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10 **STATE OF CALIFORNIA**
11 **BOARD OF EQUALIZATION**

12 In the Matter of the Petition for
13 Reassessment of the 2010 Unitary Value for:

) **APPEALS DIVISION'S**
) **HEARING SUMMARY FOR**
) **ORAL HEARING ON**
) **PROPERTY TAX PETITION**

14 **Golden State Water Company (101)**

15 Petitioner

) Appeal No.: SAU 10-023
) Case ID No.: 538248

16 _____
17 Representing the Parties:

18 For the Petitioner:

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Andrew Davis
Thomson Reuters

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23 For the Respondent:

Carole Ruwart
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28 Counsel for Appeals Division:

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PROPOSED VALUES

	Value	Penalty	Total
2010 Board-Adopted Unitary Value	\$538,900,000	\$0	538,900,000
Petitioner's Requested Unitary Value	500,000,000	0	500,000,000
Respondent's Recommendation on Appeal	538,900,000	0	538,900,000

ISSUE

Whether petitioner has shown that respondent's Historical Cost Less Depreciation (HCLD) value indicator fails to account for the economic obsolescence present in petitioner's unitary property.

BACKGROUND INFORMATION

Golden State Water Company (petitioner) is a rate-base regulated public utility, regulated by the California Public Utilities Commission (CPUC). Petitioner 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).

Petitioner's 2010 Board-adopted unitary value of \$538,900,000 was determined by placing a 75 percent reliance on the historical cost less book depreciation (HCLD) value indicator of \$551,513,547 and a 25 percent reliance on the capitalized earning ability (CEA) value indicator of \$501,171,042. Petitioner does not dispute the weighting of the value indicators used to determine the value of its property.

Summary of Appeals Conference

At the November 9, 2010 appeals conference, petitioner argued (as discussed in detail below) that its property does not earn its allowed rate of return as a rate-regulated utility and that, as a result, its earnings are reduced by regulatory lag. Consequently, petitioner asserts that its property suffers from economic obsolescence and that such obsolescence can be measured through the application of the capitalized loss in income method. Petitioner submitted a recent Idaho state trial court decision (*PacifiCorp v. Idaho State Tax Commission* No. CV OC 08 18158 (2010)) in support of its position, which is likewise summarized in detail below.

1 Subsequent to the appeals conference, petitioner submitted a revised calculation of its economic
2 obsolescence adjustment to the HCLD value indicator. This calculation did not change petitioner's
3 requested value on appeal of \$500,000,000. Nevertheless, the post-conference submission was made to
4 reflect a correction in petitioner's calculation for respondent's review. In response to this submission,
5 respondent filed a response. These submissions are summarized as part of the parties' contentions
6 below.

7 **Appeals Division's Recommendation**¹

8 The Appeals Division recommends that the Board deny the petition for reassessment because
9 petitioner has not met its burden of proving that the 2010 Board-adopted unitary value does not reflect
10 fair market value.

11 **Issue**

12 **Whether petitioner has shown that respondent's HCLD value indicator fails to account for the**
13 **economic obsolescence present in petitioner's unitary property.**

14 **Petitioner's Contentions**

15 Petitioner states that the California Public Utilities Commission (CPUC) requires water
16 companies to provide adequate service to customers while charging "reasonable" rates for service, and
17 allows water companies to earn a "reasonable" profit. The CPUC establishes an allowed rate base and
18 authorizes a rate of return that the company can earn on its invested capital. However, petitioner asserts
19 that its allowed rate of return may not equal the market rate of return. In addition, petitioner contends
20 that the lag time (i.e., the regulatory lag) between the CPUC's adjustments to a company's allowed rate
21 of return, due to the company's actual rate of return, can affect the company's achieved rate of return
22 because the company's income stream remains stagnant while expenses increase. As a result, petitioner
23 asserts that its inability to earn the allowed rate of return may negatively impact the value of its assets.
24 (July 20, 2010 Petition, p. 2; August 26, 2010 Petition, p. 1.)

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26
27 ¹ Unless the Board otherwise holds, the Board shall take official notice of: the property statement filed with the Board,
28 together with any attachments, including without limitation any reports to regulatory agencies such as the U.S. Securities and
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 asserts that HCLD is a common indicator of value for rate-base regulated utilities and
2 that HCLD approximates market value by closely estimating the rate base on which the CPUC allows a
3 company to earn a return on investment. However, petitioner argues that if a company is not earning its
4 allowed rate of return, the company's market value may be less than its HCLD-indicated value. (July
5 20, 2010 Petition, p. 2.) Moreover, petitioner asserts that only 80 percent of its property is included in
6 the rate base by the CPUC, such that petitioner is not earning a return on the remainder of its property
7 which was excluded from the rate base. (August 26, 2010 Petition, p. 1.)

8 Petitioner argues that its property suffers from economic obsolescence. Petitioner alleges that,
9 under the HCLD approach, the depreciation used is book depreciation (i.e., the amortized portion of the
10 investment in the total property) and that such depreciation does not reflect the loss in value of property
11 from economic obsolescence. Petitioner states that, according to the Appraisal Institute, there are two
12 methods of measuring economic obsolescence, including a method to “[c]apitalize the income or rent
13 loss attributable to the negative influence.” Further, petitioner asserts that, to find the most reliable
14 measurement of obsolescence possible, a comparison is made between the HCLD and the income
15 approach (i.e., with the market-required rate of return or capitalization rate). Petitioner further asserts
16 that the measurement of economic obsolescence for public utilities is the standard capitalized loss in
17 income method. (July 20, 2010 Petition, pp. 2-3.)

18 In support of its position, petitioner refers to several publications.² First, petitioner refers to the
19 Board's Assessors' Handbook section 502, *Advanced Appraisal* (December 1998) (AH 502), with
20 regard to estimating external (economic) obsolescence: “Depreciation resulting from external
21 obsolescence is generally estimated using the two methods described above under incurable functional
22 obsolescence: namely, capitalization of the net income loss . . .” (AH 502, p. 30.) Next, petitioner
23 references Assessors' Handbook section 542 *Assessment of Water Companies and Water Rights*
24 (December 2000) (AH 542), with regard to the total capitalization rate, which states in part (AH 542, pp.
25 43-44):

26 “An appraiser's or auditor-appraiser's yield rate and the rate of return allowed by the
27 CPUC may be similar; however, the yield rate that the appraiser or auditor-appraiser

28 _____
² Portions of these publications are attachments to petitioner's August 26, 2010 petition.

1 derived is never identical to the CPUC's allowed rate of return on the rate base. The rates
2 differ for several reasons:

- 3 1. The CPUC rate is on an after-income tax basis. The yield rate is pre-tax.
- 4 2. The CPUC rate may be higher or lower than current market rates because of a
5 time lag [footnote deleted] associated with the rate setting process. (The CPUC
6 generally adjusts an allowable rate of return every three years.) Appraisers and
7 auditor-appraisers attempt to measure the current market.
- 8 3. The CPUC utilizes the company's embedded cost rather than current debt in
9 determining a company's allowable rate of return. Thus the CPUC's rate may not
10 be reflective of current investor requirements.
- 11 4. Determination of a yield rate is not an exact science. The CPUC determination of
12 the rate base is not authoritative or binding on appraisers or auditor-appraisers."

13 Next, petitioner references the Board's guidelines for *Obsolescence for Equipment of State-*
14 *Assessed Telecommunication Properties* (Letter to Assessors No. 2008/068, dated December 5, 2008)
15 which provides that "[i]f there is negative appraisal income, or if the CEA indicator is lower than the
16 ReplCLD, sales, or HCLD indicators, this may be an indication that a further adjustment for
17 obsolescence may be warranted."

18 Petitioner also references Cornell, *Corporate Valuation: Tools for Effective Appraisal and*
19 *Decision Making* (1993) Chapter 2: The Adjusted Book Value Approach with respect to its argument
20 that most reliance should be placed on the CEA value indicator instead of the HCLD value indicator to
21 be consistent and to value the earning assets as regulated by law. Petitioner proposes as an alternative
22 that the HCLD value indicator should be adjusted for the difference between the allowed rate of return
23 and the required market-derived rate of return by adjusting the HCLD value indicator to its earning
24 capacity. Petitioner warns that an income shortfall adjustment might not be independent in and of itself.
25 (August 26, 2010 Petition, p. 1.)³ In support of that proposition, petitioner cites the Cornell book which
26 states in part:

27 ³ Petitioner states that it has made an average investment of \$68,402,148 in each of the last five years, for a total investment
28 of \$342,010,740. Petitioner also states that, with an increase in net income over that period of \$5,495,219, its new plant
assets are yielding an incremental return of only 1.6 percent. This likewise indicates the disconnect between the HCLD value
indicator and the earnings generated from rate base assets. (August 26, 2010 Petition, p. 1.)

1 Estimating obsolescence on the basis of the earning power of the assets can lead
2 to circularity in an appraisal whereby the discounted cash flow approach is “counted
3 twice.” That is, the appraiser first uses the discounted cash flow (DCF) method to
4 calculate the value of the firm. The DCF estimate of value is then used again to measure
5 obsolescence, where obsolescence is defined as the difference between the book value of
6 the assets and the DCF value of the assets. For instance, in an appraisal of a major
7 railroad, a well know appraiser estimated DCF value of the company to be approximately
8 \$300 million compared to an historical book value of about \$1 billion. The appraiser
9 calculated obsolescence as the difference between the DCF value and the historical book
10 value, or \$700 million. He then deducted this estimate of obsolescence from the
11 historical book value to reach an adjusted book value of \$300 million. By construction
12 this “book” estimate of value equals the DCF value indicator.

13 Such circular reasoning reduces the adjusted book value approach to the DCF
14 approach. In this situation the adjusted book value approach does not add new
15 information about the value of the company and should not be considered an independent
16 approach. If adjusted book value is to provide new information, the adjustments to book
17 value to account for obsolescence must depend on something other than the DCF
18 estimate of value.

19 In addition, petitioner cites a recent Idaho state trial court decision (*PacifiCorp v. Idaho State*
20 *Tax Commission* (Idaho Dist. Ct., Fourth District, Ada County, 2010, No. CV OC 08 18158, judgment
21 entered October 19, 2010) in which the court ruled on the January 1, 2008 ad valorem property tax
22 valuation of the operating property of PacifiCorp, which operates as a regulated electric utility in Idaho,
23 and concluded the following:

- 24 • A public utility’s rates are set by determining a revenue requirement for the utility that provides
25 the utility with the opportunity to recover its operating costs and earn a reasonable market return
26 on its invested capital (its rate base). A utility’s revenue requirement equals the utility’s
27 expenses plus the product of the rate base multiplied by a rate of return (i.e., Revenue
28 Requirement = Expenses + (Rate Base x Rate of Return)).
- Once a utility’s revenue requirement is determined by the public utilities commission
(commission), the utility is usually not allowed to adjust the rates that it charges until a new rate
case is filed with the commission and the commission issues an order which modifies the
revenue requirement.
- In the Idaho case, PacifiCorp made significant investments in its property, plant, and equipment
in the years prior to the valuation date. However, the utility was not allowed to automatically

1 include the new property in its rate base until it had filed a rate case and received an order from
2 the public utilities commission which authorized the inclusion of the new properties. Likewise,
3 if PacifiCorp's operating costs increase, the utility usually could not recover these increased
4 expenses until it had filed a rate case and received authorization from the commission.

- 5 • It ordinarily takes six to eighteen months for the Idaho public utilities commission to process and
6 rule on a rate filing. As a result of this regulatory lag, PacifiCorp's earnings were negatively
7 affected until such time that a favorable rate increase was allowed.
- 8 • One result of rate regulation is that PacifiCorp's actual average net rate of return on its plant in
9 service was 7.2 percent over the five-year period immediately preceding the valuation date,
10 while the "investor-market required rate of return", or the allowed rate of return, for the
11 regulated electric utility industry was 9.1 percent over that same period of time. Consequently,
12 PacifiCorp's actual rate of return as of the valuation date was approximately 20.88 percent less
13 than the market rate of return (i.e., $100 \text{ percent} - (7.2 \text{ percent} / 9.1 \text{ percent})$).
- 14 • External depreciation or economic obsolescence refers to diminution in value due to negative
15 influences outside of the property, such as regulation, regulatory lag, political considerations, and
16 changes in demand. In addition, book depreciation does not account for all forms of functional
17 and external obsolescence that may affect a utility's assets.
- 18 • Generally accepted appraisal principles provide that, when utilizing the HCLD approach, an
19 appraiser may use a variety of methods to measure external or economic obsolescence, including
20 the capitalization of income loss method.
- 21 • The capitalization of income loss method is an appropriate method of measuring external
22 (economic) obsolescence as a willing, informed buyer of a regulated utility would expect net
23 operating income equal to a market rate of return. If the net operating income of a utility is more
24 than the market rate of return, this will be reflected in the external appreciation of the value of
25 the operating property. However, if the net operating income of a utility is less than the market
26 rate of return, this will be reflected in the external depreciation of the value of the operating
27 property.

- With PacifiCorp's 20.88 percent negative difference between its rate of return and the market rate of return, this difference should be treated as a measure of external obsolescence resulting in additional depreciation and a reduction in PacifiCorp's HCLD indicator of value.

Petitioner states that it applied the capitalization of income loss method to determine the economic obsolescence present in its property. First, petitioner argues that it is inappropriate to remove petitioner's total construction work in progress (CWIP) from its HCLD value when determining economic obsolescence. Instead, petitioner contends, and consistent with respondent's methodology in calculating petitioner's CEA value indicator, that the "growth" portion of petitioner's CWIP is properly removed from the "Average HCLD Subject to Economic Obsolescence" in the denominator of the "Return on Average HCLD" calculation.⁴ Once this adjustment is made, petitioner's appraisal income is then compared to the "Average HCLD Subject to Economic Obsolescence" and the resulting ratio is a return on average HCLD of 13.012 percent. When comparing this return (i.e., 13.012 percent) to respondent's total capitalization rate of 14.374 percent, such results in an obsolescence adjustment of negative nine percent. When applying a nine percent obsolescence rate to petitioner's year-end HCLD valuation of \$551,513,547, such results in an obsolescence adjustment of \$52,244,236, and a revised HCLD value indicator of \$499,269,311. When the revised HCLD value indicator (\$499,269,311) is weighted with respondent's CEA value indicator (\$501,171,042), petitioner calculates a value of \$500 million for its property. (See Petitioner's Post-Conference Brief.)

Respondent's Contentions

Respondent asserts that the petition presents substantially the same objections and arguments to respondent's HCLD methodology that were rejected by the Board in petitioner's 2008 and 2009 appeals and that petitioner does not provide any new evidentiary or analytical support for its position.

Respondent also asserts that petitioner takes the same position as in prior years: that petitioner's earnings reflect a "regulatory lag" that should be quantified by an "income shortfall" amount and

⁴ However, petitioner argues, at the same time, that the "replacement" portion of its CWIP should not be removed from the "Average HCLD Subject to Economic Obsolescence" in the denominator because these assets are required to replace existing assets and do not increase appraisal income.

1 subtracted from the HCLD value indicator, in addition to a consideration of the CEA value indicator, in
2 the determination of petitioner's unitary value. (Respondent's Opening Brief, p. 2.)

3 However, when there is a reasonable expectation that a rate-base regulated utility will earn an
4 allowed rate of return, respondent argues that an adjustment to the HCLD value indicator is not
5 appropriate. Respondent contends that petitioner has not provided any evidence of obsolescence to the
6 value of its property due to petitioner's failure to achieve its CPUC-allowed rate of return on investment
7 or that the rate of return which petitioner is earning is viewed by the marketplace as inadequate or
8 insufficient.⁵ (Respondent's Opening Brief, pp. 2-3.)

9 Respondent contends that the following evidence from the annual report (the form 10-K) of
10 petitioner's parent company (ASWC) does not support petitioner's position (Respondent's Opening
11 Brief, p. 3):

- 12 • Petitioner and ASWC represented to investors and the public that, as of December 31, 2009,
13 petitioner had a strong financial position, was able to recover the costs and investments related to
14 its property with a reasonable rate of return, and made significant capital expenditures only when
15 it expected to be adequately compensated.
- 16 • ASWC's already-favorable investment rating from Standard & Poor's ('S&P') Ratings Services
17 improved compared to the prior year and S&P affirmed the 'A' corporate credit rating on ASWC
18 and petitioner. In addition, S&P believed that ASWC's sound capital structure and stable credit
19 rating would enable it to have access to the debt and equity markets.
- 20 • In 2009, ASWC completed a successful public offering of stock and petitioner obtained
21 favorable financing which paid off loans and funded capital expenditures.
- 22 • Petitioner's cash flows are ASWC's main source of revenue to issue dividends such that, through
23 2009, ASWC issued dividends (continuing a history of dividend issuance of more than 75
24 consecutive years) and actually increased the amount of dividends distributed in 2009 compared
25 to the prior year.
- 26
- 27
- 28

⁵ Respondent also questions whether petitioner is able to include only 80 percent of its property into its rate base.

1 In summary, respondent argues that petitioner provided no evidence that the financial marketplace views
2 petitioner as an unsound investment or that a return on an investment in petitioner would be less than the
3 amount allowed by the CPUC or required by the market for reasons related to its property.

4 (Respondent's Opening Brief, p. 3.)

5 Respondent next argues that petitioner has failed to provide any evidence that the CPUC has
6 denied any material amount of compensation for petitioner's costs or investments related to its property.
7 To the contrary, respondent alleges that the form 10-K states that rates sufficient to cover these costs,
8 compensation for revenues not received due to water conservation measures, and the capturing of
9 differences between estimated and actual expenditures through the use of balancing and memorandum
10 accounts, have been granted by the CPUC. Respondent notes that petitioner reviews its long-lived
11 assets for impairment and recognizes impairment losses only if the carrying value amount of long-lived
12 assets are not recoverable from customer rates authorized by the CPUC. Respondent further notes that
13 petitioner's form 10-K states that no write-downs were required for the year ending December 31, 2009.
14 Respondent argues that this is additional evidence that the value of petitioner's unitary property is not
15 materially impaired by a failure to achieve the CPUC-allowed rate of return. (Respondent's Opening
16 Brief, pp. 3-4.)

17
18 Respondent also notes that the form 10-K states that petitioner "intends to invest capital
19 prudently to provide essential services to its regulated customer base, while working with its regulators
20 to have the opportunity to earn a fair rate of return on investment" and that petitioner would potentially
21 defer capital investment if unfavorable market or financing conditions occur. Respondent also points
22 out that the form 10-K states that petitioner's parent "anticipates that depreciation expense will continue
23 to increase due to ongoing construction at its regulated subsidiaries" but that "depreciation expense
24 related to property additions approved by the appropriate regulatory agency will be recovered through
25 water and electric rates." Respondent asserts then that petitioner's parent believes that costs associated
26 with capital, used to fund construction at its regulated subsidiaries, will continue to be recovered in rates
27 charged to customers. However, if the utility does not expect a sufficient recovery, it will not make the
28 investments. (Respondent's Opening Brief, p. 4.)

1 Respondent also argues that the cost of capital is determined by the CPUC on an ongoing,
2 cyclical basis which allows petitioner to address any shortfall in the cost of its capital in the next
3 proceeding with the CPUC. However, respondent asserts that petitioner has not provided any credible
4 evidence that it will not be able to recover its capital expenditures and operating expenses at a
5 reasonable rate of return, such that making the adjustment to the HCLD value indicator as requested by
6 petitioner would constitute a permanent obsolescence adjustment for a temporary condition that can, and
7 will likely, be corrected in the future. Thus, respondent concludes that no adjustment to the HCLD
8 value indicator is appropriate on this basis. (Respondent’s Opening Brief, p. 4.)

9 Respondent instead argues that petitioner’s regulatory lag is not permanent and is accounted for
10 by the consideration of, and the 25 percent weighting given to, the CEA value indicator. Further,
11 respondent contends that the utilization of the CEA value indicator is consistent with an appropriate
12 consideration of the income approach. For these reasons, respondent concludes that no adjustment to
13 the Board-adopted value is appropriate and that petitioner’s 2010 Board-adopted value should remain
14 \$538,900,000. (Respondent’s Opening Brief, pp. 4-5.)

15 In response to petitioner’s post-conference submission, respondent asserts that the use of the
16 income shortfall method is appropriate, for purposes of measuring obsolescence, if the method is
17 properly used. Respondent contends that, in the income shortfall method formula, appraisal income
18 only relates to property in operation—property which is earning income as of the lien date. Respondent
19 contends that property which is CWIP on the lien date is not included in the HCLD base value because
20 CWIP is not in operation and does not earn income as of the lien date. Consequently, respondent argues
21 that petitioner’s requested adjustments to respondent’s formula improperly removes only “growth”
22 CWIP (CWIP related to new service areas), even though “replacement” CWIP (CWIP related to existing
23 service areas) is also not operational on the lien date, such that “replacement” CWIP should also be
24 adjusted out of respondent’s formula. (Respondent contends that once the appropriate adjustments for
25 CWIP are made, petitioner’s obsolescence adjustment would be reduced to 0 percent.) Respondent
26 contends that, under California rate regulation, once CWIP is placed into service, the CPUC allows for
27 an increase in the utility’s rate base and a resulting increase in income. (Respondent’s Post-Conference
28 Submission.)

1 the accuracy of a value indicator depends on the amount of available comparable data, the number and
2 type of adjustments, and the dollar amount of adjustments. Finally, if a large amount of comparable data
3 is available for a given approach, the appraiser may have more confidence in that approach. For
4 example, if income, expense, and capitalization rate data can be obtained from many properties
5 comparable to the subject, the appraiser may attribute significant accuracy to the income approach. The
6 greatest reliance should be placed on that approach or combination of approaches that best measures the
7 type of benefits the subject property yields. The final value estimate reflects the relative weight that the
8 appraiser assigned, either implicitly or explicitly, to each approach. (AH 502, p. 112.)

9 **Historical Cost Approach** The Historical Cost Approach may be considered appropriate for estimating
10 property value under subdivision (d) of Property Tax Rule 3 “if income from the property is regulated
11 by law and the regulatory agency uses historical cost or historical cost less depreciation as a rate base,”
12 then the value of the property would be based on the “amount invested in the property or the amount
13 invested less depreciation computed by the method employed by the regulatory agency.” AH 542
14 defines the term “regulatory lag” as “the time between changes in a utility’s costs or sales and the
15 corresponding changes in utility rates. It can be advantageous when costs are declining and sales are
16 increasing, and disadvantageous when costs increase and sales decrease.” (AH 542, p. 44.)

17 **Income Approach to Value** Board Property Tax Rule 8, subdivision (a), states that “the income
18 approach is used in conjunction with other approaches when the property under appraisal is typically
19 purchased in anticipation of a money income and either has an established income stream or can be
20 attributed a real or hypothetical income stream by comparison with other properties.” Subdivision (b)
21 describes the income approach to value as the valuation method whereby, “an appraiser values an
22 income property by computing the present worth of a future income stream. This present worth depends
23 upon the size, shape, and duration of the estimated stream and upon the capitalization rate at which
24 future income is discounted to its present worth.” Subdivision (c) provides that “the amount to be
25 capitalized is the net return which a reasonably well-informed owner and reasonably well informed
26 buyers may anticipate on the valuation date that the taxable property existing on that date will yield
27 under prudent management and subject to legally enforceable restrictions as such persons may foresee as
28 of that date.”

