors as sales of comparable assets or the business entity's stock and debt value.

Ideally, each of these methods should yield about the same value of the entity being assessed. In practice, however, these methods often produce widely disparate results. To resolve the differences, the appraiser will weight each approach in order to produce a final unit value. Weighting of the indicators is called "correlation" and may involve significant judgment on the part of the appraiser. The particular weighting method may cause disputes between the appraiser, who may put the highest weight on the highest value, and the taxpayer, who wants more weight given to the lowest indicator of value.⁸

⁸Lawrence C. Walters and Gary C. Cornia, "Electric Utility Deregulation and the Property Tax in the United States", in Impacts of Electric Utility Deregulation on Property Taxation, edited by Philip Burling (Lincoln Land Institute of Land Policy: 2000), p. 49.

PPL Montana has appealed the valuation of its electrical generation in the state on the basis, in part, that the Department of Revenue has improperly assessed the generation facilities as centrally assessed property and that the valuation of the facilities "is higher than the valuation of similar and identical properties owned by Montana taxpayers in violation of the principles of Montana law and the United States Constitution requiring fair, just and equitable valuation of taxable property. . .".⁹

Regardless of the merits of the case, the dispute reiterates the issue of whether the procedures for valuing generation property for property tax purposes under a partially restructured environment should be reexamined. The following questions may be considered regarding the valuation of electrical generation property in Montana.

- How does (partial) restructuring, new technology, and obsolescence affect the fair market value of existing electrical generation plants?
- What are the Department Revenue's methods for valuing electrical generation property and what are the significant disputes raised by using those methods?
- Should other models of valuation be considered and would other valuation methods work better in a restructured environment?
- Is there a need to revise Montana's procedures for revising the methods for valuing electrical generation property?
- What are the criteria for valuing electrical generation property as centrally assessed property?
- Is there a rational basis for a disparity in valuation of electrical generation property based on whether the property is owned by a nonutility generator or a regulated electrical utility?

MAJOR STUDY AREAS

If the Revenue and Transportation Committee undertakes the study, its primary focus of work may include the following:

1. Conduct a literature review on the valuation methods applied to electrical generation property in a regulated environment and in a restructured environment. The review would focus on the advantages and disadvantages of existing valuation methods and alternative methods.
2. Review the valuation methods used by the Montana Department of Revenue to determine the fair market value of electrical generation property.
3. Evaluate the valuation methods of the electric industry used in selected states. The evaluation would be based on the restructuring climate in the state, changes in technology, and the type of generation facility (e.g., coal-fired generation and hydroelectric generation).

⁹PPL Montana, LLC v. Montana Department of Revenue, State Tax Appeals Board, Case No. SPT-02-6.

4. Assess the potential for the development of additional generation capacity in Montana.
5. Evaluate the effects of federal energy legislation and the FERC's (revised) proposed rule on standard market design (related to sufficient electric infrastructure, reliability, affordable electricity, transparent market rules, technological innovation, and efficient use of resources)¹⁰ on the development of regional transmission organizations and wholesale electrical energy competition in Montana, the Pacific Northwest, and the western grid.
6. Identify legal, policy, and fiscal issues related to the assessment procedures of electrical generation property.
7. Develop options, if options are considered necessary, to revise the assessment procedures of electrical generation property in Montana, with attention focused on direct and secondary effects that any option might entail. The options should be evaluated using established criteria of good tax policy, including equity and fairness, economic efficiency, and simplicity.

PROPOSED SCHEDULE

The following schedule is proposed for conducting the study:

- October 2003 meeting -- Review, refine, and adopt study plan; provide overview of the Department's methods for valuing centrally assessed property.
- December 2003 meeting -- Report on literature review. This task will provide information that the Committee may use to identify additional study questions and problems to be included in the scope of the study.
- February 2004 meeting -- Present results of survey of other states' electrical generation property and compare and contrast their valuation methods with the Department's methods; analyze legal and policy issues related to valuation methods of electrical generation property.
- April 2004 meeting -- review federal legislation and FERC standard market design rule; assess potential of new electrical energy in Montana; evaluate the implications, if any, of federal policy and the development of new generation on appraisal methods; develop options and initial recommendations for consideration; request draft legislation if considered appropriate.

¹⁰See Federal Energy Regulatory Commission, "White Paper: Wholesale Power Market Platform" (Issued April 28, 2003), <http://www.ferc.gov/industries/electric/indus-act/smd.asp>. The Federal Energy Commission uses white papers to announce policy changes.

- July 2004 meeting -- Analyze impact of options and recommendations related to the appraisal of electrical generation property; review draft legislation, if any; formulate findings, conclusions, and recommendations.
- September 11 meeting -- approve draft legislation, if any; finalize recommendations; approve outline for the final report.

WHITE PAPER OPTION

In lieu of significant Committee involvement in the study, Senate Joint Resolution No. 29 also allows the use of staff resources to conduct the study requested by the resolution. Under this option, staff would prepare a white paper that would address the major study issues identified in the study plan. The findings and conclusions of the white paper would be presented to the Revenue and Transportation Committee.

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