Montana Department of
REVENUE

Valuation of Centrally Assessed Properties

Revenue and Transportation Interim Committee

December 2, 2005

Prepared by the Department of Revenue

Central Assessment and Unit Valuation

- Montana law provides the criteria for determining centrally assessed property (15-23-101, MCA)
- Unit valuation methodology is used to determine the market value of centrally assessed property
- Unit valuation involves "appraising the whole pie and then taking Montana's slice"
  - appraising as a going concern and a single entity, the entire operating property of a company, wherever the company is located in the U.S.
  - allocating a part of that overall appraised value to the state

Revenue & Transportation Committee Meeting
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Exhibit #2

Central Assessment and Unit Valuation

- "Going-concern value includes an intangible enhancement of the value of an operating business enterprise which is produced by the assemblage of the land, building, labor, equipment and marketing operation. This process creates an economically viable business that is expected to continue. Going-concern value refers to the total value of an property, including both real property and intangible personal property attributed to business value." *The Appraisal of Real Estate, 10th Edition*
- The unit value concept is superior to fractional or summation appraisals for valuing centrally assessed properties because it correctly captures the "going-concern value." Without this concept, only the salvage value of the properties would remain.

Department of Revenue 3 December 2, 2005

Case History of Unit Valuation

James C. Bonbright, in his landmark textbook on appraisal, explained the reasons for centrally assessing certain properties. He stated:

"The difficulty of distinguishing between the value of a parcel of real property and the value of the entire business located on the premises has proved serious even in the assessment of ordinary forms of real estate. But it becomes critical with respect to those unique combinations of land and structures used by railroads, other public utilities, and large manufacturing companies. In the first place, properties of this nature are physically and functionally integrated over wide areas, extending beyond the jurisdiction of a local assessor or even of a state board. In the second place, the physical plants of many public utilities and of some industrial companies have no value, over and above their salvage value, except as integral parts of the very enterprise by which they are now exploited. In effect, they are worth no more and no less than the business is worth ...."

James C. Bonbright, The Valuation of Property - A Treatise on the Appraisal of Property for Different Legal Purposes 511 (1965).

Department of Revenue 4 December 2, 2005

Case History of Unit Valuation

The Montana Supreme Court described the theory behind the "unit method" as:

Where property is part of a continuous system which extends through many taxing districts, the proper way to find the true cash value of any part of this property requires that the system as a unit be evaluated. The rationale of this theory is that, where a system is involved, the sum of the value of the parts of the system does not truly represent the total value thereof, and therefore, in order to get a true reflection of the economic value, the system as a whole must be valued as a unit.

Yellowstone Pipe Line Co. v. State Bd. of Equalization, 138 Mont. 603, 611, 358 P.2d 55, 60 (1960).

Case History of Unit Valuation

- Initially, property was administered and taxed locally
  - Livestock, short line railroads, telegraph
- 1871 Kansas court stated:

"A railroad is an entire thing and should be assessed (valued) as a whole. It would be almost as easy and as reasonable to divide a house or a locomotive into portions, and assess each portion separately, as to divide a railroad into portions and assess each portion of it separately."

Case History of Unit Valuation

- State railroad tax cases (1876) and Indiana railroad tax cases
  - Both U.S. Supreme Court decisions upheld state statutes providing for unit valuation for railroads

- Adams Express Company Case (1880)
  - Cost approach $4,000,000 (each individual piece value)
  - Market based approach $16,000,000 (assembled property operation value)

Central Assessment Criteria

Centrally assessed companies are appraised annually and include:

Properties Specifically Listed - MCA 15-23-101(1) through (3); ARM 42.22.102 (1)

Railroad; railroad car; microwave; telecommunications; telephone cooperatives; gas; electric; electric cooperatives; ditch; canal; flume; natural gas pipeline; oil pipeline; and airlines.

AND

Physically Connected - Companies that actually have physically connected property that crosses a county or state boundary.

OR

Unity of Operation - Companies that have operating characteristics that exhibits unity where the property is functionally operated as a single entity but may not have a physical connection.

Centrally Assessed Companies' Facts

The classes of property include

Class 5 Rural Cooperatives (3%)
- Telephone Cooperatives - 10
- Electric Cooperatives – 34

Class 9 Pipelines and Non-electric Generating Portion of Utilities (12%)
- Pipelines - 20
- Electric and Electric/Gas Utilities – 9

Class 12 Railroads and Airlines (Calculated annually, 2005 was 3.74%)
- Railroads - 5
- Airlines - 21
- (Private railroad companies/rail car) 250-300

Class 13 Electric Generation and Telecommunications (6%)
- Telecommunications - 28
- Electric Generation - 8

Centrally Assessed Companies' Facts

- Reappraised annually
  - March 31st of each year for the rural electric and telephone cooperatives, telecommunications and electric utilities
  - April 15th of each year for the pipelines, railroads and airlines
- The appraisal process takes place from April through June
- The properties account for approximately 15% of Montana's market value and 25% of the taxable value
- Staff consists of 3 appraisers, 1 auditor and a unit manager

Centrally Assessed Companies' Facts

Information Sources:

- Montana Department of Revenue Annual Report
- Federal Energy Regulatory Commission (FERC) Report
- Public Service Commission (PSC) Report
- Securities and Exchange (SEC) Report
- Companies Report to Shareholders
- Independent Auditors Report
- Other sources such as independent sources, other states information and other tax or financial data

Three Approaches to Determine the System Value

Cost Approach:

- Original or historic cost less depreciation
- Information is derived from the balance sheet and other audited records

Income Approach:

- Discounting an income stream
- Information is derived from income statement and financial markets

Market Approach:

- Market value of the stock and debt
- Comparable sales data
- Information is derived directly from the market

Definitions

System or unit market value – the market value of all assets owned by the company being appraised

Allocation – process of assigning system or unit market value to Montana

Allocated or state market value – the market value of the Montana assets

Apportionment – the process of assigning the Montana market value to the proper taxing jurisdiction

Situs property – real and personal property other than a transmission or distribution system (machinery, equipment, buildings)

Central Assessment Example

Western Pipeline Company:

- Owns gathering and transmission assets in 10 western states
- Files reports with the Montana Department of Revenue: Montana Annual, FERC, SEC and Independent Auditors Reports
- Appraisal is for tax year 2005

Cost Approach

Original Cost Less Depreciation:

Plant in service	$ 750,000,000
Materials and supplies	$ 1,000,000
Construction work in progress	$ 5,000,000
Less accrued depreciation	$(120,000,000)
Cost indicator before intangible personal property	$ 636,000,000
Less intangible personal property (5% reduction)	$ (31,800,000)
Cost indicator after intangible personal property	$ 604,200,000

Income Approach

Capitalization of Income

Net operating income:		
Year-end 2004	$ 48,000,000	
Year-end 2003	$ 60,000,000	
– Average net operating income		$ 54,000,000
Capitalization rate		÷ 9%
Income indicator before intangible personal property		$600,000,000
Less intangible personal property (5% reduction)		$(30,000,000)
Income indicator after intangible personal property		$570,000,000

Market Approach

Comparable sales approach - information comes from the sales document, company records

Stock and debt approach - information comes from the stock and bond markets and other market sources

Stock (equity):		
Shares outstanding	30,000,000	
Average price per share	x $ 18.00	
– Market value of common stock		$540,000,000
Debt (bonds):		
Long term debt		$150,000,000
Market indicator before intangible personal property		$690,000,000
Less intangible personal property (5% reduction)		$(34,500,000)
Market indicator after intangible personal property		$655,500,000

Allocation Factor

	Montana	/	System	=	Factor
Gross installed cost	$151,200,000	/	$756,000,000	=	0.2 or 20%
Gross revenues	$19,000,000	/	$100,000,000	=	0.19 or 19%
Miles of pipe	3,675 miles	/	17,500 miles	=	0.21 or 21%

Average Montana allocation factor = 0.20 or 20%

Correlated Unit Value

Cost approach (40%)	$ 604,200,000
Income approach (50%)	$ 570,000,000
Market approach (10%)	$ 655,500,000
System market value	$ 592,230,000
Montana allocation factor	x 20%
Montana market value	$ 118,446,000

Department's House Bill 569 Suggestions

For Senate Tax Committee, the department drafted language to illustrate how a bright-line distinction could be formulated. It is not an interpretation of existing law.

Marketable condition

- oil sufficiently free from impurities and otherwise in a condition a purchaser will accept under a sales contract typical for the field or area
- gas products, which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area

Department's House Bill 569 Suggestions

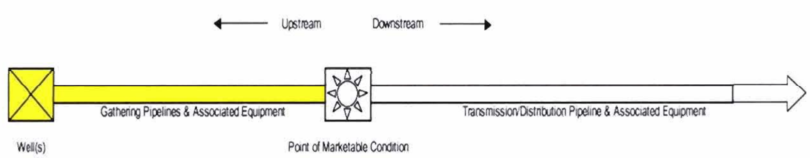
Natural gas or oil pipelines:

(a) If the owner of the natural gas or oil pipeline owns 100% of the oil or gas in the pipeline upstream from the point where the oil or gas is in marketable condition then, all property, including but not limited to the pipeline property, is locally assessed

(b) If the owner of the natural gas or oil pipeline does not own 100% of the oil or gas in the pipeline upstream from the point where the oil or gas is in marketable condition then, all property, including but not limited to the pipeline property, is centrally assessed

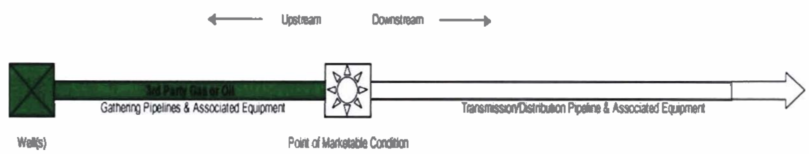
(c) If an owner of the natural gas or oil pipeline owns any portion of property downstream from the point where the oil or gas is in marketable condition then, all of the property is subject to central assessment

Definition: (a)



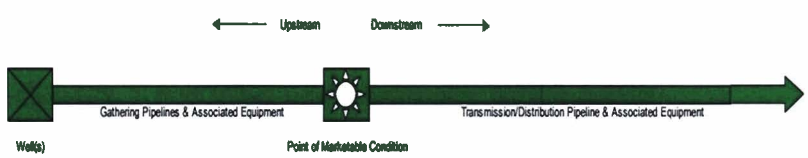
** Local If the oil or gas producer owns 100% of the oil or gas in the pipeline **upstream** from the point where the oil/gas is in marketable condition then, all property, including but not limited to the pipeline property, is locally assessed.

Definition: (b)



If the oil or gas producer does not own 100% of the oil or gas in the pipeline upstream from the point where the oil/gas is in marketable condition then, all property, including but not limited to the pipeline property, is centrally assessed.

Definition: (c)



If the oil or gas producer owns any portion of property downstream from the point where the oil/gas is in marketable condition then, all of the property is subject to central assessment.