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Taxation of Public Utilities in the State of Wisconsin

by

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TAXATION OF PUBLIC UTILITIES IN THE STATE OF WISCONSIN

The subject which has been assigned for this period is the taxation of public utilities in the State of Wisconsin. Certainly there is no reason to complain for lack of subject matter. The difficulty is to select some few phases of the subject which can be discussed intelligably in a half hour.

In this paper the general statutory provisions now in operation for the taxation of public utilities in this state and the methods of determining value, which are now in use, will be discussed briefly.

There are fourteen different kinds of companies which are treated in Chapter 76, the public utility taxation chapter of our statutes. They are, in order:

Railroads; telegraph companies; street railways and light, heat and power companies operated in connection therewith; conservation and regulation companies; insurance and guarantee companies; telephone companies; sleeping car, express and freight line and equipment companies; gas, water, electric and steam companies; and properties created for the improvement of navigation in public waters.

The methods provided for the taxation of these various kinds of utilities are far from being uniform. In fact, it can be said that the methods produce decidedly inequitable results as between utilities and often in relation to other property. There are six different

methods now in use for the valuation and taxation of the fourteen utilities just named.

In the first class railroads stand alone. Their property is valued and assessed by the Tax Commission. The values fixed by the Commission for assessment are certified to the state treasurer together with the taxes thereon computed at the average state rate. Before going farther with the discussion it will probably be well to explain at this time what it meant by the average state rate. The average state rate is arrived at by dividing the total taxes levied on general property of the state (by which is meant real estate and personal property taxes collectable locally) by the total true cash value of general property in the state. In arriving at this state rate you will notice that the true cash value of property is used and not the assessed value. The method of determining this true cash value is a subject in itself. Suffice it to say that it involves the classification and inspection of representative sales of property throughout the state. By using the true cash value to arrive at the average state rate, those companies which pay taxes at that rate are automatically equalized with those properties which are assessed locally. The equalization is not, however, with the properties of a single taxing district, but with all properties in the state.

As mentioned, the railroad assessments with taxes computed at the average state rate are certified to the state treasurer for collection. Of the taxes so collected, the state retains all except that portion based on docks,

piers, wharves, and grain elevators used in transferring freight or passengers between cars and vessels. These special properties are called terminals and the statute requires that the state shall remit to the towns, cities and villages within which they are located, the amount of tax paid by the railroads on the basis of such terminals. Inasmuch as railroad values are determined on the entire operating unit this problem of determining the values of the terminals is much like cutting the tail off of a dog and then computing what the tail is worth.

The second group includes telegraph, sleeping car, express, freight line and equipment companies. There are only two telegraph systems, one sleeping car company and one express company operating within the State. Under freight line and equipment companies the statute includes cars which are used in the transportation of freight, and which are not operated as part of the equipment of a railroad or express company. In this group are the cars of such concerns as the Standard Oil Company, Armour and Company, and the Heintz Pickle Company. The Commission is required to arrive at a value for the **property** of these various companies, which is being operated in the State of Wisconsin. Considering the fact that many of these companies operate cars which enter the State only occasionally, there are many interesting problems involved in this valuation.

After determining the value of the properties falling in this class, the Commission certifies such values to the state treasurer,

together with taxes thereon at the average state rate. The state treasurer collects the tax and all of it remains in the state treasury for general state purposes.

The third group is composed of street railways, light, heat and power companies operated in connection with street railways, and conservation and regulation companies. There were assessed under this group in the year 1925, nineteen street railways and connected light, heat and power properties and two conservation and regulation companies. By the term light, heat and power companies operted in connection with street railways, there has been some difference of opinion. The Commission has interpreted, (and to date the interpretation has not been seriously contested) that this term means both corporate and physical connection. With corporate connection should also be included that relationship which grows out of a leasehold in which the street railway leases and operates the property. The **physical** connection necessary to fulfill this provision has been rather liberally construed. The Commission has even interpreted a connection between electric property and gas property in which the gas plant uses electric current for operating pumps, coke crushers, etc., to be a connection within the meaning of the statute.

Conservation and regulation companies are those companies which are specially incorporated for the purpose of conserving and regulating the height and flow of water in public streams. The Commission values for taxation purposes all properties coming under

the head of Street Railways and connected utilities and conservation and regulation companies. The assessments so determined, together with taxes thereon computed at the average state rate, are certified to the state treasurer for collection. The taxes so collected by the state treasurer are distributed in part to the counties and in part to the towns, cities and villages within which the property of the utility is located and its business transacted. The percentages of apportionment are: 15% to be retained by the state, 20% to the counties, and 65% to the towns, cities and villages. The provisions for the distribution of the tax after it has reached the town, city or village treasurer are somewhat confusing and apparently without rhyme or reason. In counties having a population of 250,000 or more, which includes only Milwaukee County, the town board, city council or village trustees **may**, if they so desire, distribute 20% of the taxes received from these utilities to the school districts within the municipality in proportion to the last school census. In counties having a population of over 50,000 and less than 250,000, no distribution may be made to school districts.. But in counties having a population of 50,000 or less, 50% of the tax received from these utilities **must** be apportioned by the town board, city council or village trustees to the school districts in which the property of the utility is located and its business transacted. Prior to 1925 there was no provision for the distribution of public utility taxes among school districts.

The provisions just mentioned are the result of laws passed during the 1925 session of the legislature, chapters 441 and 423 respectively. No doubt many utility accountants will have plenty of reason to wish no such provision had been made, since they may probably be called upon to supply information which will help in the allocation to school districts.

The fourth group includes gas, water, electric and steam companies, and those properties which were constructed for the improvement of navigation in public waters. These utilities may be divided into two classes; those operating within the confines of a single taxation district and those which extend into two or more districts.

Such utilities as do not extend beyond the confines of a single district and which are privately owned are assessable by the local assessor the same as if they were farms or other general property. If publicly owned they are not taxable except insofar as any municipality may choose to assign a tax to them for accounting purposes. This procedure has been recognized by the railroad commission as a proper one for determining proper rates to consumers. In the case of utilities operating in more than one taxation district, it is provided that the Tax Commission shall fix their value. After arriving at the value of the utility the Commission is authorized to equalize such valuation with the general property assessment in the towns, cities and villages within which the property

is located and certify such equalized value to the local clerks for entrance on their rolls.

To illustrate what is meant by equalization assume that the XY Utility was valued as a unit by the Tax Commission at $20,000, and assume that it was found in working out the apportionment that $10,000 worth of the property was located in Village A and $10,000 in Town B. If general property in Village A is assessed at less than its true value, it would be unjust to the utility to require it to pay its taxes on a 100% valuation. For this reason the Commission compiles figures tending to show the ratio of assessed to true value in each district within which the utility is located. Suppose it is found that the assessed value of general property in the Village of A is 80% of true value and in the Town of B, 75% of true value. The Commission would then equalize by applying 80% to the $10,000 true value in the Village of A and arrive at an assessment value of $8,000, and in the Town of B it would apply the 75% to the $10,000 true value, arriving at an assessment in the town of B of $7,500. The same method of equalization is followed in cases where the general property is assessed at more than 100% of true value. In making these equalizations, however, the Commission does not use its figures without allowing any leeway for differences in opinion. It is possible for two people equally competent and equally honest to look at a horse and one of them judge the horse to be worth $90 and the other $100 and both be satisfactory valuations. Value is a relative thing and it is

difficult to say that one person's judgment is absolutely right and another's absolutely wrong where they differ but little. For this reason it is assumed that if a local assessor is within 10% of the Commission's figures he has made a satisfactory valuation and a 10% variable is allowed in all equalizations. That is, if the Commission finds that its figures show property to be locally assessed at 120% of its true value, the assessment of the utility is not raised to 120%, but only to 110%, and on the other hand in districts showing a 60% assessment the utility is equalized to 70%.

After having arrived at the equalized value of the property in the various districts, the Tax Commission certifies such values to the clerks of the towns, cities and villages within which the property of the utility is located and its business transacted. Upon receipt of such valuation it is the duty of the town board, city council or village trustees to equitably allocate the assessment so certified, to the school districts in which the utilities own propery or transact business. This provision is also a child of the 1925 legislature and is one which will probably cause more difficulty for utility accountants than will the provision of the allocation of the taxes to school districts in the case of the companies in group three.

After having been allocated to school districts the assessment is placed on the tax roll the same as other local property and is subjected to the same rates of taxation.

The fifth group is composed of insurance and guarantee companies. These companies

are not ordinarily thought of as public utilities, but they are so treated in the tax statutes. This group pays taxes into the state treasury on the basis of various percentages of gross earnings.

In the sixth group are telephone companies. Telephone companies are required to pay taxes on the basis of various percentages of gross earnings. After computing the tax on gross earnings, the company pays so much of such tax as is based on toll line revenues, directly into the state treasury. Of the tax based on exchange revenues, 15% is paid into the state treasury and the remaining 85% is paid to the town, city or village in which the exchange is located. The enforcement of the taxation of these last two groups of utilities does not rest upon the Tax Commission. Presumably they are enforced by the local authorities, the state treasurer, and the attorney general.

Can you conceive of a combination of methods of taxing public utilities that could be much more confusing? Not only is it confusing, but it is also inequitable. For example, the Milwaukee Gas Light Company's assessment is entered on the local rolls, mostly in the City of Milwaukee, on which it is required to pay a rate of 31½ mills. Its strongest competitor, the Milwaukee Electric Railway and Light Company, being a street railway company and its properties being operated in connection with a street railway, is taxed at the average state rate, which is about 21 mills. In other words, because of this different method of taxation, the Milwau-

kee Gas Light Company is required to pay 50% more taxes annually on a given amount of property than is its competitor. .

In other localities it works the opposite way, those being taxed at the state rate having to pay a higher tax than those assesed locally. Considering the fact that the street railway properties in the State of Wisconsin are for the most part unprofitable investments, relatively few in number, and in value insignificant in comparison to other utilities, it certainly seems improper to let the mere connection with a street railway govern so radically the method of taxation.

The question has been asked, why tax public utilities at all, since such taxes are merely passed on to the consumer by increased rates? If every inhabitant of the municipality used the services of the utility in exact proportion to the amount of taxable real and personal property which he owned there would be no use. This is not the case, however, and such taxation is necessary in order to equalize the tax burden between the user and non-user of the utility. If A buys coal and kerosene for heating and lighting his home, he does, in the price of those commodities, pay taxes on the property used in the conduct of such businesses. Why then should B, who chooses to use gas and electricity to heat and light his home, not pay taxes on the property which is used to serve him?

Granting the need for taxation of utilities there seems to be some honest confusion as to why there should be two values for the

same property, one for taxation and one for rate purposes.

In arriving at a value for rate purposes, the Railroad Commission is seeking to find how much has been actually invested in property in an honest and prudent manner, so that the investor may be allowed a rate which will yield him a reasonable return on whatever has been so invested for the purpose of serving the public. For taxation, the Tax Commission is attempting to arrive at a value which will coincide with the value at which other property in the state is required to be taxed. In other words, it is attempting to arrive at the value at which the property would ordinarily sell. The statute provides that general property should be assessed "at the full value which could ordinarily be obtained therefor at private sale". This has been interpreted by the courts to mean, not a price which would produce a buyer, but a value at which an exchange would take place in case the owner desired to sell but was not forced to sell, and one having the means to do so desired to buy. Suppose that a company invested $100,000 in utility property in the justifiable belief that is was a reasonable and prudent investment. Then conditions unforseen by such investor rendered the property less valuable than was expected, so that, it could not possibly be sold for more than $50,000. The owners of that property would not for a moment agree that the value for taxation and for rates should be the same. Their arguments would be, and justly so, that $100,000 had been invested in a man-

ner in which any prudent man might have been reasonably expected to invest money for the benefit of the consuming public, and that they should be permitted to earn a reasonable return on that investment, but that for taxation purposes the property should be assessed only at the figure for which it would sell. It is in cases where the probable sales value of the property is in excess of the investment that it is argued that the valuation should be the same for both purposes. The position taken is usually this; that under our present system of regulation the state sets a maximum beyond which a company may not earn but it does not guarantee that the amount allowed will be earned, therefore, the value of the property can never be greater than the rate base but it may often, and usually be less. This does not follow. Experience shows that utilities occasionally do earn on a figure greater than the rate base without accompanying decreases in rates. But, assuming that no utility ever earns on more than is allowed by the Railroad Commission, the value of the property may still be in excess of the rate base. Suppose for a moment, that a utility with an investment of $100,000 has been permitted to fix its rates on the basis of that investment and assume, (something which practically never happens,) that the utility makes just exactly what the Railroad Commission estimated it should make in fixing the rate base. Would the utility sell for the rate base or would it be worth more?

In fixing the rate of return to be allowed on utilities the Railroad Commission attempts to fix a rate sufficient to attract new capital into the field to promote new enterprises and to expand services as needed by the public. This rate, because of the possibility of losses in new and untried developments, must necessarily be larger than that necessary to attract investors to a business already tried and found profitable. For that reason, if investors will buy securities in sound operating utilities on a 7% basis, it can reasonably be expected that the Railroad Commission will allow as a rate base 7% plus whatever variable is necessary to offset the risk of losses in new and untried developments. Assume that this variable is 1%. The rate allowed by the Railroad Commission would then be 8%. Now, in the case of the utility with a rate base of $100,000—, if it earns exactly what the commission figured it should earn, it would make $8,000 per annum on its investment; but being an established utility of proved earning capacity it would attract capital at a 7% rate; or in other words, it would sell on a valuation of about $114,000. Due to this fact, therefore, together with the fact that practically never does a utility earn exactly what the Railroad Commission intended it should earn, but either more or less, it is essential that for tax purposes a different basis of valuation be used than that which is accepted for rate purposes.

In valuing ordinary real estate or personal property there are usually sufficient sales to give some basis of comparison by which to

arrive at a probable sales value for property which has not changed hands. In the utility field, however, there are very few sales of such a character as to be useful in fixing a standard of value. There have been a great many exchanges of utility ownership during the last few years but they are nearly all under conditions which make them of little value as standards for assessing similar properties. Most of them are the results of consolidations or of the expansion programs of the larger companies. All utilities which can possibly do so are now buying up territory and in this period of rapid expansion we find that utilities are discounting the future on a much higher valuation than the tax commission considers a safe basis. Certainly the properties are not earning on anywhere near the basis at which many sales are being made and cannot be expected to earn on any such basis until the lapse of a number of years.

It is also true that the sales are based on the anticipation of future profits growing out of consolidation and do not indicate the value of the individual utility operated as a unit in itself. For this reason assessing officials have found it quite difficult to check up on their valuations by the recent sales which have been made.

Without sufficient data, and experience in the valuing of utilities, such determinations can resolve themselves into nothing more than guessing contests. But with sufficient data and sufficient experience coupled with sound judgment it is possible to arrive very closely to the figure at which representative

sales do take place. The methods used by purchasers of utilities are much the same as those used by the Tax Commission, and in checking up its valuations with such representative sales as there are, the Commission finds that it is both above and below the sales prices.

Among the factors determining the value of a utility, the earning power is probably the most important. While earnings in the past do not prove what the earnings in the future will be, it is difficult to forecast the future except on the basis of the past. For this reason the capitalization of the average earnings of a period of years past is one of the criterions of value most relied upon. Since the earnings of the utility do not remain constant from year to year but fluctuate up and down in accordance with general business conditions, with the price of labor, material, etc., a single year's earnings can not be used as a safe guide. The rate of capitalization of such earnings must depend on the nature of the business. The rates for small and untried businesses must necessarily be higher than the rates for established companies whose earnings give every indication of being constant or steadily increasing. No fixed rate is used in the computations of the Commission but it uses its judgment as among a number of rates varying from 6% in the case of some of our railroads to over 8% in the case of some of our unstable inter-district utilities.

In arriving at the net earnings to be capitalized, the earnings from non-operating

properties, are eliminated, since such properties are not subject to assessment by the Tax Commission but are assessable locally.

It has also been found necessary to adjust the depreciation deductions. Some utilities deduct no depreciation or relatively little, while others make very ample provision. The same utility will often fluctuate in its depreciation deduction from year to year. In order to arrive at a satisfactory comparable figure for the various utilities, the Commission found it necessary to make corrections or adjustments of the depreciation taken and allow a uniform rate to companies which have the same kind of properties and maintain them in about the same manner. Formerly a single composite rate of depreciation was allowed on the cost of reproduction figures which had been obtained from the engineering department, but recently an attempt has been made to collect data which will make the equalization for depreciation more scientific. Efforts will be made to obtain some assistance from the utilities in arriving at a sound method of handling this problem.

In arriving at net income for capitalization purposes, the interest on funded or mortgage debts is not deducted, since the property is represented not only by the stock but by the bonds. In order to get the fair value of the property therefore the earnings going to the owners of all kinds of equity must be considered.

A second method which is used when the data can be found is the market value of securities. Where this is obtainable it gives

a very satisfactory criterion of sales value, since it is the nearest thing to an actual current sale that can be found outside of the sale of the entire property. In arriving at such value, the stocks and bonds are both taken into consideration. The sale price of such securities applied to the entire issues outstanding does not result in a figure entirely indicative of the actual value of the utility, since the sales prices are based on occasional sales and not upon the transfer of a controlling interest. Where controlling interests are involved, the prices are always higher than otherwise.

In arriving at a value upon the stock and bond market basis it is necessary to make deductions for any non-operating properties which are covered by the securities and tend to affect their market value. Unfortunately, very few of the gas and electric utilities in the state have their securities on the market in sufficient quantity to make it possible for the Commission to use this method in valuing them. It is, however, a very satisfactory criterion of value in the case of the railroads.

Original cost and the cost of reproducing the properties of a company cannot be ignored entirely. The amount of physical property owned by a company has some effect on its sales price. The cost of the properties per books, representing the amount of the original investment, is therefore given some consideration.

For each company which was operating in 1916 the Commission has an appraisal by the engineering department showing the cost of

reproducing the properties new and less depreciation as of that time. To these figures have been added the cost of subsequent additions and the whole has been depreciated to the 1916 condition percent. These reproduction figures are also given some weight by the Commission altho in many instances they are too unreliable to be given much consideration. Where recent reliable appraisals are available they have more influence in the assessment than have the figures built up from the old engineering reports. As pointed out earlier in this paper, however, the amount of investment or the present reproduction cost of the properties does not indicate very accurately the possible sales value. For that reason such figures are considered for what they may be worth but can not be given too serious attention. A concrete example or two will serve to illustrate how the various factors have tended to influence assessments.

The **A. Heat & Power Co.** is an old company operating in a small thriving community. Its earnings have been steadily increasing over the past four years altho prior to that there had been five years of decrease. The increased earnings are due to a change in management four years ago. Altho this company is old and fairly successful, investors can not be obtained on much less than a 7½% basis. An average of the company's earnings for three years past when capitalized at 7½% gives a value of $58,500. The investment of the company to date is $57,000 while the cost of reproducing the properties at this time is estimated to be $46,000 new

and $40,000 after allowing for depreciation. The management is prudent and careful but pays its executives fair salaries. The depreciation rates are a little higher than those acceptable to the Commission and after their adjustment the earnings capitalized at 7½% show a $62,000 valuation.

With such data the Commission found an assessment of $55,000.

The B. Railway Company on the other hand, operating nothing but a street railway, shows an investment in property of $285,000 with a cost of reproduction new of $175,000 and less depreciation of $109,000. Its average earnings for the past three years capitalized at 7% show a value of $16,000 and after deducting adequate depreciation show a net loss.

This property was valued for assessment at $50,000.

From these examples it will be seen that no single factor is used to determine the value. In the first case the small amount of physical property tended to shade down the capitalized value while in the second case the large amount of physical property tended to add to the capitalized value.

As stated before, valuation is a relative matter and is, at its best, an approximation. Unfortunately rules of valuation cannot be stated in formulas but must depend upon the variables of human judgment.