Assembly
TAXATION COMMITTEE
February 22, 1973

Members Present:	Messrs.	May	Demers
		Smalley	McNeel
		Broadbent	Huff
		Craddock	Bremner
Members Absent:	Messrs.	Fry (excused)	
Guests Present:	Messrs.	Louis Starr, C.L. Wishart, Carl A. Soduldom, Henry M. Ortiz, Clark J. Guild, Rowland M. Dolan, Oliver A. Thomas, Edward Klatt.	

Chairman May called the meeting to order at 8:05 a.m. on February 22, 1973. He stated that this meeting would be directed to providing information on the railroad's contribution to the tax structure in Nevada and also some of the basic concepts of taxation in Nevada.

Mr. O.A. Thomas, General Tax Commissioner for the Southern Pacific Transportation Company from San Francisco, began his presentation by distributing written copies of his presentation to the committee members. (atch. 1) He went on to read this prepared statement to the committee members and clarified points of interest and answered relative questions. He pointed out that he would like to attempt to explain the method of arriving at the value of the railroads for assessment purposes.

Chairman May requested that Mr. Thomas explain the three factors, each weighted differently, by which the railroads are taxed. Mr. Thomas distributed three copies, one of which was put on file with the secretary for the committee's reference, of the "Southern Pacific Company, Southern Pacific Transportation Company System, 1972, Statistical Data" report that contained the data on which the Tax Commission uses in its evaluation of the Railroad. Mr. Thomas proceeded to go into a great deal of explaination of the statistical report. He informed the committee on the items that establish the stock and debt and income of the Southern Pacific. Mr. Thomas explained to the committee the dollar amounts that contribute to the net income, the amounts of equipment rentals and depreciation charged to net railway operating income for equipment owned and not used for the year specified. He went on to explain the development of the market value of the stock and debt to the net income.

Chairman May stated that the committee is not challenging the figures or charts that Mr. Thomas was explaining but would like to seek a basic understanding of how railroads are taxed.

In concurrence, Mr. Thomas explained that Southern Pacific Transportation Company is a holding company of which only a portion is the railroad, so in determining the value of the railroad it must be determined what the railroad income is, what the stock and debt value related to the railroad is, and then take a look at the property cost which are portions of the railroad.

Mr. Thomas then referred to the "Southern Pacific Company, The Southern Pacific Transportation Company Full Taxable Value for Nevada, 1972" report which showed that the total estimated income allocated to Nevada, capitalized 10% income rate, is $65,725,000. Dr. Broadbent asked if the bulk of this amount was from livestock grazing, and Mr. Thomas stated that none of it was. This amount was determined from the incomes from the leases of property within the railroad right of way such as services stations, warehouses located along side the railway, and other industrial type of leases.

There was further discussion of the land holdings of the Railroad and its plans for such lands. Mr. Demers brought up discussion on the "non-operating" pieces of land and their taxable status. Mr. Thomas stated that these lands are picked up under the non-operating or other properties and are distributed as all the other railroad properties are distributed throughout the counties.

As for Mr. Thomas' idea on whether Nevada is fair and equitable in its assessment, he has no quarrel with the Tax Commission over the assessment of the Southern Pacific Transportation Company. He feels that they are following the 35% ratio.

It was pointed out that the formula used by the Nevada Tax Commission is primarily a nationwide concept. This formula was adopted by the National Association of Tax Administrators after four or five years of extensive study that would fairly allocate to each of the states according to the income from the operation of the railroad.

Chairman May requested explanation of the last paragraph on page 1 of the "Full Taxable Value" report. Mr. Thomas stated that he believed that perhaps this paragraph should be eliminated because it was dealing with a situation two years prior and is not applicable now.

Mr. Clark Guild introduced Mr. Rowland M. Dolan, General Tax Agent for the Union Pacific Corporation and its subsidiaries. He stated that most of the things that Mr. Thomas talked about this morning were things that his company subscribes to, also.

He also explained that the NATA is an association much like the Tax Commission and its staff. They get together over a period of years and come up with an approach to different values in each state. He stated that the three approaches generally used is (1) stock and debt, average price of stock and outstanding debt, (2) capitalization of income, average of net income for five years, and (3) depreciation of book value of property and the weight placed on each catagory would determine taxable value.

Chairman May inquired as to where the revenues received from the railroad are placed. Mr. Dolan explained that the revenue is allocated to the counties based on railroad mileage in each county. Those counties not having any railroad mileage would receive none.

There was discussion on obselance and how it is derived.

Mr. C.L. Wishart, Regional Tax Manager for Western Union, stated that he felt that a look should be taken at the judgement factor in addition to stock and debt, income, and investment. By this, he believed that people that are in the position to make judgements of different companies should not make them based on mathematics, but should have specific tax knowledge of certain organizations on which he must make judgements.

The Chairman thanked all of the guests that appeared. There being no further business before the committee, motion was made to adjourn. The meeting was adjourned at 10:05 a.m.

Respectfully submitted,

Cindy Benjamin

Cindy Benjamin
Assembly Attache

Southern Pacific Transportation Company

Statement

of

O. A. Thomas
General Tax Commissioner

For presentation to Taxation Committee

Nevada State Legislature, Carson City, Nevada

February 22, 1973

ATTACHMENT 1

Mr. Chairman and Members
of the Tax Committee:

I am Oliver A. Thomas, General Tax Commissioner for Southern Pacific Transportation Company, with offices at One Market Street, San Francisco. Accompanying me today is Mr. C. A. Soderblom, Tax Agent, and Mr. Wendell S. Harnish, Assistant Tax Agent, whose offices are One East First Street, Reno, Nevada.

It is with a bit of nostalgia that I appear today as it recalls to mind many hours that I have spent as an observer at the Legislative Sessions. One of the most noticeable changes is that the committees now have much better facilities for holding hearings.

I welcome the opportunity of appearing before this committee in an attempt to explain the method of arriving at a value for railroads for assessment purposes. A subject, I might add, which is greatly misunderstood. I can recall when as County Assessor of Churchill County in the mid 30's that I anticipated the receipt of the assessment of utilities from the Tax Commission, always hoping that they would be greatly increased for this meant that I would have to dig less money from those electors who had seen fit to put me in the office of County Assessor.

While I dislike reading a prepared text, I am going to do so today in order that I may more accurately present to you information concerning the Southern Pacific Transportation Company.

The Nevada Tax Commission uses the unit method in placing a valuation upon the interstate operations of our railroad. This method has been developed over the years and the propriety of its use has been challenged in the courts many times, the first case dating back to 1875 in the State Railroad Tax Cases reported in Volume 92 U.S. 575. Another leading case is Cleveland, C.C. & St. L. R. Co. v. Backus (1893), 154 U.S. 439. In this area the U.S. Supreme Court approved the unitary valuation concept in these words:

> "The true value of a line of railroad is something more than an aggregation of the values of separate parts of it, operated separately. It is the aggregate of those values plus that arising from a connected operation of the whole, and each part of the road contributes not merely the value arising from its independent operation, but its mileage proportion of that flowing from a continuous and connected operation of the whole. This is no denial of the mathematical proposition that the whole is equal to the sum of all its parts, because there is a value created by and resulting from the combined operation of all its parts as one continuous line. This is something which does not exist, and cannot exist, until the combination is formed."

In spite of the difficulties involved in the appraisal of public utility property, certain evidences of value are uniformly accepted. They are: (1) capitalized earnings; (2) market price of stock and debt; (3) original or historical cost less depreciation; and (4) reproduction cost new less depreciation. The latter two, however, are generally given only minor significance by the courts in the appraisal of public utility property. The earning capacity of a utility has long been recognized by the United States Supreme Court as a primary indication of value. In Cleveland, et al v. Backus the court stated:

> "But the value of property results from the use to which it is put and varies with the profitableness of that use, present and prospective, actual and anticipated. There is no pecuniary value outside of that which results from such use. The amount and profitable character of such use determines the value, and if property is taxed at its actual cash value it is taxed upon something which is created by the uses to which it is put."

The court in City of Detroit v. Detroit & Canada Tunnel Co. (7th Cir. 1937), 92 F.2d 833, reversed a tax commission's valuation of a tunnel for failing to consider the income of the enterprise. The tunnel property was valued at original cost less depreciation. The tunnel company, a public utility, resisted this assessment challenging it as grossly excessive. The company established that due to economic conditions the market value of their outstanding stock, bonds, and debentures had shrunk from $22 million to about $1 million and that their earnings were ridiculously low in comparison with the cost of their facilities.

The court struck down the tax commission's valuation holding that in persistently relying on original cost less depreciation as a formula for arriving at "true cash value" and in ignoring the capitalized income method the commission was fundamentally wrong.

The analysis of the market value of stock and debt of a utility has also long been approved by the courts, dating back to the State Railroad Tax Cases in 1875. In Adams Express Co. v. Ohio State Auditor

(1896), 166 U.S. 185, the U. S. Supreme Court held that the cost at which a utility property could be reproduced was not the indication of its value for taxation. The court said, "The value which property bears to the market, the amount for which its stock can be bought and sold, is the real value." The court went on to say, "Businessmen buy and pay for that which is of value in its power to produce income, or for purposes of sale."

There are many cases I could cite all holding that properly capitalized income and stock and debt values are a proper method of valuing a railroad. In Rowley v. Chicago & Northwestern Rwy. Co. (1934), 293 U.S. 102, the court said, "The most widely accepted method of valuing a public utility is a combination or averaging of both the market value of stock and debt and capitalized income either with or without a consideration of depreciated historical cost."

The courts generally have frowned on the use of historical cost or reproduction cost as an index of value for ad valorem taxation purposes.

While reproduction cost is a good evidence of value in a competitive or unregulated economy, the following comment by the Committee on Unit Valuation of the NATA in June 1954 is typical of the criticism levied at its use in the valuation of a regulated utility for taxation purposes.

"It is a common misconception that reproduction cost must be used as a main evidence of value for utility purposes as long as it is so used for other properties. The assessor's objective is to assess at a uniform percentage of value, not of cost. If reproduction cost is a good test of the value of nonutility property and a poor test of the value of utility property, it is obviously inequitable to insist that it be used as a test of value in both areas. If it is a poor test of value even for nonutility properties, then it should be abandoned in both instances."

The reliability of reproduction cost as an evidence of value is greatest with respect to the assets of a firm which is actively investing and reinvesting in its plant and equipment and which carries on its operation in a competitive setting. In the sphere of regulated enterprise, characterized by administrative fixing of prices and the imposition of limitations upon entry into the industry and withdrawal from it, the going or commercial value of a given firm's investment may or may not bear a close relationship to current reproduction cost.

In 1971 the Ohio Supreme Court in the case of Pennsylvania RR v. Porterfield, 267 N.E. 792, held that an assessment of the railroad was unlawful where the method used did not consider the value of any of the railroad's property except by reference to its cost when acquired over a long period of years and where no consideration was given to the market value of its stock and debt or to the earnings of the railroad.

Mr. C. M. Chapman in his report to the California Legislature in 1959 on the method of appraisal of utility properties pointed out the fallacy of using either original cost or historical cost as a basis for ad valorem taxation as follows:

"Even though the so-called 'original cost' as developed by the I.C.C. may have been a fair reflection of prudent investment by rail carrier management at the turn of the century, much has transpired since that time. At the time the original valuation was made by the I.C.C., rail carriers were definitely monopolistic. Today they have lost most of such characteristics. Not only have they lost a large amount of business to competitive forms of transportation, but the economics of survival have caused intense competition among the several rail carriers operating in the same general area.

As a result, original cost for rail carriers has lost any relevance it may have had as to present-day market value. Such costs have little or no bearing on the process of present-day rate making.

To summarize, historical cost is a good evidence of value in the appraisal of electric, gas and telephone utility properties. It has no relevance whatever in the appraisal of rail carrier properties."

As I have stated, experts on utility valuation and the courts have given very little consideration to property costs for utility valuations. Particularly is it a poor indicator of value for the railroad. Our rates are not fixed on the cost of the property but rather on what rate will attract business to the railroad and give us a profit after handling it. Our business is so competitive that the regulatory commissions have long ago abandoned reference to investment cost in fixing our traffic rates.

Now I would like to discuss our railroad and what we may expect of it in the future. I think a great deal of misunderstanding results from the use of the name Southern Pacific Company. Until November 26, 1969 this primarily meant the railroad. Following that date SP Co. became a holding company and the railroad became Southern Pacific Transportation Co.

The stock quotations you see daily are for the holding company and reflect the value not only of the railroad but of the other subsidiary companies held by the holding company. The same is true of the announcements of the earnings. These are for the consolidated operations of which the railroad is only a part. For example, we recently announced 1972 earnings of $108.2 million as compared to $92.4 million last year. The railroad portion of this for 1972 was approximately $93 million, which is almost the same as the income for 1971 which was $92.9 before extraordinary charges mostly payments to Amtrak which reduced the net income to $77.5 million.

For ease of identification I will hereafter refer to the Southern Pacific Transportation Co. as the railroad. An examination of the ten year record of operations shown below will show some figures which are of concern.

Year	Rev. Net Ton Miles (Billions)	Net Railway Operating Income	Fixed Charges	Net Income From Railroad Operations
1961	44.9	$53.1	$26.1	$27.0
1962	48.2	60.4	26.3	34.1
1963	49.7	71.3	26.2	45.1
1964	53.0	60.3	27.4	32.9
1965	57.3	68.6	28.8	40.1
1966	61.0	62.1	30.1	32.0
1967	58.9	52.5	30.6	21.9
1968	64.7	65.2	31.6	33.6
1969	66.2	69.3	33.4	35.9
1970	65.0	61.6	36.7	24.9
1971	66.8	74.8	38.8	26.0

As shown in the table while the revenue net ton miles have increased substantially in the period 1961 to 1971, the 1971 net income from railroad operations after fixed charges was less than in 1961 and substantially less than the net realized in 1963. Among the major 76 reasons for the decline in net income are higher operating expenses (including wages) and the increasing amount of fixed charges, together with a leveling off of traffic in the last four years. We need to make increasing expenditures for capital improvements, principally rolling stock and roadway improvements, just to stay in business. These increasing demands are a severe drain on the Company's resources as funds for these capital expenditures are generally limited to retained income, depreciation accruals, sales of equipment obligations and by tapping our working capital.

Our working capital reflects a very wide fluctuation. During sixteen of the first twenty years following World War II net working capital or net current assets of Southern Pacific ranged from $90 to $130 million and the remaining four years were never less than $75 million. During the most recent five years our net working capital has dropped abruptly, being only $68.2 million at the close of 1971, which is less than one months operating expenses.

From a practical matter equipment obligations are the only outside source of money available to railroads for capital expenditures. We have almost twice the dollar amount of equipment obligations outstanding as there were in 1961. Long-term mortgage bonds and debentures have declined in this period but not enough to offset the large increase in the dollar amount of equipment obligations. The change in the character of debt from long-term mortgage bonds issued in the past at low or moderate interest rates to more short-term equipment obligations at higher interest rates is of tremendous significance as it resulted in higher interest charges thereby reducing the dollars available for the Company's needs.

Because the railroad industry is a service industry, it requires a substantial payroll as well as a large plant which has to be renewed and replaced constantly. These two factors have made the industry particularly vulnerable to inflation. Not only has inflation been responsible for increased wages and material prices, it has also had an adverse effect on our equipment purchases. Under normal circumstances, the accumulated annual depreciation charges on freight cars retired should provide sufficient funds to replace them in kind. However, as new cars now cost $16,000 instead of $4,000, it now takes depreciation accruals of four cars to buy one car. True, the car has been changed and improved to keep up with the times but the fact remains that the bulk of the increased cost reflects inflation and necessitates increased borrowing.

As a regulated industry, the rate of return earned by the railroads is substantially lower than that of other regulated industries, such as electric or gas companies. State regulatory commissions have recognized the need for rates of return for the latter closer to the current cost of money. For example, the California Public Utilities Commission recently awarded Pacific Gas and Electric Company an increase in gas rates designed to yield an estimated rate of return of 7.3%.

In contrast, the rates of return earned by Southern Pacific last year and for all of the recent years has been substandard. Shown below are the rates of return earned by the Southern Pacific Company (including the Texas and New Orleans RR during 1960 and 1961) which is now the Southern Pacific Transportation Company:

1961	2.89%	1967	2.76%
1962	3.32	1968	3.40
1963	3.93	1969	3.57
1964	3.33	1970	3.12
1965	3.67	1971	3.76
1966	3.34	1972	4.6

Another factor which should be considered is the decline in the traffic which the railroad handles across Nevada. Rather than burden you with a lot of statistics I am simply quoting two; however, the trend is well established. The statistic which I am using is the total line haul statistic and is the accumulation of those statistics which represent the line haul usage of the railroad such as railway operating revenues, equipment mileage, and net revenue ton miles. In 1961 this figure for Nevada was 40.6% of the system total, but in 1971 had declined to 34.5%. This reflects the effect of highway competition.

All of the statistics and information which I have given you pretty well show the trend of the railroad over the past ten years and reflect some of the problems, not only of our railroad but that of the industry. This is not to say that it is all a bad picture. Southern Pacific Transportation Company is either the No. 1 or No. 2 railroad in the United States, we think we're No. 1. And certainly our earnings this year have shown a turn around. My philosophy is that we should pay taxes on the fair value of the railroad and that we will resist vigorously any attempt to arbitrarily or capriciously inflate our assessed valuation.

So far we have been discussing the railroad operating property. There is one other category of property owned by the railroad which may be classed as "non-operating". This is the property included within the railroad right-of-way but which is leased to others generally for purposes connected with the railroad; that is, most of our lessees are users of rail transportation.

Historically in Nevada this property has been included in the assessment of the railroad operating property.

Last year the Chairman of the Tax Commission and the Assessor of Elko County and Senator Swobe and the Assessor of Washoe County requested that we return this property for situs assessment. Under this method the property will be assessed by the Local Assessor on the same basis as adjoining property. This we are pleased to do and have already filed maps with each county assessor and the Tax Commission giving the location of leased property within the respective counties. While this is no big deal, I would like to point out that the previous unit method distributed the value of this property over the entire railroad in Nevada with each county getting a portion. Under the situs assessment some of the smaller counties, including Elko, will see a reduction in the assessed value of the railroad in their county. Of course, if the leases in each county are of sufficient magnitude this reduction will be offset by the local assessment.

Mr. Chairman if the Committee has time I would like to depart from my prepared statement and distribute to you a copy of the statistical tables which are used in arriving at the assessed value of the railroad and to explain the statistics used.

SOUTHERN PACIFIC COMPANY
THE
SOUTHERN PACIFIC TRANSPORTATION COMPANY

FULL TAXABLE VALUE

NEVADA - 1972

SOUTHERN PACIFIC TRANSPORTATION COMPANY

NEVADA TAXES - 1972

This pamphlet sets forth the full taxable value of the Southern Pacific Transportation Company property located in Nevada for the tax year 1972 as estimated by the Company. In arriving at this value it was necessary first to collect and analyze the appropriate railway statistics showing the past performance of the Company and second, to estimate future performance from these data. The method followed and the computations made by the Company in making its estimate of full taxable value are contained in this pamphlet and an accompanying set of statistical tables 11" X 17" in size.

The full taxable value of the Southern Pacific Transportation Company operative property located in Nevada for the year 1972 is estimated by the Company to be a total not to exceed $75,000,000.

It is the position of the Company that the assessed value of its property should bear the same relation to the full taxable value thereof that the assessed value of locally assessed property bears to the full taxable value of locally assessed property.

[The Company therefore respectfully recommends that the Nevada State Tax Commission give consideration to the full taxable value above set forth and apply an assessment ratio factor thereto which has been equalized with locally assessed property when setting the total 1972 assessed value on property of the Southern Pacific Transportation Company in Nevada.]

SOUTHERN PACIFIC TRANSPORTATION COMPANY

NEVADA TAXES - 1972

Evidences of Value

For the tax year 1972 three main evidences of value have been considered in estimating the full taxable value of the Company's property located in Nevada.

1. Capitalized Income
2. Market Value of Stock and Debt
3. Property Costs - ICC Costs based on ICC Order No. 32153, dated April 17, 1963, adjusted to date for subsequent changes less depreciation.

In addition to these three evidences of value shown above, probable future economic conditions, and competition of other types of transportation have been considered.

ALLOCATION FACTORS

Property Costs in the road accounts are allocated situs. Equipment Costs are allocated on an equipment mileage basis. Factors for allocating income and stock and debt value of operating property were computed from the following six railway statistics representing terminal and line-haul influence.

(1) Property Costs new exclusive of equipment
(2) Terminal Tons handled
(3) Way and yard switching tracks
(4) Railway operating revenues
(5) Equipment mileage
(6) Net ton and passenger miles

The relation in percent that the Nevada total bore to the Southern Pacific Transportation System total was computed for each statistic.

SOUTHERN PACIFIC TRANSPORTATION COMPANY

NEVADA TAXES - 1972

The Amount to be Capitalized Net Railway Operating Income

Year (1)	As Booked (2)	As Adjusted (3)
1971	$74,761,216	$74,010,479
1970	61,595,756	64,752,266
1969	69,271,697	67,289,164
1968	65,160,641	61,118,677
1967	52,521,146	56,603,151
5 Year Average	64,662,091	64,752,747

(Reference Notes: Column 2 taken from annual report of Southern Pacific Transportation System, Column 3 taken from Item 12 of Statistical Table)

The amount shown in Column 3 of above table has been adjusted in order to allow for distribution of federal income tax between tax base and non-tax base income and also to allow for elimination from net railway operating income of the net effect of rents from non-tax base equipment.

Based on the data hereinbefore set forth and giving consideration to probable future economic conditions, competition, the capital requirements for replacement and modernization of facilities to meet future demands for service, costs of borrowed funds and a reasonable return on equity in terms of relevant comparisons with other industries of comparable risk the annual amount of net railway operating income to be capitalized, adjusted for tax purposes, is estimated to be not in excess of $70,000,000.

The Amount to be Capitalized Other Income

The net result of income recorded in Accounts 502 to 519 grouped under the heading of "Other Income" and the expenses recorded in Accounts 534 to 551 grouped under the heading of "Miscellaneous Deductions from Income" has been analyzed and separated between tax base and non-tax base net income.

Year (1)	Amount (2)
1971	$363,757
1970	264,639
1969	213,869
1968	173,497
1967	231,218
5 Year Average	$249,396
Estimated annual amount to be capitalized	249,400

(Reference: Col. 7 from Item 14 of Statistical Table)

The Amount to be Capitalized Operating and Other Income

Description (1)	Income Amount (2)	Capitalized 10% Income Rate (3)
Estimated annual net railway operating income, adjusted for tax purposes, allocated to Nevada. 9.033 percent of $70,000,000. (Ref. Sh. 6, Col. 7, Line 25).	$6,323,100	$63,231,000
Estimated annual other income allocated to Nevada on situs basis where possible	$ 249,400	$ 2,494,000
Total estimated income allocated to Nevada	$6,572,500	$65,725,000

Stock and Debt Value Resulting
from Net Railway Operating Income

Year (1)	Amount (2)
1971	$782,458,545
1970	646,616,064
1969	773,656,894
1968	667,072,405
1967	664,274,146

(References: Item 13 of Statistical Table)

Estimated Annual Stock and Debt Value Resulting from net railway operating income, $780,000,000.

Stock and Debt Value
Resulting from Other Income

Year (1)	Amount (2)
1971	$3,845,736
1970	2,642,685
1969	2,458,958
1968	1,893,612
1967	2,735,026
5 Year Average	$2,715,203
Estimated Annual Stock and Debt Value resulting from other income	$2,715,200

(Reference: Column 7, Item 15 of Statistical Table)

SOUTHERN PACIFIC TRANSPORTATION COMPANY

NEVADA TAXES - 1972

Stock and Debt Value
Resulting From
Net Railway Operating Income and Other Income

Description (1)	Amount (2)
Estimated annual stock and debt value resulting from net railway operating income allocated to Nevada	$70,457,400
9.033 per cent of $780,000,000 (Ref. Sh. 6, Col. 7, Line 25)	
Estimated annual stock and debt value resulting from other income allocated to Nevada on situs basis where possible	$ 2,715,200
Total estimated annual Stock and Debt Value allocated to Nevada	$73,172,600

NEVADA TAXES - 1972

Evidences of Value Weighted Composite Value Indicators

In the tabulations below the amounts previously determined for capitalized income, stock and debt value and property costs, have been weighted into composite value indicators by applying various combinations of weighting percentages.

Evidences of Value

Evidence of Value (1)	Amount (2)
Capitalized Income 10%	$65,725,000
Market Value Stock and Debt	73,172,600
Property Costs	107,043,705

Composite Value Indicators

Weighting Percentages CI (1)	S&D (2)	PC (3)	Amount (4)
50	50	0	$69,448,800
45	45	10	73,208,290
40	40	20	76,967,781