



**VALUES AT ISSUE**

	Value	Penalty	Assessment in lieu of Interest	Total
2008 Escaped Assessment	\$5,200,000	\$0	\$312,000	\$5,512,000
2007 Excessive Assessment	(\$16,400,000)	\$0	(\$2,460,000)	(\$18,860,000)
2006 Excessive Assessment	(\$15,500,000)	\$0	(\$3,720,000)	(\$19,220,000)
2005 Excessive Assessment	(\$14,000,000)	\$0	(\$4,620,000)	(\$18,620,000)
Total Audit Escaped/Excessive Assessments	(\$40,700,000)	\$0	(\$10,488,000)	(\$51,188,000)
Petitioner's Requested Value (as detailed below)	(\$296,539,538)	\$0	(\$56,009,887)	(\$352,549,425)
Respondent's Recommendation On Appeal	(\$40,700,000)	\$0	(\$10,488,000)	(\$51,188,000)

**ISSUES**

- Whether the capital structure used in formulating the capitalization rate upon which a Board-adopted Capitalized Earning Ability (CEA) value indicator is based can be corrected by the Board in this appeal and, if so, whether respondent used the correct capital structure in formulating the capitalization rate to determine the CEA value indicator.**
- Whether the capital replacement expenditure allowance amount used in computing petitioner's CEA value indicator can be corrected in this appeal and, if so, whether respondent used the correct capital replacement expenditure allowance in computing petitioner's CEA value indicator.**
- Whether respondent's audit adjustment related to Deferred Income Taxes (DIT) is correct.**

**BACKGROUND INFORMATION**

Golden State Water Company (petitioner) is a rate base regulated public utility, regulated by the California Public Utilities Commission (CPUC), which is engaged in the purchase, production, and distribution of water in sixteen water service districts located in ten counties. Petitioner also distributes electricity in one customer service area in San Bernardino County. Petitioner is a wholly-owned subsidiary of American States Water Company (ASWC).

1 Audit and Escaped/Excessive Assessments

2 Respondent conducted an audit of petitioner's property for the purpose of verifying the  
3 "accuracy, validity, and appropriateness of the data furnished to, and used by the Board of Equalization  
4 in the assessment process for the 2005, 2006, 2007, and 2008 lien dates." The audit also provided "an  
5 internal review of the methods and computations employed by the Board in the valuation process for the  
6 years under audit." (The audit report is attached as Exhibit A to the hearing summary.)

7 The audit was conducted under the scope of Revenue and Taxation Code (R&TC) section 828  
8 and Government Code section 15618 so that respondent could conduct a review for the accuracy and  
9 validity of petitioner's accounts and the data and/or information relative to the development of the  
10 Historical Cost Less Depreciation (HCLD) and Capitalized Earning Ability (CEA) value indicators for  
11 the audit period. The Board-adopted unitary value for each of the years under audit was based upon a  
12 75 percent reliance on the HCLD value indicator and a 25 percent reliance on the CEA value indicator.

13 Respondent's audit included the following adjustments:

- 14 • Respondent discovered that the difference between the estimated original cost of  
15 property, less accumulated depreciation, and the purchase price of such property was not  
16 subtracted from petitioner's HCLD value. This adjustment, which is an adjustment to  
17 rate base, should also be an adjustment to the HCLD value. Respondent's analysis also  
18 found that the adjustment was also improperly subtracted from petitioner's intangible  
19 assets for lien dates 2005, 2006, and 2007, which resulted in an understatement of  
20 intangible assets and an increase to the HCLD value.
- 21 • Consistent with the adjustment above, petitioner was overassessed for its depreciation  
22 reserve for 2005, 2006, and 2007, primarily due to the subtraction of estimated  
23 intangibles, which had already been taken out of depreciation reserve.
- 24 • Petitioner underreported its franchise fee expenses for 2005 and 2006, reporting only its  
25 actual payments. Respondent's adjustment reflected the reporting of these expenses on  
26 an accrual basis.
- 27 • Respondent found that petitioner's deferred income tax (DIT) accounts were overstated  
28 for 2005, 2006, and 2007. Petitioner had included certain non-assessable property related

1 DIT account balances in the amounts reported on its property statements but also  
2 excluded tax credits relating to investment tax credits.

- 3 • Respondent found that petitioner underreported its CWIP costs for 2005 and 2006.
- 4 • Petitioner overstated its Contributions in Aid of Construction (CIAC) and Advances for  
5 Construction amounts.
- 6 • The CEA value indicator for 2007 was adjusted to reflect the use of petitioner's actual  
7 accumulated amortization amount (which affects the income imputed to intangible  
8 assets).

9 The audit adjustments are summarized as follows:

DESCRIPTION	2008	2007	2006	2005	TOTAL
<b>HCLD Weighted:</b>					
Plant Acquisition – Water Adjustment		(6,531,046)	(6,531,022)	(6,531,023)	
CWIP			195,853	25,214	
Advances for Construction	18,731				
CIAC	3,670,360	751,739	590,974	469,189	
Intangible Assets		(6,531,023)	(6,531,023)	(6,531,023)	
Franchise Fee Possessory Interests			508,248	948,021	
Deferred Income Taxes	1,425,693	1,462,443	1,493,250	1,933,694	
Depreciation Reserve		(5,651,558)	(5,344,001)	(4,659,619)	
<b>CEA Weighted:</b>					
Franchise Fee Possessory Interests			169,416	316,007	
Intangible Assets Net Effect		121,265			
<b>Total Audit Adjustments</b>	<b>5,114,783</b>	<b>(16,378,179)</b>	<b>(15,448,305)</b>	<b>(14,029,539)</b>	<b>(40,741,240)</b>
<b>Rounded Audit Adjustments</b>	<b>\$5,200,000</b>	<b>(\$16,400,000)</b>	<b>(\$15,500,000)</b>	<b>(\$14,000,000)</b>	<b>(40,700,000)</b>

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1 In its appeal, petitioner asserts the following excessive assessments are appropriate for the years  
2 at issue in this matter:

	Value	Penalty	Assessment in lieu of Interest	Total	
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4	2008 Excessive Assessment	(\$58,273,228)	\$0	(\$19,230,165)	(\$77,503,394)
5	2007 Excessive Assessment	(\$84,403,032)	\$0	(\$20,256,728)	(\$104,659,760)
6	2006 Excessive Assessment	(\$81,013,305)	\$0	(\$12,151,996)	(\$93,165,301)
7	2005 Excessive Assessment	(\$72,849,972)	\$0	(\$4,370,998)	(\$77,220,971)
8	Petitioner's Requested Value	(\$296,539,538)	\$0	(\$56,009,887)	(\$352,549,425)

### 9 **Summary of Appeals Conference**

10 At the November 9, 2010 appeals conference, petitioner briefly discussed its position relating to  
11 Issue 1 as detailed below and made a submission in support of its position on that issue. The parties did  
12 not discuss Issues 2 or 3 at the appeals conference. The appeals conference was held in conjunction  
13 with petitioner's appeal of its 2010 unitary assessment.

### 14 **Appeals Division's Recommendation**<sup>1</sup>

15 The Appeals Division recommends that the Board deny the petition as Issues 1 and 2 request  
16 relief that is beyond the scope of this appeal and, as for Issue 3, petitioner failed to meet its burden of  
17 proof.

### 18 **Issue 1**

19 **Whether the capital structure used in formulating the capitalization rate upon which a Board-**  
20 **adopted CEA value indicator is based can be corrected by the Board in this appeal and, if so,**  
21 **whether respondent used the correct capital structure in formulating the capitalization rate to**  
22 **determine the CEA value indicator.**

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26 <sup>1</sup> Unless the Board otherwise holds, the Board shall take official notice of: the property statement filed with the Board,  
27 together with any attachments, including without limitation any reports to regulatory agencies such as the U.S. Securities and  
28 Exchange Commission and the California Public Utilities Commission, and any annual reports to shareholders; the Appraisal  
Data Report (ADR) prepared by the State-Assessed Properties Division (SAPD) together with any workpapers; the Notice of  
Unitary Value; and any correspondence between SAPD and petitioner.

1 **Petitioner's Contentions**

2 Petitioner asserts that significant errors were made in the development of the capitalization rate  
3 used to determine the CEA value indicator for each of the years in the audit period. Petitioner alleges  
4 that, after bringing these errors to respondent's attention during the course of the 2008 unitary appeal,  
5 respondent corrected the errors for the capitalization rate it used in the 2009 unitary assessment of  
6 petitioner's property. (Petition, p. 2.)

7 Petitioner contends that respondent improperly applied a company-specific capital structure,  
8 which it derived from the CPUC, when determining petitioner's CEA value indicator for lien dates 2005  
9 through 2008. In doing so, petitioner argues that respondent violated its own guidelines. According to  
10 the Board's March 2008 Capitalization Rate Study, "the capital structure contemplated is a  
11 representative or typical structure of an industry group of companies with a similar bond rating, not that  
12 of the present owner. The objective of doing so is to strike an optimum capital structure from the  
13 perspective of a potential investor." Petitioner likewise notes that, according to Tegarden's Public  
14 Utilities Basic Appraisal Course (2008), for purposes of "estimating the capitalization rate in appraising  
15 public utilities, it is appropriate to use the typical market capital structure of similar companies."  
16 (Petition, p. 3.)

17 Petitioner agrees and asserts that, to find fair market value, respondent should use the market  
18 value of debt and equity and a market value capital structure which would be used by a prospective  
19 purchaser. Petitioner also agrees with the Board's capitalization rate study: the appropriate capital  
20 structure to use is the indicated market value capital structure of the assessee's same industry group.  
21 (Petitioner's Reply Brief, p. 2.)

22 In addition, petitioner argues that debt and equity rates should also be market derived, as  
23 Property Tax Rule<sup>2</sup> 8, subdivision (g)(2), provides that "[t]he appraiser shall weight the rates for debt  
24 and equity capital by the respective amounts of such capital he deems most likely to be employed by  
25 prospective purchasers." However, petitioner contends that respondent used an imputed debt-to-equity  
26 ratio for ratemaking purposes and not the market-derived ratio of a prospective purchaser. Petitioner  
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<sup>2</sup> All references to Property Tax Rule or Rule are to those sections of title 18 of the California Code of Regulations.

1 contends that respondent utilized the following capital structure for lien dates 2005 through 2008  
2 (Petition, pp. 3-4.):

	Equity	Debt
2005	50%	50%
2006	55%	45%
2007	55%	45%
2008	55%	45%

6  
7 Petitioner argues that the following capital structure for lien dates 2005 through 2008 should instead  
8 have been applied (Petition, pp. 3-4.):

	Equity	Debt
2005	68%	32%
2006	71%	29%
2007	73%	27%
2008	71%	29%

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11  
12 Petitioner disagrees with respondent's characterization that respondent's change in the capital  
13 structure for the 2009 lien date was related to "appraiser judgment." Petitioner instead contends that this  
14 change by respondent reflects the correction of a clerical error and that it is disingenuous for respondent  
15 to describe the change as appraiser judgment when petitioner had previously presented evidence to show  
16 respondent this error. As a result, petitioner contends that respondent's characterization of this change  
17 negates the basis, and the opportunity, for respondent to correct this error for the years under audit.  
18 Petitioner asserts that the determination of the life of a piece of equipment might be the use of  
19 appraiser's judgment, for example, but that the use of a capital structure which is not derived from the  
20 market when such data is available, and in light of the many appraisal texts on the subject, is more akin  
21 to an error than to the use of appraiser judgment. (Petitioner's Reply Brief, pp. 1-2.)

22 Petitioner argues that the use of a market value capital structure is supported in the industry.  
23 Petitioner references Morin, *New Regulatory Finance* (2006), which provides that

24 There is a significant difference between the overall cost of capital traditionally measured  
25 by the expected return on a portfolio of a company's debt and equity instruments and the  
26 procedure actually used by regulatory bodies in arriving at an overall rate of return  
27 allowance. The traditional practice uses current market returns and market values of the  
28 company's outstanding securities to compute WACC.<sup>3</sup> By contrast, in the context of

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<sup>3</sup> "WACC" is a reference to the weighted average cost of capital. The weighted average cost of capital represents the calculation of the weighting of each category of a company's capital (i.e., its equity and its debt). For example, if there is a

1 ratemaking for regulated utilities, it is an almost universal practice to employ a hybrid  
2 computation consisting of embedded costs of debt and a market-based cost of equity,  
3 with costs of debt and equity both weighted at their respective book values in the  
determination of the WACC.

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4 One seemingly potent argument in favor of market value weights is that if cost of capital  
5 is not formulated in terms of current market costs, there is no assurance that the  
6 commitment of funds to investment projects by utilities will earn a rate sufficient to cover  
these costs. (Petitioner's Reply Brief, p. 2.)

7  
8 Thus, petitioner asserts that, according to this publication, the use of an embedded/historical cost of debt  
9 and a book value capital structure is only appropriate for ratemaking purposes; such a computation,  
10 however, is inappropriate for use by respondent for valuation purposes. (Petitioner's Reply Brief, p. 3.)

11 Petitioner contends, as mentioned above, that respondent determined a market value capital  
12 structure using a representative industry group but that respondent then ignored its own analysis (i.e., the  
13 Board's Capitalization Rate Study) and instead employed a historical book value capital structure which  
14 artificially lowered the WACC. Petitioner asserts that, in October 2008 during the appeal of the 2008  
15 unitary assessment, respondent rejected the use of a market value based capital structure for petitioner  
16 because petitioner is a rate-base regulated utility. Petitioner contends that it presented respondent with  
17 the 71 percent equity and 29 percent debt capital structure. However, petitioner asserts that respondent  
18 rejected this capital structure, as respondent revised the equity rate downward to negate the effect of the  
19 change in the capital structure and its calculations included the use of the original 45 percent debt capital  
20 structure.<sup>4</sup> (Petitioner's Reply Brief, pp. 3-4.)  
21  
22  
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24 capital structure with a 50 percent weighting to equity, with a cost of equity of 10 percent, and a 50 percent weighting to debt,  
25 with a cost of debt of 8 percent, the weighted average cost of capital is 9 percent (i.e., (10 percent x .50 weighting) + (8  
percent x .50 weighting)).

26 <sup>4</sup> In its post-conference submission, petitioner argues that respondent "used a 'market' debt rate in their 2008 WACC  
27 calculation. [Respondent] then mixes the current 'market' debt rate with a historical 'embedded cost' capital structure . . .  
28 The incongruent variable is clearly evidence of an 'appraisal error' rather than sound 'appraisal judgment.' A 'market' debt  
rate cannot be factored by an 'embedded historical cost' capital structure. 'Market' rates of debt and equity can only be  
factored by a 'market' capital structure, to use anything else is in error." (Petitioner's Post-Conference Submission, p. 2.)

1 Finally, petitioner cites an article from the Journal of Property Tax Management (Hladek, Spring  
2 1997, Surviving a Property Tax Audit)<sup>5</sup> which provides in part

3 The second reason for property tax auditing is the internal clock and review of internal  
4 controls and assessment practices of the taxing jurisdiction. . . .

5 The replacement cost factors are reviewed, and the assigned lives for each category of  
6 equipment are examined, along with the capitalization rate. Various adjustments to the  
7 cost and capitalized income indicators are reviewed for accuracy, and the final indicators  
and value conclusions are scrutinized.

8 As such, petitioner contends that respondent's error relating to the capitalization rate is an error  
9 which can be corrected as part of the audit process. (Petitioner's Appeals Conference Submission, p. 1.)  
10 Additionally, petitioner asserts that the Board's audit program was designed and intended to determine  
11 whether all of an assessee's property was correctly reported but, more importantly, to act as an internal  
12 check of respondent's valuation model for the integrity and correctness of the calculations made on  
13 various components (e.g., replacement cost new factors, life tables, capitalization rates) of the valuation  
14 used to determine the fair market value of the property. Petitioner further notes that the WSATA Public  
15 Utility Audit Course provides that the audit program is an internal check of the assessment jurisdiction's  
16 work. As such, along with verifying the correctness and appropriateness of the reported data, an auditor  
17 should also verify the manner in which the data is used, reviewing the components of the valuation  
18 model used and checking for clerical and other errors made in the valuation of the property.  
19 (Petitioner's Post-Conference Submission, p. 1.)

## 20 **Respondent's Contentions**

21 Respondent first contends that whether an incorrect capital structure was used in formulating the  
22 capitalization rate cannot be decided in an audit appeal because such an adjustment constitutes an  
23 exercise of the appraiser's judgment as to value. As such, respondent asserts that this issue is unrelated  
24 to the recommended 2005-2008 audit adjustments and is beyond the scope of the audit. In any event,  
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27 <sup>5</sup> This article was written by Mr. Hladek, petitioner's representative, in 1997 when he was employed as a Supervising  
28 Property Appraiser with the Property Taxes Department of the Board. However, the article solely represented the viewpoint  
of Mr. Hladek, as the author of the article, and did not represent the position or opinion of the Board or Board staff.

1 respondent argues that the capital structure used to develop the CEA value indicator for each lien date  
2 was not incorrect.

3         Respondent argues that the audit was conducted pursuant to the statutory authority given to  
4 respondent to audit state assessees and that the purpose of a routine audit is to verify the accuracy,  
5 validity, and appropriateness of the records provided by a state assessee, as well as accounting  
6 calculations provided by the assessee or as determined by respondent during the valuation process.  
7 Respondent may also conduct an internal review of its methods and computations used in the valuation  
8 process, but such review does not encompass the exercise of appraisal judgment, such as the  
9 determination by the Board of the capitalization rate to be applied to a particular company. The audit  
10 adjustments recommended by respondent in this matter are as a result of accounting-type errors, such as  
11 the correction of a double subtraction of estimated intangibles from petitioner's reported depreciation  
12 reserve.

13         Respondent contends that R&TC section 4876 describes the limits of the Board's authority to  
14 correct its own errors pertaining to values placed on the Board roll and that only errors "not involving  
15 the exercise of judgment as to value" are subject to correction by the Board in an audit appeal. As such,  
16 respondent argues that the determinations of the appropriate capital structure and the appropriate  
17 capitalization rate used to formulate an income indicator involve the exercise of the appraiser's  
18 judgment as to value. Consequently, respondent contends that the Board is therefore prohibited from  
19 taking corrective action as requested by petitioner in the present appeal and that petitioner may only seek  
20 relief in superior court.

21         Additionally, respondent argues that petitioner did not raise this issue in its 2005, 2006, and 2007  
22 unitary value petitions and, in its 2008 unitary value petition, petitioner raised the issue of capital  
23 structure but the Board denied the petition with regard to this issue. As such, respondent contends that,  
24 under Rules for Tax Appeals (RTA) 5345 (Cal. Code Regs., tit. 18, § 5345), the decisions of the Board  
25 on a property tax petition are final and the Board may only modify a decision to correct a clerical error.  
26 Consequently, respondent asserts that the Board's determinations on this issue are final and are not  
27 subject to correction for any year because the determinations are not the result of clerical errors.  
28

1 As to the specific issue raised by petitioner, respondent contends that there was no error in its  
2 formulation of petitioner's capitalization rate, as the capital structure used was appropriate for a rate-  
3 base regulated utility and was determined in a manner consistent with other rate-regulated utilities. As  
4 for determining the appropriate capital structure, respondent states that it gave consideration to the  
5 CPUC's capital structure and cost of capital determination because that is the structure that would most  
6 likely be considered by a prospective purchaser of petitioner's property.

7 In summary, respondent argues that the appeal should be denied on this issue because the  
8 development of a capitalization rate is beyond the scope of a routine audit, is not subject to correction by  
9 the Board because it involves the exercise of appraiser judgment as to value, and the Board has made a  
10 final determination on the issue that is not subject to correction under the Rules for Tax Appeals.

### 11 **Applicable Law and Appraisal Principles**

12 **Burden of Proof** Assessing officers are presumed to have properly performed their duties. (Evid.  
13 Code, § 664.) The Board has promulgated the RTA to govern the administrative and appellate review  
14 processes for all of the tax and fee programs administered by the Board. (Cal. Code Regs., tit. 18, §  
15 5000.) Of relevance here, RTA 5541, subdivision (a), places the burden of proof upon the taxpayer as to  
16 all issues of fact except as otherwise specifically provided by law. Courts have long presumed that the  
17 Board assesses all property correctly, placing on the taxpayer the burden of proving that an assessment  
18 is incorrect. (*Trailer Train Co. v. State Bd. of Equalization* (1986) 180 Cal.App.3d 565, 584.)  
19 Therefore, petitioner bears the burden of showing that the assessment is illegal. (*ITT World*  
20 *Communications v. Santa Clara* (1980) 101 Cal.App.3d 246.)

21 **The Scope of an Audit; the Board's Review on Appeal** R&TC section 4876 provides that

22 When it can be ascertained from any roll or from any papers of the board what was  
23 intended or what should have been assessed, defects in description or form or clerical  
24 errors of the board in assessing state-assessed property or other errors of the board not  
25 involving the exercise of judgment as to value which result in the entry on the roll of  
26 assessed values other than those intended by the board may be corrected by the board  
27 under this article at any time within four years after the assessment was made or within  
28 the period for which a waiver is given pursuant to Section 868.  
(Underlines and italics added.)

RTA 5345, subdivision (a), provides, regarding property tax petitions, that the decision of the Board on  
a property tax petition is final and that the Board may not reconsider or rehear a petition. However, the

1 Board may modify a decision on a petition to correct a clerical error. (Cal. Code Regs., tit. 18, § 5345,  
2 subd. (a).)

3 **Reconciliation of Value Indicators** Property Tax Rule 3 requires that, in estimating value, the assessor  
4 shall consider one or more of the approaches to value “as may be appropriate for the property being  
5 appraised,” which includes the comparative sales approach, the replacement or reproduction cost  
6 approach, the historical cost approach, or the income approach. The appropriateness of an approach is  
7 often related to the type of property being appraised and the available data. (Assessors’ Handbook  
8 section 502, *Advanced Appraisal* (December 1998) (AH 502), p. 109.) In addition, the validity of a  
9 value indicator will depend upon the accuracy of data and adjustments made to the approach. That is,  
10 the accuracy of a value indicator depends on the amount of available comparable data, the number and  
11 type of adjustments, and the dollar amount of adjustments. Finally, if a large amount of comparable data  
12 is available for a given approach, the appraiser may have more confidence in that approach. For  
13 example, if income, expense, and capitalization rate data can be obtained from many properties  
14 comparable to the subject, the appraiser may attribute significant accuracy to the income approach. The  
15 greatest reliance should be placed on that approach or combination of approaches that best measures the  
16 type of benefits the subject property yields. The final value estimate reflects the relative weight that the  
17 appraiser assigned, either implicitly or explicitly, to each approach. (AH 502, p. 112.)

18 **Historical Cost Approach** The Historical Cost Approach may be considered appropriate for estimating  
19 property value under subdivision (d) of Property Tax Rule 3 “if income from the property is regulated  
20 by law and the regulatory agency uses historical cost or historical cost less depreciation as a rate base,”  
21 then the value of the property would be based on the “amount invested in the property or the amount  
22 invested less depreciation computed by the method employed by the regulatory agency.”

23 **Income Approach to Value** Board Property Tax Rule 8, subdivision (a), states that “the income  
24 approach is used in conjunction with other approaches when the property under appraisal is typically  
25 purchased in anticipation of a money income and either has an established income stream or can be  
26 attributed a real or hypothetical income stream by comparison with other properties.” Subdivision (b)  
27 describes the income approach to value as the valuation method whereby, “an appraiser values an  
28 income property by computing the present worth of a future income stream. This present worth depends

1 upon the size, shape, and duration of the estimated stream and upon the capitalization rate at which  
2 future income is discounted to its present worth.” Subdivision (c) provides that “the amount to be  
3 capitalized is the net return which a reasonably well-informed owner and reasonably well informed  
4 buyers may anticipate on the valuation date that the taxable property existing on that date will yield  
5 under prudent management and subject to legally enforceable restrictions as such persons may foresee as  
6 of that date.”

7 In addition, subdivision (g)(2) of Rule 8 provides that the capitalization rate may be developed as  
8 follows:

9 By deriving a weighted average of the capitalization rates for debt and for equity  
10 capital appropriate to the California money markets (the band-of-investment method) and  
11 adding increments for expenses that are excluded from outgo because they are based on  
12 the value that is being sought or the income that is being capitalized. The appraiser shall  
13 weight the rates for debt and equity capital by the respective amounts of such capital he  
14 deems most likely to be employed by prospective purchasers.

#### 14 **Appeals Division’s Analysis and Recommendation**

15 This Board has consistently followed a policy whereby the scope of a property tax audit is  
16 limited to the review of information and the correction of errors not involving the exercise of appraisal  
17 judgment. R&TC section 4876, which specifically applies to property assessed by the Board, provides  
18 that an assessment may be corrected for errors which do not involve “the exercise of judgment as to  
19 value.” Here, respondent’s, and the Board’s, determinations of the appropriate capital structure and the  
20 appropriate capitalization rate used to formulate petitioner’s CEA value indicator were exercises of the  
21 appraiser’s judgment as to value. In other words, when faced with a choice of the appropriate capital  
22 structure (and corresponding capitalization rates) to apply, the Board made the judgment that the  
23 adoption of respondent’s method was appropriate in valuing petitioner’s property. Consequently, in the  
24 view of the Appeals Division, petitioner’s requested adjustment to the capital structure and the  
25 capitalization rate constitutes an adjustment of items that involved an exercise of appraisal judgment  
26 which is prohibited by R&TC section 4876.

27 Petitioner essentially requests that the Board reassess its unitary property subsequent to the  
28 Board’s decision of petitioner’s appeals for each of the lien dates, in violation of the December 31st

1 deadline for the unitary assessment of property. (Rev. & Tax. Code, § 733, subd. (a); Rev. & Tax. Code,  
2 § 744, subd. (a).) The implication of petitioner's argument is that anytime respondent audits an  
3 assessee's unitary property, the assessee would be allowed to make revisions to the valuation  
4 methodology to determine a new value for the property. Petitioner's only authority regarding its opinion  
5 of the proper scope of an audit is an article written by petitioner's representative. At the hearing,  
6 petitioner should be prepared to present additional authority to support its position that the requested  
7 adjustment may be properly considered as an issue within the scope of a property tax audit.

8 With respect to the substantive issue, respondent argues that it is inappropriate to use the capital  
9 structure provided by the Board's 2008 Capitalization Rate Study because its capital structure and  
10 capitalization rates were appropriate for the valuation of a rate-regulated utility such as petitioner. At the  
11 hearing, the parties should be prepared to explain the development of their respective capital structure  
12 models and capitalization rates used to compute the 2008 CEA indicator.

### 13 Issue 2

14 **Whether the capital replacement expenditure allowance amount used in computing petitioner's**  
15 **CEA value indicator can be corrected in this appeal and, if so, whether respondent used the**  
16 **correct level of capital replacement expenditure allowance in computing petitioner's CEA value**  
17 **indicator.**

### 18 Petitioner's Contentions

19 Petitioner asserts that the capital replacement expenditure allowance used in respondent's CEA  
20 value indicator should reflect actual capital replacements and not current year depreciation expense as a  
21 surrogate for capital replacements. Petitioner contends that there is a huge difference in cash flows over  
22 the last five years when comparing its depreciation expense against its actual capital expenditures.

23 (Petition, p. 2.)

24 Petitioner asserts that respondent utilizes a perpetual income model in determining petitioner's  
25 CEA value indicator based upon anticipated revenues and expenses. Petitioner contends that, in this  
26 income model, respondent incorrectly relies upon book depreciation rather than utilizing petitioner's  
27 actual capital replacement expenditures. Petitioner argues that the use of book depreciation is an error,  
28

1 as book depreciation does not reflect the required capital replacement expenditures necessary to  
2 perpetuate a level income stream. (Petition, p. 5.)

3         Petitioner argues that depreciation is not a cash flow but merely an accounting mechanism by  
4 which the cost of long-lived assets are allocated over the period of years in which those assets will be  
5 used to generate income. However, petitioner contends that depreciation expense can only be used as a  
6 proxy for capital asset replacements if the amount of the depreciation approximately equals the cost of  
7 the replacement assets necessary to continue the income stream at its current level. (Petition, p. 5.)  
8 Petitioner references the Western States Association of Tax Administrators (WSATA) manual which  
9 provides that “[s]ome appraisers advocate using book depreciation charges as a substitute for the cost of  
10 replacing those assets necessary to maintain and perpetuate the present income stream. This practice is  
11 questionable since book depreciation, for the most part, will fall far short of the current cost of  
12 replacement assets, except in an inflation-free environment. (WSATA Appraisal Handbook: Valuation  
13 of Utility & Railroad Property, p. 46.) (Petition, p. 6.)

14         Petitioner asserts that significant capital expenditures are necessary for the purchase of its  
15 property, plant, and equipment. For example, petitioner alleges that it averaged approximately \$62  
16 million annually in capital expenditures over the last five years, with book depreciation averaging \$22  
17 million per year and its net operating income remaining level over that the same period of time.  
18 (Petition, p. 5.) Petitioner asserts that if respondent’s valuation model was adjusted to include the  
19 \$61,976,000 in average capital expenditures required to maintain a steady income stream, and then  
20 factored by 90 percent (attributable to capital expenditures made for the purchase of replacement  
21 property), the correct capital replacement allowance to be used in respondent’s CEA value indicator  
22 would be \$55,778,400. In summary, petitioner argues that its actual capital expenditures, averaged over  
23 the last five years, should be considered in the final estimate of value. (Petition, pp. 6-7.)

24         In response to respondent’s opening brief, petitioner agrees (with respondent) that the use of its  
25 actual capital expenditures in the calculation of the CEA value indicator would understate the value of  
26 its property, because of petitioner’s failure to include expected revenues from such capital expenditures.  
27 However, petitioner continues by asserting that, because respondent utilizes depreciation expense as a  
28 surrogate for capital replacements, respondent’s projected appraisal income results in a contrived and

1 false level of cash flow. Petitioner contends that its audited financial statements show actual net cash  
2 flows which are far below those capitalized by respondent. Further, petitioner states that its capital  
3 expenditures have exceeded its net income over the last six years. (Petitioner's Reply Brief, p. 4.)

4 Petitioner also argues that respondent ignores the fact that the cost of replacing older plant assets  
5 far exceeds the depreciation expense related to those assets and that even respondent's replacement cost  
6 new (RCN) calculation shows that the cost of reproducing a replacement plant is 2.29 times the original,  
7 historic cost to which the depreciation expense is tied. Petitioner continues by arguing that the WSATA  
8 manual and respondent's publications were written at a time in which theoretical models assumed that  
9 plant prices were stable and that assets were replaced in a timely manner. However, petitioner notes  
10 that, at its current rate, it will take 130 years for it completely replace its plant. Thus, petitioner  
11 concludes that the use of depreciation expense creates a false level of cash flow to capitalize, resulting in  
12 a false CEA value indicator. Instead, petitioner argues that the use of actual forecasted growth and  
13 replacement costs would provide a much clearer and accurate estimate of value. (Petitioner's Reply  
14 Brief, pp. 4-5.)

#### 15 **Respondent's Contentions**

16 First, respondent asserts that the issue of whether an incorrect capital replacement expenditure  
17 allowance was used in computing petitioner's CEA value indicator is beyond the scope of the audit  
18 because that determination involved the exercise of the appraiser's judgment as to value. As such,  
19 respondent contends that the issue is unrelated to the recommended 2005-2008 audit adjustments and  
20 may not be raised in this appeal. However, even though respondent argues that the capital replacement  
21 allowance used to develop the CEA value indicator for each lien date was not incorrect.

22 Respondent asserts that, as discussed above, the purpose of a routine audit is to verify the  
23 accuracy, validity, and appropriateness of the records provided by an assessee. Further, and in citing  
24 R&TC section 4876 and Property Tax Annotation 390.0055, respondent contends that its decision to  
25 rely on book depreciation rather than actual capital expenditures in calculating the amount of capital  
26 replacement expenditure allowance involves the exercise of appraisal judgment and is therefore not  
27 properly raised in this proceeding. (Respondent's Opening Brief, p. 5.)  
28

1 Respondent argues that the capital replacement expenditure allowance advocated by petitioner is  
2 inappropriate for use in the calculation of petitioner's CEA value indicator as such use would be  
3 inconsistent with Board regulations. Respondent states that, under Rule 8, subdivision (c), the amount  
4 of the capital replacement expenditures allowed is the expenditure required to maintain the estimated  
5 income stream by replacing existing assets, not expenditures necessary to increase capacity or to service  
6 new customers. Respondent contends that it properly used book depreciation in order to calculate the  
7 amount of the capital replacement expenditure allowance in computing petitioner's CEA value indicator.  
8 Respondent states that Rule 8, subdivision (c), provides that when using the income approach,  
9 respondent must offset revenues by "current expenses and capital expenditures . . . required to develop  
10 and maintain the estimated income." Respondent's use of book depreciation is consistent with Rule 8,  
11 subdivision (c), because book depreciation is the reasonable amount of capital expenditures that would  
12 be necessary to maintain the projected income stream. Additionally, respondent's use of book  
13 depreciation to calculate the amount of petitioner's capital replacement expenditure allowance, as a rate-  
14 based regulated utility, is consistent with the directive of the Unitary Valuation Methods Book, adopted  
15 by the Board in March 2003, which provides that "[f]or rate based regulated utilities, the appropriate  
16 level of capital replacement expenditures is book depreciation." (Unitary Valuation Methods Book, p.  
17 43.) Respondent asserts that the Board has used book depreciation in calculating the amount of capital  
18 replacement expenditure allowance for rate-base regulated utilities since the 2000 lien date.

19 Finally, respondent states that petitioner did not raise this issue in its 2005 or 2006 unitary  
20 appeals, but did raise the issue in its 2007 and 2008 appeals. Petitioner's appeal was denied by the  
21 Board relating to this issue in both of those years. Respondent argues then (in citing RTA 5345,  
22 subdivision (a)) that the Board's determinations on this issue are final and not subject to correction for  
23 any year because the determinations are not the result of clerical errors. Respondent argues that the  
24 appeal should be denied on this issue because the development of a capital replacement expenditure  
25 allowance is beyond the scope of a routine audit, is not subject to correction by the Board because it  
26 involves the exercise of appraiser judgment as to value, and the Board has made a final determination on  
27 the issue that is not subject to correction under the Rules for Tax Appeals.  
28

## Applicable Law and Appraisal Principles

**Burden of Proof** Assessing officers are presumed to have properly performed their duties. (Evid. Code, § 664.) The Board has promulgated the Rules for Tax Appeals (RTA) to govern the administrative and appellate review processes for all of the tax and fee programs administered by the Board. (Cal. Code Regs., tit. 18, § 5000.) Of relevance here, RTA 5541, subdivision (a), places the burden of proof upon the taxpayer as to all issues of fact except as otherwise specifically provided by law. Courts have long presumed that the Board assesses all property correctly, placing on the taxpayer the burden of proving that an assessment is incorrect. (*Trailer Train Co. v. State Bd. of Equalization* (1986) 180 Cal.App.3d 565, 584.) Therefore, petitioner bears the burden of showing that the assessment is illegal. (*ITT World Communications v. Santa Clara* (1980) 101 Cal.App.3d 246.)

**The Scope of an Audit; the Board's Review on Appeal** R&TC section 4876 provides that

When it can be ascertained from any roll or from any papers of the board what was intended or what should have been assessed, defects in description or form or clerical errors of the board in assessing state-assessed property or other errors of the board not involving the exercise of judgment as to value which result in the entry on the roll of assessed values other than those intended by the board may be corrected by the board under this article at any time within four years after the assessment was made or within the period for which a waiver is given pursuant to Section 868.  
(Underlines and italics added.)

RTA 5345, subdivision (a), provides, regarding property tax petitions, that the decision of the Board on a property tax petition is final and that the Board may not reconsider or rehear a petition. However, the Board may modify a decision on a petition to correct a clerical error. (Cal. Code Regs., tit. 18, § 5345, subd. (a).)

**Capital Replacement Expenditure Allowance** With respect to the theoretical bases for the capital replacement expenditure allowance in the income approach and historical cost valuation models, the AH 542 states:

The [CEA] perpetual life model assumes that the income stream is sustained into perpetuity because individual assets are replaced as they are retired. Therefore, the amount of capital replacement required to perpetuate the income stream is allowed as an expense. For rate base regulated utilities, the appropriate level of capital replacement expenditures is book depreciation. The reason for this is that when a depreciable item must be replaced, the income stream will remain level if the dollar investment in the replacement item (i.e., the new property) corresponds to the dollar investment in the

1 replaced item (i.e., the old property). If the actual replacement is more (or less) expensive  
2 than the original, the income stream will increase (or decrease) because the amount of the  
investment has changed.

3 The Board's Unitary Valuation Methods book (2003), at page 43, is to the same effect.  
4

### 5 **Appeals Division's Analysis and Recommendation**

6 Consistent with our analysis relating to Issue 1 above, the Board has consistently followed a  
7 policy whereby the scope of a property tax audit is limited to the review of information and the  
8 correction of errors not involving the exercise of appraisal judgment. R&TC section 4876, which  
9 specifically applies to property assessed by the Board, provides that an assessment may be corrected for  
10 errors which do not involve "the exercise of judgment as to value." It is the view of the Appeals  
11 Division that the determination of an appropriate capital replacement expenditure allowance amount  
12 used in formulating petitioner's CEA value indicator involves the exercise of the appraiser's judgment.  
13 Consequently, petitioner requests an audit adjustment to change an item that involved the exercise of  
14 appraisal judgment which is prohibited by R&TC section 4876.

15 With respect to the substantive issue, respondent uses book depreciation in order to calculate the  
16 amount of the capital replacement expenditure allowance when computing petitioner's CEA value  
17 indicator. Rule 8, subdivision (c), provides that when using the income approach, respondent must offset  
18 revenues by "... current expenses and capital expenditures (or annual allowances therefor) required to  
19 develop and maintain the estimated income." The use of book depreciation is consistent with subdivision  
20 (c) of Rule 8 because, as the AH 542 and Unitary Valuation Methods book both state, book depreciation  
21 represents the amount of capital replacement expenditures necessary to maintain projected income for  
22 rate base regulated utilities. Moreover, this Board has consistently used book depreciation in calculating  
23 the amount of capital replacement expenditure allowance for rate base regulated utilities since 2000. At  
24 the hearing, petitioner should be prepared to explain why the use of petitioner's actual capital  
25 replacements instead of book depreciation as the amount of the capital replacement expenditure  
26 allowance is not the exercise of appraisal judgment and should be prepared to present additional  
27 authority to support its position that the requested adjustment may be properly considered as an issue  
28 within the scope of a property tax audit.



1 accounting rules allow for certain deductions to be taken, such as accelerated depreciation expense, for  
2 income tax purposes prior to when those deductions are allowed for financial accounting purposes. This  
3 timing difference gives rise to a balance sheet account called Deferred Income Taxes which records the  
4 amount of future income taxes that will be due because deductions have already been taken for income  
5 tax purposes, but remain to be taken for financial accounting purposes.

6 The income tax expense allowed in a utility's rate structure is the amount determined by  
7 financial accounting and not by the amount of income taxes actually paid. Regulatory agencies require  
8 that a utility's deferred income tax liability be deducted from the HCLD in the calculation of the rate  
9 base. Therefore, a regulated company would not earn a return on property purchased with funds  
10 provided by the deferral of income taxes if the regulatory treatment of deferred taxes is ordered. The  
11 HCLD value indicator is adjusted to reflect this earnings limitation and the amount of this adjustment  
12 should reflect the time value of money. The rate-making treatment of deferred income taxes effectively  
13 allows a company to recover only the income taxes actually paid and that the proper adjustment to the  
14 HCLD value indicator reflecting the time value of money is 100 percent of deferred income taxes.

15 **Appeals Division's Analysis and Recommendation**

16 This issue is properly before the Board as an audit adjustment for DIT was made by respondent  
17 for each of the lien dates under audit. However, the Appeals Division believes that petitioner has failed to  
18 meet its burden of proof to show error in respondent's adjustments as petitioner has not provided any  
19 documentation in support of its position. At the hearing, petitioner should be prepared to present  
20 evidence in support of its position.