

06-0773 & 06-0767
CENTRALLY ASSESSED PROPERTY
TAX YEAR: 2006
SIGNED 02-28-08
COMMISSIONERS: P. HENDRICKSON, R. JOHNSON
CONCURRENCE: M. JOHNSON
EXCUSED: D. DIXON

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER,

Petitioner,

vs.

PROPERTY TAX DIVISION OF THE UTAH
STATE TAX COMMISSION,

Respondent.

COUNTIES,

Petitioners,

vs.

PROPERTY TAX DIVISION OF THE UTAH
STATE TAX COMMISSION,

Respondent.

**FINDINGS OF FACT, CONCLUSIONS OF
LAW, AND FINAL DECISION**

Appeal No. 06-0773

Appeal No. 06-0767

Tax Type: Property Tax/Centrally Assessed
Tax Year: 2006

Judge: Phan

This Order may contain confidential "commercial information" within the meaning of Utah Code Sec. 59-1-404, and is subject to disclosure restrictions as set out in that section and Utah Admin. Rule R861-1A-37. The rule prohibits the parties from disclosing commercial information obtained from the opposing party to nonparties, outside of the hearing process. However, pursuant to Utah Admin. Rule R861-1A-37 the Tax Commission may publish this decision, in its entirety, unless the property taxpayer responds in writing to the Commission, within 30 days of this order, specifying the commercial information that the taxpayer wants protected.

Presiding: Pam Hendrickson, Commission Chair
R. Bruce Johnson, Commissioner
Marc Johnson, Commissioner
Jane Phan, Administrative Law Judge

Appearances: For PETITIONER: PETITIONER REP, Attorney
For Property Tax Division: RESPONDENT REP, Assistant Attorney General
For COUNTIES: COUNTIES REP, Attorney

STATEMENT OF CASE

This matter came before the Utah State Tax Commission (“Commission”) for a Formal Hearing on August 27-31, 2007. This matter pertains to a Notice of Assessment issued by the Property Tax Division (the “Division”) of the Commission to PETITIONER on May 1, 2006, in which the Division asserted that the system value of PETITIONER’s operating property was \$\$\$\$ as of January 1, 2006, and the allocated value of PETITIONER’s taxable Utah operating property was \$\$\$\$.¹

Both PETITIONER and COUNTIES, et al (“PETITIONER”) timely filed a Petition for Redetermination challenging the Division’s assessed valuation. PETITIONER’s Petition was assigned Appeal No. 06-0773. COUNTIES’ Petition was assigned Appeal No. 06-0767. PETITIONER’s and COUNTIES’ appeals were consolidated before the Commission and were the subject of the Formal Hearing. The parties submitted Proposed Findings of Fact and Conclusions of Law on November 2, 2007 and November 5, 2007.

Based upon the oral and written pleadings, as well as the evidence, testimony, and exhibits presented at the Formal Hearing, the Commission makes and enters its:

FINDINGS OF FACT

1. Both PETITIONER and COUNTIES are appealing the assessed value as set by the Division for PETITIONER’s Utah taxable property, for *ad valorem* property tax purposes, for the 2006 lien date.

¹ See Formal Hearing Exhibit 20, p. 1 (hereinafter all exhibits admitted into the record at the Formal Hearing shall be referred to as “Exhibit”).

2. The Commission received testimony from four appraisers during the Formal Hearing: APPRAISER 1 who prepared the original assessment and a hearing appraisal on behalf of the Division;² APPRAISER 2, who assisted with the hearing appraisal for the Division; APPRAISER 3 who prepared an appraisal on behalf of PETITIONER,³ and APPRAISER 4 who prepared an appraisal on behalf of COUNTIES.⁴ In addition to these appraisal witnesses, the Commission received testimony from the following witnesses: WITNESS 1, Director of Revenue Requirements for PETITIONER; WITNESS 2, Tax Director for PETITIONER; WITNESS 3, Professor of Finance at UNIVERSITY; WITNESS 4, Economist; and WITNESS 5, Economist.

3. PETITIONER is a regulated electric company, serving customers in portions of the states of (VARIOUS STATES NAMED). PETITIONER additionally has transmission and electrical generation property in (VARIOUS STATES NAMED).⁵

4. On the January 1, 2006 lien date, all of PETITIONER's outstanding shares of common stock were owned by COMPANY 1, a STATE 1 corporation ("COMPANY 1"). COMPANY 1 was a wholly owned subsidiary of COMPANY 2 ("COMPANY 2").⁶ Shortly after the lien date PETITIONER was acquired by COMPANY 3 ("COMPANY 3"). COMPANY 4 ("COMPANY 4") owns %%% of the outstanding common stock of COMPANY 3.

COMPANY 3 ACQUISITION

5. On May 23, 2005, prior to the lien date, COMPANY 2 announced that COMPANY 1 would sell its PETITIONER common stock to COMPANY 3 with the expectation that

² Exhibits 20 and 21. APPRAISER B, an employee with the Division, provided assistance to APPRAISER 1 in preparing the Division's hearing appraisal.

³ Exhibit 22.

⁴ Exhibit 23.

⁵ Exhibit 1, and Exhibit 6.

⁶ Exhibit 22, p. 66.

the transaction could be closed sometime within the following (X) to (X)months.⁷

6. On that same date, COMPANY 3 entered into an agreement with COMPANY 2 to purchase the equity of PETITIONER consisting of its common stock for the price of \$\$\$\$\$ which would be payable at the future closing.⁸ As part of the transaction, COMPANY 3 also agreed to assume the amount of debt PETITIONER would have at the time of the future closing.⁹

7. The stock purchase transaction eventually closed on (X) approximately (X) days after the subject lien date of January 1, 2006,¹⁰ when final regulatory approval for the transaction was issued.¹¹

8. The amount of PETITIONER's debt and preferred stock assumed as of the (X) closing date was approximately \$\$\$\$\$.¹²

9. The book value of the equity of the PETITIONER common stock, as of March 31, 2006, was approximately \$\$\$\$\$ and the common stock was not publicly traded.¹³

10. As a condition of regulatory approval, COMPANY 3 agreed to not restate the book values of PETITIONER's tangible assets to reflect the premium paid above book value on acquisition.¹⁴

11. COMPANY 3 paid a premium of approximately \$\$\$\$\$ for PETITIONER's common stock.¹⁵ Under SFAS 141, COMPANY 3 booked the premium, which was the residual number after the fair value of all the intangible and tangible assets, as goodwill.

⁷ Exhibit 5, p. 6 and Exhibit 6, p. 10.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ Exhibit 7, p. 10.

¹² Exhibit 22, p. 68.

¹³ Exhibit 9, PacUt 01351; Ex. 6, p.25.

¹⁴ Hearing Transcript 818, 819,1022; Exhibit 9, p.3.

12. Goodwill is not included in rate base for PETITIONER and the COMPANY 3 shareholders will not be allowed to receive a return on the purchase premium of \$\$\$\$ that is booked as goodwill.¹⁶

13. The COMPANY 3 shareholders recognized that they would not be allowed to earn a return on the premium booked as goodwill, but believed the price negotiated for the stock was fair “*if* PETITIONER is able to earn its authorized return.”¹⁷

14. As part of COMPANY 3’s purchase price allocation under SFAS 141, COMPANY 3 allocated no value to brand names, customer lists, franchise value or market related intangible assets of PETITIONER.¹⁸ The Division’s witness, WITNESS 5, an economist specialization in regulatory issues, testified along with COUNTIES witness, WITNESS 4, that PETITIONER has little intangible property.¹⁹

15. The last time PETITIONER appealed its property tax value in Utah was for the 1999 tax year. In December of 1998, COMPANY 2 had announced that it was acquiring all of the stock of PETITIONER from its then existing shareholders. COMPANY 2 paid a premium that was recorded as goodwill on the books of the COMPANY 2 acquisition company.²⁰

16. When COMPANY 2 acquired the PETITIONER stock in 1998, it had hoped that deregulation and other events would allow PETITIONER to earn its allowed return or in excess of its allowed return. Neither of these expectations was ever reached.²¹

17. When COMPANY 1 sold the PETITIONER common stock to COMPANY 3,

¹⁵ Exhibit 7, pp. 10-11.

¹⁶ Transcript, pp. 449, 608, and 1042-1043.

¹⁷ Exhibit 54, p. 13 (emphasis added), Transcript, pp. 1329-1330, and Exhibit 22, p. 14.

¹⁸ Exhibit 9, p. 19.

¹⁹ Hearing Transcript pp. 1124.

²⁰ Exhibit 48, p. 20-1.

COMPANY 2 recognized an impairment of its booked goodwill, and COMPANY 2 ultimately recognized a loss of approximately \$\$\$\$\$ due to the sale of the PETITIONER common stock.²²

18. PETITIONER's witnesses claimed that COMPANY 3 paid a premium in anticipation that PETITIONER could earn a return greater than COMPANY 3's cost of capital; however, in contradiction, PETITIONER's same witnesses testified that under regulation, PETITIONER would never earn more than its allowed rate of return and will likely continue to earn below its allowed rate of return.²³

19. As part of the transaction, COMPANY 3 obtained the services of COMPANY 5 ("COMPANY 5") to determine whether COMPANY 3's offer to purchase PETITIONER at the stated premium was fair. COMPANY 5 performed a discounted cash flow analysis based upon internal planning documents of PETITIONER and COMPANY 3 and determined that the purchase price of \$\$\$\$\$ for the equity was fair. In its analysis COMPANY 5 used an %%% cost of capital.²⁴

20. The parties called witnesses to give their opinion regarding the acquisition by COMPANY 3. PETITIONER's witness, APPRAISER 3, MAI Appraiser, suggested that the premium was paid by COMPANY 3 because COMPANY 3 may have thought it could achieve the authorized rate of return.²⁵ APPRAISER 3 also indicated that the COMPANY 3 acquisition was relevant to the valuation of PETITIONER as of January 1, 2006.²⁶ COUNTIES witness WITNESS 4, an economist specializing in regulatory issues, testified that there was no reason why COMPANY

²¹ Transcript, pp. 486-487, and Exhibit 48, p. 20-1.

²² Exhibit 52, and Transcript, pp. 1267-1270.

²³ Transcript, pp. 481, 1212.

²⁴ Exhibit 39.

²⁵ Transcript, pp. 1335-1336.

²⁶ Exhibit 22, p. 66.

3 would pay anything more for PETITIONER than what the market would require.²⁷

REGULATION

21. PETITIONER's rates are regulated by the public service commissions in each of the states in which it operates. The public service commissions and other agencies including the Federal Energy Regulatory Commission ("FERC") and the Securities and Exchange Commission ("SEC") regulate many aspects of PETITIONER's business. They regulate customer rates, service territories, sales of securities, asset acquisitions and sales, accounting policies and practices, wholesale purchases of electricity, and the operation of its electric generation and transmission facilities.²⁸

22. PETITIONER's rate regulation may be referred to as cost or rate base regulation. Under this type of regulation, the respective public service commissions set PETITIONER's rates at an amount that will allow PETITIONER the opportunity to cover its allowed revenue requirement. The revenue requirement is an amount derived by the various public service commissions that is designed to allow PETITIONER to recover enough money through its rate collections to pay its reasonable operating costs and a reasonable return to its investors who have funded the utility's operating property (i.e. rate base).²⁹

23. The basic formula used to estimate PETITIONER's revenue requirement may be stated as³⁰:

$$R = O + (V-D)r$$

Where: *R* is the total revenue requirement

O is the operating costs

V-D is the rate base (Value of property less accrued *D*epreciation)

²⁷ Transcript, pp. 1195-1196.

²⁸ Exhibit 6, p. 1.

²⁹ Transcript, pp. 143-144.

³⁰ Exhibit 25, and Transcript, p. 147.

r is the allowed rate of return

24. PETITIONER is required to file summaries with each of the states where it operates that summarize its rate base, operating costs and earnings. These summaries are filed at least bi-annually in Utah.³¹

25. As of September 2005, PETITIONER's estimated rate base was approximately \$\$\$\$\$.³²

26. For the past six or seven years, PETITIONER has been earning less than its allowed rate of return.³³

27. WITNESS 5 and WITNESS 4, both testified that the purpose of regulation is to mimic competition and that within regulation there were winners and losers just like in a purely competitive market.³⁴

28. WITNESS 5 testified that in his experience, most regulators set the cost of capital higher than the "bare cost of capital as a safety measure and as an incentive."³⁵ It was his opinion that a regulator does not want a utility to chronically under earn its allowed rate of return because the regulator will eventually have to raise rates.³⁶ He also testified that companies can, and often do, earn more than their allowed rate of return in a regulatory context.³⁷ It was his position that regulators would prefer a company to earn more than its allowed rate of return so that subsequent rate changes will be downward rather than upward and ratepayers will benefit from lower rates.³⁸

³¹ Exhibit 25, p. 2, Transcript, p. 148.

³² Exhibit 25, p. 2, Transcript, p. 157.

³³ Transcript, p. 154.

³⁴ Transcript, pp. 520-524; 989.

³⁵ Transcript, p. 995.

³⁶ Transcript, p. 996.

³⁷ Transcript, p. 992.

³⁸ Transcript, pp. 995-996.

29. WITNESS 4 stated that regulators do not want to see a utility consistently under earn its cost of capital because that will impair the ability of the utility to provide safe service.³⁹

30. WITNESS 1, the Director of Revenue Requirements for PETITIONER, indicated that PETITIONER’s situation was different than the general regulatory environment.⁴⁰ He also testified that “over the long haul, regulated utilities will generally earn less than what their authorized rate of return is” because of regulatory lag and the disallowance of certain investments into rate base.⁴¹ It was his position that rate regulation has negatively affected PETITIONER’s earnings due to regulatory lag, i.e., when there is a delay between the time an investment is made and the time when the utility is allowed to adjust its rates to earn a return on the new investment.⁴² In addition it was WITNESS 1’s position that rate regulation has also negatively affected PETITIONER’s earnings because some public service commissions have not allowed certain investments to be included in the rate base upon which PETITIONER is allowed to apply its rates.⁴³

31. Since 2002, PETITIONER has been involved in at least sixteen rate proceedings.⁴⁴ These proceedings have occurred in the states of (TEXT REMOVED).⁴⁵ Decisions in three of these rate proceedings became effective during the 2005 year immediately preceding the subject lien date:⁴⁶

<u>Date</u>	<u>Jurisdiction</u>	<u>Estimate Annual Increase to Revenues</u>
Mar. 1, 2005	Utah Public Ser. Comm’n	\$\$\$\$\$
Sept. 16, 2005	(X) Public Ser. Comm’n	\$\$\$\$\$

³⁹ Transcript, p. 523.

⁴⁰ Transcript, p.1212.

⁴¹ Transcript, pp. 165-166.

⁴² *Id.*, and see testimony of WITNESS A, Transcript, pp. 140-204.

⁴³ *Id.*

⁴⁴ Exhibit 26, and Transcript, p. 159.

⁴⁵ Exhibit 26.

⁴⁶ Exhibit 26, Exhibit 22, p. 31, and Transcript, pp. 386-388.

Oct. 04, 2005

(X)Public Ser. Comm'n

\$\$\$\$\$

PRIOR DECISION

32. The Commission had heard a Formal Hearing and issued a decision regarding the taxable value of PETITIONER for the 1999 tax year. On April 4, 2001, the Commission issued its Findings of Fact, Conclusions of Law and Final decision in Appeal No. 99-0568 (“1999 Decision”), concluding that the system wide value of PETITIONER for the 1999 lien date was \$\$\$\$\$.⁴⁷

VALUATION EVIDENCE

33. The Division’s Utah property assessment for tax year 2006 had been based on a system value of \$\$\$\$\$. This value was established with an income indicator of \$\$\$\$\$ and a cost indicator of \$\$\$\$\$, which were each given %%%% weight. In the assessment, the Division had concluded that the appropriate interstate allocation factor for Utah was %%%%. After deduction for locally assessed vehicles, this resulted in a Utah taxable value of \$\$\$\$\$.

34. Three appraisals were submitted at the Formal Hearing. APPRAISER 1, who prepared the original assessment, and APPRAISER 2, Certified General Appraiser, Tax Commission Senior Analyst, prepared a hearing appraisal on behalf of the Division, which supported the original assessment.⁴⁸ APPRAISER 3 prepared an appraisal on behalf of PETITIONER.⁴⁹ APPRAISER 4 prepared an appraisal on behalf of COUNTIES.⁵⁰ Their general value conclusions are summarized as follows:

⁴⁷ 1999 Decision.

⁴⁸ Exhibits 20 and 21. APPRAISER B, an employee with the Division, provided assistance to APPRAISER 1 in preparing the Division’s hearing appraisal.

⁴⁹ Exhibit 22.

⁵⁰ Exhibit 23.

	Division	PETITIONER	COUNTIES
Income			
Type of Calculation	Yield Cap.	Yield Cap.	DCF
Income Type	Cash Flow	CF=NOI	Cash Flow
Income Capitalized	\$\$\$\$	\$\$\$\$	Variable
Cost of Capital (“r”)	% % % %	% % % %	% % % %
“r” without flotation	% % % %	% % % %	% % % %
Deduction for Intang.	\$\$\$\$	\$\$\$\$	
Income Value	\$\$\$\$	\$\$\$\$	\$\$\$\$-\$\$\$\$\$*
Cost			
Included CIAC	Yes	No	Yes
CWIP	P. V. Expan.	All CWIP	P. V. All CWIP
Deduction for Intang.	\$\$\$\$	\$\$\$\$	\$\$\$\$
Cost Value	\$\$\$\$	\$\$\$\$	\$\$\$\$
Market/ Stock Sales Value	None	\$\$\$\$	\$\$\$\$
Weighting	I/X% C/ X%	I/X% C/X% S/X%	Not Specified
System Value	\$\$\$\$	\$\$\$\$	\$\$\$\$
Interstate Allocation	XX.XX%		XX.XX%
Utah Taxable	\$\$\$\$	\$\$\$\$**	\$\$\$\$

*From a corrected Schedule, PETITIONER Exhibit 40.

**PETITIONER’s appraisal did not determine a Utah taxable value. For purposes of comparison, this is the resulting value if the Division’s interstate allocation and locally assessed property deduction were applied to PETITIONER’s system value.

A. Division’s Appraisal.

35. The Division submitted an appraisal at the hearing that supported its original assessment for the Utah taxable assets of PETITIONER. It was the Division’s appraisal conclusion that the system value of PETITIONER was \$\$\$\$\$. This was derived from an income indicator of \$\$\$\$\$ and a cost indicator of \$\$\$\$\$. Each indicator was given equal weight in the final reconciliation. Of the system value, the Division concluded XX.XX % was allocable to Utah. The Division concluded that the Utah taxable value was \$\$\$\$\$.⁵¹

36. **Income Approach.** The appraisers for the Division prepared an income estimate using the yield capitalization model.⁵² Utah Admin. Rule R884-24P-62 (“Rule 62”) specifies that the yield capitalization approach is the preferred method. The formula specified in Rule 62 is CF/(k-g),

⁵¹ Exhibit 21.

⁵² Exhibit 21, p. 6.

where 'CF' is a normalized cash flow, 'k' is the cost of capital and 'g' is the growth rate.

37. For taxes years 2003 through 2005, the Division used normalized NOI as its cash flow or "CF" estimate for PETITIONER and all other cost regulated utilities in Utah.⁵³ In making this calculation, the Division equally offset all non-cash charges such as depreciation, amortization and deferred income tax expense ("DIT") with replacement capital expenditures.⁵⁴

38. In 2006 the Division came to the conclusion that use of normalized NOI as cash flow was not in compliance with Rule 62. The Division determined that it should add non-deferred cash charges, such as DIT to arrive at cash flow, without offset for capital expenditures.⁵⁵

39. Therefore, in its 2006 assessment, the Division calculated gross cash flow by determining a normalized NOI of \$\$\$\$\$, which was essentially the prior year's NOI of \$\$\$\$\$ rounded,⁵⁶ to which it added non-cash charges in the amount of \$\$\$\$\$ for depreciation, \$\$\$\$\$ for amortization expenses and \$\$\$\$\$ for DIT.⁵⁷

40. The amount of the normalized depreciation, amortization and DIT used by the Division in its approach was determined by rounding the annual depreciation, amortization and DIT figures from the most recently completed year (2005).⁵⁸

For its 2006 assessment, the Division then made the assumption that replacement capital expenditures were equal to depreciation and amortization expenses, which totaled \$\$\$\$\$, an amount that the Division subtracted (or offset) from the gross cash flow. The Division felt that this was conservative as PETITIONER reported its replacement capital expenditures for the 2005 fiscal year to be only

⁵³ Exhibit 27, Transcript, pp. 210-212, 82-82, 920.

⁵⁴ Exhibit 27, and Transcript, pp. 210-212.

⁵⁵ Transcript, pp. 82-83, 906-907.

⁵⁶ Exhibit 21, p. 8, and Transcript, p. 85.

⁵⁷ Exhibit 21.

⁵⁸ Transcript, p. 87.

\$\$\$\$\$.⁵⁹

41. The Division's decision to add \$\$\$\$ of DIT to the estimate for PETITIONER's cash flow without offset for capital expenditure increased the Division's value estimate under the income indicator by \$\$\$\$ more than it would have been had the Division followed its prior practice of assuming that all non-cash charges would be offset by replacement capital expenditures.⁶⁰

42. The Division did not take into account any regulatory rate decisions that had been issued during 2005 that might have impacted the estimated NOI for the first future year.⁶¹

43. Regarding the 'g' in the yield capitalization formula the Division assumed a zero growth rate, which the Division argued accounted for the effects of regulation along with its NOI estimate.

44. For the 'k' in the yield capitalization formula, which represents the cost of capital, the Division used a yield capitalization rate of %%%%. The Division reviewed three costs of equity models in deriving its cost of equity: an *ex post* capital asset pricing model ("CAPM"), a risk premium model, and a dividend growth model.⁶²

45. The Division placed %%%% weight on its CAPM estimate and %%%% weight on its risk premium estimate to derive a cost of equity of %%%%.⁶³

46. The Division had determined the cost of debt was %%%%. The Division weighted its debt and equity components as follows and did not add an amount for flotation:⁶⁴

<u>Capital Structure</u>	<u>Rate</u>	<u>Weighted Rate</u>
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⁵⁹ Exhibit 21.

⁶⁰ Transcript, p. 102.

⁶¹ Transcript, pp. 85-86.

⁶² Exhibit 21, p. 3-23.

⁶³ Exhibit 21, pp. 3-23 and 3-15, and Transcript, p. 941.

⁶⁴ Exhibit 21, p. 9.

Debt	%%%%%%%%	x	%%%%%%%%	=	%%%%%%%%
Equity	%%%%%%%%	x	%%%%%%%%	=	%%%%%%%%
Totals	%%%%%%%%				%%%%%%%%

47. APPRAISER 2 testified that the Division used the same methodology for PETITIONER that he used for other taxpayers, and recommended that to be consistent among taxpayers the Commission should not change the estimate of equity.⁶⁵

48. With all the factors indicated above the Division’s income approach is summarized as follows:⁶⁶

Normalized NOI	\$\$\$\$\$
Add estimated depreciation	\$\$\$\$\$
Add estimated amortization	\$\$\$\$\$
Add estimated DIT	\$\$\$\$\$
Less gain on CO ₂ allowance	<\$\$\$\$\$>
Less estimated replacement capital expenditures	<\$\$\$\$\$>
Cash flow to capitalize	\$\$\$\$\$
Capitalization Rate	%%%%%%%%
Income Indicator w/ intangibles	\$\$\$\$\$
Estimated intangibles	<\$\$\$\$\$>
Income Indicator	\$\$\$\$\$

49. **Cost Approach:** The Division prepared an HCLD cost indicator of value from which it concluded a system value of \$\$\$\$\$.⁶⁷

50. As part of its HCLD indicator the Division included \$\$\$\$\$ of contributions in aid of construction (“CIAC”). CIAC represents amounts given by developers or other individuals to PETITIONER to pay for connection facilities beyond the typical connection point, including lines, transformers and switches. Any property that is acquired through the use of CIAC becomes titled in the name of PETITIONER, but is not allowed by regulators to be included in PETITIONER’s rate

⁶⁵ Transcript, p. 915.

⁶⁶ Exhibit 21, p. 6.

⁶⁷ Exhibit 21.

base.⁶⁸

51. In its HCLD approach the Division also included only the present value of expansionary Construction Work in Progress (“CWIP”). This is consistent with the Division’s assessments for centrally assessed taxpayers for several years. APPRAISER 2 testified the inclusion of only expansionary CWIP resulted from the Commission’s 1999 Decision regarding PETITIONER.⁶⁹

52. The Division also subtracted from its HCLD approach \$\$\$\$ in accumulated deferred income tax.

53. **Market Approach:** The Division did not prepare a market indicator for this case.⁷⁰ The Division testified that it was not comfortable using a stock and debt indicator for PETITIONER because PETITIONER did not have any publicly traded stock.⁷¹ APPRAISER 2 also testified that the Division did not attempt to prepare a market indicator based upon the sale of the common stock from COMPANY 2 to COMPANY 3.⁷² APPRAISER 2 noted that one sale is not necessarily indicative of the market, and that it is extremely difficult to properly adjust the sales price to derive an estimate of fair market value unless you are able to study multiple comparable sales.⁷³

54. APPRAISER 2 further testified that without making an analysis among comparable sales, it is difficult to determine what unique factors may have influenced the price of the stock and how the stock price might relate to the value of the underlying taxable property.⁷⁴

B. APPRAISER 3’s Appraisal.

⁶⁸ Transcript, pp. 157-158, 200, 265, 932, and 1024.

⁶⁹ Exhibit 21, Transcript, pp. 934-935, 982.

⁷⁰ Exhibits 20 and 21.

⁷¹ Transcript, p. 929.

⁷² Transcript, pp. 929-931.

⁷³ Transcript, pp. 930-931.

⁷⁴ Transcript, p. 931.

55. It was APPRAISER 3's appraisal conclusion that the system value of PETITIONER was \$\$\$\$\$. This was based on income indicator of \$\$\$\$\$ to which he gave X% weight, a cost indicator of \$\$\$\$\$ to which he gave X% weight and a stock sales approach of \$\$\$\$\$ to which he gave X% of the weight. APPRAISER 3 did not calculate an allocation factor to determine the portion of the system value taxable to Utah.⁷⁵

56. **Income Approach:** Like the Division, APPRAISER 3 used the yield capitalization method in preparing the income approach for the operating properties of PETITIONER as of January 1, 2006.⁷⁶

57. APPRAISER 3 testified that in order to properly determine the normalized NOI to be capitalized in a yield capitalization model, the appraiser must not only review the historical earnings of PETITIONER, but must also consider (1) the impact any recently decided rate cases would have on future NOI, (2) the impact current construction work in progress properties would have on future NOI as they came on-line as operational properties, and (3) company NOI projections.⁷⁷

58. Because three rate decisions became effective during 2005, only a portion of the approved rate increases were recorded in the 2005 historical NOI used by the Division to derive its NOI estimate. APPRAISER 3 determined that if these three rate decisions had been in place for the entire year, the NOI for 2005 would have been increased by approximately \$\$\$\$\$.⁷⁸

59. To derive his estimate of normalized NOI for PETITIONER, APPRAISER 3 (1)

⁷⁵ Exhibit 22.

⁷⁶ Exhibit 22.

⁷⁷ Exhibit 22, p. 31.

⁷⁸ Exhibit 22, pp. 31-32, and Transcript, pp. 386-388.

calculated multiple averages and trends associated with the prior five years' net operating income, (2) accounted for the increases associated with the 2005 rate decisions previously noted above, (3) accounted for the increases that would be expected for the inclusion of CWIP that had come on line prior to the lien date, and (4) considered company projections for future NOI. Based on this analysis APPRAISER 3 estimated a normalized NOI \$\$\$\$.⁷⁹ This estimate was not refuted by any of the witnesses at the hearing.

60. APPRAISER 3 estimated that the total non-cash charges associated with depreciation, amortization and DIT would be approximately \$\$\$\$.⁸⁰

61. Unlike the Division, APPRAISER 3 assumed that the replacement capital expenditures would equally offset all the non-cash charges and thus, he determined that the total net cash flow to capitalize under Rule 62 would be \$\$\$\$.⁸¹ The Division had offset depreciation and amortization but not DIT. APPRAISER 3 testified that it is a generally accepted appraisal practice to assume that DIT, amortization, and depreciation are offset by capital expenditures.⁸²

62. Despite the different factors, APPRAISER 3's net cash flow of \$\$\$\$ was not substantially different from the cash flow capitalized by the Division of \$\$\$\$.

63. APPRAISER 3 calculated an *ex post* CAPM in the same manner as the Division, and also calculated multiple estimates under the DGM model, multiple estimates of *ex post* and *ex ante* calculations under the risk premium model, and an *ex ante* calculation under the CAPM model. APPRAISER 3 placed at least %%% weight on the *ex post* CAPM model and the balance of the

⁷⁹ Exhibit 22. pp. 31-32.

⁸⁰ Exhibit 22, p. 30.

⁸¹ *Id.*

⁸² Transcript, p. 391.

weight on the other indicators, and derived a cost of equity prior to flotation of %%%%.⁸³

64. APPRAISER 3 determined the cost of debt was %%%%. His weighted average cost of capital which included an addition for flotation was determined as follows:⁸⁴

<u>Capital Structure</u>	<u>Rate</u>	<u>Weighted Rate</u>	<u>Flotation Adjustment</u>	<u>Adjusted Rate</u>
Debt	%%%	x %%% = %%%	+ %%% =	%%%
Equity	%%%	x %%% = %%%	+ %%% =	%%%
Totals	%%%			%%%
Rounded				%%%

65. Except for the flotation adjustment, APPRAISER 3’s yield capitalization rate (%%% prior to flotation) is virtually identical to the rate calculated by the Division.

66. Like the Division, APPRAISER 3 assumed a growth rate (“g”) of %%%%.⁸⁵

67. APPRAISER 3’s yield capitalization income approach is summarized as follows⁸⁶:

Normalized NOI	\$\$\$\$
Add: Non-cash charges (depr., amort., DIT exp.)	\$\$\$\$
Less: Capital expenditures & Additions to WC	<\$\$\$\$>
Cash flow to capitalize	\$\$\$\$
Capitalization Rate	%%%
Income Indicator w/ intangibles	\$\$\$\$
Estimated intangibles	<\$\$\$\$>
Income Indicator (Rounded)	\$\$\$\$

68. **Cost Approach:** Like the Division, APPRAISER 3 prepared an HCLD cost approach and it was his conclusion that the system value from this approach was \$\$\$\$\$. APPRAISER 3 gave %%% weight to this approach. APPRAISER 3’s value from this approach was higher than the Division’s system cost value and there were two significant differences.

⁸³ Exhibit 22, p. 45.

⁸⁴ Exhibit 22, p. 33

⁸⁵ Exhibit 22, p. 30.

69. APPRAISER 3 did not add in a value for CIAC, pointing out that these costs were not in the rate base. The Division had included a value for the CIAC in its appraisal.

70. APPRAISER 3, unlike the Division, added an undiscounted amount for all CWIP to his cost approach. He testified that he had been unaware of Utah's procedure to only include discounted expansionary CWIP in the HCLD indicator. APPRAISER 3 indicated that it would not be difficult to make a correction for this item and such a correction would decrease his cost approach.

71. **Market Approach:** APPRAISER 3 agreed with APPRAISER 2 that use of an unadjusted price for the PETITIONER common stock would lead to a very speculative valuation. APPRAISER 3 testified that if he were to use the purchase price as an indicator of value for the tangible personal property, he would have to assume a hypothetical condition that PETITIONER was actually earning its authorized return. Based on the facts that (1) PETITIONER was not earning its authorized return, (2) that PETITIONER had not earned its authorized return for the past decade, (3) that regulators were unlikely to allow significant rate increases, and (4) COMPANY 2 had had a similar desire to increase earnings but had failed, APPRAISER 3 did not believe it would be appropriate for an appraiser to use an unadjusted stock sales price as an indicator of value.⁸⁷

72. APPRAISER 3 did, however, analyze the sales price and attempted to make some necessary adjustments and to then incorporate some of the sales information into a variation of a stock and debt indicator, from which he concluded the taxable system value of PETITIONER was \$\$\$\$\$. APPRAISER 3 placed %%%%% weight on this stock sales comparison indicator.⁸⁸

⁸⁶ Exhibit 22, p. 30.

⁸⁷ Transcript, pp. 1331-1334.

⁸⁸ Transcript, pp. 428-429, and Exhibit 22, p. 66.

73. APPRAISER 3 asserted that in order to properly estimate a value of the tangible, taxable operating property on the lien date by using the transaction price, an appraiser must adjust the transaction price to (1) remove all intangibles, (2) account for the time value of money, (3) account for any property that was added to the system after the lien date, but prior to the closing date, and (4) remove the value associated with non-operating properties.⁸⁹

74. APPRAISER 3 determined the purchase price by adding to the sale price the long-term debt and preferred stock less the residual goodwill of \$\$\$\$ reported by COMPANY 3 in its purchase price allocation.⁹⁰

75. COMPANY 3 assumed current liabilities of PETITIONER with the purchase transaction in the amount of \$\$\$\$\$. APPRAISER 3's operating ratio failed to consider the assumed current liabilities and other deferred liabilities that corresponded to the current regulatory assets.⁹¹

76. APPRAISER 3 reduced the total transaction price by \$\$\$\$ of intangible goodwill and \$\$\$\$ of intangible software.⁹²

77. APPRAISER 3 determined that the time value of money for the 79 days between the lien date and the closing date was approximately \$\$\$\$\$. APPRAISER 3 reduced the total transaction price to account for this time value of money.⁹³ However, he failed to include the earnings that would have accrued to the benefit of COMPANY 3 during that time period.⁹⁴

78. APPRAISER 3 determined that PETITIONER had added approximately \$\$\$\$\$ of property to its system after the January 1, 2006 lien date. He reduced his total transaction price by

⁸⁹ Exhibit 22, pp. 67-69, and Transcript, pp. 418-430.

⁹⁰ Exhibit 22, p.68.

⁹¹ Exhibit 22 and Transcript, pp. 1024-1025.

⁹² Exhibit 22, p. 68, and Transcript, pp. 422-424.

⁹³ Exhibit 22, p. 68, and Transcript, pp. 424-425.

⁹⁴ Transcript, pp. 1023-1024.

this amount to prevent the taxation of assets that did not exist on the subject lien date.⁹⁵

79. APPRAISER 3 determined that %%% of the adjusted transaction price was attributable to operating property and that the remaining %%% was attributable to non-operating property. APPRAISER 3 derived the %%% by averaging an operating property ratio and an income influence ratio.⁹⁶

80. APPRAISER 3's stock sales comparison is summarized as follows⁹⁷:

Sales Price for Common Stock (3/21/06)		\$\$\$\$
Assumed Debt (3/21/06)		\$\$\$\$
Less: Goodwill		<\$\$\$\$>
Time Value of money (79 days @ 8.70%)		<\$\$\$\$>
Property acquired after lien date		<\$\$\$\$>
Net Purchase Price as of lien date		\$\$\$\$
Less Operating Properties:		
Electric Assets	\$\$\$\$	
Total Assets	\$\$\$\$	
Percent	%%%	
Operating NOI	\$\$\$\$	
Total NOI	\$\$\$\$	
Percent	%%%	
Average Operating Asset Percentage		%%%
Estimated Sales Price of Electric Assets		\$\$\$\$
Less software intangibles		<\$\$\$\$>
Estimate S&D Value (Rounded)		\$\$\$\$

C. APPRAISER 4's Appraisal.

81. APPRAISER 4's appraisal had some substantial differences from both the Division and APPRAISER 3's appraisals in all three approaches. It was APPRAISER 4's conclusion that the system value for the property was \$\$\$\$ and the Utah taxable value \$\$. This value was

⁹⁵ Exhibit 22, p. 68, and Transcript, p. 425.

⁹⁶ Exhibit 22, p. 68, and Transcript, pp. 426-427.

derived from a market indicator of \$\$\$\$\$, an income indicator that ranged from \$\$\$\$\$ to \$\$\$\$\$, and a cost indicator of \$\$\$\$\$. APPRAISER 4 placed the most weight on the market indicator and gave little if any weight to his cost indicator.

82. **Income Approach:** Unlike the Division and APPRAISER 3, APPRAISER 4 did not use the yield capitalization model for his income approach. It was APPRAISER 4's opinion that the standard yield capitalization model of $CF/(k-g)$ should not be used in this case because he did not think it would yield a reasonable estimate of value. Instead, APPRAISER 4 prepared a discounted cash flow ("DCF") model and pointed to Utah Admin. Rule R884-24P-62.D.2(a), which states, a party may utilize a DCF model if it can demonstrate that such a method is "necessary to more accurately estimate fair market value."⁹⁸

83. APPRAISER 4 stated that he thought it was inappropriate for the Division and APPRAISER 3 to assume that the company's future depreciation charges and capital expenditures would remain the same and offset each other into perpetuity.⁹⁹ He also stated that he felt that Rule 62's restriction to only deduct capital expenditures intended to replace and maintain the assets in existence was impermissibly restrictive.¹⁰⁰

84. It was APPRAISER 4's opinion that Rule 62's restrictive and limiting assumptions for cash flows and growth would not lead to the fair market value of the property.¹⁰¹ It was his opinion that the assumption there was a relationship between depreciation and capital expenditures, which was constant into perpetuity, would not allow an appraiser to arrive at fair

⁹⁷ Exhibit 22, p. 68.

⁹⁸ Utah Admin. Rule R884-24P-62.D.2(a).

⁹⁹ Exhibit 23, p. 10-30.

¹⁰⁰ Exhibit 23, p. 10-29.

¹⁰¹ Transcript, pp. 698-699.

market value in all situations.¹⁰²

85. To avoid the problems that he perceived with the Rule 62 yield capitalization model, APPRAISER 4's income indicator was based on a DCF analysis. In his appraisal, APPRAISER 4 estimated that the value of PETITIONER's operating system under DCF would range between \$\$\$\$\$ to \$\$\$\$\$.¹⁰³

86. During the discovery phase of this case, WITNESS 3 pointed out a math error in one of the terminal value calculations in APPRAISER 4's DCF spreadsheet. The correction of this math error reduced APPRAISER 4's DCF model by approximately \$\$\$\$\$.¹⁰⁴ APPRAISER 4 submitted a new DCF model at the Formal Hearing that corrected this math error and set the value range between \$\$\$\$\$ to \$\$\$\$\$.¹⁰⁵

87. APPRAISER 4 estimated a cash flow for each of the eight years included in the DCF and applied a discount rate of %%% to those cash flow estimates.¹⁰⁶

88. APPRAISER 4's discount rate was based on both debt and equity components. He calculated a cost of equity using an *ex post* CAPM model, an *ex ante* CAPM model and a three-stage dividend growth model. He placed %%% weight on his *ex post* model and the balance of weight on the other models, to derive an estimate of %%% for the cost of equity. His cost of debt rate was %%%. He weighed the equity component %%% and the debt component %%% which resulted in the weighted average cost of capital of %%%.¹⁰⁷ Like the Division, APPRAISER 4 did not add flotation to his rate.

¹⁰² Transcript, p. 700.

¹⁰³ Exhibit 23, pp. 10-73.

¹⁰⁴ Transcript, p. 714.

¹⁰⁵ Exhibit 40.

¹⁰⁶ Exhibit 23.

¹⁰⁷ Exhibit 23, pp. 10-63.

89. In this matter, APPRAISER 4 used COMPANY 6, COMPANY 7, and COMPANY 8 as guideline companies. Each of these companies had Value Line financial strength ratings that were B or worse.¹⁰⁸

90. In the eighth year of his model, APPRAISER 4 estimated a terminal value by taking what he believed the cash flow would be in 2013 and incorporated that estimate into the standard yield capitalization formula of $CF/k-g$.¹⁰⁹

91. Approximately 90% of APPRAISER 4's valuation estimate is based on his terminal value calculation that in turn is based on what he expects PETITIONER's cash flow will likely be in 2013.¹¹⁰

92. In connection with the COMPANY 3 acquisition of PETITIONER's common stock, COMPANY 3 retained COMPANY 5 to prepare a DCF model that would estimate a range of equity values associated with PETITIONER's common stock.¹¹¹

93. COMPANY 5 based its DCF model on data extracted from internal PETITIONER projections that were prepared in October 2004.¹¹²

94. Rather than derive his own assumptions for EBITDA, income taxes, capital expenditures, change in working capital and growth rates, APPRAISER 4 decided to use the assumptions made by COMPANY 5 for these items. APPRAISER 4, however, decided he would not use the cost of equity and cost of debt rates identified in COMPANY 5's materials, but elected to use his own discount rate.¹¹³ COMPANY 5 had utilized an *ex post* CAPM model and derived a cost of

¹⁰⁸ Transcript, pp. 794-797.

¹⁰⁹ Exhibit 23.

¹¹⁰ Transcript, p. 765.

¹¹¹ *Id.*, and Transcript, p. 705.

¹¹² Transcript, p. 756.

¹¹³ Transcript, p. 750.

equity of %%% and a debt rate of %%%. This would indicate an overall weighted average cost of capital of %%%.¹¹⁴

95. APPRAISER 4 testified that the COMPANY 5 data from which he drew his assumptions in the DCF model was prepared in October 2004. The subject lien date was more than 14 months later. APPRAISER 4 testified that COMPANY 5's discount rate had been "determined in a period prior to the lien date" so he prepared his own calculations to obtain a more "current" rate closer to the subject lien date.¹¹⁵

96. APPRAISER 4 pointed out that the capital expenditures he utilized were about \$\$\$\$ on an annual basis, which were being forecast by PETITIONER, and were used by COMPANY 5 in its analysis. The depreciation charges forecast by PETITIONER to be taken during the same period were roughly \$\$\$\$.¹¹⁶

97. Despite APPRAISER 4's stated intent to use COMPANY 5's capital expenditure estimates, he made a mistake in transferring the data into his model, which caused him to underestimate the capital expenditure amounts and thus overstate his value conclusions.¹¹⁷

98. The COMPANY 5 model deducted all capital expenditures including AFUDC (Allowance for Funds Used During Construction). APPRAISER 4 mistakenly imported the capital expenditure line from one of the COMPANY 5 spreadsheets that did not include AFUDC. This error alone caused APPRAISER 4's DFC model to be overestimated by more than \$\$\$\$.¹¹⁸

99. The proper capital expenditure amount to deduct should have included the

¹¹⁴ Exhibit 39, p. PAC-UT01027, and Transcript, pp. 790-791.

¹¹⁵ Transcript, p. 750.

¹¹⁶ Transcript 707.

¹¹⁷ Exhibit 51, and Transcript, pp. 1250-1264, 768-787.

¹¹⁸ Exhibit 51, p. PAC-UT01690, and Transcript, p. 1262.

AFUDC component.¹¹⁹

100. The hearing testimony also established that APPRAISER 4 previously used the same COMPANY 5 data in preparing a DCF model in a review appraisal of PETITIONER that he presented in the state Of (X)In that review appraisal, APPRAISER 4 correctly imported the capital expenditures that included AFUDC.¹²⁰

101. Although APPRAISER 4 had calculated his own discount rate based on differing circumstances between October 2004 and the lien date, the hearing testimony established that there had been additional intervening events that affected the other assumptions used by COMPANY 5.¹²¹ These events included less favorable rate case decisions than expected, failure of PETITIONER to obtain the expected Power Cost Recovery Mechanisms, changes in gas prices and other factors.¹²² APPRAISER 4 did not make adjustments regarding the other components of his DCF model for any of these other intervening events that occurred from October 2004 through January 2006.¹²³

102. Had APPRAISER 4 utilized the %%% cost of capital rate identified in the COMPANY 5 materials, his DCF numbers would have dropped by an additional \$\$\$\$.¹²⁴

103. When the capital expenditure error is corrected and the COMPANY 5 discount rate is used, the range of values under APPRAISER 4's DCF model would have been from \$\$\$\$ to \$\$\$\$.¹²⁵

¹¹⁹ See Testimony of WITNESS D (Transcript, p. 616), of Mr. Ross (Transcript, pp. 1250-1258) and APPRAISER D (Transcript, pp. 786-787).

¹²⁰ Transcript, pp. 771-780, and Exhibit 42.

¹²¹ Transcript, pp. 757-764.

¹²² *Id.* and Exhibit 39, pp. PAC-UT1042-1043.

¹²³ Transcript, pp. 757-764.

¹²⁴ Exhibit 51, p. PAC-UT01691, and Transcript, pp. 1263-1264.

¹²⁵ Exhibit 51, p. PAC-UT01692, and Transcript, pp. 1250-1264.

104. **Cost:** Like the Division and APPRAISER 3, APPRAISER 4 also prepared an HCLD cost indicator and it was his conclusion that it resulted in a cost approach system value of \$\$\$\$\$, which was higher than both the Division and APPRAISER 3's. However, it was APPRAISER 4's opinion that the "cost approach is not as relevant to investors in vertically integrated electric companies such as PETITIONER," and he gave his HCLD indicator little if any weight.¹²⁶

105. Like the Division, APPRAISER 4 had added into his cost indicator an amount for the CIAC. APPRAISER 3 did not include this in the value.

106. APPRAISER 4 testified that 55% of the states that do unitary appraisal include CIAC in their cost approach.¹²⁷

107. While the Division had included only a discounted value for expansionary CWIP, and APPRAISER 3 an undiscounted amount for all CWIP, APPRAISER 4 added a discounted amount for all CWIP. He indicated that Utah Admin. Rule R884-24P-20 required that the amount be based on the present value of all CWIP, and not limited in the manner indicated in the Division's appraisal.

108. Although he did comply with Rule 62 regarding accumulated deferred income taxes in the cost approach, APPRAISER 4 did not agree with Rule 62 on this point. The rule requires that accumulated deferred taxes be subtracted from the cost approach. It was APPRAISER 4's opinion that if deferred taxes are eliminated from the cost approach a very valuable interest in that property is not being accounted for in the tax base of the taxpayer. APPRAISER 4 believed that Rule 62's methodology does not lead to a reliable cost indicator of value that was consistent with fair

¹²⁶ Exhibit 23, p. 10-47.

market value and asked that the Commission overturn the portion of the rule that required the deduction.¹²⁸ However, for purposes of the appraisal APPRAISER 4 did deduct DIT as had APPRAISER 3 and the Division.¹²⁹

109. **Market Approach:** Like APPRAISER 3, APPRAISER 4 performed a market approach to value in which he considered the sale of PETITIONER to COMPANY 3 at or around the lien date. It was his conclusion that the value from this approach was \$\$\$\$\$, a substantially higher value conclusion than APPRAISER 3's. In determining the total consideration paid for PETITIONER in this transaction, APPRAISER 4 summed the equity and the debts that were assumed. PETITIONER's Form 10-k for the year-ending March 31, 2006, stated its equity value was \$\$\$\$\$. In the case of PETITIONER, COMPANY 3 assumed long-term debt obligations of close to \$\$\$\$\$. COMPANY 3 also assumed \$\$\$\$\$ in current liabilities of PETITIONER with the purchase transaction.¹³⁰

110. APPRAISER 4 did not make an adjustment to his stock and debt indicator for goodwill.¹³¹

111. APPRAISER 4 did not make any adjustment to the transaction price to account for the time value of money. Nor did APPRAISER 4 make an adjustment to the transaction price for property that was acquired after the lien date.¹³²

112. In his STATE 2 report, APPRAISER 4 previously used and recommended the use of the operating property ratio and the income influence ratio to estimate the

¹²⁷ Transcript, pp. 733-735.

¹²⁸ Transcript, pp. 687-689.

¹²⁹ Exhibit 23, Transcript, pp. 693-694.

¹³⁰ Transcript, pp. 724-726.

¹³¹ Exhibit 23, pp. 10-75, and Transcript, pp. 816-817.

¹³² Exhibit 23, pp. 10-75.

portion of a stock and debt associated with operating property.¹³³

113. Had APPRAISER 4 applied the operating property ratio identified in his STATE 2 report to this matter, his operating property ratio would have been approximately XX.XX%.¹³⁴

114. APPRAISER 4, however, did not use the recommended operating property or income influence ratios in this case. Instead, he argued that PETITIONER had a de minimus amount of non-operating property and opted to adjust his estimated sale price by adding current liabilities to the price and subtracting current assets.¹³⁵

115. Some of the current liabilities added by APPRAISER 4 were for such things as accrued employee expenses and tax expenses.¹³⁶ PETITIONER asserted that these types of items are not claims on the tangible assets and should not be included in the stock and debt indicator as tangible property.

COMMISSION'S VALUE CONCLUSIONS

A. Income Approach

116. The Commission believes that a discounted cash flow analysis may be appropriate when there is sufficient information to accurately estimate fair market value.

117. However, if there are errors in the factors relied on in this method, as the Commission concludes there are in APPRAISER 4's appraisal, the resulting value is unreliable. The Commission notes that there were errors with initial terminal value calculation and with the capital expenditure estimates. The Commission is concerned that 90% of APPRAISER 4's DCF value

¹³³ Exhibit 41, p. Appendix 1, and Transcript, pp. 831-833.

¹³⁴ Transcript, pp. 832-833.

¹³⁵ Exhibit 23, pp. 10-75, and Transcript, pp. 824-831.

estimate is based on his terminal value calculation, which is, in turn, based on a projection of PETITIONER's 2013 cash flow.

118. The Commission is also concerned with the manner in which APPRAISER 4 calculated his discount rate. Some of the guideline companies do not seem appropriate for this taxpayer. In addition there appears to be a selective consideration of data from the COMPANY 5 report and intervening time period that would result in a higher value. The Commission notes that APPRAISER 4's conclusion from his discounted cash flow calculations ranged in value spanning more than \$\$\$\$\$, a significant difference considering the total value conclusion. The Commission finds APPRAISER 4's DCF model to be insufficiently reliable to establish an accurate value for this property.

119. There are three material areas of dispute identified in the Division's and APPRAISER 3's yield capitalization models: (1) what is the proper estimate of normalized NOI to be included in cash flow; (2) what is the proper estimate of normalized DIT expense to be included in cash flow; and (3) should a flotation adjustment be made in deriving the yield capitalization rate.

1. Normalized NOI.

120. Pursuant to Rule 62, "Cash flow is to be projected for the year immediately following the lien date, and may be estimated by reviewing historic cash flows, forecasting future cash flows, or a combination of both."¹³⁷

121. We find that APPRAISER 3's estimate of \$\$\$\$\$ of normalized NOI is more appropriate than the Division's estimate of \$\$\$\$\$. The Division's estimate failed to consider several relevant factors. APPRAISER 3, on the other hand examined historic earnings for the past

¹³⁶ Transcript, pp. 824-826.

five years, and also considered (1) the impact recent rate cases would have on future NOI, (2) the impact recent construction work in progress additions would have on future NOI, and (3) Company officials' future income projections. The Commission finds APPRAISER 3's analysis regarding normalized NOI to be more thorough than the Division's and accepts it as a starting point for determining the cash flow.

2. DIT Expense in the Cash Flow Estimate.

122. The Division added an estimate of \$\$\$\$ in DIT Expense to its NOI in its calculation of cash flow or "CF" in the yield capitalization model, and did not offset this amount with capital expenditures. It was undisputed that this treatment was a departure from the Division's assessments for prior years for PETITIONER and other centrally assessed taxpayers. It was also undisputed that for 2006 the Division made this change uniformly with other similar centrally assessed taxpayers. Ultimately the Division and APPRAISER 3's income indicators were more similar than this difference would otherwise indicate, as the Division had started with a lower normalized NOI. The Division had added the \$\$\$\$ to its lower NOI, so that the cash flow capitalization by the Division had been \$\$\$\$\$. APPRAISER 3 had more accurately calculated a higher normalized NOI, and although he had offset all DIT with capital expenditures, the cash flow he capitalized was \$\$\$\$\$.

123. DIT expense is calculated by applying the company's tax rate to the difference between tax depreciation and book depreciation.¹³⁸

124. During the early years of an asset's life accelerated tax depreciation exceeds the book depreciation and thus the company is able to defer taxes associated with the

¹³⁷ Utah Admin. Rule R884-24P-62.E.2.a(1)(c).

increased tax depreciation.¹³⁹

125. During the later years of an asset's life the accelerated tax depreciation is less than the book depreciation and thus the company is then required to pay back the taxes it had previously deferred in the earlier years of the assets' life.¹⁴⁰

126. PETITIONER, like other utilities, may utilize the DIT funds for any normal corporate function. For example, utilities use DIT to diversify into a non-regulated business, move their business operations to another state and for additions to plant to handle growth. The use of DIT by a taxpayer is a choice and is strictly optional. It is a favorable tax treatment utilized by prudent businesspersons and its use is widespread.¹⁴¹ WITNESS 4 testified that deferred taxes are a positive component of a utility and are designed to stimulate investment. The existence of the DIT component provides assurances or improves the likelihood that these cash flows will continue to be available for future investments and enhancements to the property. It is one of the fundamental environmental factors that enhance the asset value of a utility. WITNESS 4 further testified that the time value of money is absolutely crucial in understanding DIT and its positive impact on a firm. The timing benefit encourages investment by a utility.¹⁴²

127. WITNESS 4 and WITNESS 5 both testified that it is appropriate to consider the cash flow effect from DIT expense.¹⁴³

128. WITNESS 4 and WITNESS 5 both pointed out that the purpose of the

¹³⁸ Transcript, p. 167.

¹³⁹ Exhibit 29, p. PAC-UT01497.

¹⁴⁰ *Id.*

¹⁴¹ Transcript, pp. 532-533.

¹⁴² Transcript, pp. 541-544.

¹⁴³ Transcript, pp. 536-552, 559-563, 1007.

yield capitalization method is to reduce assumptions about future cash flows into a single formula.¹⁴⁴

129. WITNESS 4 and WITNESS 5 both agreed that any assumption made in a simplified perpetuity model is difficult to reconcile in an infinity analysis.¹⁴⁵

130. WITNESS 4 and WITNESS 5 both testified that PaciCorp could improve its cash flow by efficiencies and growth. COMPANY 3 shared this same view.¹⁴⁶

131. WITNESS 1 testified that PETITIONER in Utah was presently only earning a return on equity of %%%%.¹⁴⁷

132. WITNESS 4 testified that the exclusion of accumulated deferred income tax from rate base is done to mirror the benefits of deferred income taxes in a competitive market.¹⁴⁸

133. WITNESS 5 explained that historically, regulators recognized accumulated deferred income taxes as zero cost capital and calculated the allowed rate of return by including the zero cost capital in the utility's capital structure.¹⁴⁹

134. WITNESS 5 testified that in order to make it easier to address the differing impacts of accumulated deferred income tax in the various regulatory jurisdictions, most regulators deduct accumulated deferred income tax from rate base instead of considering it as zero cost capital in calculating the allowed rate of return. WITNESS 5 provided an example in which he showed that the result is the same whether the regulator excludes the accumulated deferred income taxes from rate base or includes it as zero cost capital in the weighted average cost of capital for purposes of calculating the allowed return of the regulated company. WITNESS 5 also testified that

¹⁴⁴ Transcript, 1201-1202, 1009-1010.

¹⁴⁵ Transcript, 1202, 1009-1010.

¹⁴⁶ Transcript, pp. 1354-1357, 1013-1014.

¹⁴⁷ Transcript, p. 1221.

¹⁴⁸ Transcript, pp. 532-539.

¹⁴⁹ Transcript, pp. 997-1000.

it is incorrect to state that PETITIONER is not able to earn a return on property acquired with accumulated deferred income tax. PETITIONER does earn a return on all of its net plant, but such return includes the zero cost capital related to DIT.¹⁵⁰

135. PETITIONER argued that the Division's CF/k-g formula implies a declining cash flow in perpetuity because the addition of DIT expense to cash flows causes a decline in rate base.¹⁵¹

136. PETITIONER's witnesses, WITNESS 2, WITNESS 3 and APPRAISER 3, argued that the yield capitalization method, when applied in perpetuity, should be reduced in all cases to a NOI/k formula.¹⁵²

137. WITNESS 2 demonstrated that if you assume a constant level of replacement capital expenditures each year like the Division did, mathematically you will reach a point where the amount of tax deferred will be equally offset by the tax due. Thus, the net DIT expense for that year and thereafter will be \$\$\$\$\$.¹⁵³

138. WITNESS 2 testified that if you had a mature company, the net DIT expense each year would be \$\$\$\$\$ if you were to assume a constant level of capital expenditures each year. On cross-examination WITNESS 5 agreed with this statement but claimed that it was not relevant in the real world because PETITIONER was not making a constant level of capital expenditures each year.¹⁵⁴ WITNESS 2, however, identified that the assumptions in the Division's valuation model assumed a constant level of reinvestment for a mature cost-regulated utility.

¹⁵⁰ Transcript, 997-1000.

¹⁵¹ Transcript, p. 225.

¹⁵² Transcript pp. 300,354, 355 and 465.

¹⁵³ Exhibit 29, p. PAC-UT01498 – 01500, and Transcript, pp. 239-242.

¹⁵⁴ Transcript, pp. 1048-1050.

139. The testimony of WITNESS 3 confirmed the conclusions made by WITNESS 2. WITNESS 3 testified that when an appraiser uses the yield capitalization model, basic mathematics and finance principles require that the appraiser match his growth assumption with his cash flow assumption.¹⁵⁵

140. WITNESS 3 testified that the Division's income model for PETITIONER in 2006 implicitly assumes that (1) future rate base and cash flow are declining, and (2) the growth factor is %%%%.¹⁵⁶

141. WITNESS 3 concluded that the Division's assumption of a declining cash flow in the numerator of the yield capitalization formula with a level growth assumption in the denominator creates a mismatch in the formula and violates basic principles of mathematics and finance, as well as Rule 62.¹⁵⁷

142. WITNESS 3 testified that the Division's violation of these basic mathematics and finance principles caused the Division's yield capitalization indicator to be overstated. Both WITNESS 3 and WITNESS 2 testified that the Division could correct its yield capitalization calculation in one of three ways: (1) do not add DIT expense into its cash flow (i.e., assume that all non-cash charges are offset by replacement capital expenditures), (2) make an offsetting adjustment by increasing the replacement capital expenditures by \$\$\$\$\$, or (3) adjust the growth rate to be negative (approximately %%%%).¹⁵⁸

143. WITNESS 1 and APPRAISER 2's testimony confirmed WITNESS 3's conclusion that the Division's cash flow assumptions would yield a declining rate base and cash

¹⁵⁵ Transcript, pp. 344-349.

¹⁵⁶ Transcript, p. 348.

¹⁵⁷ *Id.*

flow.¹⁵⁹ WITNESS 1 testified that the Division's cash flow assumptions would cause PETITIONER's rate base to decrease by \$\$\$\$ a year.¹⁶⁰ WITNESS 1 also testified that the \$\$\$\$ decrease in rate base would decrease PETITIONER's revenues and cash flow.¹⁶¹

144. Witnesses for COUNTIES and the Division argued that a reduction in revenues might not necessarily reduce PETITIONER's cash flows because PETITIONER might be able to offset the reduction in revenues by increased savings in its operating expenses or by adding new customers.¹⁶²

145. WITNESS 1 disagreed with both of these arguments. He testified that PETITIONER would not be able to save enough in operating expenses to offset the reduction in revenues. WITNESS 1 testified that it would be extremely unlikely that PETITIONER could reduce expenses by \$\$\$\$ in a single year and that it would be impossible for PETITIONER to generate annual savings of \$\$\$\$ over a prolonged period.¹⁶³ WITNESS 1 also testified that the addition of new customers would not offset the reduction in revenues.¹⁶⁴

146. WITNESS 4 and WITNESS 5 testified that they believed there was a net present value benefit to PETITIONER because it was able to defer the taxes in the earlier years.¹⁶⁵ WITNESS 4 and WITNESS 5 agreed that in a non-regulatory context, any net present value benefit associated with DIT would be passed through to the customers.¹⁶⁶

147. WITNESS 2 and WITNESS 1 testified that in a regulated context, the

¹⁵⁸ Transcript, pp. 366, 226-229, and Exhibit 28, p. PAC-UT01673

¹⁵⁹ See testimony of WITNESS A (Transcript, p. 173), and APPRAISER B (Transcript, pp. 924-925).

¹⁶⁰ Transcript, p. 173.

¹⁶¹ *Id.*

¹⁶² Transcript, pp. 1010 and 619-620.

¹⁶³ Transcript, p. 175

¹⁶⁴ Transcript, pp. 1216-1217.

¹⁶⁵ Transcript, pp. 543-544 and 1010.

present value benefit associated with DIT is passed through to the ratepayers.¹⁶⁷

148. PETITIONER's witnesses testified that in applying the yield capitalization model, the important factor to remember is that the cash flow in the numerator is to be the cash flow that accrues to the benefit of the would-be buyer. Inasmuch as any net present value benefits associated with DIT would be passed through to the rate payers, they are not benefits that should be included in the cash flow to be capitalized under the yield capitalization approach.¹⁶⁸

149. The Commission finds that the Division was incorrect when it added DIT to its cash flow calculation without making an offsetting adjustment for replacement capital expenditures. The Division's model assumes that PETITIONER will continue to make relatively constant replacement capital expenditures of \$\$\$\$ each year into the future. The evidence at the hearing established that when a mature cost regulated utility is expected to make such constant replacement capital expenditures into the future, the resulting DIT expense will be offset by the payment of taxes previously deferred and the net cash flow to PETITIONER of DIT will be \$\$\$\$.¹⁶⁹

150. The Commission also finds Rule 62 requires that the assumptions in the numerator and the denominator of the CF/k-g formula match. By inserting the \$\$\$\$ DIT expense, it appears the Division has assumed a declining rate base in its appraisal. The facts presented in this case demonstrate that such an assumption for PETITIONER would lead to a decreasing cash flow. Because the Division assumed a zero growth rate, its assumptions in the numerator and denominator of the cash flow formula do not match. To reconcile this mismatch, the Division should have either made an offsetting adjustment in capital expenditures, or used a negative growth rate as contemplated

¹⁶⁶ Transcript, pp. 595-596 and 1046.

¹⁶⁷ Transcript, pp. 1237-1240 and 1217-1218, and Exhibit 49.

¹⁶⁸ Transcript, pp. 1217-1218, 1237-1239.

in section E.2(a)(i) of Rule 62.¹⁷⁰

3. Cost of Capital & Flotation Costs

151. The cost of capital estimates derived by the Division of %%% and APPRAISER 3 of %%% (%%% without flotation) are very similar except for the inclusion of a flotation adjustment. APPRAISER 4's rate of %%% was lower.¹⁷¹

152. Based on the evidence presented, the Commission is not convinced APPRAISER 4's rate was better than the Division or APPRAISER 3's due to the issues stated above. The Division and APPRAISER 3's cost of capital rates (absent flotation) are supportive of each other. The Commission concludes that as it is in agreement with APPRAISER 3's NOI and treatment of DIT, it would be appropriate to apply his rate prior to the addition for flotation. Thus the Commission finds that the weighted average cost of capital is %%%.

153. Considering whether or not to add flotation costs to the rate, the parties have noted that in several prior decisions, including the Commission's 1999 Decision regarding PETITIONER, the Commission has disallowed flotation cost adjustments to the weighted average cost of capital. The Commission has previously found that flotation costs are related "to transaction costs as opposed to costs of capital," and that to make a "small adjustment [for flotation costs] assumes a greater degree of accuracy in the cost of capital than is warranted."¹⁷²

154. The Division did not add flotation costs to its cost of capital for PETITIONER or for any other similar taxpayer for the subject year or prior years.

¹⁶⁹ Exhibit 29.

¹⁷⁰ Exhibit 28.

¹⁷¹ Exhibit 23, p. 10-63.

¹⁷² Commission Decision in *PETITIONER v. Property Tax Division et al.*, Appeal No. 99-0568, p. 15 (Utah State Tax Commission 2001).

155. Flotation costs are the costs associated with issuing debt and equity that would be incurred by a typical buyer to raise the cash needed to purchase the subject property. Examples of flotation costs would include security registration fees, printing and distribution costs, prospectus fees, accounting and legal fees, underwriting fees, title and mortgage insurance, origination fees, and etc.¹⁷³

156. It was generally agreed by the witnesses that the issuance costs for debt and equity would be amortized on the books of the company, and as a result, the cost of capital for the purchaser would be higher than the stated bond or equity rate identified in the secondary market.¹⁷⁴

157. APPRAISER 3 testified that if flotation costs are not included in the cost of capital calculation, only “a partial cost of capital” is determined because the costs of financing are not being fully recovered.¹⁷⁵

158. He also testified that when we are looking at an assumed purchase transaction, we are not looking for the rate in the secondary market, but rather in the primary market.¹⁷⁶

159. Initially, APPRAISER 3 testified that the application of flotation costs in deriving the weighted average cost of capital is a generally accepted appraisal and financial practice.¹⁷⁷

160. APPRAISER 3 testified that when an appraiser prepares a property tax

¹⁷³ Exhibit 22, p. 61, and Exhibit 35, p. 3.

¹⁷⁴ Transcript, pp. 954-957.

¹⁷⁵ Transcript, p. 396, and Exhibit 35, p. 6.

¹⁷⁶ Transcript, p. 1326.

¹⁷⁷ Transcript, pp. 396-397.

valuation he is required to assume that there is a sale of the subject property between a knowledgeable, willing buyer and a knowledgeable, willing seller.¹⁷⁸ He further testified that the typical, knowledgeable buyer would be required to issue debt and equity securities in order to raise sufficient cash to acquire an entity like PETITIONER, and thus the appraiser must consider and account for the costs the buyer would incur to raise debt and equity capital to finance the purchase.¹⁷⁹

161. It was WITNESS 5's opinion that it was unnecessary to make a flotation adjustment because the typical buyer of a large electric utility like PETITIONER would typically finance the acquisition price through retained earnings and would not issue debt or equities to finance the purchase price.¹⁸⁰

162. APPRAISER 2 testified that flotation costs are transaction costs, or buyer specific costs, and have nothing to do with what is ultimately received by the seller in a market transaction. APPRAISER 4 agreed.¹⁸¹

163. APPRAISER 4 pointed out that the investor's rate of return, not the company's is what is important for valuation purposes.¹⁸²

164. APPRAISER 3 discussed some treatises related to flotation costs. However, most of these papers address flotation costs in the context of determining a cost of capital for an allowed rate of return in a regulatory context.¹⁸³

165. APPRAISER 4 pointed out that the determination of a cost of capital for a rate case is significantly different than the market rate. In regulation, the cost of capital is company

¹⁷⁸ Transcript, p. 403.

¹⁷⁹ *Id.*

¹⁸⁰ Transcript, p. 987.

¹⁸¹ Transcript, pp. 865, 897, 898.

¹⁸² Transcript, p. 865.

¹⁸³ Transcript, p. 731-732.

specific and is focused on what the company is going to receive, not the investor.¹⁸⁴

166. WITNESS 5 testified the cost of capital on the allowed rate of return for PETITIONER has no significant flotation costs. PETITIONER has no publicly issued common stock and COMPANY 3 did not publicly issue stock to acquire PETITIONER, nor did its parent COMPANY 4.¹⁸⁵

167. WITNESS 3 acknowledged that he does not make an adjustment for flotation costs. He further testified that it is not required and that many experts do not make the adjustment since it is usually relatively small.¹⁸⁶

168. The Commission concludes from the testimony of the witness in this matter that while there is an argument for adding flotation costs, there is considerably more support for the Division's position. Considering the evidence, equity with other similar taxpayers and that the burden of proof is on PETITIONER, the Commission concludes that the Division's method of determining the cost of capital absent flotation is appropriate in this matter.

4. Commission's Findings Concerning the Yield Capitalization Indicator.

169. Based on the foregoing, the Commission finds the yield capitalization value should be derived from APPRAISER 3's NOI and his cost of capital absent the flotation adjustment. Using his normalized NOI of \$\$\$\$ and applying his discount rate of %%%%, with zero growth, results in a value of \$\$\$\$\$. From this a value for intangibles of \$\$\$\$\$¹⁸⁷ is subtracted to result in a value from the income indicator for the system wide taxable assets of \$\$\$\$\$.

¹⁸⁴ Transcript, p. 732.

¹⁸⁵ Transcript, pp. 987-988.

¹⁸⁶ Transcript, pp. 876-877.

¹⁸⁷ Value for Intangibles is determined using APPRAISER C's appraisal ratio with the corrected cost and income values.

B. Historic Cost Less Depreciation

170. “HCLD is the preferred cost indicator of value for cost regulated utilities because it represents an approximation of the basis upon which the investor can earn a return.”¹⁸⁸

171. All three appraisers prepared an HCLD cost indicator of value.¹⁸⁹

172. The Division placed approximately XX% weight on its HCLD cost indicator.¹⁹⁰ APPRAISER 3 gave his HCLD indicator XX% weight,¹⁹¹ and APPRAISER 4 gave his HCLD indicator little if any weight indicating disagreement with Rule 62’s limitations on this approach.¹⁹²

173. The difference in value between the parties HCLD indicators was due to the various treatment of CIAC and CWIP in the appraisals.

1. Evidence Relating to Contributions in Aid of Construction (“CIAC”).

174. Both the Division and APPRAISER 4 included \$\$\$\$ of CIAC in their respective HCLD estimates.¹⁹³ While PETITIONER argued that it should not be included.

175. Property acquired through the use of CIAC becomes titled in the name of PETITIONER. However, regulators do not allow CIAC to be included in rate base and PETITIONER is not allowed to recover the cost (return of) or earn a profit (return on) on any property acquired with CIAC funds.¹⁹⁴ The CIAC property consists of transmission lines, connection facilities, transformers and switches acquired by PETITIONER with funds contributed by the end user of the electric power. The CIAC property represents tangible items of property. As these items

¹⁸⁸ Utah Admin. Rule R884-24P-62.F.1.a.

¹⁸⁹ Exhibit 21, p. 4, Exhibit 22, p. 23, and Exhibit 23, pp. 10-61.

¹⁹⁰ Exhibit 21, p. 1.

¹⁹¹ Exhibit 22, p. 70.

¹⁹² Exhibit 23, p. 10-47.

¹⁹³ Exhibit 21, pp. 2, 4; Exhibit 23; and Transcript, pp. 102-104, 733.

are titled in PETITIONER's name, they are not assessed for property tax purposes to the end user.

176. The manner in which the HCLD is to be calculated is set out by rule. Utah Admin. Rule R884-24P-66(F) provides that for cost regulated utilities, such as PETITIONER, the HCLD method is preferred because it represents an approximation of the basis upon which the investor can earn a return. The CIAC is not in rate base and would represent amounts upon which the investor could not earn a return. Therefore, the Commission finds that CIAC should not be included in an HCLD approach for cost regulated utilities like PETITIONER.

2. Evidence Relating to Construction Work in Progress.

177. The Division included only the present value of expansionary CWIP in its cost indicator. COUNTIES maintained this was in violation of Utah Admin. Rule R884-24P-20¹⁹⁵(Rule 20), that the Division should have included the present value of all CWIP, which is how APPRAISER 4 prepared his appraisal. APPRAISER 3 had included an undiscounted value for all CWIP.

178. For many years the Division has only included the present value of expansionary CWIP in its cost indicators for centrally assessed taxpayers.¹⁹⁶ For tax year 2006, the Division uniformly limited CWIP in this manner.

179. Rule 20 provides general valuation guidelines regarding CWIP for both unitary and non-unitary property. However, the Commission concludes that the general approach suggested in the rule does not reflect market value when performing an HCLD approach for cost regulated utilities. Specific instructions for the HCLD method of valuing cost regulated utilities are

¹⁹⁴ Transcript, pp. 106, 157-158.

¹⁹⁵ Transcript, p. 685.

¹⁹⁶ Transcript, pp. 934 – 935.

specified at Rule 62.

180. Because only limited evidence was presented in this hearing relating to the CWIP issue and because the Division has already limited its assessments for other rate-base regulated utilities for the 2006 year to expansionary CWIP, and has done so for preceding years as well, there is no reason to vary from the past rulings of the Commission on this issue and the Division's past practice. To include the value of both CWIP and the assets being replaced by CWIP would overvalue the property. The Commission finds that only discounted expansionary CWIP should be included in the HCLD indicator for a rate base regulated utility like PETITIONER.

3. **Evidence Relating to the Deduction of DIT from the HCLD Indicator.**

181. At the hearing, COUNTIES argued that the Commission should repeal the provisions of Rule 62 that require that "items not included in the utility's rate base (e.g., deferred income taxes and, if appropriate, acquisition adjustments)" be deducted from the HCLD indicator.¹⁹⁷ In his appraisal APPRAISER 4 did comply with the rule by deducting the accumulated deferred income tax from his HCLD indicator, however, he gave the indicator little if any weight.

182. The evidence at the formal hearing established that accumulated deferred income tax is not included in rate base and that a prospective purchaser of PETITIONER would not be allowed to earn a return on accumulated DIT.¹⁹⁸

183. All three appraisals complied with the rule and deducted accumulated deferred income tax in the HCLD indicator. Furthermore, the Division has consistently followed the rule in this regard with all other centrally assessed taxpayers. The Commission concludes that if it did, at some point, find APPRAISER 4 was correct in the position that including accumulated

¹⁹⁷ Utah Admin. Rule R884-24P-62.F.1(a)(2), and Transcript, p. 695.

deferred income tax in the cost approach resulted in a better appraisal value, the appropriate action would be to repeal the applicable sections of Rule 62. This would result in uniform and prospective application. The Commission declines to repeal the rule in this proceeding.

4. Commission's Findings Concerning the Cost Indicator.

184. Based on the conclusions indicated above the Commission finds that the evidence supports the HCLD indicator of \$\$\$\$\$. This is primarily the Division's cost indicator with a deduction of \$\$\$\$\$ for the CIAC, which the Commission finds should not have been added into the indicator.

C. Market Indicator

185. "[T]he stock and debt method typically capture[s] the value of intangible property at higher levels than other methods. To the extent intangible property cannot be identified and removed, relatively less weight shall be given to such methods in the reconciliation process."¹⁹⁹

186. Both APPRAISER 4 and APPRAISER 3 determined a market indicator in their respective appraisals based on COMPANY 3's purchase of PETITIONER. Because PETITIONER did not have publicly traded stock, both APPRAISER 3 and APPRAISER 4 used the announced purchase price of the common shares as a starting point from which to estimate the value of PETITIONER's equity in their respective stock and debt models.²⁰⁰

187. APPRAISER 4 had concluded from his approach that the system value for PETITIONER was \$\$\$\$\$ and had placed the majority of his correlation weight on this indicator. APPRAISER 3 had concluded that the value from this approach was \$\$\$\$\$ and had given this

¹⁹⁸ Transcript, pp. 157.

¹⁹⁹ Utah Admin. Rule R884-24P-62.D.2.b.

²⁰⁰ Exhibit 22, p. 68, and Exhibit 23, pp. 10-75.

indicator % % % % weight.

188. APPRAISER 3 testified that he believed the subject sale of common stock was largely based on investment value considerations and thus made consideration of the unadjusted price suspect.²⁰¹ APPRAISER 3 made adjustments to the sales price in his market indicator.

189. APPRAISER 4 used the sale price to prepare his stock and debt indicator, making few, if any adjustments to the sales price.

190. APPRAISER 4 did not make an adjustment for goodwill, the time value of money, or for property acquired after the lien date.

191. APPRAISER 3 had reduced the total transaction price by \$\$\$\$ for intangible goodwill and \$\$\$\$ for intangible software. He determined that PETITIONER had added approximately \$\$\$\$ in property to its system after the lien date, which he deducted. He also deducted the time value of money for the 79 days between the lien date and the closing date, which he determined to be approximately \$\$\$\$\$. APPRAISER 3 did not take into account the current liabilities and assets that COMPANY 3 assumed when it purchased PETITIONER. APPRAISER 3's largest adjustment was for non-operating properties of approximately \$\$\$\$\$.

192. APPRAISER 4 assumed that the regulatory assets would be offset by the regulatory liabilities and thus did not make any adjustments to his stock and debt indicator to account for these items.²⁰²

193. It is the Commission's conclusion that APPRAISER 4's market approach overstates the taxable value of PETITIONER and because he gave the most weight to this

²⁰¹ Transcript, pp. 418-420, 1329-1334.

indicator, which was his highest indicator, his appraisal conclusion is overstated. The hearing evidence established that a premium had been paid for goodwill in the transaction and as of the subject lien date, goodwill was statutorily recognized as intangible property that is exempt from property tax.²⁰³

194. The Commission finds that the goodwill of \$\$\$\$ should be deducted in the stock sales comparison and market models in this case. The amount of the goodwill was clearly identifiable.

195. The Commission has some concern over whether APPRAISER 4 should have made an adjustment for the time value of money between the lien date and the transaction date, and for property acquired after the lien date. Further, the Commission has concerns that APPRAISER 4's assumption that current and regulatory assets and derivative contract assets are offset by regulatory liabilities and derivative contract liabilities was not supported by the facts.

196. The Commission also has concerns that APPRAISER 3's stock sales comparison approach is understated as he did not take into account the assumption of the net current liabilities in deriving his the purchase price as of the lien date. The Commission is also concerned about the adjustment for non-operating property.

197. Based on the evidence the Commission does not find either party's market indicator to be reliable and concludes that no weight should be placed on these approaches as prepared by APPRAISER 3 and APPRAISER 4.

D. Summary of Valuation Findings.

198. Upon consideration of all the evidence submitted in this matter, the

²⁰² Exhibit 23, pp. 10-75, and Transcript, pp. 827-829.

Commission finds that the taxable system value for the property as of the lien date at issue is \$\$\$\$\$. This is derived from an income indicator applying APPRAISER 3's NOI and cost of capital, absent flotation, which, after deduction for intangibles, results in a system value of \$\$\$\$\$. The income indicator is given equal weight with the cost indicator of value of \$\$\$\$\$, which is the Division's indicator minus CIAC.

199. There was no dispute from the parties that the Utah allocation factor was XX.XX%. Applying this factor to the system value of \$\$\$\$\$ results in a value allocated to Utah of \$\$\$\$\$. From this \$\$\$\$\$²⁰⁴ is subtracted for exempt property including the locally assessed vehicles. This results in a Utah taxable value of \$\$\$\$\$.

APPLICABLE LAW

1. The Utah Constitution mandates that all tangible property in the state shall be taxed at a uniform and equal rate. Utah Const. Article XIII, Section 2(1) provides as follows:

So that each person and corporation pays a tax in proportion to the fair market value of his, her, or its tangible property, all tangible property in the state that is not exempt under the laws of the United States or under this Constitution shall be:

- (a) assessed at a uniform and equal rate in proportion to its fair market value, to be ascertained as provided by law; and
- (b) taxed at a uniform and equal rate.

2. Consistent with the Constitutional provisions to tax all property at its fair market value, the Legislature enacted Utah Code Ann. § 59-2-103 (2005), which provides as follows:

- (1) All tangible property shall be assessed and taxed at a uniform and equal rate on the basis of its fair market value, as valued on January 1, unless otherwise provided by law.

²⁰³ Utah Code Ann. § 59-2-102(16).

²⁰⁴ Based on corrected market value/book ratio.

3. Utah Code Ann. § 59-2-201 (2005) describes which classes of property must be centrally assessed. The relevant parts of section 59-2-201 provide:

(1) By May 1 of each year the following property . . . shall be assessed by the Commission at 100% of fair market value, as valued on January 1, in accordance with this chapter: (a) . . . all property which operates as a unit across county lines, if the values must be apportioned among more than one county or state; (b) all property of public utilities;

4. Utah Code Ann. § 59-2-102(12) (2005) defines “fair market value” in relevant part, as follows:

(9) “Fair market value” means the amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. . . .

5. The Utah Constitution also provides that if intangible property is taxed as property it may not be subject to income tax. Utah Const. Art. XIII, § 2(5) (2005) provides, in relevant part, as follows:

(5) The Legislature may by statute determine the manner and extent of taxing or exempting intangible property, except that a property tax on intangible property may not exceed .005 of its fair market value. If any intangible property is taxed under the property tax, the income from that property may not also be taxed.

6. The Legislature has also created by statute an exemption for intangible property. Utah Code Ann. § 59-2-1101 (3)(g) provides as follows:

(3) The following property is exempt from taxation . . . (g) intangible property.

7. In Utah Code Ann. § 59-2-102(19), the Legislature has defined intangible property as follows:

“Intangible property” means:

- (a) property that is capable of private ownership separate from tangible property, including:
 - (i) monies;
 - (ii) credits;
 - (iii) bonds;

- (iv) stocks;
 - (v) representative property;
 - (vi) franchises;
 - (vii) licenses;
 - (viii) trade names;
 - (ix) copyrights; and
 - (x) patents. . . .
- (c) goodwill.

8. The Commission has adopted Rule 62 for the valuation of state assessed properties.

The relevant portions of that Utah Admin. Rule R884-24P-62 are:

D. General Valuation Principles. Unitary properties shall be assessed at fair market value based on generally accepted appraisal theory as provided under this rule.

* * *

2. The preferred methods to determine fair market value are the cost approach and a yield capitalization income indicator as set forth in E.

a) Other generally accepted appraisal methods may also be used when it can be demonstrated that such methods are necessary to more accurately estimate fair market value.

b) Direct capitalization and the stock and debt method typically capture the value of intangible property at higher levels than other methods. To the extent intangible property cannot be identified and removed, relatively less weight shall be give to such methods in the reconciliation process, as set forth in E.4.

E. Appraisal Methodologies.

* * *

2. Income Capitalization Approach. Under the principle of anticipation, benefits from income in the future may be capitalized into an estimate of present value.

a) Yield Capitalization. The yield capitalization formula is $CF/(k-g)$, where "CF" is a single year's normalized cash flow, "k" is the nominal, risk adjusted discount or yield rate, and "g" is the expected growth rate of the cash flow.

(1) Cash flow is restricted to the operating property in existence on the lien date, together with any replacements intended to maintain, but not expand or modify, existing capacity or function. Cash flow is calculated as net operating income (NOI) plus non-cash charges (e.g., depreciation and deferred income taxes), less capital expenditures and additions to working capital necessary to achieve the expected growth "g". Information necessary for the Division to calculate the cash flow shall be summarized and submitted to the Division by March 1 on a form provided by the Division.

* * *

(b) Capital expenditures should include only those necessary to replace or maintain existing plant and should not include any expenditure intended primarily for expansion or productivity and capacity enhancements.

* * *

(3) The growth rate “g” is the expected future growth of the cash flow attributable to assets in place on the lien date, and any future replacement assets.

* * *

F. Property Specific Considerations. Because of unique characteristics of properties and industries, modifications or alternatives to the general value indicators may be required for specific industries.

1. Cost Regulated Utilities.

a) HCLD is the preferred cost indicator of value for cost regulated utilities because it represents an approximation of the basis upon which the investor can earn a return. HCLD is calculate by taking the historic cost less depreciation as reflected in the utility’s net plant accounts, and then: (1) subtracting intangible property; (2) subtracting any items not included in the utility’s rate base (e.g. deferred income taxes and, if appropriate, acquisition adjustments); and (3)adding any taxable items not included in the utility’s net plant account or rate base.

b) Deferred Income Taxes, also referred to as DIT, is an accounting entry that reflects the difference between the use of accelerated depreciation for income tax purposes and the use of straight-line depreciation for financial statements. For traditional rate base regulated companies, regulators generally exclude deferred income taxes from rate base, recognizing it as ratepayer contributed capital. Where rate base is reduced by deferred income taxes for rate base regulated companies, they shall be removed from HCLD.

c) Items excluded from rate base under F.1.a)(2) or b) should not be subtracted from HCLD to the extent it can be shown that regulators would likely permit the rate base of a potential purchaser to include a premium over existing rate base.

9. The Commission adopted Utah Admin. Rule R884-24P-20 regarding the treatment of construction work in progress, or CWIP, for both unitary and non-unitary valuations. The rule provides in pertinent part:

B. All construction work in progress shall be valued at “full cash value” as described in this rule.

* * *

F. Appraisal of Properties Valued Under the Unit Method of Appraisal.

* * *

2. The full cash value of a project under construction as of January 1 of the tax year, shall be determined by adjusting the cost and income approaches as follows:

(3) The adjusted cost value for each of the future years prior to the functional completion shall be discounted to reflect the present value of the project under construction. The discount rate shall be determined under C.

(4) The discounted adjusted cost value shall then be added to the values determined under the income approach and cost approach.

CONCLUSIONS OF LAW

1. When a taxpayer protests its property tax assessment, the Division “must present available evidence supporting the original valuation” and “once that is done the taxpayer . . . must meet its twofold burden of demonstrating “substantial error or impropriety in the [original] assessment;” and providing “a sound evidentiary basis upon which the Commission could adopt a lower valuation.” Utah Railway Co. v. Utah State Tax Comm’n, 2000 UT 49 ¶ 10, 5 P.3d 652, 655, 656, quoting, Utah Power & Light Co. v. Tax Comm’n, 590 P.2d 332 (Utah 1979). As a general rule, the “original valuation is entitled to a ‘presumption of correctness.’” *Id.* at ¶ 9. “This presumption does not arise, however, unless and until available evidence supporting the original property valuation is submitted to the Commission.” *Id.* In the present matter the original assessment was made part of the record and the Division has submitted an appraisal in support of the original assessment. The Division’s assessment is entitled to the presumption of correctness. For either PETITIONER or COUNTIES to prevail they must establish error in the original assessment and a sound evidentiary basis to lower or raise the value.

2. The HCLD is the preferred cost indicator for value for cost regulated utilities such as PETITIONER. Utah Admin. Rule R884-24P-62.F. The appraisals submitted by all three parties had prepared an HCLD indicator, but differed on the treatment CIAC and CWIP. These issues present both questions of law and fact to the Commission.

3. It was the Division’s position that CIAC should be included in the HCLD

indicator because subsection (3) of Utah Admin. Rule R884-24P-62.F.1(a) states that an appraiser should add “any taxable items not included in the utility’s net plant account or rate base.” The Commission disagrees with the Division on its interpretation of the rule. As PETITIONER noted, the stated purpose of the HCLD approach under Utah Admin. Rule R884-24P-62.F.1(a) is to determine the “basis upon which the investor can earn a return.” Based on this it would be inconsistent to add CIAC in the HCLD indicator when a would-be investor would not be allowed to earn a return on CIAC. PETITIONER pointed to subsection 2 of Utah Admin. Rule R884-24P-62.F.1(a) as support for its position. That section requires the subtraction of “any items not included in the utility’s rate base.” The evidence at the hearing established that properties funded by CIAC are taxable items of tangible property that are owned by PETITIONER but are not included in the rate base. The Commission finds for the HCLD indicator Utah Admin. Rule 884-24P-62.F.1 requires that CIAC be deducted from the cost value.

4. It had been the Division’s position, apparently for several years, that it should include only the present value of expansionary CWIP in the cost approach. The Division had consistently been treating centrally assessed taxpayers in this manner and attributed the policy to the Commission’s decision in the 1999 PUBLIC UTILITY case. COUNTIES point to Utah Admin. Rule R884-24P-20 for the position that the present value of all CWIP should have been added in the cost approach, not just the expansionary CWIP. The Commission notes that Rule 20 provides general guidelines in valuing unitary and non-unitary properties. The Commission finds that it is Rule 62 that is specific in regards to the HCLD cost indicator for cost regulated utilities such as PETITIONER. The Commission notes that adding a discounted value for all CWIP would overvalue the assets, as it would capture the value of both the CWIP and the assets being replaced by the CWIP. Based on prior guidance from the Commission the Division has consistently included only the present value of expansionary

CWIP. The Commission does not find reason to vary from its past rulings and Division practice.

5. Utah Admin. Rule R884-24P-62.D.2 provides that the yield capitalization income indicator is the preferred income approach to be used when valuing a cost regulated utility such as PETITIONER. Both the Division and PETITIONER's appraisers utilized a yield capitalization income indicator. The rule also provides that other generally accepted appraisal methods may be used when it can be demonstrated that such methods are necessary to more accurately estimate fair market value. COUNTIES utilized the discounted cash flow income indicator. However, COUNTIES' conclusion from this indicator was a range that varied by more than \$\$\$\$\$, and there were numerous concerns that have been noted with how the value was determined.

6. Although there were some factual differences between the Division and PETITIONER in the income indicator, there were also questions of both fact and law regarding flotation and DIT. PETITIONER argued that flotation should be added to its cost of capital, while the Division argued against adding flotation. Expert opinion in this matter was both for and against the addition of flotation. PETITIONER did not convince the Commission that the Division's consistent treatment, which was uniform for other centrally assessed taxpayers was erroneous.

7. The Division made a departure from its practice in prior years regarding the treatment of DIT in the yield capitalization method. In prior years the Division had added DIT in the cash flow, but then had equally offset DIT as capital expenditure. The Division made a determination, which it uniformly applied for the 2006 year to other similar properties, that the DIT amount should no longer be offset. After listening to the expert witnesses' testimony in this matter, the Commission concludes that this results in a mismatch of assumptions in the numerator and denominator of the yield capitalization formula and for a mature utility like PETITIONER the DIT expense created will be equally

offset by the payment of taxes previously deferred.

8. COUNTIES argued during the course of the hearing that the Commission should repeal the sections of Rule 62 that require accumulated deferred income taxes to be subtracted from the HCLD indicator. If the Commission were to consider this request it would be more appropriate to do so through its rule making procedures, which are open to public comment. For PETITIONER's assessed value in this matter the Commission has deducted the deferred income taxes in its HCLD indicator, as is required by the rule.

9. As noted in the rule, the stock and debt method typically captures the value of intangible property at higher levels than other methods. The rule further states that to the extent intangible property cannot be identified and removed, relatively less weight shall be given to such methods in the reconciliation process. See Utah Admin. Rule R884-24P-62. Utah Code Ann. § 59-2-102 makes it clear that goodwill is an intangible. In this matter the amount of goodwill was clearly identifiable. It was, therefore, appropriate to subtract goodwill from the market indicators submitted in this matter.

FINAL DECISION

Based on the foregoing, the Commission finds that for the lien date January 1, 2006 the Utah taxable value of the subject property is \$\$\$\$\$. It is so ordered.

DATED this ____ day of _____, 2008.

Jane Phan
Administrative Law Judge

BY ORDER OF THE COMMISSION:

DATED this ____ day of _____, 2008.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Excused

D'Arcy Dixon Pignanelli
Commissioner

CONCURRENCE

I agree with the ultimate findings and decision in this order. However, my agreement is premised on compliance with Rule 62, rather than on market-based valuation principles. While I have had some past reservations on certain issues, particularly the adjustment for DIT is the cost approach, it is not until now that we have been able to see the marketplace at work with a true accounting for intangibles. That is through the actual sale of PETITIONER to COMPANY 3. I also note that in this proceeding we had the benefit of two expert witnesses in the field of public utility regulation, whose testimony effectively corroborated my perception of the marketplace as manifested in the transaction.

Before beginning my analysis, I observe that heretofore the Commission's valuations for the income approach and the standards promulgated in Rule 62 were essentially basic mathematical models. While models are appropriate in many circumstances, including valuations, they are inadequate for complex analyses. "If a theory is very simple, you can use mathematics to predict what it'll do. If it's very complicated, you have to do a simulation." Marvin Minsky, *Discover*, January 2007. Other than perhaps designing a nuclear reactor, I do not believe many theories are more complex than the valuation of a rate

regulated public utility. Ironically, however, the answer is quite simple, and ultimately should not result in a value much different than the one established in this order.

I will first recapitulate the transaction as I interpret it, from the perspective of APPRAISER 3 and APPRAISER 4:

	<u>APPRAISER 3</u>	<u>APPRAISER 4</u>
Cash	\$\$\$\$\$	\$\$\$\$\$
Assumed Debt:		
Long Term	\$\$\$\$\$	\$\$\$\$\$
Preferred Stock		\$\$\$\$\$
Net Current Liabilities	_____	<u>\$\$\$\$\$</u>
Total Purchase Price	\$\$\$\$\$	\$\$\$\$\$
Adj. For Intangibles		
Goodwill	(\$\$\$\$\$)	(\$\$\$\$\$)
Intangibles	(<u>\$\$\$\$\$</u>)	(<u>\$\$\$\$\$</u>)
Price of Tangible Property	<u>\$\$\$\$\$</u>	<u>\$\$\$\$\$</u>

With the exception of a few adjustments, both appraisers are quite close in value; roughly \$\$\$\$\$ billion. In fact, the only substantive differences between this analysis and the original conclusions of the appraisers, as well as the only differences between the two appraisers themselves, are the adjustments that were addressed in the decision, primarily for goodwill and non-operating property.

The \$\$\$\$\$ billion figure can be compared somewhat favorably with the four cost approaches, including the Commission's, which range from about \$\$\$\$\$ - \$\$\$\$\$, in that they are within 10%, and closer to 5%, of each other. However, that indicator clearly appears to be low. Of greater concern is the contrast with the income approaches, excepting APPRAISER 4's, which did bracket the value, but was nonetheless unreliable for the reasons mentioned in the decision. The income value indicators from the other two parties, as well as the Commission in its decision, were around \$\$\$\$\$ below the adjusted purchase price. Finally, the Taxpayer's system value was \$\$\$\$\$ lower than the indicated adjusted

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purchase price, while the Division and the Commission were about \$\$\$\$ lower. Although COUNTIES' value is closer, it is, in my opinion, clearly too high.

Based on this analysis, I have reached several conclusions. First, although I personally agree in general with APPRAISER 4's position that the income approach, particularly DCF, is the preferred approach, I no longer believe it is feasible in valuing rate regulated utilities for ad valorem tax purposes. This is because market oriented investors are speculating on intangible investment opportunities with assets that are not transacted in an open market economy. As a result the underlying assumptions, which are critical in deriving an accurate income estimation, are not readily observed or ascertainable. Before leaving the income approach I note, as an aside, my concern that all of the parties treat yield capitalization as similar to a bond or perpetual annuity. Although the end results are mathematically equivalent, this is the exact opposite of yield capitalization as used in real estate appraisal. In fact DCF is a form of yield capitalization. In general, a true yield capitalization model should be constructed to reflect the timing and patterns of cash flows, as well as any changes in value.

Second, it is obvious that, even in a regulated environment, rate base may not be equivalent to fair market value. At best, rate base is a simplistic model that attempts to mimic market behavior.

Finally, related to the second point, I believe that the cost approach is the most reliable predictor of value for a rate regulated utility, and should be the main approach considered. The income and market approaches might be used as sanity checks, but should not be relied upon without extensive research and analysis, and unless the effect of intangibles is addressed properly. This is not to say that investors use HCLD as the basis for a transaction (there is no doubt that they consider future cash flows first and foremost), but rather that it best represents or predicts the fair market value of tangible property.

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Although a sound argument could be made in this specific case that the actual sale, properly adjusted, could be used, such transactions are so rare that a possible equalization issue could be raised.

I note further that the starting point for a cost approach should be net book value. Although the adjusted sales price is below book, I am not persuaded that the adjustment for DIT simulates market reality. Nonetheless, I do believe that an HCLD cost approach based on net book value still needs to take into consideration the potential impact of factors such as CIAC, regulatory assets, and deferred liabilities in determining market value.

In conclusion, I strongly recommend to my colleagues that we convene a study group or rule-making hearings. We should take this rare opportunity and carefully analyze this transaction to establish a more sound approach to value.

Marc B. Johnson
Commissioner

NOTICE: You have twenty (20) days after the date of this order to file a Request for Redetermination with the Commission pursuant to Utah Code Ann. § 63-46b-13. A Request for Redetermination must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Redetermination with the Commission, this order constitutes final agency action. You have thirty (30) days after the date of this order to pursue judicial review of this order in accordance with Utah Code Ann. § 59-1-601 et seq. and 63-46b-14 et seq.

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