

BEFORE THE UTAH STATE TAX COMMISSION

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PETITIONER ET AL,	)	<b>FINDINGS OF FACT,</b>
	)	<b>CONCLUSIONS OF LAW AND</b>
Petitioners,	)	<b>FINAL DECISION</b>
	)	
v.	)	Appeal Nos. 97-0948, 97-0950, 97-0947,
	)	97-1244, 97-0949, 97-0946, 97-0945, 97-0986,
PROPERTY TAX DIVISION,	)	97-0985, 97-0984, 97-0978, 97-0977, 97-0970,
UTAH STATE TAX COMMISSION,	)	97-0992, 97-0989
	)	
Respondent,	)	Tax Type: Centrally Assessed
	)	
	)	
COUNTY ET AL,	)	
	)	Presiding: Phan
Petitioners,	)	
	)	
v.	)	
	)	
PROPERTY TAX DIVISION,	)	
UTAH STATE TAX COMMISSION,	)	
	)	
Respondent.	)	

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

**Appearances:**  
For the Petitioner: PETITIONER REP, Esq.  
  
For the Respondent: RESPONDENT REP 1, Assistant Attorney General  
RESPONDENT REP 2, Assistant Attorney General  
  
For the Counties: COUNTIES REP, Esq.

**STATEMENT OF THE CASE**

This matter came before the Utah State Tax Commission for a Formal Hearing on March 6, 2000 through March 8, 2000. Based upon the oral and written pleadings and the evidence, testimony, and exhibits presented at the hearing, the Commission hereby makes and enters the following:

**FINDINGS OF FACT**

1. The Petitioners are PETITIONER, COMPANY A, COMPANY B, COMPANY C, COMPANY D, COMPANY E, and COMPANY F (collectively, the “Independent Telcos”). The Respondent is the Property Tax Division of the Utah State Tax Commission. The Intervening Counties are COUNTY A, COUNTY B, COUNTY C, COUNTY D, COUNTY E, COUNTY F, and COUNTY G, State of Utah.

2. At issue are 1997 ad valorem property taxes assessed against the Independent Telcos. The parties presented evidence regarding PETITIONER (“PETITIONER”) and COMPANY A (“COMPANY A”), for the purpose of resolving those particular 1997 issues common to all appeals of all Petitioners, and all 1997 issues relating to the appeals of PETITIONER and COMPANY A.

3. The lien date is January 1, 1997.

4. All Petitioners are centrally assessed pursuant to Utah Code Ann. §59-2-201. On or about May 1, 1997, the Division issued property tax assessments to all Petitioners. All Petitioners filed timely appeals of those assessments.

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5. Petitioners retained APPRAISER A of COMPANY G to prepare appraisals for the formal hearing. APPRAISER A estimated the value of PETITIONER's property to be \$\$\$\$\$ and the value of COMPANY A's property to be \$\$\$\$\$.

6. Respondent submitted appraisals prepared by APPRAISER B, an employee of the Utah State Tax Commission. APPRAISER B determined the value of PETITIONER and COMPANY A's property using two scenarios, one in compliance with the Commission's final decision in COMPANY H vs. Property Tax Division, Nos. 95-0789, 95-0824 and one in compliance with the Commission Utility Rule, Utah Admin. Code R884-24P-62 ("Rule 62"). APPRAISER B's COMPANY H approach resulted in a value for PETITIONER of \$\$\$\$\$ and a value for COMPANY A of \$\$\$\$\$. APPRAISER B's Rule 62 approach resulted in a value for PETITIONER of \$\$\$\$\$ and a value for COMPANY A of \$\$\$\$\$.

7. The Intervening Counties did not submit an appraisal, but instead chose to rely on the appraisal of APPRAISER B.

### **The Companies**

8. COMPANY A and PETITIONER each have a certain portion of their respective telephone business that is regulated by the Public Service Commission and Federal Communications Commission. Under the FCC, both PETITIONER and COMPANY A are "( X )" companies. The Utah Public Service Commission ("PSC") sets rates for PETITIONER and COMPANY A's intrastate business on a cost-regulated basis.

9. The majority of PETITIONER and COMPANY A's revenues are derived from

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access charges paid by other carriers (i.e. long-distance carriers).

10. ( PORTION REMOVED )

11. The highest and best use of PETITIONER and COMPANY A's property is as  
( PORTION REMOVED ).

12. ( PORTION REMOVED )

13. ( PORTION REMOVED )

14. Each of the companies: (a) are subject to capital intensive requirements associated with their respective businesses; (b) operate in ( X ) areas of the state; (c) have ( X ) associated with recent acquisitions; (d) are subject to competition from ( X ) and (f) exhibit ( X )

15. PETITIONER and COMPANY A are members of national and local associations which ( X ). PETITIONER and COMPANY A also have access ( X ).

#### **PETITIONER**

16. PETITIONER is a ( PORTION REMOVED ) which operates primarily in COUNTY C, COUNTY B, and COUNTY H, Utah. In addition to local service, PETITIONER provides access services for ( X ).

17. PETITIONER is a wholly owned subsidiary of COMPANY I. ("COMPANY I"). COMPANY I is a closely-held corporation and has been owned by members of the ( X ) family since its inception. All of PETITIONER's senior management are members of the ( X ) family.

18. PETITIONER is a well managed and profitable company. PERSON A testified that PETITIONER was better able to provide quality service to its customers than was

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COMPANY J. He also testified that PETITIONER's management is competent and does not negatively impact PETITIONER's financial operations.

19. On December 29, 1989, COMPANY I acquired PETITIONER from COMPANY K for \$\$\$\$\$. COMPANY I borrowed \$\$\$\$\$ to acquire PETITIONER.

20. COMPANY I paid a premium in excess of net book value for PETITIONER's property. The premium of \$\$\$\$\$ was booked as "goodwill," which is being amortized over forty years. On January 1, 1997, the net book value of the goodwill was \$\$\$\$\$.

21. The PSC approved COMPANY I's purchase of PETITIONER but directed that the "goodwill" was not to be included in PETITIONER's rate base. Typically, items such as the "goodwill," which is an acquisition adjustment, are not allowed in rate base by the PSC.

22. In September 1996, PETITIONER acquired two local exchanges from COMPANY J, EXCHANGE A & EXCHANGE B ("the Acquisitions"). The total purchase price was \$\$\$\$\$. The purchase price included some intangible assets not subject to property taxation in the State of Utah as well as tangible assets which were (i) not in existence at the time of the acquisition, (ii) were technologically obsolete, or (iii) were never placed in service by PETITIONER. PERSON A testified that the purchase price was reasonable and necessary as a means of acquiring the EXCHANGE A & EXCHANGE B, including the intangible nonexistent, technologically obsolete, and abandoned assets.

23. PETITIONER borrowed approximately \$\$\$\$\$ from COMPANY L to finance the acquisitions. There were three notes involved, with interest rates of %%%%, %%%%, and

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%%%%%%%%. Most of PETITIONER's older debt was paid off with this loan. PERSON A testified that the interest rates PETITIONER paid to COMPANY L were at COMPANY L's current "market rates."

24. COMPANY L is a quasi-governmental organization which regularly provides loans at below-market rates, but only to certain qualified borrowers.

25. The interest rate charged by COMPANY L may not accurately reflect the true cost of debt because of membership fees and required deposits which must be maintained by borrowers with COMPANY L earning below-market returns.

26. Of the total acquisition price for the Eureka and Goshen exchanges, PETITIONER booked \$\$\$\$\$ as "plant in service" and \$\$\$\$\$ as "non-operating" assets. The amount of the "non-operating" assets was the difference between the purchase price and the net book value of the assets acquired, or an "acquisition adjustment" similar to the "goodwill" account. The PCS ordered that the "non-operating property" or acquisition adjustment" be excluded from rate-making.

27. After a hearing, internal investigation and review of pre-filed testimony, the PSC approved the acquisitions and concluded that the agreed upon purchase price was a reasonable price for the assets. However, as a condition of the purchase, the PSC required COMPANY J, the seller, to make improvements to the local offices of each exchange and to lay fiber optic cable between Goshen and Eureka. The PSC estimated the value of these improvements to be \$\$\$\$\$.

28. The PSC approved the acquisition, finding that "PETITIONER also has a history of efficient management" and that:

PETITIONER is experienced in the provision of high quality telephone service and has a good track record relative to customer satisfaction. There is no evidence that transferring the exchanges to PETITIONER will have any adverse impact on service; indeed, service may improve because PETITIONER will have a more local presence in those rural exchanges, is familiar with the area and terrain, and thus may be better positioned to provide responsive service in those areas more economically than could COMPANY J.

29. After the acquisitions, the EXCHANGE A & EXCHANGE B were upgraded to digital switching. After the acquisition, PETITIONER had approximately ( X ) to ( X ) access lines.

30. In the acquisitions, PETITIONER paid for all property which was listed on COMPANY J's books as plant in service of EXCHANGE A & EXCHANGE B. The net book value of that property was put on PETITIONER's books as plant in service and became part of PETITIONER's rate base. This property was in PETITIONER's plant in service account and rate base on the lien date, however a portion of this property was not in existence, not in use, and/or technologically obsolete on the lien date.

31. PETITIONER is currently seeking approval from the PSC to purchase the EXCHANGE C and EXCHANGE D from COMPANY J.

#### **COMPANY A**

32. COMPANY A is a not-for-profit cooperative which operates as a local exchange telephone company primarily in COUNTY, Utah. In addition to local service, COMPANY

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A provides access services for intrastate and interstate carriers.

33. In theory, all of COMPANY A's profits are to be distributed to its subscribers. In practice, COMPANY A has been approximately ( X ) years behind in making such distributions. As a cooperative, COMPANY A pays income taxes on portions of its earnings, but does not pay income taxes on distributed earnings.

34. COMPANY A is also able to obtain debt at "co-op rates" which are typically lower than rates charged to investor-owned companies.

35. COMPANY A's fixed rate of return on rate base as set by the PSC is %%%%. COMPANY A's fixed rate of return on its rate base as set by the FCC is %%%%.

36. COMPANY A and its wholly owned subsidiaries are attempting to expand into other markets, including CITY A, CITY B, CITY C and CITY D, Utah, and are currently requesting approval from the PSC to buy exchanges in those areas from COMPANY J.

### **The Appraisals**

37. The appraisal submitted by the Petitioners, prepared by APPRAISER A, CPA, ASA CFA, determines the fair market value of taxable, tangible property in Utah on January 1, 1997, to be \$\$\$\$\$ for PETITIONER and \$\$\$\$\$ for COMPANY A.

38. The appraisal submitted by the Respondent, prepared by APPRAISER B, determines the fair market value of taxable, tangible property in Utah on January 1, 1997, to be \$\$\$\$\$ (based on APPRAISER B's interpretation of the COMPANY H Decision), or \$\$\$\$\$ (based on APPRAISER B's interpretation of Rule 62) for PETITIONER and \$\$\$\$\$ (based on APPRAISER



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B's interpretation of the COMPANY H Decision), or \$\$\$\$ (based on APPRAISER B's interpretation of Rule 62) for COMPANY A.

39. In addition to the appraisals submitted by APPRAISER B, Respondent submitted a formal Review Appraisal prepared by APPRAISER C.

40. Most of the difference between the fair market values as determined by APPRAISER A and APPRAISER B arise from APPRAISER A's adjustments for the (i) The ( X ), and (ii) The Company Specific Risk Premium.

41. Other differences between the appraisals of APPRAISER A and APPRAISER B result in a relatively minor difference in valuation. APPRAISER C testified that the sum total of all differences, other than the two fundamental differences described above, might account for as much as %%% of the difference in the finally determined fair market values. APPRAISER A testified that the sum total of all differences, other than the two fundamental differences described above, would be considered insignificant under properly applied appraisal theory and practice and would account for less than %%% of the difference in finally determined fair market values.

#### **The APPRAISER A Appraisals**

42. In his appraisal of the subject properties for the January 1, 1997, lien date at issue in this appeal, APPRAISER A considered both the income approach to value as well as the cost approach. The valuation based on the income approach as calculated by APPRAISER A for COMPANY A was \$\$\$\$ and for PETITIONER was \$\$\$\$\$. It was APPRAISER A's conclusion that the cost approach value of COMPANY A was \$\$\$\$ and of PETITIONER was \$\$\$\$.

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APPRAISER A used a %%%%, %%% correlation between the income approach and the cost approach for both companies. It was his appraisal opinion that the fair market value of the tangible operating assets for property taxation purposes was \$\$\$\$ for COMPANY A and \$\$\$\$ for PETITIONER.

### **I. Income Approach**

43. APPRAISER A used a yield capitalization model to derive his income approach values for both PETITIONER and COMPANY A.

44. In his appraisals APPRAISER A used the capital structure for the subject companies of %%% equity and %%% debt.

45. In his appraisal for PETITIONER, APPRAISER A determined the yield capitalization rate by taking the after-tax cost of debt of %%% and the cost of equity of %%% weighted as provided in paragraph 44 above for a yield capitalization rate of %%%.

46. In his appraisal for COMPANY A, APPRAISER A determined the yield capitalization rate by taking the after-tax cost of debt of %%% and the cost of equity of %%% weighted as provided in paragraph 44 above for a yield capitalization rate of %%%.

47. The valuation based on the income approach as calculated by APPRAISER A for COMPANY A was \$\$\$\$ and for PETITIONER was \$\$\$\$.

#### **A. Cost of Equity**

48. For both PETITIONER and COMPANY A, APPRAISER A calculated the

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cost of equity for the subject companies by adding a risk free rate of %%%%, plus the market equity risk premium of %%%% adjusted by a beta of ( X ) (%%%), plus a ( X ) of %%%%, and a company specific equity risk premium of %%%% for a total cost of equity of %%%%.

49. Concerning the market equity risk premium, APPRAISER A in his testimony stated that Ibbotson and all of the applicable texts advocate use of the 70 plus-year period as providing the most accurate, reliable measure of the market equity risk premium of %%%%. However, Rule 62 requires that the Equity Risk Premium be based on 40 years of Ibbotson Data.

50. Concerning the small company risk premium, APPRAISER A testified it was appropriate and necessary to reflect the return that an investor/purchaser would require in purchasing the stock and assets in COMPANY A or PETITIONER. APPRAISER A based the adjustment on the ( X ) of %%%% calculated by Ibbotson Associates' over the seventy-year period from 1926 to 1996 and indicated that it would more accurately reflect the premium which a purchaser/investor would require in connection with the subject companies. This adjustment is based on the difference between the average return of "large-cap" stocks (the 1<sup>st</sup> decile of the New York Stock Exchange ("NYSE"), with the average return of "small-cap" or "micro-cap" stocks. Over the 70 year Ibbotson period, the 10<sup>th</sup> decile earned a %%%% higher average return than large cap stocks. APPRAISER A testified that sound appraisal theory and practice requires that the small company risk premium adjustment be made and submitted numerous authorities who agreed that the adjustment should be made, but were not necessarily in agreement as to the amount of the adjustment. The stocks in the

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10th decile are companies generally 100 times or more larger than the subject companies. The stocks in the 1st decile of the NYSE had an average Beta of ( X ), stocks in the 10th decile had an average Beta of 1( X ).

51. The Commission notes that the Ibbotson yearbook suggests a size premium on January 1, 1997 of less than the %%% calculated by APPRAISER A. Page 161 from Ibbotson's Yearbook states that the "expected micro-capitalization equity size premium" was %%%. Ibbotson estimates the small firm risk premium using a different group of companies than APPRAISER A used. Ibbotson's group of "micro-cap" stocks includes the 9<sup>th</sup> and 10<sup>th</sup> deciles of the NYSE plus over-the-counter stocks with the same or less market capitalization as the 9<sup>th</sup> decile. APPRAISER A used the 10<sup>th</sup> decile only, and no over-the-counter stocks.

52. Concerning the company specific risk premium, APPRAISER A concluded that it was also appropriate and necessary. The amount of the premium applied by APPRAISER A was %%%. This amount was based on appraisal judgment determined by APPRAISER A to be necessary as he testified the companies exhibited the following: a) slow growth associated with the rural areas in which they operate; b) capital intensive requirements associated with their respective business; c) operate in low income areas of the state; d) added financial risks associated with recent acquisitions; e) subject to competition from competitive local exchange carriers, cellular and other telecommunications companies; and f) lack of management depth.

## **B. Net Cash Flow**

53. Under his yield capitalization model, APPRAISER A arrived at "Net Cash Flow" by estimating after-tax operating profit, after-tax interest expense, depreciation expense, capital expenditures and net working capital additions. APPRAISER A considered historical data and what he termed to be company specific factors to estimate net cash flows until 2001, with a terminal year of 2002.

54. APPRAISER A testified that he attempted to estimate "expected cash flows," which generally refers to cash flows which take into account all possible outcomes, good and bad. In making his cash flow estimates, APPRAISER A considered what he called slow population growth in PETITIONER and COMPANY A's service areas, the fact that PETITIONER and COMPANY A operate in low income areas, competition, lack of management depth, the capital intensive nature of the telephone business and the fact that PETITIONER and COMPANY A are very small companies.

55. The 1996 historical data regarding PETITIONER's income stream included only 3 months of influence from the EXCHANGE A & EXCHANGE B acquisitions. APPRAISER A's projected cash flows appear to be based on the assumption that future revenues and expenses will be similar to those in 1996, even though future revenues and expenses will be affected for the full year by the increases which resulted from the EXCHANGE A & EXCHANGE B acquisitions.

### **C. Growth Rate**

56. The Value Line growth rate as of January 2, 1997, was %%%%, which reflects data through December 31, 1996.

57. APPRAISER A projected after-tax operating profit, depreciation, capital

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expenditures and net working capital additions to grow at %%% per year in the future. APPRAISER A did not apply a growth rate to his estimate of after-tax interest. Thus, APPRAISER A's overall implied growth rate for the net cash flows is less than %%%.

58. APPRAISER A's growth rate estimate was based on consideration of what he called slow population growth in PETITIONER and COMPANY A's service areas, the fact that PETITIONER and COMPANY A operate in low income areas, competition and lack of management depth.

## **II. Cost Approach**

59. APPRAISER A used the Reproduction Cost New Less Depreciation ("RCNLD") cost approach in both appraisals. In both appraisals APPRAISER A adjusted his RCNLD cost approach for what he believed to be external obsolescence, using what is known as the "income shortfall" method and he made an adjustment for functional obsolescence. An additional deduction made by APPRAISER A in the cost approach for PETITIONER was a \$\$\$\$ cable cost adjustment. For the PETITIONER appraisal APPRAISER A used trending factors to derive a surrogate for replacement cost new. This adjustment for PETITIONER is approximately \$\$\$\$\$. He then made a depreciation adjustment for each item, the total of which was \$\$\$\$\$. The net change to APPRAISER A's historic costs in his PETITIONER appraisal is \$\$\$\$.

### **A. External Obsolescence**

60. Under the income shortfall method, obsolescence is determined based on the difference between actual earnings and the theoretical earnings that a company should have achieved

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if they were earning what APPRAISER A calls a “fair rate of return.” In both appraisals, APPRAISER A used his weighted average cost of capital ("WACC") as the estimate of a “fair rate of return.”

61. Since APPRAISER A uses the WACC in determining obsolescence, any errors in the WACC will affect the cost approach. APPRAISER A admitted that, since his WACC is affected greatly by the ( X ) and the Company Specific Equity Risk Premium, the existence of any external obsolescence depends largely on those adjustments. APPRAISER A agreed that if these two premiums were removed from the WACC, there would be virtually no obsolescence in his cost indicators.

62. APPRAISER A admitted at hearing that there was an error in his obsolescence calculation in the COMPANY A appraisal. APPRAISER A originally estimated \$\$\$\$\$ of obsolescence in COMPANY A. At hearing, APPRAISER A explained that he had used an incorrect After-tax Operating Profit figure in this calculation. APPRAISER A prepared a revised obsolescence calculation but did not present it at hearing. Despite the clear data-input error, APPRAISER A did not change his opinion of value in COMPANY A.

63. The Division presented APPRAISER A’s revised obsolescence calculation into evidence. The revision showed external obsolescence in COMPANY A of \$\$\$\$\$, an increase in obsolescence of \$\$\$\$\$. In the revised calculation, APPRAISER A corrected the data-input error and also changed some assumptions about depreciation, presumably to arrive at a reasonable result. If the revised exhibit had been incorporated into APPRAISER A’s appraisal, the cost approach in

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COMPANY A would have been \$\$\$\$\$. If this number had been incorporated into APPRAISER A's appraisal, the system value would have been \$\$\$\$\$, a decrease of \$\$\$\$\$.

64. If APPRAISER A had corrected only the data-input error in his COMPANY A revised obsolescence calculation, without changing depreciation, the obsolescence would have been \$\$\$\$\$, resulting in a negative cost approach value.

### **B. Functional Obsolescence**

65. APPRAISER A adjusted both COMPANY A and PETITIONER's cost approach for items which he believed were either not in existence or not in use on the lien date. APPRAISER A did this by including the property at ( X ) value. APPRAISER A testified that in order to verify the functional obsolescence, he personally inspected PETITIONER and COMPANY A's property, made numerous phone calls to the management of the companies to determine which items of property were not it existence or no longer in use. Based on his findings he made modifications to the Continuing Property Records ("CPR's") of PETITIONER and COMPANY A. However, the Commission notes that for PETITIONER, APPRAISER A's original cost is virtually identical to APPRAISER B's even though he is claiming only existing assets. In fact, the only substantial difference between APPRAISER A's original cost and APPRAISER B's plant in service is the cable cost adjustment of \$\$\$\$\$. This adjustment appears to be a %%% adjustment on certain cable items. In his appraisal for COMPANY A, APPRAISER A's RCNLD (\$\$\$\$\$) prior to the external obsolescence deduction is much higher than the HCLD used by APPRAISER B (\$\$\$\$\$).

66. After adjusting for both functional obsolescence and external obsolescence, it



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was APPRAISER A's conclusion that the cost approach value of COMPANY A was \$\$\$\$ and of PETITIONER was \$\$\$\$.

### **The APPRAISER B Appraisals**

67. The Division's appraisals were performed by APPRAISER B, using a unitary approach and generally accepted appraisal methods. APPRAISER B determined the value of PETITIONER and COMPANY A's property using two scenarios, one in compliance with the Commission's final decision in COMPANY H v. Property Tax Division, Nos. 95-0789, 95-0824, and one in compliance with Rule 62.

68. After the COMPANY H decision, the Commission entered into rule-making proceedings. Rule 62 was the result of these and became effective on January 1, 1999.

#### **I. COMPANY H Scenario**

69. Income Approach: APPRAISER B used a yield capitalization income approach which resulted in a value of \$\$\$\$ for PETITIONER and \$\$\$\$ for COMPANY A.

70. Cost Approach: APPRAISER B's COMPANY H cost approach was a trended Historic Cost Less Depreciation ("HCLD") approach. A trended HCLD is similar or equivalent in result to an RCNLD approach. Under this approach, APPRAISER B derived a value of \$\$\$\$ for PETITIONER and \$\$\$\$ for COMPANY A.

71. Correlation: As directed by the Commission in COMPANY H, APPRAISER B weighted both indicators equally, arriving at a correlated unit value in PETITIONER of \$\$\$\$ and a value of \$\$\$\$ in COMPANY A.

## II. Rule 62 Scenario

### A. Income Approach

72. Under the Rule 62 scenario, APPRAISER B used a yield capitalization income indicator, with the formula “cash flow / cost of capital minus growth” or:

$$\frac{CF}{k - g}$$

73. APPRAISER B’s “Normalized Income” estimates for 1997 in both appraisals were conservative and below 1996 actual net operating income for both companies.

74. The “k” in APPRAISER B’s formula was the %%% weighted average cost of capital (“WACC”) established by the Division in its 1997 Cost of Capital study for Rural Telephones. The components of the WACC are a debt rate and an equity rate. APPRAISER B used the same equity and debt rates in both appraisals. A capital structure of %%% debt, %%% equity was applied to arrive at a WACC of %%% using a debt rate of %%% and an equity rate of %%%.

75. APPRAISER B’s debt rate of %%% comes from the “Baa” public utility bond yield rate.

76. Mr. APPRAISER B’s equity rate of %%% is derived from a %%% cost of equity plus the addition of %%% for a “X ADJUSTMENT.”

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a. The estimated % cost of equity was derived from both a capital asset pricing model ("CAPM") and a risk premium model. APPRAISER B concluded that pursuant to the CAPM model that the equity rate was %. For the CAPM model APPRAISER B used a market risk premium of %, and an industry beta of ( X ), to conclude that the appropriate industry risk premium was %. To this he added a risk free rate of %. From his risk premium model, APPRAISER B derived an equity rate was %. The components of the risk premium model were a % market risk premium multiplied by an industry risk factor of ( X ), for an industry risk premium of %, to this APPRAISER B added a risk-free rate of % which totaled a cost of equity based on the risk premium model of %. APPRAISER B's correlated cost of equity from the CAPM and risk premium model was %.

b. To the % cost of equity, Petitioner added a "X ADJUSTMENT" of %. Although the Property Tax Division did not necessarily support the accuracy of this % adjustment, the Property Tax Division has made this adjustment in its valuation of all CLASSIFICATION A for several years.

77. The % X ADJUSTMENT originated from a settlement agreement for prior years between the Division and CLASSIFICATION A. This "X ADJUSTMENT" varies from year to year and is calculated by taking the difference between the yield on "Aaa" and "Baa" rated public utility bonds. The Division makes the "X ADJUSTMENT" to take into account the additional systematic risk in the rural telephone industry as compared to regional bell operating companies - which the Division uses as guideline companies in deriving its equity rate.

78. APPRAISER B found that COMPANY A and PETITIONER, when compared to other firms in their industry, including substantially larger firms, fared much better on most financial indicators. As a result, APPRAISER B concluded that his appraisals appropriately considered the risks of COMPANY A and PETITIONER and that no company specific factors warranted further adjustments.

79. APPRAISER B acknowledged that the actual capital structures of PETITIONER and COMPANY A in 1996 were heavily weighted in favor of debt and did not comport with the industry structure used in the appraisals. A weighting of the debt and equity rates based upon company specific information would have increased the income approach values in both appraisals.

80. For the “g” in the foregoing equation, APPRAISER B used %%%%, which was Value Line's long-term estimate of inflation on December 27, 1996. APPRAISER B’s growth rate is inflationary only, to capture real growth of assets in place on the lien date attributable to the business enterprise.

### **B. Cost Approach**

81. APPRAISER B used an HCLD cost indicator in the Rule 62 scenario. Under the HCLD approach, APPRAISER B derived a value of PETITIONER’s property of \$\$\$\$ and a value of COMPANY A’s property of \$\$\$\$\$. The Commission finds that APPRAISER B's cost approach values are reasonable, and reflective of the market value of the subject properties. The Commission does not find evidence of any significant error in APPRAISER B's cost approach.

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82. APPRAISER B did not include acquisition adjustments (“non-operating property” and “goodwill”) in his cost approach because they were not included in rate base of either company.

### **C. Correlation**

83. As directed by Rule 62, APPRAISER B gave more weight to the cost approach than to the income approach. He gave %%% weight to the income approach and %%% to the cost approach. The resulting correlated system values under the Rule 62 scenario were \$\$\$\$ for PETITIONER and \$\$\$\$ for COMPANY A.

84. APPRAISER B’s valuations of COMPANY A and PETITIONER excluded all separately identifiable intangibles. Possible intangibles such as the acquisition adjustments, which were not in rate base, were not included in APPRAISER B’s estimates of future cash flows or in his cost approach.

### **APPRAISER C’s Review Appraisals**

85. APPRAISER C performed formal review appraisals of APPRAISER A’s appraisals, outlining several criticisms.

86. APPRAISER C criticized the use of the “( X )” and the “Company Specific Equity Risk Premium,” calling both adjustments inappropriate for various reasons. Consequently, APPRAISER C disagreed with APPRAISER A’s income approaches and his calculation of external obsolescence in both appraisals.

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87. APPRAISER C determined that if one considered the 40 years of Ibbotson data that is required by Rule 62, the appropriate market risk premium was %%%%. APPRAISER C approved of the risk free rate of %%%%, which was applied by APPRAISER A in his appraisals. APPRAISER B had used a rate of %%%%.

88. APPRAISER C also challenged the appropriateness of the “income shortfall” method and the use of the RCNLD cost approach. APPRAISER C noted that the “income shortfall” method makes the cost approach a function of the discount rate, therefore any errors in the discount rate will affect the cost approach. APPRAISER C also indicated that RCNLD is not the preferred cost approach for cost-regulated utilities.

89. APPRAISER A estimated PETITIONER’s before-tax interest expense to be \$\$\$\$ in 1997. APPRAISER C stated that this estimate was not supported by historical data nor based on PETITIONER’s capital structure, as APPRAISER A had suggested. APPRAISER C noted that “PETITIONER financed the EXCHANGE A & EXCHANGE B purchase with \$\$\$\$ in long term debt with an interest rate of approximately %%%%. On January 1, 1997, PETITIONER had \$\$\$\$ in long term debt. [APPRAISER A’s] estimate of 1997 interest would imply a cost of debt of approximately %%%%.”

90. APPRAISER C estimated the proper after-tax interest expense in PETITIONER to be \$\$\$\$\$, based on the amount of PETITIONER’s long term debt and an %%%% interest rate. If APPRAISER A had used this interest expense, and had removed the “( X )” and “Company Specific Risk Premium” from his equity rate, the resulting income approach

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in PETITIONER would have been \$\$\$\$\$.

91. APPRAISER C noted that APPRAISER A's removal of "goodwill" from the income approach in PETITIONER was improper because that account was clearly not in PETITIONER's rate base. Moreover, even if the subtraction were proper, APPRAISER A removed the full, un-amortized amount of goodwill, rather than the net book amount. APPRAISER C also pointed out that APPRAISER A's subtraction of goodwill was inconsistent with his treatment of the same type of acquisition adjustment that was booked as "non-operating property."

92. APPRAISER C pointed out a data-input error in APPRAISER A's calculation of external obsolescence. APPRAISER C stated that if the error were corrected, the obsolescence in COMPANY A would be so high that APPRAISER A's cost approach would be less than ( X ).

### **Tax Commission's Appraisal Conclusions**

#### **I. Income Approach**

93. The Commission determines from all the appraisals and evidence presented at the hearing that the appropriate way to determine the income approach value of the subject properties is the yield capitalization model. The yield capitalization formula is  $CF/(k-g)$ . In this formula "CF" is cash flow, "k" is the nominal, risk adjusted discount rate, and "g" is the expected further growth of the cash flow.

#### **A. Weighted Average Cost of Capital (WACC)**

94. The "k" component of the above formula was determined by the appraisers using the weighted average cost of capital (WACC). The components of the WACC are a equity rate

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and a debt rate. It is the Commission's determination that the equity rate should be %%% and the debt rate should be %%%. The Commission determines that the appropriate weighting of these two components is %%% to the equity rate and %%% to the debt rate with the resulting WACC of %%%.

95. In determining the equity rate component of the WACC, the Commission is reluctant to accept APPRAISER A's inclusion in the cost of equity the market risk premium of %%% which is based on Ibbotson's 70 year period. The Commission finds, from the information provided in the review appraisal by APPRAISER C, that the appropriate market risk premium, based on 40 year data from Ibbotson is %%%. The Commission then determines that the market risk premium should be multiplied by the beta of ( X ) for an industry risk premium. The ( X ) beta was supported by APPRAISER B in his appraisal. To the industry risk premium the Commission adds the risk free rate. The Commission determines that the appropriate risk free rate, which was used by APPRAISER A and supported by APPRAISER C, is %%%.

96. The Commission agrees with APPRAISER A's assertion that an additional adjustment to the equity rate component of the WACC is appropriate due to the fact that the subject companies are small CLASSIFICATION A that do not compare to the regional bell operating companies. However, it is the Commission's conclusion that APPRAISER A's %%% ( X ) and %%% company specific risk premiums added together (%%%) are an over statement and duplicative estimate of the actual risks associated with PETITIONER and COMPANY A in comparison to the regional telephone companies. It is also the Commission's conclusion that the



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%% added by APPRAISER B to the cost of equity is insufficient to account for the risks of the subject companies as compared to the larger regional companies. After considering the evidence presented it is the Commission's conclusion that instead of the %% suggested by APPRAISER A or the %% suggested by APPRAISER B, a company specific adjustment of %% should be added to the cost of equity to take into account all the actual risks involved in the subject company in comparison to the regional companies, which the various parties have attempted to address with their small cap risk premium, company specific risk premium and X ADJUSTMENT.

97. For the debt component of the WACC the commission determines that the appropriate debt rate is %. This amount is well supported by evidence presented by APPRAISER B.

### **C. Growth Rate**

98. In determining the appropriate "g" or growth rate in the yield capitalization formula, the Commission finds that APPRAISER A's use of the growth rate of % from Value Line's January 2, 1997, edition is more appropriate than Respondent's use of the December 27, 1996, Value Line publication which included data up to December 24, 1996. The January 2, 1997 Value Line included data up to December 31, 1996, and given its proximity to the lien date is the better choice.

### **B. Cash Flow**

99. In determining the appropriate "cf" or cash flow for the yield capitalization

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formula, the Commission determines that APPRAISER B has presented the better “Normalized Income” estimates for 1997 in his Rule 62 appraisals for both COMPANY A and PETITIONER. For this reason the Commission determines that APPRAISER B's net cashflows are appropriate for use in the yield capitalization model.

## **II. Cost Approach**

100. The Commission concludes that APPRAISER B has correctly determined the cost approach value for the subject properties using the Historic Cost Less Depreciation ("HCLD") method.

101. From the evidence presented at the hearing, the Commission finds that it is unnecessary to make the functional obsolescence adjustment to APPRAISER B's HCLD as proposed by APPRAISER A, for assets not in existence or in use on the lien date.

102. The Commission rejects the income shortfall method for determining external obsolescence as applied by APPRAISER A.

## **III. Correlation**

103. Upon review of the evidence presented, it is the conclusion of the Commission that the cost approach value should be given a weight of %%% and the income approach value a weight of %%%.

## **IV. Conclusion**

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104. a. The Commission determines the income approach value by using the yield capitalization approach. The Commission ultimately adopts APPRAISER B's net cash flows for both PETITIONER and COMPANY A. The Commission adopts the growth rate of %%. In determining the yield capitalization rate the Commission determines the weighted average cost of capital from an equity rate and a debt rate. For the equity rate the Commission relies solely on the CAPM model. In its CAPM model, the Commission uses a market risk premium of %% multiplied by a beta of ( X ), adds the risk free rate of %% and a %% adjustment for the small stock, company specific and rural telephone risk factors. From this calculation the Commission concludes that the equity rate is %%. The Commission determines the appropriate debt rate is %% and weighs the debt rate at %% and the equity rate at %%, for a yield capitalization rate of %%. In applying this approach it is the Commission's conclusion that the income approach value of PETITIONER was \$\$\$\$ as of the 1997 lien date and the income approach value of COMPANY A was \$\$\$\$ as of the 1997 lien date. b.

The Commission finds that the cost approach value to be as determined by APPRAISER B in his appraisals, with the cost approach value of PETITIONER being \$\$\$\$ and of COMPANY A being \$\$\$\$.

c. The Commission gives the cost approach value %% weight and the income approach value %% weight. The correlated values are \$\$\$\$ for PETITIONER and \$\$\$\$ for COMPANY A.

**APPLICABLE LAW**

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Article XIII, § 2(1) of the Utah Constitution requires that “. . .[a]ll tangible property in the state, not exempt under the laws of the United States, or under this Constitution, shall be taxed at a uniform and equal rate in proportion to its value, to be ascertained as provided by law.”

Article XIII, § 3(1) of the Utah Constitution requires the Legislature to “. . . provide by law a uniform and equal rate of assessment on all tangible property in the state, according to its value in money . . .” and to “. . . prescribe by law such provisions as shall secure a just valuation for taxation of such property, so that every person and corporation shall pay a tax in proportion to the value of his, her, or its tangible property. . .”

Utah Code Ann. § 59-2-103(1) requires that “[a]ll tangible taxable 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.”

### **CONCLUSIONS OF LAW**

1. Petitioners have the burden of proof. It is well settled that the burden of proof on the taxpayer in property tax cases is two-fold. First the taxpayer must “show substantial error or impropriety” in the original assessments and then must provide a “sound evidentiary basis” upon which the Commission could adopt a lower value. (X). v. Tax Comm’n, 590 P.d. 332, 335 (Utah 1979).

2. None of the parties have presented evidence supporting the original assessed values for the subject properties. For this reason, Respondent does not have the presumption of

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correctness. (  )v. Utah State Tax Comm'n, 2000 UT 49, 2000 LEXIS 63, (Utah 2000).

3. The totality of the evidence supports a value different from the original assessment.

### ANALYSIS

The issue before the State Tax Commission is the fair market value of PETITIONER and COMPANY A's tangible taxable assets as of the lien date January 1, 1997, based on a unitary valuation method. Petitioners have submitted appraisals indicating the value of PETITIONER is \$\$\$\$\$ and the value of COMPANY A on the lien date was \$\$\$\$\$. Respondent presented two sets of appraisals prepared by APPRAISER B, one following the methodology set out in the Commission's decision in COMPANY H, and one in compliance with the Commission's Rule 62. APPRAISER B's Rule 62 Appraisals concluded that the value from PETITIONER was \$\$\$\$\$ and the value for COMPANY A was \$\$\$\$\$.

While Rule 62 was not in place on the lien date, we find that the principles enunciated in the rule apply here. The Rule contains an effective date of January 1, 1999. The rule does not confine its application to tax year 1999, and thus, since APPRAISER B's appraisals were performed after January 1, 1999, he was correct to apply the rule. The Commission has spent considerable time reviewing various valuation methodologies. After doing so, the Commission has specifically embraced certain methodologies and has given specific guidance on how utility properties such as COMPANY A and PETITIONER are to be valued for property tax purposes in Utah. The

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Commission's adoption of such principles into Rule 62 indicates that those methods are preferred, and thus, may now be used, even if the tax year in question pre-dates the rule.

In comparing the appraisal submitted by APPRAISER A and the Rule 62 appraisals submitted by APPRAISER B, the major valuation discrepancy stems from the equity rate component of the WACC in the income approach and the external obsolescence determination in the cost approach.

## **I. Income Approach**

### **A. Equity Risk Premium**

In his income approach APPRAISER A added a "X PREMIUM" of %%% and a "Company Specific Risk Premium" of %%% in his equity rate - whereas APPRAISER B adds an adjustment of only %%% as a X ADJUSTMENT. This difference accounts for approximately %%% of the value difference between APPRAISER A and APPRAISER B's income approach values. After reviewing carefully the arguments and the evidence set out by the parties on these adjustments to the equity rate the Commission determines that APPRAISER A has over adjusted for the actual risks of PETITIONER and COMPANY A while APPRAISER B's adjustment is insufficient.

APPRAISER A added %%% to his equity rate in both appraisals to account for what he believes to be the additional risk of PETITIONER and COMPANY A because they are very small companies. This premium is based on the difference between the 71 year average return of "large-cap" stocks with the 71 year average return of "small-cap" stocks as reported in Ibbotson.

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Over the 71 year period reported by Ibbotson, “small-cap” stocks have earned on average, a %%% higher return than “large-cap” stocks. The “large-cap” stocks are those in the 1<sup>st</sup> decile of the NYSE. APPRAISER A testified that the “small-cap” stocks used for his adjustment were those in the 9<sup>th</sup> and 10<sup>th</sup> deciles of the NYSE, but APPRAISER A relied on information from the 10<sup>th</sup> decile only in deriving his size premium. The Commission notes that the Ibbotson yearbook does not necessarily support a size premium in the amount of %%%. Page 161 from Ibbotson’s Yearbook indicates that the “expected micro-capitalization equity size premium” was %%%.

APPRAISER A makes a further adjustment of %%% to his equity rate in both appraisals for what he calls “company-specific” risks which include: ( PARAGRAPH REMOVED ).

APPRAISER B made an adjustment of just %%% which he termed a X ADJUSTMENT. APPRAISER B explained that the Division made the adjustment to all CLASSIFICATION A to account for the additional systematic risk in the rural telephone industry as compared to the regional bell operating companies. The Division started adding this adjustment several years prior to the year at issue, after reaching a settlement agreement with some CLASSIFICATION A. APPRAISER B derived his equity rate from the CLASSIFICATION B. APPRAISER B calculated his X ADJUSTMENT by taking the difference between the yield on "Aaa" and "Baa" rated public utility bonds. It is the Commission's position that this adjustment does not reflect the actual risk faced by PETITIONER and COMPANY A in comparison to the CLASSIFICATION B.

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It is the Commission's conclusion, after reviewing the evidence and arguments of the parties, that an adjustment of %%% to the equity rate would be appropriate to take into account all of the risk factors that the parties had intended to capture in the ( X ), the company specific risk premium and the X ADJUSTMENT.

### **B. Other Items**

The Commission made determinations concerning the other elements or components of the income approach which collectively do not have the impact on value as the equity rate adjustment and are explained in detail in the Commission's Findings of Fact.

One issue considered was which period was more appropriate to determine the growth rate from Value Line. APPRAISER A's growth rate of %%%, reflects data that, although it was published on January 2, 1997, occurred up through December 31, 1996, the closest data in proximity to the lien date. APPRAISER B's %%% rate came from Value Line's report for the week prior to that considered by APPRAISER A. It is the Commission's position that the better rate is the one that is the closest in proximity to the lien date, so finds that the %%% rate should be applied. The Commission finds as a general rule, reliance on publications which contain only pre-lien date information, even if published after the lien date, does not constitute impermissible use of post lien date information. After reviewing the evidence the Commission determined that the better debt rate component of the WACC was the %%%. The parties all agreed as to the weight to give the debt and equity rates in determining the WACC. The Commission determined that



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APPRAISER B's net cash flows were the better supported.

## **II. Cost Approach**

In calculating the cost approach values APPRAISER A started with reproduction cost new less depreciation ("RCNLD"), while APPRAISER B used historic cost less depreciation ("HCLD"). Although there were several differences as have already been noted in the Findings of Fact, the major difference in value comes from the amount of obsolescence determined by APPRAISER A and APPRAISER B. APPRAISER A concluded that PETITIONER and COMPANY A suffered from both functional and external ( X ), with the external obsolescence having the largest impact of value.

To account for the functional obsolescence, APPRAISER A testified that he had modified PETITIONER and COMPANY A's Continuing Property Records ("CPRs") to eliminate property that was not in existence or in service. Although the Commission generally agrees with Petitioner that property no longer in existence should not be included in the cost approach valuation, the evidence does not support a further adjustment to APPRAISER B's HCLD. In their PETITIONER appraisals, APPRAISER A's original cost is virtually identical to APPRAISER B's historic cost, even though APPRAISER A purports to have identified only the existing assets that are used as part of the operating unit. The differences in the original costs is substantially the cable cost adjustments. In his COMPANY A appraisal, APPRAISER A's RCNLD, prior to the external

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obsolescence adjustment, is much higher than APPRAISER B's HCLD. APPRAISER A's RCNLD, prior to the deduction for external obsolescence, is \$\$\$\$\$ while APPRAISER B's is HCLD \$\$\$\$\$.

In reviewing the evidence, the Commission cannot determine if assets that APPRAISER A purported to place at \$\$\$\$\$ value had a salvage value. Further, there is not any indication as to whether they had already been fully depreciated on the CPR's. The HCLD approach is an approximation of value because it reflects allowed income receivable from the assets. Many assets have additional value over the HCLD value, but we do not make an upward adjustment for this difference. Under the evidence which was presented we do not find that an adjustment for functional obsolescence, based on assets not in existence or in use on the lien date, needs to be made to APPRAISER B's HCLD. In addition to the modification of the companies CPR's, APPRAISER A made an adjustment for external obsolescence based on the application of the "income shortfall" method. As has already been addressed in the Findings of Fact, the Commission rejects the income shortfall method as calculated by APPRAISER A. In effect it appears to the Commission that APPRAISER A bases his calculation on total invested capital, but deducts it from RCNLD. It is the Commission's opinion that this is mathematically and conceptually incorrect; his cost approach is lower than rate base, therefore there should be no obsolescence. The Commission notes that it has looked at this issue in prior cases where it rejected the "income shortfall" method. (See, ( X )v. Property Tax Division, Appeal Nos. 85-0074, 86-0255 at p. 4, and ( X )v. Property Tax Division, Appeal No. 88-1334, at p. 64).

In ( X ) v. Department of Revenue, 770 P.2d 43 (Or 1988), the Oregon Supreme

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Court affirmed an Oregon Tax Court decision, rejecting the use of the income shortfall method. The

( X ) Court noted:

the mathematical logic of [the income shortfall] approach essentially converts the cost approach to an income approach. Where the income and the rate are given, [the income shortfall] method will always result in a value exactly the same as the income approach because it shoves the cost out the back door. Algebraically, the method cancels all cost in excess of the value indicated by the income approach as obsolescence.

Id. at 51. The Oregon Supreme Court went on to say that adjusting one approach to make it rely on the result in another approach “effectively eliminates a relevant perspective from consideration.” Id.

In rejecting the income shortfall method, the Commission does not hold that obsolescence cannot exist. Rather, we reject APPRAISER A’s method of testing for obsolescence. In this case there is ample and clear evidence that properties such as the ones at issue, trade at market-to-book ratios greater than one. In other words, PETITIONER and COMPANY A have both paid premiums in the past to acquire operating property. Given these considerations the Commission would be reluctant to assume the properties had economic obsolescence in the absence of very conclusive evidence. In the absence of such evidence, the Commission finds there is no economic obsolescence in the PETITIONER and COMPANY A properties.

### **III. Correlation**

For both PETITIONER and COMPANY A, the weight given by APPRAISER A to

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the his cost approach and income approach values was %%%%/%%%. APPRAISER B weighed the cost approach %%%% and the income approach %%%%, and the Commission finds his appraisal more credible on this issue.

DECISION AND ORDER

Based upon the foregoing, the Tax Commission finds that the market value of the subject properties as of January 1, 1997, is \$\$\$\$ for PETITIONER and \$\$\$\$ for COMPANY A. It is so ordered.

The Property Tax Division is ordered to adjust its records in accordance with this order. The Property Tax Division is also ordered to calculate final adjustments to the values apportioned to each affected tax district resulting from this order and to deliver that information to the affected counties on behalf of the Commission after the time to appeal this decision has expired. The counties are ordered to use the information so provided to adjust their tax roles in accordance with the revised assessment.

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 2000.

\_\_\_\_\_  
Jane Phan  
Administrative Law Judge

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BY ORDER OF THE UTAH STATE TAX COMMISSION:

The Commission has reviewed this case and the undersigned concur in this decision.

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 2000.

Pam Hendrickson  
Commission Chair

R. Bruce Johnson  
Commissioner

Palmer DePaulis  
Commissioner

Marc B. Johnson  
Commissioner

**Notice of Appeal Rights:** You have twenty (20) days after the date of this order to file a Request for Reconsideration with the Tax Commission Appeals Unit pursuant to Utah Code Ann. §63-46b-13. A Request for Reconsideration must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Reconsideration 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 and 63-46b-13 et. seq.

*JKP97-0948.fof*