APPEAL #: 99-0568 AND 99-0622
TAX TYPE: CENTRALLY ASSESSED
TAX YEAR:1999
DATE SIGNED: 4/7/2001
COMMISSIONERS: P.HENDRICKSON, R.JOHNSON, P.DEPUALIS, AND M.JOHNSON

BEFORE THE UTAH STATE TAX COMMISSION

PROPERTY OWNER Petitioner, v. PROPERTY TAX DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**FINDINGS OF** **CONCLUSIONS OF LAW, AND FINAL DECISION** Appeal No. 99-0568
COUNTY-1 et al., Petitioners, v. PROPERTY TAX DIVISION OF THE UTAH STATE TAX COMMISSION ex rel. PROPERTY OWNER, Respondents.	Appeal No. 99-0622 Tax Type: Centrally Assessed

Presiding:

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

Appearances:

For Petitioner PROPERTY OWNER:	Petitioner Rep-1, Esq.
For Petitioning Counties:	Petitioner's Rep-2, Esq.
For Respondent:	Respondent's Rep-1, Assistant Attorney General Respondent's Rep-2, Assistant Attorney General

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on Monday, August 14, 2000 through Friday, August 18, 2000.

Based on the pleadings, evidence and testimony presented, the Commission makes the following:

FINDINGS OF FACT

I. The tax at issue is the Utah ad valorem property tax of PROPERTY OWNER'S centrally assessed properties for the tax year 1999. The lien date is January I, 1999.

2. The property that is the subject of these appeals is the portion of PROPERTY OWNER'S domestic electric operations allocable to Utah.

3. The petitioning taxpayer in Appeal No. 99-0568 is PROPERTY OWNER. The petitioning Counties in Appeal No. 99-0622 are COUNTY-1, COUNTY-2, COUNTY-3, COUNTY-4, COUNTY-5, COUNTY-6, COUNTY-7, COUNTY-8, COUNTY-9, COUNTY-10, COUNTY-11, COUNTY-12, COUNTY-13, COUNTY-14, COUNTY-15, COUNTY-16, COUNTY-17, COUNTY-18, COUNTY-19, COUNTY-20, COUNTY-21, COUNTY-22, COUNTY-23, COUNTY-24, COUNTY-25, COUNTY-26, COUNTY-27, and COUNTY-28.

4. PROPERTY OWNER is a "public utility" under Utah Code Ann. §59-2-102-(24), and is centrally assessed pursuant to Utah Code Ann. §59-2-201. The Respondent timely issued its property tax

assessment to PROPERTY OWNER on May l, 1999 ("the Original Assessment"). Both PROPERTY OWNER and the Counties timely appealed the assessment.

5. Respondent's Original Assessment for the value of PROPERTY OWNER'S Utah taxable property, was a system value of $$$$$, and a Utah taxable value of $$$$$.

PROPERTY OWNER

6. PROPERTY OWNER is an STATE-1 corporation providing retail electric service in STATE-2, STATE-3, STATE-1, Utah, STATE-4 and STATE-5. The highest and best use of PROPERTY OWNER'S operating electric property is as a vertically integrated electric utility.

7. In Utah, PROPERTY OWNER is a cost regulated electric utility. The Utah Public Service Commission ("PSC") regulates PROPERTY OWNER'S operations. In Utah, PROPERTY OWNER is regulated by public service commissions in the other states in which it does business. PROPERTY OWNER'S integrated electric operations are regulated by the Federal Energy Regulatory Commission ("FERC")

8. PROPERTY OWNER has over 100 subsidiary companies. BUSINESS-1 its wholly owned subsidiary, PROPERTY OWNER ("Holdings"), PROPERTY OWNER holds the stock of numerous subsidiaries including BUSINESS-2(the largest of five distribution companies in CITY-1, COUNTRY-1) and PROPERTY OWNER (a financing company for commercial aircraft).

9. As of the lien date, January I, 1999, PROPERTY OWNER provided services to approximately 1.5 million customers.

10. PROPERTY OWNER'S last general rate case in Utah prior to the lien date was filed in 1990. A rate case was filed in Utah in 1998, with a test year of 1997. The 1998 rate case had not been decided prior to the lien date.

11. Since at least 1992, PROPERTY OWNER has filed Results of Operations Summaries with the PSC, in which PROPERTY OWNER reports its best estimate of various figures including rate base deductions, total rate base and Utah rate base. Generally, PROPERTY OWNER files a Results of Operations Summary semi-annually. (Ex. 39, 40.)

12. PROPERTY OWNER reported a total rate base of $$$$$ in its December 1998 Results Of Operations Summary. In the same Summary, PROPERTY OWNER reported a rate base deduction of $$$$$ for Accumulated Deferred Income Taxes ("DFIT"), and $$$$$ for Unamortized Investment Tax Credit ("ITC"). PROPERTY OWNER also reported an acquisition adjustment in its rate base. (Ex. 39.)

13. Since 1994, PROPERTY OWNER'S net cash flows have declined from $$$$$ to $$$$$ in 1998. (Exhibit 5 I, p. 40.) This is not inconsistent with numbers provided in Respondent's appraisal for 1994 and 1998 as listed in Exhibit 24, p.33 and Exhibit 30.

THE BUSINESS-3/PROPERTY OWNER MERGER

14. On December 6, 1998, PROPERTY OWNER signed an Agreement and Plan of Merger with BUSINESS-3 wherein they agreed that if all the necessary regulatory approvals could be obtained, they would merge by having PROPERTY OWNER exchange ##### share of its stock for ##### shares of

BUSINESS-3 American Depository Shares ("ADS") which would be listed on the New York Stock Exchange; or for ##### ordinary shares of the BUSINESS-3 listed on the London Stock Exchange. The parties to the merger anticipated that it would take more than one year for the merger to close. There was no collar placed on the exchange ratio and PROPERTY OWNER knew that there were substantial risks that the final price would change. PROPERTY OWNER ran various risk estimates in 1998 which indicated the final price would be well below $$$$$ per share. (Exhibit 118, p. 42) In addition, there was the risk that the exchange rate between the British pound and the U.S. dollar would affect the final value.

15. On or about DATE, the shareholders of PROPERTY OWNER voted to approve the proposed plan of merger.

16. By about DATE, FERC and all of the western states in which PROPERTY OWNER operates had given their approval of the proposed merger. Some of those approvals required various rate concessions from PROPERTY OWNER.

17. After the lien date at issue in this appeal, on or about DATE, the merger between BUSINESS-3 and PROPERTY OWNER was consummated.

18. In anticipation of the merger, PROPERTY OWNER supplied financial forecasts to BUSINESS-3. At the same time, PROPERTY OWNER prepared a financial forecast for its bond rating agencies ("Rating Agency Forecast.") (Ex. 118-119; Tr. Vol. V, pp. 1235-36, 1239.) PERSON-1, PROPERTY OWNER'S director of special projects, testified that the Rating Agency Forecast was the

company's best estimate and was reasonable. PERSON-1 testified that the Rating Agency Forecast was not optimistic because PROPERTY OWNER had to establish credibility with the rating agencies over time. (Tr. Vol. V, p. 1239.)

19. PROPERTY OWNER reported to its shareholders that the merger represented a premium of %%%%%, based on PROPERTY OWNER'S share price of $$$$$ on DATE. (Ex. 24, p. 46.)

THE 1999 PROPERTY TAX REPORT

20. On or about DATE, PROPERTY OWNER'S tax representative, PERSON-2, filed PROPERTY OWNER'S "Annual Report of Electric Utilities to the Utah State Tax Commission, Property Tax Division" ("1999 Property Tax Report"). PERSON-2 signed PROPERTY OWNER'S 1999 Property Tax Report under oath. (Ex. 21.) The 1999 Property Tax Report contained some preliminary pages from PROPERTY OWNER'S 1999 FERC form I, and various schedules prepared or compiled by PERSON-2 and his staff. (Ex. 21.)

21. PERSON-2 prepared page 11 of the 1999 Property Tax Report, which contained his estimate of PROPERTY OWNER'S rate base as of DATE. However, in preparing the report, PERSON-2 made an error on page 11. PERSON-2 estimated PROPERTY OWNER'S rate base to be $$$$$ as of DATE. This estimate included rate base deductions of $$$$$ for DFIT & ITC, which were incorrect. PERSON-2 did not attempt to verify that these amounts were deducted to arrive at rate base; instead, he relied on a schedule prepared and methodologies used by his predecessor, PERSON-3, for PROPERTY OWNER'S 1998 Property Tax Report, which also contained

a similar error.

22. Respondent relied on the incorrect information presented on page 11 of the 1999 Property Tax Report in determining the Original Assessment for the 1999 tax year.

23. PERSON-2 did not consult with any PROPERTY OWNER employees who were involved in regulatory reporting when he prepared page 11 of the 1999 Property Tax Report. PERSON-2 also did not review PROPERTY OWNER'S Results of Operations Summaries or PROPERTY OWNER'S complete FERC Form 1 when he prepared page 11. (Tr. Vol. I, p. 219; Tr. Vol. II, pp. 331, 336.)

24. The 1999 Property Tax Report did not contain sufficient information to verify PERSON-2 rate base estimate on page 11.Nothing in the 1999 Property Tax Report indicated that the DFIT as estimated by PERSON-2 was the incorrect amount. (Tr. Vol. II, p. 337-38.)

25. PERSON-2 testified that the Division could have determined the proper rate base through a thorough review of the complete FERC form l. However, the Division did not receive PROPERTY OWNER'S complete FERC form 1 until after it issued the Original Assessment. (Tr. Vol. I, pp. 130-131; Tr. Vol. II, pp. 337-338.)

26. Though the Division's property tax report form requests the company file "a complete copy of the Annual Report to ... the Public Service Commission", PERSON-2 did not include any of PROPERTY OWNER'S Results of Operations Summaries with the 1999 Property Tax Report. (Tr. Vol. II, p. 342, 345.)

27. After learning of the error in page 11 of PROPERTY OWNER'S 1999 Property Tax Report, the

Division looked at PROPERTY OWNER'S prior filings to determine whether similar errors had been made. (Tr. Vol. V, pp.1182-1183.)

28. The Division began making the DFIT deduction in the 1996 assessments, pursuant to a Commission decision. However, the Division did not require the taxpayer to file a Summary of Current Rate Base until the 1997 assessment year. (Tr. Vol. V, p.1180.)

29. The Division compared the 1996 assessment with PROPERTY OWNER'S Results of Operations Summary for year-end 1995. The Division also compared PROPERTY OWNER'S 1997, 1998 and 2000 Property Tax Reports, with PROPERTY OWNER's Results of Operations Summaries for the same years to determine whether the Division had over-deducted DFIT in those assessments. (Ex.49, 50.)

Value

30. The Division discovered that it had over-deducted DFIT each year since 1996 due to incorrect or incomplete reports filed by PROPERTY OWNER and asserts that this error resulted in understatements of property values of approximately $557 million. (Tr. Vol. V, pp. 1182-1187 & Ex. 110.)

31. After PERSON-4 deposition, the Division asked PROPERTY OWNER to file an amended 1999 Property Tax Report correcting page 11. As of the time of the Formal Hearing in this matter,

PROPERTY OWNER had not submitted an amended Property Tax Report for 1999 or any other tax year.

THE ORIGINAL ASSESSMENT

32. On DATE, Respondent issued the Original Assessment to PROPERTY OWNER. The

Original Assessment determined a system value of $$$$$, and a Utah taxable value of PROPERTY OWNER'S property of $$$$$. In making this determination, Respondent relied on the incorrect data listed on Page 11, as listed by PROPERTY OWNER in its 1999 Property Tax Report.

33. The Original Assessment was completed in a mass appraisal environment. The Division determined the system value in the Original Assessment on a unitary basis, using a yield capitalization income approach, a historical cost less depreciation approach ("HCLD") and a stock and debt market approach.

34. The Division derived the system value of $$$$$ through the following values and weighting:

REDACTED TABLE

35. The Division applied a Utah allocation factor of %%%%% to the system value to arrive at a Utah value before adjustments. The Division then deducted $$$$$ of exempt property, including intangibles, to arrive at the Utah taxable value.

APPRAISAL EVIDENCE

36. At the Formal Hearing, two expert appraisers were called and presented appraisals: PERSON-5 for PROPERTY OWNER; and PERSON-6 for Respondent.

37. While the Counties called witnesses to critique the appraisals of PERSON-5

and PERSON-6, the Counties did not submit an appraisal.

38. The comparison of the reconciled system values determined by the two appraisers, as listed in PERSON-6 Revised Appraisal and PERSON-5 Rule 62 Appraisal, are as follows:

REDACTED TABLE

I. PERSON-5 Appraisal

39. PERSON-5 prepared appraisals of PROPERTY OWNER'S operating property as of the January 1, 1999 lien date and testified at the Formal Hearing as an expert witness.

40. PERSON-5 prepared an appraisal, which purports to comply with Rule 62. ("Rule 62 Appraisal") In preparing his Rule 62 appraisal, PERSON-5 noted that he was taking a jurisdictional exception under the Uniform Standards of Professional Appraisal Practices ("USPAP") because he did not believe he could come to fair market value by applying subsection B.3.a. (2) of Utah Admin. Rule R884-24P-62 ("Rule 62") which relates to the calculation of the discount rate.

41. In addition PERSON-5prepared an "Addendum Supplement" to his appraisal. The main purpose of the Addendum Supplement was to re-calculate the weighted average cost of capital ("WACC") without regard to the restrictions of Rule 62, and apply that WACC to his income and

cost indicators. In the Addendum Supplement, PERSON-5 used the entire Ibbotson period for developing his equity risk premium. PERSON-5 also calculated several different cost of equity models, including an ex ante model. PERSON-5 did not place specific weight on any cost of equity model, nor did he place specific weight on the income and cost indicators.

42. The changes to the cost of capital in PERSON-5 Addendum Supplement also affected his cost approach because the cost of capital was used in PERSON-5 income shortfall method to determine obsolescence.

43. PERSON-5 prepared his appraisal by using three indicators of value: (I) a Historical Cost Less Depreciation ("HCLD") Model, (2) a Yield Capitalization Income Model, and

(3) a Stock and Debt Model.

44. The values determined by PERSON-5 for each of his models, and his final system values for PROPERTY OWNER’S taxable property are as follows:

TABLE REDACTED

45. The PERSON-5 appraisals did not include an inter-state allocation or an exempt property deduction.

A. PERSON-5 Cost Approach

46. PERSON-5 used an HCLD cost indicator to determine a cost approach value for the subject property. In applying this method PERSON-5 net plant estimate was $$$$$. PERSON-5 did not make any adjustments for Construction Work in Progress ("CWIP".) PERSON-5 did not subtract DFIT as a surrogate for external obsolescence as would have been allowed by Rule 62. Instead, PERSON-5chose to use the capitalized income loss method, otherwise referred to as an income shortfall method, to calculate external obsolescence. Under PERSON-5 income shortfall method, external obsolescence was based on the difference between PERSON-5 estimate of historical return on net plant (%%%%%) and his estimate of the "rate of return required by investors." PERSON-5 used his weighted average cost of capital ("WACC") as the "rate of return required by investors."

47. Based on a comparison of %%%%% return on net plant with the WACC of %%%%%, PERSON-5 estimated %%%%% external obsolescence in the Rule 62 Appraisal. In the Addendum Supplement, Petitioner determined the WACC was %%%%% and that the indicated economic obsolescence from this was %%%%%. PERSON-5 removed that percentage from the HCLD of $$$$$ to arrive at a cost indicator of $$$$$ in the Rule 62 Appraisal and

$$$$$ in the Addendum Supplement. (Ex. 51, p. 29.)

B. PERSON-5 Income Approach

48. PERSON-5 used two income indicators, which he referred to as Method No. l and Method No. 2. Income Method No. I assumed zero growth while Method No. 2 assumed a negative growth rate of %%%%% annually. (Ex. 51.) PERSON-5 applied the cost of capital in both income methods using the yield capitalization approach. (Ex. 51, p. 38-40.) PERSON-5 used the formula CF/(k-g) to derive his valuation estimate under the income approach. CF in the formula is cash flow, k is the cost of capital and g is the growth rate.

I. k (Cost of Capital)

49. In his Rule 62 Appraisal, PERSON-5 WACC was %%%%%; in the Addendum Supplement, the cost of capital was %%%%%. PERSON-5 determined these rates after considering both an equity rate and a debt rate. PERSON-5 determined the appropriate weight for these components was %%%%% debt, %%%%% preferred stock and %%%%% equity. However, the cost of debt and preferred stock were virtually the same so the end result was similar to PERSON-6 weighting of %%%%% debt and %%%%% equity. In addition, PERSON-5 made a flotation cost adjustment. In his appraisal, PERSON-5 used %%%%% as the cost of debt, the same rate as used by PERSON-6. In his Rule 62 Appraisal, PERSON-5 used a cost of equity rate of %%%%%. In the Addendum Supplement, PERSON-5 determined the market cost of equity was %%%%%.

50. The Commission rejects PERSON-5 Addendum Supplement for the reasons discussed in more detail below.

51. In his Rule 62 appraisal, PERSON-5 developed the %%%%% equity rate using the CAPM model. In his CAPM model he determined the appropriate risk free rate was %%%%%, the beta was ##### and the risk premium was %%%%%. PERSON-5 relied solely on his CAPM model to determine the equity rate in the Rule 62 Appraisal. In his Addendum Supplement, PERSON-5 did not disclose the weight he gave to his CAPM and other models in determining his equity rate.

52. One factor in PERSON-5 Rule 62 CAPM model is the risk free rate of %%%%% which he based on 20 year long term treasury bonds. The evidence supported PERSON-5 rate for this factor.

53. A second factor in PERSON-5 Rule 62 CAPM model is the risk premium of %%%%%. In his Rule 62 Appraisal, PERSON-5 based this rate on Ibbotson data for the 40-year period, as required by the Rule. In addition, PERSON-5 used the "income return" and not the "total return." The difference between total return and the income return over the 40-year Ibbotson period is approximately %%%%%. (Tr. Vol. V, pp. 1205-1206, Exhibit 112.) As is discussed more fully below, it is the Commission's conclusion that "income return" is the appropriate factor and for that reason concludes that the risk premium of %%%%% is the appropriate risk premium t0 apply in the CAPM model.

54. The third factor applied in the CAPM model is beta. PERSON-5 beta of ##### came from three calculations: (1) he considered over 80 electric utility companies, including the subject property; (2) he separately reviewed electric utility companies only located in the Western United

States; and (3) he reviewed Western electric utilities that did not have nuclear generating plants. PERSON-5 beta of ##### was fully supported by his appraisal.

55. PERSON-5 addition of a flotation cost adjustment to both his debt and equity rates increased his WACC by %%%%%. (Ex. 51, p. 51.)

56. Flotation costs should not be added to the discount rate since they relate to transaction costs as opposed to costs of capital. Moreover, as PERSON-7 noted, the flotation cost adjustment is small and the amount is uncertain. PERSON-7 testified as an expert in finance and appraising. To make such a small adjustment assumes a greater degree of accuracy in the cost of capital than is warranted. (Tr. Vol. V, pp. 1213-1214.) The Commission disallows the flotation cost.

2. Cash Flow/Growth

57. PERSON-5 testified that cash flows in the numerator must be properly matched with the growth in the denominator. PERSON-5 looked at two different methods or pairings of cash flow with growth. In his Method 1, PERSON-5 considered a cash flow of $$$$$ into perpetuity with zero growth. For Method 2, PERSON-5 used cash flows of $$$$$, paired with a negative growth rate of %%%%% annually. He apparently averaged the resulting number from the two methods to determine his income approach value.

C. PERSON-5 Market Approach

58. PERSON-5 performed a Stock and Debt Approach, but did not give it any weight. For the market indicator, PERSON-5 ignored the PROPERTY OWNER/BUSINESS-3 sale. PERSON-5 did not use the comparable sales method because he believed there were no truly comparable sales to the subject and it would be difficult, if not impossible, to adjust the data for all the differences between the subject property and the comparables. PERSON-8 testified that there were several inconsistencies with PERSON-5 stock and debt indicator. We disregard this indicator as determined by PERSON-5.

I. PERSON-6 Appraisal

59. PERSON-6 prepared a full narrative appraisal for the Property Tax Division ("Original Appraisal") (Ex. 24), which supported the Original Assessment. PERSON-6 testified at the Formal Hearing as an expert witness. PERSON-6 is employed by the Division. He is a registered appraiser in the state of Utah. He was responsible for the assessment work papers as well as the appraisal. PERSON-6 testified that he considered the appraisal to be the same as the original assessment, but with the inclusion of additional supporting information. PERSON-6 incorporated the Original Assessment schedules into the Appraisal, added a narrative, a certification page and various backup documents. The system value in PERSON-6 Original Appraisal is the same as that in the Original Assessment. Since the conclusions and schedules in the Original Appraisal and the Original Assessment are virtually identical, for purposes of this proceeding, they are the same

Appeal Nos. 99-0568 &
99-0622 valuation.

60. Because there had been an error in the information reported by PROPERTY OWNER To Respondent concerning DFIT, PERSON-6 prepared a supplement to his Original Appraisal, Wherein he adjusted his cost approach and final reconciled system value based on the corrected information. ("Revised Appraisal") PERSON-6 did not abandon the Original Appraisal. The Revised Appraisal was merely a technical correction of an undisputed error made by Petitioner in its 1999 Property Tax Report.

61. PERSON-6 prepared his appraisal, as supplemented, by using three indicators of value: (1) an HCLD Cost Model, (2) a Yield Capitalization Income Model, and (3) a Stock and Debt Model.

62. The values determined by PERSON-6 for each of his models, and his final taxable value are as follows:

REDACTED TABLE

A. PERSON-6 Cost Indicator

63. As directed by Rule 62, PERSON-6 relied on an HCLD cost indicator. The starting point of his HCLD is the book value of the total physical plant, including contributions in aid of construction ("CIAC").

64. As allowed by Rule 62, PERSON-6 deducted deferred federal income tax ("DFIT") from the cost indicator as a surrogate for economic obsolescence. (Ex. 24, p. 22.) PERSON-6 also deducted investment tax credits ("ITC") under the same theory. The resulting value from the cost approach as prepared by PERSON-6 was $$$$$ in the Revised Appraisal.

B. PERSON-6 Income Indicator

65. The Division used a Yield Capitalization Income Indicator. The formula for this indicator, as directed by Rule 62, is CF / k - g.

1. CF (Cash Flow)

66. The Division estimated PROPERTY OWNER'S 1999 cash flow to be $$$$$. As a starting point, Respondent looked at PROPERTY OWNER'S historical net operating income ("NOI") and projected a normalized 1999 NOI Respondent then made several adjustments to the normalized 1999 NOI to arrive at the 1999 cash flow estimate. PROPERTY OWNER had some extraordinary charges in 1997 and 1998. The Division adjusted PROPERTY OWNER'S I997 NOI using information taken from PROPERTY OWNER'S 1997 FERC Form I. PROPERTY OWNER had provided the Division with adjustments to be made to the 1998 NOI to account for these extraordinary charges. The Division accepted some of

PROPERTY OWNER'S suggestions and rejected others in making its adjustments for these extraordinary charges to arrive at its normalized 1999 NOI estimate. PERSON-2 provided different 1998 adjustment information to PERSON-5 than he did to the Division.

67. Because PROPERTY OWNER had an outstanding rate case on the lien date, the Division reduced its I 999 NOI estimate by $IO million to adjust for a possible rate reduction. The exact magnitude of any such rate reduction was not known or knowable on January 1, 1999.

2. k (WACC)

68. The Division estimated a weighted average cost of capital ("WACC") of 8%. The WACC was based on a cost of equity of %%%%%, a cost of debt of %%%%% and a market capital structure of %%%%% equity, %%%%% debt.

a. Cost of Equity

69. The Division's cost of equity was based on the capital asset pricing model ("CAPM"), and a Dividend Grov.1h Model ("DGM"). A risk premium model was considered but given no weight. The Division placed %%%%% weight on the CAPM and %%%%% weight on the DGM model.

70. CAPM: The Division's CAPM is based on an industry Beta of #####, an equity or market risk premium of %%%%%, and a risk free rate of %%%%%. In comparison, PERSON-5 used a beta of #####, an equity risk premium of %%%%% and a risk free rate of %%%%%. PERSON-6 risk free rate was not well supported. His equity risk premium was derived using the most recent forty years of data in the Ibbotson Yearbook and using the "total return" on long-term bonds. PERSON-5 used

the income return.

71. DGM: The Division's DGM of %%%%% was based on an analysis of projected earnings growth and projected dividend growth for seven comparable companies. The Commission concludes that the DGM as prepared by PERSON-6 is a relevant consideration and concludes that it should be weighted at %%%%% with PERSON-5 CAPM model, in determining the cost of equity.

b. Cost of Debt

72. For the cost of debt, PERSON-6 used a rate of %%%%%, which was the same rate used by PERSON-5.

3. g (Growth Rate)

73. The Division applied a growth rate of %%%%% in the formula CF/ k- g. The growth rate was based on an analysis of industry data regarding growth in operating revenue, NOI, gross cash flow, and net electric utility plant.

74. In its preliminary work papers, the Division had estimated a growth rate of %%%%%.

PERSON-2 pointed out a mathematical error in the growth rate calculation. The Division corrected the calculation prior to the Original Assessment, which reduced the growth estimate to .85%.

75. In addition to the growth study, the Division considered other growth factors based on industry data and data specific to PROPERTY OWNER. These additional factors included forecasts from Value Line relating to growth in revenue, NOI, gross cash flow and electric utility plant for the industry and for PROPERTY OWNER. All factors but one showed positive growth. Most of the factors

showed significantly higher growth than inflation, and all but one factor showed higher growth than the %%%%% rate used by the Division, which is lower than inflation. PERSON-6 testified that he considered growth factors such as gross utility plant and net utility plant. Net utility plant was apparently growing over the years at a rate of about %%%%% per year. Gross utility plant grew at %%%%% per year. PERSON-6 adjusted for certain extraordinary items and determined that NOI was growing at about %%%%% over the measured time period. It was PERSON-6 opinion that gross cash flow, NOI plus depreciation was growing at %%%%%. However, this growth includes all growth and is not limited to growth from existing assets.

C. PERSON-6 Market Indicator

76. The Division prepared a Stock and Debt market approach. The resulting value was $$$$$.

77. PERSON-6 testified that the Stock and Debt indicator was appropriate because the domestic electric operations represented a significant portion of PROPERTY OWNER’S publicly traded stock on the lien date, good data was available and intangibles were not an issue.

78. PERSON-6 estimated that the domestic electric operations of PROPERTY OWNER accounted for %%%%% of its publicly traded stock. PERSON-6 estimate of %%%%% was based on his analysis of four factors. Three of the factors used to allocate the common stock to the electric utility were used based on negotiations with PROPERTY OWNER’S tax representative and the fourth factor was added based on PERSON-2' request. The addition of the fourth factor had the effect of lowering the

allocation percentage slightly in the company's favor.

79. PERSON-6 did not specifically remove intangibles, especially business intangibles, in his stock and debt approach. However, he did remove the book intangibles from his system value. In addition, PERSON-6 conceded that several of his allocation factors were significantly impacted by nonrecurring items and that he had not made any adjustments for these items. In particular, the net sales and revenue, and the net earnings contribution factors were challenged. The Division either eliminated or significantly changed these factors for PROPERTY OWNER for the 2000 assessment. PERSON-6 also performed a merger analysis for the Division's Appraisal, but did not give it any weight. PERSON-6 used the merger analysis as a "sanity test" on his Stock and Debt indicator. PERSON-6 concluded, based on the merger analysis, the Division's value was conservative.

D. Correlation

81. PERSON-6 assigned %%%%% weight to cost, %%%%% to income, and %%%%% to stock and debt in reaching his value conclusion of $$$$$ in the Original Appraisal and $$$$$ in the Revised Appraisal.

E. Division's Revised Appraisal

82. On DATE, the Division prepared the Revised Appraisal after it learned of an error in PROPERTY OWNER'S 1999 Property Tax Report during the deposition of PERSON-4. The system value determined in the Revised Appraisal was $$$$$ compared with the original

value of $$$$$. The Utah taxable value in the Division's Revised Appraisal was $$$$$ as compared with $$$$$.

83. The Division obtained PROPERTY OWNER'S Results of Operations Summary for December 1998. From this information, the Division was able to determine the best estimate of the proper DFIT and ITC deductions made to arrive at rate base.

84. At the Formal Hearing, PERSON-2 acknowledged that page 11 of PROPERTY OWNER'S 1999 Annual Report did not accurately report the DFIT and ITC rate base deductions. (Tr. Vol. II, p. 329.)

D. PERSON-4, Director of Regulatory Policy for PROPERTY OWNER in the states of Utah, STATE-3 and STATE-5, acknowledged that the DFIT and ITC amounts in the Results of Operations Summary were reasonable estimates of the deductions made to arrive at rate base, and that those categories were generally not adjusted. (Tr. Vol. I, pp. 214-217.)

85. The Revised Appraisal changed the Cost Indicator to reflect the acquisition adjustment and the correct DFIT and ITC deductions. (Ex. 35.) The Cost Indicator in the Division's Revised Appraisal is $$$$$. This revised cost indicator was given %%%%% weight. PERSON-6 testified that the Revised Appraisal value of $$$$$ was his opinion of the fair market value of PROPERTY OWNER's operating property as of January 1, 1999, pursuant to Tax Commission rules and policies.

II. PERSON-9's Appraisal Review

86. PERSON-9, on behalf of the Counties, presented testimony regarding critiques he had of the Division's Appraisal. PERSON-9 made changes to the Division's Appraisal to reflect his critiques. PERSON-9 testified that after such changes, the system value of PROPERTY OWNER should be $$$$$. (Ex. 79.)

87. PERSON-9 agreed in substance with the Division's stock and dept approach, but believed it to be conservative. PERSON-9 also concurred that the market data relevant to the BUSINESS-3 merger showed no economic obsolescence in PROPERTY OWNER'S property. PERSON-9 agreed that the price of PROPERTY OWNER'S stock at the time of the announcement of the merger and approval by the two boards of directors was relevant for purposes of the subject appraisal. (Tr. Vol. III, pp. 759, 763.)

88. The price of PROPERTY OWNER stock under the terms of the merger as announced

reflected the value determined through negotiations and the research of investment bankers. PERSON-9 testified that after the announcement of the merger, the price of PROPERTY OWNER'S stock became less relevant to the valuation of PROPERTY OWNER'S property because it reflected investors' valuation of the soon to be merged entity of PROPERTY OWNER and BUSINESS-3. (Tr. III, p. 763.)

89. PERSON-9 testified that the cost indicator of value in PERSON-6 appraisal contained an error in that PERSON-6 excluded the "replacement" portion of PROPERTY OWNER'S taxable construction work in progress ("CWIP"). PERSON-9 testified that Rule 884-24P-20 requires that

all CWIP be included and assessed.

90. PERSON-9 also testified that "replacement" CWIP increases rate base. Consequently, the utility's regulatory income increases because the property being replaced is fully depreciated. It was PERSON-9's opinion that all property contributing to rate base should be included because, pursuant to Rule 62, the cost indicator is grounded on rate base. The Commission finds, however, no persuasive evidence to support this conclusion. The preponderance of the evidence indicated that including replacement CWIP with the original assets in place results in double counting.

91. Finally, PERSON-9 critiqued PERSON-6income approach. Essentially he provided several alternative cash flow scenarios, the primary differences being higher NOI, higher depreciation, and lower replacement capital expenditures. (TR Vol. III, pp. 774-8) These figures, although they were more closely tied to PROPERTY OWNER'S actual numbers tended to mix "representative years" for NOI with 5 year ratio's for depreciation and replacements. This mixing tends to belie the fact that PROPERTY OWNER'S actual cash flows have been decreasing in the recent past. It also raises the same difficulty observed in PERSON-6 analysis, as discussed below, of justifying increasing cash flows in the presence of a decreasing rate base.

92.PERSON-9 testified that he had not done an appraisal, and was not giving an opinion of value other than what he believed PERSON-6 appraisal would have shown had certain perceived errors been corrected.

93. PERSON-9, in his critique of the PERSON-6 appraisal, testified that he performed an obsolescence "inquiry" (as opposed to a formal study), and relied, to some extent, on PERSON-11 study. We find his analysis to be unpersuasive, and insufficient to reject the use of the DFIT adjustment for economic obsolescence.

94. The primary thrust of PERSON-9's testimony was that the Division had erred in being too conservative. Many of PERSON-9's criticisms fall within the area of appraiser judgment. (Tr. Vol. III, pp. 781-784.) Thus, the Commission finds that the counties have not met their two-pronged burden proof. The Counties have failed to show that the Division's Revised Appraisal is in error or provide a sound evidentiary basis to increase the Revised Appraisal value.

COMMISSION'S APPRAISAL CONCLUSIONS

I. Income Approach-Yield Capitalization Method CFHk-g)

A. Growth/Cash Flow

95. One of the factors that contributed to the value difference between PERSON-5 and PERSON-6 appraisals was the growth rate. PERSON-5 maintained that PROPERTY OWNER was not growing and considered two income methods, one with a zero growth rate and one with a negative growth rate of %%%%%. PERSON-6 applied a growth rate of %%%%%. It was PERSON-5's testimony that PERSON-6 had mismatched his cash flow with the growth rate, in effect, using a model where cash flow was increasing forever into perpetuity when the rate base was decreasing.

96. PROPERTY OWNER projected positive future grov.th. In late 1998, PROPERTY OWNER's representative stated in a public company news release "that by refocusing its operations it can achieve its five-year target of %%%%% average growth in earnings per share, starting in the year 2000." The financial forecast given to BUSINESS-3 projected %%%%% future growth in cash flows. (Tr. Vol. V, pp. 1235-1236, Ex. 119.) The Rating Agency Forecast projected %%%%% future growth in cash flows. (Tr. Vol. V, p. 1237, Ex. 119.) However, these projections include new growth along with growth from assets in existence on the lien date or their replacements.

97. While the Rating Agency Forecast assumed 1.89% annual growth from 1999 forward for PROPERTY OWNER'S Electric Segment, it also assumed annual growth in net investment of less than 2/10 of a percent. (Ex. 119.)

98. Petitioner's net cash flows have declined from $821 million in 1994 to $$$$ in 1998. This fact was not disputed by Respondent and was in fact supported by numbers for 1994 and 1998 provided in PERSON-6 appraisal.

99. PERSON-1, who was PROPERTY OWNER'S Managing Director of Financial Planning and Analysis during 1998, testified that "it would be impossible to hold your cash flows constant long term while your rate base is declining. It is just a matter of time until you end up having a price decrease to keep you at your allowed rate of return." (Tr. Vol. V, p. 1317) His testimony supported PERSON-5 no growth position.

100. The industry growth figures presented by Respondent did not purport to identify growth only from existing assets. Rather, they also included growth from expansion. The "growth" factor in the yield capitalization formula is growth from the assets in existence on the lien date or their replacements. After weighing the evidence presented by all parties on the issue of growth, it is the Commission's position that the appropriate growth rate is the zero, or no growth, which was PERSON-5 conclusion: We find that a negative growth rate used by PERSON-5 in his alternative calculation is untenable for a perpetuity property such as a utility.

101. The cash flow factor in the yield capitalization formula was another substantial area of differences between the two appraisers. In his no growth method, PERSON-5 determined that the appropriate cash flow was $$$$$. In his negative growth method, PERSON-5 cash flow was significantly higher, however, the Commission rejects that method. In his appraisals, PERSON-6 used a cash flow of $$$$$ in his yield capitalization formula. After review of the appraisals and supporting evidence, it is the conclusion of the Commission that the appropriate cash flow is the $$$$$. This figure appeared to be a better reflection of stabilized income.

Implicit in PERSON-6 appraisal is the assumption that rate base is declining while cash flow is increasing.

B. WACC

I02. Another difference between the two appraisals was the weighed average cost of Capital, or WACC. PERSON-5 used his WACC both to calculate his income approach and to

determine economic obsolescence in the cost approach. In the appraisal prepared by Respondent, PERSON-6 determined that the appropriate WACC was %%%%%. In his appraisal which purported to comply with Rule 62, PERSON-5 had used a WACC of %%%%%. In his Addendum Supplement, whose main purpose was to re-calculate the WACC without regard to Rule 62, PERSON-5 applied a cost of capital of %%%%%.

103. The Commission determines that for the lien date at issue in this appeal, the appropriate Ibbotson period is the 40 year period as provided in Rule 62. No party carried the burden of demonstrating that the 72 year Ibbotson period was superior to the 40 year period 'Moreover, the 40 year period has been used by the Division for other centrally assessed tax payers for the tax year 1999. 'The Commission reaffirms its use for this taxpayer for 1999, For this reason the Commission rejects PERSON-5 Addendum Supplement.

104. One component of the WACC is the equity rate. The CAPM method is a common method for determining the equity rate. In his Rule 62 Appraisal, PERSON-5 equity rate of %%%%% is developed solely from the CAPM method. PERSON-5 factors in the CAPM model are a beta of #####, a risk free rate of %%%%% and a risk premium of %%%%% PERSON-6 equity rate of %%%%% comes primarily from his CAPM method, although he considered other methods including the DGM method. PERSON-6 gave %%%%% weight to the CAPM and %%%%% to the DGM method in determining an equity rate of %%%%%.

a. In comparing the risk premium of %%%%% in PERSON-5 Rule 62 Appraisal with

PERSON-6 risk premium of %%%%%, a substantial portion of the difference can be attributed to the "income return" versus the total "return factor." It is the Commission's decision that the risk premium should be based on "income" rather than "total" return and that it should adopt PERSON-5 CAPM model.

b. PERSON-5 better supported his risk free rate than. PERSON-6, although the difference between the two is minimal. PERSON-5 beta was also well supported.

105. As discussed above, the Commission concludes that each of PERSON-5, three factors in the CAPM model were well supported and it is the Commission's conclusion that his CAPM value is more appropriate than the CAPM value derived by PERSON-6. However, the commission concludes that PERSON-6 DGM of %%%%% is also a relevant indicator which should be considered and given some weight. Like PERSON-6, the Commission allocates the weight with %%%%% to the CAPM of %%%%% and %%%%% to the DGM of %%%%%. The result is an equity rate of %%%%%.

106. The other component of the WACC is the cost of debt. The Commission accepts, and both parties agree, that the appropriate cost of debt is %%%%%.

107. In weighting the cost of equity and the cost of debt to determine the WACC, PERSON-6 used a weight of %%%%% equity and %%%%% debt, while PERSON-5 used %%%%% debt, %%%%% common equity and %%%%% preferred stock. However, PERSON-5 preferred stock rate and debt rate were identical. PERSON-10 who provided expert testimony concerning finance and economic issues related to appraisal practices, supported PERSON-6 weighting and Mr.

PERSON-5 approach has essentially the same result. The Commission concludes that the cost of debt should be weighted at %%%%% while the cost of equity should be weighted at %%%%%, Applying the Commission's cost of equity of %%%%%, the undisputed cost of debt of %%%%% to this weighting results in a WACC of %%%%%.

I 08. As noted earlier in the decision, the Commission rejects the flotation costs.

I 09. Using the values determined to be correct by the Commission, the yield capitalization formula is $$$$$$ / (8.26% - 0). The resulting income approach value for the company using the yield capitalization method is $$$$$.

II. Cost Approach

A. Historic Cost Less Depreciation ("HCLD")

110. PERSON-5 determined that the historic cost for the subject property was $$$$$$ From this he subtracted depreciation in the amount of $$$$$ and added $$$$$$ for materials and supplies, $$$$$ for "other," and $$$$$ for construction work in progress ("CWIP") for a net plant estimate of $$$$$. PERSON-6 determined that the historic cost for the subject property was $$$$$. From this number he deducted $$$$$ in deprecation and added $$$$$ for CWJP. From these numbers his net plant would be $$$$$ which is fairly close to PERSON-5 number for net plant.

111. The Commission concludes that PROPERTY OWNER has failed to prove its value for net plant is superior to PERSON-6 value.

B. Obsolescence

112. Since the net plant value was similar between the two appraisers, the significant difference in the cost approach value presented by PERSON-5 and by PERSON-6 was the amount of economic or external obsolescence. PERSON-5 used an income shortfall approach to determine external obsolescence in the amount of $$$$$ in his Rule 62 appraisal. As provided by Rule 62, PERSON-6 subtracted DFIT and ITC in the amount of $$$$$. When subtracted from their net plant estimates the appraisers cost approach values are $$$$$ for PERSON-5 and $$$$$ for PERSON-6.

113. Though the Division removed DFIT from its cost indicator, in compliance with the directives of Rule 62, it also performed an obsolescence study, as allowed by Rule 62. PERSON-11 performed the obsolescence study based on the BUSINESS-3/PROPERTY OWNER merger, the terms of which were agreed upon by the boards of directors and announced on DATE, and an analysis of other electric sales and mergers. At the time of the hearing, PERSON-11 was the Assistant Director of the Property Tax Division with primary responsibility for the annual assessment of centrally assessed properties.

114. The transactions PERSON-11 analyzed showed· that the subject property and similar properties have traded at market-to-book ratios higher than one. This means the properties traded for more than net book value. Thus, PERSON-11 concluded that PROPERTY OWNER'S property was not suffering from any economic obsolescence on the lien date. However, the Division requested that

the study be considered for future tax periods and did not request that the Commission disallow the obsolescence adjustment based on DFIT for the year at issue in this appeal.

115. PERSON-9 prepared an "Obsolescence Inquiry," and testified to the absence of any external obsolescence in light of the recent BUSINESS-3 merger. It was his conclusion that there was no indication of obsolescence.

116. PERSON-12, a consulting engineer, who testified on behalf of the counties, found no evidence of economic impairment of the PROPERTY OWNER'S assets below net book value. PERSON-12 opined that any economic impairment of PROPERTY OWNER'S property was the result of internal factors such as PROPERTY OWNER'S non-core business and management decisions. (Tr. Vol. IV, p. 930- 947.) PERSON-12 concurred with PERSON-11 obsolescence study which was based on market data that showed PROPERTY OWNER'S assets would sell above net book value. (Tr. Vol. IV, pp. 954-1016.) He testified that market to book ratios for recent sales of the type of property at issue (non-nuclear generation property) are greater than 1 (100%). According to PERSON-12, the circumstances translated to a complete lack of economic obsolescence for Utah property. He had personally visited PROPERTY OWNER'S Utah power plants and it was his opinion that PROPERTY OWNER'S Utah properties were not impaired. PERSON-12, however, also testified that PROPERTY OWNER on the whole may well suffer from economic obsolescence. He stated, "if you find economic depreciation for PROPERTY OWNER as a whole, it is not attributable to the tangible property assets in the state of Utah." He testified that the way to segregate the obsolescence would be to value the Utah sited assets separately from the system-wide

assets; in other words to abandon the use of the unitary valuation method. PERSON-12 further stated that he was critical of the unitary valuation method as opposed to the Utah unit for PROPERTY OWNER. (TR Vol.IV. pp. 1 023-3 7)

117. PERSON-5 income shortfall fails to distinguish between internal and external factors. An external obsolescence calculation should not consider internal factors, such as management prerogative and control. (Tr. Vol. III, p. 813.)

118. PERSON-13 testified that there were theoretical and application problems in PERSON-5 income shortfall method. (Tr. Vol. IV, p. 1095.) PERSON-8 is an appraiser with 27 years of experience who was qualified as an expert and gave expert testimony concerning his review of PERSON-5 appraisal. PERSON-8 stated that the income shortfall method is a derivative of what real estate appraisal texts call the capitalized rent loss procedure, but is not the same thing. The capitalized rent loss procedure focuses on a comparison of two properties, one property with the obsolete feature and the other property without. Based upon this comparison, the capitalized rent loss method determines the difference between the properties and their rents, expenses, or cash flows and capitalizes that difference. (Tr. Vol. IV, pp. 1095-1096.) PERSON-5 income shortfall method differs from the capitalized rent loss method, because he does not compare properties. (Tr. Vol. IV, p. 1096.) Accordingly, he can point to no specific condition, event, or factor that gives rise to his claimed economic obsolescence.

119. PERSON-8 stated that the preferred method of determining economic obsolescence is a market or sales comparison analysis, which looks at market-to-book ratios. If the market-to-book ratio of comparable sales is greater than one, there is no external obsolescence. (Tr. Vol. IV, pp. 1097-1098.) PERSON-8 noted that it is incorrect to conclude that if you have not adjusted the HCLD for economic obsolescence, you have assumed there is no economic obsolescence. In reality, there may be economic obsolescence, but it may be already subsumed within the book depreciation. (Tr. Vol. IV, pp. 1098-1099.)

120. PERSON-8 further illustrated the circularity of the PERSON-5income shortfall approach by showing that the cost approach and the income approach in the Addendum Supplement changed by the exactly the same 8.7%. (Tr. IV, pp.1106-1107, Exhibit 99.)

121. PERSON-10 also agreed that a sales comparison method of measuring economic obsolescence is preferred. The sales comparison method focuses on market information or outside factors. According to PERSON-10, the income shortfall method is more likely to measure internal factors, and is, therefore, less reliable. (Tr. III, pp. 818, 821.) It was his testimony that PERSON-5 appraisal combines forward looking cost of capital with historic actual rates which is internally inconsistent.

122. Based on the evidence and testimony from the experts, the Commission rejects the income shortfall method as prepared by PERSON-5 for determining economic or external obsolescence and adopts the cost approach which was prepared by PERSON-6 in his Revised

Appraisal.

123. PERSON-12 testified that there was no evidence of economic obsolescence in the Utah assets. He acknowledged the possibility that PROPERTY OWNER'S assets as a whole may suffer from economic obsolescence. To the extent, PERSON-12's testimony repudiates the use of a unitary methodology, we must reject it. The use of the unitary method to value properties like PROPERTY OWNER is well established in Utah and has been frequently upheld by our courts. It may be theoretically possible that economic obsolescence can be identified with regard to specific assets, even in the context of a unitary valuation. There may be other situations where economic obsolescence is system-wide and, under the unitary method, some of that obsolescence would be appropriately attributable to Utah. Thus, PERSON-12's testimony that specific Utah assets suffered no economic obsolescence is not dispositive of the issue.

III. Market Approach-Stock and Debt

124. Both appraisers considered a stock and debt approach. In his approach, PERSON-5 determined that the value based on a stock and debt market approach was $$$$$. However, he gave this value indicator no weight and testified that it should not be considered in determining the market value for the subject property. PERSON-6 determined that the value for the PROPERTY OWNER'S taxable assets using the stock and debt approach was $$$$$. He gave this value indicator %%%%% weight in the overall value correlation.

125. The Division used the stock and debt approach in the valuation of only one other cost

regulated utility property for the 1999 tax year. For that property, the stock and debt indicator was given only %%%%% weight.

126. PERSON-12, testified that appraisers in the East did not typically use the stock and debt approach. He had stated during his deposition and during the hearing acknowledged and agreed with the statement that, "Typically our tribunal courts have found the volatility has just been too great to use -- to use it for the underlying value of real property assets, and has been virtually wiped out east of the Mississippi." (Tr. Vol. V. Pp.982-983.)

127. The Commission concludes from the evidence presented that the stock and debt approach.as applied to PROPERTY OWNER should be given no weight.

IX. Correlation

128. The Commission has determined that the correct value from the cost approach is $$$$$, the correct value from the income approach is $$$$$, and that no weight should be given to the stock and debt approach. PERSON-5 gave his cost approach value %%%%% weight and his income approach value %%%%% weight. PERSON-6 gave more weight to the cost approach than the income, with %%%%% to the cost approach, %%%%% to the income approach and %%%%% to stock and debt.

129. The Commission finds that it is appropriate based on the evidence, including PERSON-6 appraisal, to give more weight to the cost approach in correlating its final value for PROPERTY OWNER'S taxable property. We note that Rule 62 gives a preference for the cost approach in rate

based utility properties. The Commission allocates the percentage PERSON-6 had allowed for stock and debt on a pro rata basis to the other two approaches as weighted by PERSON-6. The result is a weight of %%%%% for the income approach and %%%%% for the cost approach.

130. Based on this correlation, the Commission concludes that the value of the subject property for the 1999 lien date is $$$$$. The Utah allocation factor of 36. %%%%% was not disputed. This indicates a value for the Utah taxable assets of PROPERTY OWNER, before adjustments, of $$$$$. According to the formula used by the Division in calculating the adjustment for Utah exempt property, the adjustment, based on a system value of $$$$$, is $$$$$. Petitioner did not dispute Respondent's methodology on this point. When the exempt property is subtracted from the Utah value, the Utah taxable value is $$$$$.

APPLICABLE LAW

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

All 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.

The Utah Constitution also requires the Legislature to enact provisions to equalize the tax burdens. Article XIII, Section 3(1) provides in relevant part:

> (1) The Legislature shall provide by law a uniform and equal rate of assessment on all tangible property in the state, according to its value in money, except as otherwise provided in Section 2 of this Article. The Legislature shall 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 ....

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

> 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.

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

> (I) By May I of each year the following property ... shall be assessed by the commission at 100% of fair market value, as valued on January I, in accordance with this chapter: (a) all property which operated 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;
>
> (5) Property assessed by the unitary method, which is not necessary to the conduct and does not contribute to the income of the business as determined by the commission, shall be assessed separately by the local county assessor.

Utah Code Ann. §59-2-102(9) 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, and includes the adjustment for intangible values under Sections 59-2-304 and 59-2-201 for real property assessed by the county assessor or the commission.

The Legislature has also defined the term "property" for purposes of property tax assessment. Utah Code Ann. §59-2-102(23) (1999) provides in part:

(23)(a) "Property" means property that is subject to assessment and taxation according to its value.
(b) "Property" does not include intangible property as defined in this section.

I 0. The Commission has adopted Utah Administrative Rule R884-24P-62 (Rule 62) for the valuation of state assessed properties. The rule defines "depreciation" as follows:

3. "Depreciation" is the loss in value from any cause. There are two distinct types of depreciation encountered in the appraisal of properties subject to this rule: accounting depreciation and appraisal depreciation. Accounting depreciation is often called "book depreciation" and is generally calculated in accordance with generally accepted accounting principles or regulatory guidelines. Appraisal depreciation is the total loss in property value from any cause. There are three recognized types of appraisal depreciation: physical deterioration, functional obsolescence and external obsolescence. Physical deterioration is the physical wearing out of the property evidenced by wear and tear, decay and structural defects. Physical deterioration includes the loss in value due to normal aging. Functional obsolescence is the loss in value due to functional deficiencies or inadequacies within the property depicted as the inability of the property to perform adequately the functions for which it was originally designed. External (economic) obsolescence is the loss in value from causes outside the boundaries of the property and is generally incurable. Appraisal depreciation is often called "accrued depreciation."

Utah Administrative Rule R884-24P-62 (B) establishes valuation principles relevant here as follows:

A. General Valuation Principles. State assessed utility and transportation properties shall be assessed at fair market value for property tax purposes based on generally accepted appraisal theory and the provisions of this rule.
I. Taxable Property and Unit Methodologies. All taxable property, as defined in this rule, is subject to assessment, and if the property operates together as a unit, the assemblage or enhanced value attributable to the taxable property operating together should be included in the assessed value. The value attributable to intangible property must, when possible, be identified and removed from value when using any valuation

method and before that value is used in the correlation process.

a. The preferred methods to determine the fair market value for all state assessed utility and transportation property are a cost indicator and a yield capitalization income indicator.

b. Other generally accepted appraisal methods may also be used when it can be demonstrated that such methods are necessary in order to more accurately estimate the fair market value, which includes assemblage or enhanced value, of properties that operate together as a unit.

c. The direct capitalization income method and the stock and debt market method may tend to capture the value of intangible property, as defined in this rule, at higher levels than other methods. To the extent such intangible property cannot be identified and removed, relatively less weight shall be given to such methods in the correlation process.

d. No final estimate of value will be imposed or considered unless the weighting percentages of the various value indicators used to correlate the final estimate of value are disclosed in writing. Disclosure of the weighting percentages also includes a written explanation describing why a party weighted the particular indicators of value by the percentages so indicated. e. A party may challenge a final estimate of value by proposing changes to the application of a methodology, by proposing a different valuation methodology or weighting formula, or by presenting any other evidence or argument that establishes a more accurate final estimate of value. A challenge to a final estimate of value will be considered effective only if the proposed valuation methodology or weighting formula demonstrates, by a preponderance of the evidence, that it establishes a more accurate estimate of fair market value.

2. Cost Indicator. Cost is relevant to value under the principle of substitution, which states that no prudent investor would pay more for a property than the cost to construct a substitute property of equal desirability and utility without undue delay. Generally a cost indicator may be developed under one or more of the following approaches; replacement cost new less depreciation ("RCNLD"), reproduction cost less depreciation ("Reproduction Cost"), and historic cost less depreciation ("HCLD").

a. RCNLD. Replacement cost is the estimated cost to construct, at current prices, a property with utility equivalent to that being appraised, using modem materials, current technology and current standards, design, and layout.

b. Reproduction Cost. Reproduction cost is the estimated cost to construct, at current prices, an exact duplicate or replica of the property being assessed, using

c. the same materials, construction standards, design, layout and quality of workmanship, and

embodying all the deficiencies, superadequacies, and obsolescence of the subject property. Reproduction cost shall be adjusted for appropriate depreciation.

d. HCLD. The HCLD approach is the historic cost less depreciation. Depending upon the industry, it may be appropriate to trend HCLD to current costs. Only trending indexes commonly recognized by the industry may be used as a trending adjustment to HCLD.

e. In the mass appraisal environment for state assessed utility and transportation property, RCNLD is impractical to implement. The preferred cost indicator of value is HCLD. A party may challenge the use ofHCLD by proposing a different cost indicator that establishes a more accurate cost estimate of value. A challenge to the use of HCLD as the cost indicator of value will be considered effective only if the proposed cost indicator of value demonstrates, by a preponderance of the evidence, that it establishes a more accurate cost estimate of value.

3. Income Indicator. An income indicator recognizes that value is created by the expectation of future benefits to be derived from the property.

a. Yield Capitalization Approach. This income indicator shall be determined by converting future cash flows to present value as of the lien date by capitalizing future estimated cash flows at an appropriate discount rate. The yield capitalization formula is CF/(k-g), where "CF" is cash flow, "k" is the nominal, risk adjusted discount rate, and "g" is the expected future growth of the cash flow in the numerator. Each of these terms is defined below. A discounted cash flow method in which (i) individual years' cash flow are projected, (ii) the formula CF/(k-g) is used to compute terminal value, and (iii) the projected cash flows and terminal value are discounted back to present value; may be used as a substitute income valuation approach for the above yield capitalization approach when the use of a single representative annual cash flow is clearly inappropriate. (1) Cash Flow ("CF"). Cash flow is restricted to cash flows provided by the operating property in existence on the lien date, together with any replacements intended to maintain, and not expand or modify, the existing capacity or function thereof. 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 net working capital necessary to achieve the expected growth "g". The cash flows should reflect the cash flows available to pay sources of financing for the assets in existence on the lien date or an equivalent pool of assets. The capital expenditures should include only those expenditures necessary to replace or maintain existing plant and should not include any expenditures intended for expansion or productivity and capacity enhancements. If a taxpayer is unable to separate replacement capital expenditures with reasonable accuracy from expansion capital

expenditures, the taxpayer must provide the Property Tax Division sufficient data to adjust the "g" in the yield capitalization formula appropriately. If the taxpayer is unable to provide data to adjust the "g", the Property Tax Division will estimate an adjustment to cash flows or "g" based on the best information available, including industry specific cost indices. Information necessary for the Property Tax Division to calculate the appropriate cash flow shall be summarized and submitted to the Property Tax Division by March 1 on a form provided by the Property Tax Division. The calculation of Cash Flow may be illustrated by the following formula: CF= NOI
+ Non-cash Charges - Replacement Capital Expenditures -Additions to Net Working Capital
(a) Cash flow is the projected cash flow for the next year and may be estimated by reviewing the last five years' cash flows, forecasting future cash flows, or a combination of both....
(2) Discount Rate ("k"). The discount rate shall be based upon a weighted average cost of capital considering current market debt rates and equity yields determined by recognized market measurements such as capital asset pricing model ("CAPM"), Risk Premium, Dividend Growth models, or other recognized models. The weighting of debt and equity should reflect the market value weighting of comparable companies in the industry.
(a) Cost of Debt. The cost of debt should reflect the current market rate (yield to maturity) of debt with the same credit rating as the subject company.
(b) Cost of Equity. In the discount rate, the CAPM is the preferred method to estimate the cost of equity. More than one method may be used to correlate a cost of equity, but only if the CAPM method is weighted at least 75% in the correlation.
(c) CAPM. The CAPM formula is k(e) = R(f) + (Beta x Risk Premium), where k(e) is the cost of equity and R(f) is the risk free rate.
(i) Risk Free Rate ("R(f)"). The risk free rate shall be the current market rate on 20 year Treasury bonds.
(ii) Beta. The beta should reflect an average or value-weighted average of comparable companies. The beta of the comparable companies should be drawn from Value Line or a comparable source. Once a source is chosen, beta should be drawn consistently from this source. However, the beta of the specific assessed property should also be considered.
(iii) Risk Premium. The risk premium shall be obtained from the current Ibbotson Associates study. The risk premium shall be the arithmetic average of the spread between the return on stocks and long tenn bonds for the most recent 40 years.

(3) Growth Rate ("g"). The growth rate "g" is the expected future growth of the cash

flow in the numerator of the formula given in CF/(k-g). If insufficient information is available to the Property Tax Division, either from public sources or from the taxpayer, to determine an appropriate "g", then "g" will be the expected inflationary rate as given by the Gross Domestic Product Price Deflator obtained in Value Line.

b. Direct Capitalization Approach. This is an income approach that converts an estimate ofa single year's income expectancy into an indication of value in one direct step, either by dividing the normalized income estimate by an appropriate income capitalization rate or by multiplying the normalized income estimate by an appropriate factor. ...

5. Correlation. When reconciling value indicators into a final estimate of value, the appraiser shall take into consideration the availability, and quality or reliability of data and the strength and weaknesses of each value indicator. The percentage weight assigned to each indicator in the correlation process shall be established, disclosed and explained as set forth in Section B.l.

6. Non-operating property. Property that is not necessary to the operation of the state assessed utility or transportation properties and is assessed by the local county assessor, and property separately assessed by the Property Tax Division, such as registered motor vehicles, shall be removed from the correlated unit value or from the state allocated value.

7. Leased property. All tangible operating property owned, leased, or used by state assessed utilities and transportation companies is subject to assessment.

8. Property Specific Considerations. The Commission recognizes that because of unique differences between certain types of properties and industries, modifications or alternatives to these general cost and yield income indicators, as set forth in Sections C., D., and E., may be required for the following industries: (a) cost regulated utilities, (b) telecommunications properties, and © transportation properties.

A. Cost regulated utilities:

I. Cost Indicator. The HCLD approach 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. The HCLD approach is calculated by taking the historic cost less depreciation as reflected in the state assessed utility's net plant accounts, and by then (1) subtracting intangible property, (2) subtracting any items not included in the state assessed utility's rate base (e.g., deferred federal income taxes ("DFIT") and, if appropriate, acquisition adjustments), and (3) adding any taxable items not included in the state assessed utility's net plant account or in rate

base.

a. Deferred Federal Income Taxes. DFIT is an accounting entry that reflects a timing difference for reporting income and expenses. Accumulated DFIT 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 DFIT from rate base, recognizing it as ratepayer contributed capital. Where rate base is reduced by DFIT for rate base regulated companies, DFIT may be removed from HCLD as one type of economic obsolescence.

b. DFIT can be one type of economic obsolescence. If a study is prepared that authenticates actual economic obsolescence and is approved by the Commission, the amount of the actual economic obsolescence will be subtracted from HCLD to develop the cost indicator of value.

2. Income indicator. The yield capitalization approach set forth in Section B.3. is the preferred method to derive the income indicator of value

CONCLUSIONS OF LAW

1. Petitioners have the burden of proof to have the value lowered below the assessed value. 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 assessment, then must provide a "sound evidentiary basis" upon which the Commission can adopt a lower value. Utah Power & Light Co. v. Tax Comm'n, 590 P2.d. 332,335 (Utah 1979).

2. Clearly the Divisions' Original Assessment and Original Appraisal 2re entitled to the presumption of correctness. In addition, the Commission finds that the Division's Revised Appraisal is also entitled to that presumption of correctness, as the Revised Appraisal is merely a technical correction of the Original Assessment to compensate for a reporting error made by Petitioner.

3. The Commission concludes that based on the weight of the evidence presented, PROPERTY OWNER has met its burden of proof for some of the issues, while for other issues, the Petitioner has not met this burden. Identification and discussion of each issue is set forth in the Findings of Fact above and the Analysis below.

ANALYSIS

I. Cost Approach

A. Economic Obsolescence

Economic obsolescence is "the loss in value from causes outside the boundaries of the property and is generally incurable." Utah Admin. Code R884-24P-62.A.3 As directed by Rule 62, the Division deducted DFIT from its cost approach as a surrogate for economic obsolescence. PERSON-5 deducted obsolescence from his cost approach under the income shortfall method. As noted in our Findings of Fact, the Commission finds that the appropriate cost indicator of value is

$$$$$, as determined by PERSON-6in Ex. 35. The Commission rejects the income shortfall method for determining obsolescence as was presented by PERSON-5. We note that the only substantive difference between PERSON-5 and PERSON-6 cost approach is the issue of economic obsolescence.

In two recent cases, the Commission also looked at income shortfall for determining obsolescence and in both cases the Commission rejected the approach. See Kern River Gas

Transmission Co. v. Property Tax Division, Appeal No's. 99-0513, 99-0635; Skyline Telecom et al v. Property Tax Division, Appeal No's. 97-0948 etc. In both Kern River and Skyline Telecom we quoted United Telephone Co. of the Northwest, Inc. v. Department of Revenue, 770 P.2d 43 (Or 1988) which rejected the income shortfall method. The United Telephone 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 STATE-1 Supreme Court went on to say that adjusting one approach to make it rely on another approach "effectively eliminates a relevant perspective from consideration." Id.

In rejecting the income shortfall method, we do not hold that economic obsolescence cannot exist. Rather, we reject PERSON-5 method of testing for obsolescence. Rule 62 clearly contemplates that the appraiser test for obsolescence. However, rather than using the income shortfall method, we find that market evidence is the best indicator of whether the property is suffering from obsolescence.

In Skvline Telecom we rejected an income shortfall calculation because there was "ample and clear evidence that properties such as the ones at issue, trade at market-to-book ratios greater than one." Id. at p. 35. Moreover, we have, in this case, a sale of the subject property announced shortly before the lien date, which shows no obsolescence in the property. We find there is ample

and clear evidence that this adjustment for obsolescence made by PERSON-5was unwarranted.

The Division deducted DFIT as a surrogate for obsolescence because Rule 62 provides that it should. However, Rule 62 also allows a party to prepare a study that "authenticates actual economic obsolescence." The Division has complied with this provision and has submitted a study prepared by PERSON-11which concluded that this property is not suffering from any external or economic obsolescence and, accordingly, that the DFIT deduction may be unnecessary. However, the Division does not ask us to depart in this case from the $$$$$ value in the Revised Appraisal, which includes a DFIT deduction.

The Division, however, has proposed PERSON-11 study as a method for use in future valuations and asks the Commission to validate the methodology. We decline the Division's invitation to pre-approve any specific methodology in the context of this case. Any future consideration of the acceptable methodologies may be handled more appropriately through a rule or policy making process.

II. Income Approach

Both PERSON-5 and PERSON-6 used a yield capitalization method to determine the income approach value for the property at issue. The yield capitalization formula, as directed by Rule 62, is CF *I* (k-g). In the formula CF is cash flow, k is the rate and g is growth. Each of these elements at issue affected the final value conclusions in the appraisal submitted by PERSON-5 and PERSON-6.

Upon review of the totality of the evidence presented, the Commission determines that PERSON-5's cash flow of $$$$$ and zero growth rate were the appropriate pairing for the yield capitalization formula. Respondent did present evidence of anticipated growth, however, this evidence did not distinguish between new growth and growth from the assets in existence on the lien date or their replacement. The relevant inquiry for the purposes of the property tax assessment is growth from the assets in existence on the lien date or their replacements. Although the evidence in this matter indicated that cash flows have been declining, there was also testimony that such a decline would not continue in perpetuity. Considering all the testimony presented, we conclude that a zero growth rate is appropriate.

The k portion of the formula, or weighted average cost of capital ("WACC"), comes from the equity rate and the debt rate. The two rates are weighted based on market factors. There was no dispute as to the debt rate and little dispute as to the weight given to each component.

The equity rate was a major difference between PERSON-5 and PERSON-6 appraisals. Both appraisers relied primarily on the CAPM model to determine the equity rate. As discussed in the findings, the Commission agreed with PERSON-5 beta, risk free rate and risk premium as set out in his Rule 62 appraisal. These are the three factors in the CAPM model.

The Commission rejected PERSON-5 CAPM model in his Addendum Supplement because the risk premium was based on data from the full Ibbotson study and not the 40 years which is a requirement of Rule 62 as in effect on the lien date. Rule 62 directs the appraiser to derive the

equity risk premium by using the most recent 40 years of data from the Ibbotson Yearbook. The Division complied with this direction and PERSON-5 complied in his Rule 62 Appraisal. The Commission determines that the use of an equity risk premium derived from 40 years of data is appropriate.

This decision comports with our recent decisions in Kern River and Skyline Telecom. As we said in Kern River, "all other centrally assessed properties for 1999 have been assessed and the values for such assessments determined by the use of the 40-year period adopted by Rule 62 ... the Commission is reluctant to change the parameters and modify the calculation of taxable value for one company on a basis different from all other companies, unless the calculation using the established rule produced a value that is not within a reasonable range of the fair market value of the property." See Kern River, at p. 29. The evidence in this case demonstrates that the use of the 40 years does not result in a value that is outside the range of fair market value.

A second issue in the risk premium component was whether to use "total return" or "income return." Tl1is was an issue that the Commission carefully considered in Kern River and determined that the "income return" should be 11sed in calculating the risk premium. The Division argues that the decision to do so in Kern River was incorrect, that Ibbotson's data comprising the "income return" does not include the re-investment component. The Division argues if the reinvestment component is added, the difference between income return and total return is negligible. The Commission has yet to hear, from any party, a definitive analysis of the Ibbotson methodology. In

the absence of such an analysis, we find no reason to revise our analysis in Kern River. The major difference between the risk premium used by PERSON-5in his Rule 62 Appraisal and the one used by PERSON-6 can be attributed the difference between "income return" and "total return."

As we found in Kern River, the Commission concludes that "income return" is the appropriate factor, to consider in developing the risk premium for the CAPM model.

In addition to the CAPM model, which he had given %%%%% weight, PERSON-6 had considered a DGM model which he gave %%%%% weight. The DGM model is a relevant inquiry in determining the rate and the Commission gave it consideration in concluding that the cost of equity rate of %%%%%. This is only a slight difference from PERSON-5 rate of %%%%% from his Rule 62 Appraisal.

PERSON-5 added a flotation cost to his weighted average cost of capital. As discussed in the findings the Commission has rejected this adjustment.

Using the facts which the Commission finds to be appropriate for the cash flow, growth and WACC, the Commission's income approach value of $$$$$ is just slightly higher than PERSON-5's at $$$$$.

III. Stock and Debt Approach

PERSON-5 performed a Stock and Debt approach, but did not give it any weight. PERSON-6 performed a Stock and Debt approach to which he assigned %%%%% weight. The Division used the stock and debt approach in its valuation of only one other cost regulated utility. Rule 62

recognized that the stock and debt method tends to capture intangibles at higher levels than other methodologies. PERSON-6 conceded that several of its allocation factors were significantly impacted by nonrecurring items and that he had not made adjustments for these items. In particular, the net sales and revenue, and the net earnings contribution factors were challenged on this basis. The Division itself either eliminated or significantly changed these factors for PROPERTY OWNER for the following year's assessment. In addition PERSON-6 did not separately identify and remove intangibles from this approach.

The stock and debt approach has been discouraged or rejected by the Commission and the courts in the past. In WilTel , Inc., et al., 995 P.2d 602 (Utah 2000) the Court upheld the Commission's position that the use of the stock and debt method is discouraged. In Utah Ass'n of Counties, et al. v. Tax Comm'n, et al., 895 P.2d 819 (Utah 1995), the Commission and Court rejected the use of the stock and debt approach as advocated by PERSON-8 and by PERSON-9.

As a sanity check PERSON-6 considered the merger between BUSINESS-3and PROPERTY OWNER. He prepared a revised stock and debt approach where he used the $26 share price of the BUSINESS-3equivalent shares as of December 6, 1998 to estimate the total value of PROPERTY OWNER'S equity. However, as has been discussed in the Findings of Fact, DATE, was merely the date when the merger was announced. The actual exchange rate of shares was not pegged to an particular price, the merger was instead based on an exchange ratio. The parties to the merger knew that it would take one year or more before the merger would close and that there were substantial

risks that the final share price would change prior to closing. Even a set price, however, is based on stock value or on the perceived value of the firm as a whole and, therefore, not the value of the underlying tangible assets.

It is the Commission's finding that the stock and debt approach as prepared by PERSON-6 should be given no weight.

IX. Correlation.

As noted in its findings, the Commission concluded that the cost approach should be given more weight than the income approach in the correlation of the final value for PROPERTY OWNER’S taxable property. Rule 62 gives a preference for the cost approach in rate based utility properties. PERSON-6 had given the cost approach more weight. The Commission also determined to give no weight to the stock and debt approach. The Commission allocates the percentage PERSON-6 had allowed for stock and debt on a pro rata basis to the other two approaches and weighting given by PERSON-6. The result is a weight of %%%%% for the income approach and %%%%% for the cost approach. The Utah allocation factor of %%%%% was not disputed.

CONCLUSION

The Commission finds that the fair market value of PROPERTY OWNER'S taxable operating electric property as of January I, 1999, is $$$$$, and the unadjusted Utah value is $$$$$. After subtracting the adjustment for exempt property the Utah taxable value is $$$$$.

DATED this_____day of _____, 2001

Jane Phan
Administrative Law Judge 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 DePualis
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 oflaw 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.JKP/99-0568.ITT