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STATE OF CALIFORNIA

BOARD OF EQUALIZATION

In the Matter of the Petition for Reassessment of the 2009 Unitary Value for: **Qwest Communications Corporation (2463)** Petitioner	**APPEALS DIVISION'S HEARING SUMMARY FOR ORAL HEARING ON PROPERTY TAX PETITION** Appeal No.: SAU 09-006 Case ID No.: 494029

Representing the Parties:

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PROPOSED VALUES

	Value	Penalty	Total
2009 Board-Adopted Value	$182,400,000[1]	$0	$182,400,000
Petitioner's Requested Unitary Value	$130,800,000[2]	0	$130,800,000
Respondent's Recommendation On Appeal	$182,400,000	0	$182,400,000

Issues

1. **Whether petitioner has shown that 25 percent reliance should be placed on its Capitalized Earning Ability (CEA) value indicator.**

2. **Whether petitioner has shown that the 2009 Board-adopted unitary value, based entirely on the Replacement Cost New Less Depreciation (ReplCLD) value indicator, does not adequately account for economic obsolescence.**

   a. **Whether petitioner has shown that the ReplCLD should be adjusted for additional economic obsolescence by using its "Loss in Income Method."**

   b. **Whether petitioner has shown that the ReplCLD should be adjusted for additional economic obsolescence by using its "Inutility Method."**

3. **Whether petitioner has shown that 25 percent reliance should be placed on its "market approach" value indicator.**

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[1] This number has been rounded up from $182,360,934.

[2] Petitioner's original requested unitary value was $106,020,000. In an e-mail dated October 9, 2006, petitioner changed its requested value to $130,800,000 based on several adjustments that are discussed in the hearing summary.

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Appeals Division's Recommendation[3]

The Appeals Division recommends that the Board deny the petition for reassessment because petitioner has not presented evidence or legal authority showing error in respondent's assessment.

BACKGROUND INFORMATION

Qwest Communications Corporation (petitioner) is a long distance subsidiary of Qwest Communications International (hereafter "Qwest International"). Qwest International is a multi-media service provider of voice, video, internet, and data services.[4] Petitioner requests reassessment of its unitary property from the 2009 Board-adopted unitary value of $182,400,000 to $130,800,000 for a total reduction of $51,600,000. Petitioner's 2009 Board-adopted unitary value was determined by placing 100 percent reliance on the Replacement Cost New Less Depreciation (ReplCLD) value indicator. Petitioner contends that its 2009 unitary value should be determined by placing 25 percent reliance on the CEA value indicator, 25 percent reliance on the ReplCLD value indicator using petitioner's "loss in income method" to account for economic obsolescence, 25 percent reliance on the ReplCLD value indicator using petitioner's "inutility method" to account for economic obsolescence, and 25 percent reliance on the "market approach" value indicator. (Petition "Summary of Value Indicators")

Issue 1

Whether petitioner has shown that 25 percent reliance should be placed on its Capitalized Earning Ability (CEA) value indicator.

Petitioner's Contentions

Petitioner contends that the Board should assign 25 percent weight to its CEA value indicator. (Petition - Summary of Value Indicators.) Petitioner explains that it has spent over $300 million in capital expenditures across its entire network to sustain its aging plant and provide necessary upgrades

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[3] Unless the Board otherwise holds, the Board shall take official notice of: the property statement filed with the Board, 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.

[4] In it analysis, respondent mischaracterized petitioner as "multi-media service provider of voice, video, internet, and data services." (Resp. p.1.) Respondent states that its characterization was a mistake and that petitioner is a long-distance carrier.

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and has experienced little growth in its customer base which has prevented it from increasing revenue (Petition, p. 2.)

Petitioner calculated its CEA value indicator by imputing the estimated net operating revenue that a prospective purchaser would anticipate if the property were utilized at an industry average rate of 8 percent. That rate of 8 percent was then multiplied by petitioner's net property in California to obtain an estimated net operating income. Petitioner then prorated the estimated California portion of income attributable to intangibles and working cash and subtracted out that amount. The resulting CEA value indicator was $105,043,386. (Petition, p. 2.)

Respondent's Contentions

Respondent contends that a CEA value indicator is not an appropriate indicator of value in this case because petitioner's income projections are unreliable. Rather, respondent contends that the ReplCLD value indicator is appropriate here because it is a reliable indicator of value for unitary property owned by companies that are not closely regulated and when adjustments for obsolescence have been recognized. Respondent contends that the ReplCLD is also the preferred value indicator when neither reliable sales data nor reliable income data are available. (Resp. Analysis, p. 2.)

Respondent contends that intense competition and current technological and regulatory forces in the telecommunications market make it difficult to determine a reliable income stream. Additionally, respondent contends that petitioner's forecast of future growth is inconsistent with the fact that petitioner is making significant additions to its California property. Respondent points out that petitioner has added over $100 million of California plant in the last 2 years. Respondent contends that the income approach to value may be a reliable indicator of value if developed properly for a mature company that has an established income stream, however, it is inappropriate here because petitioner is adding significant plant capacity. (Resp. Analysis, p.4.)

Petitioner's Reply

Petitioner contends that according to respondent's own appraisal handbooks and California law, appraisers must use all available information to arrive at fair market value but that respondent has failed to do so. Petitioner contends that appraisers do not value property in a vacuum, but rather assess the market conditions, analyze technical and financial data, and use generally accepted appraisal techniques.

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Petitioner contends that respondent's conclusion "flies in the face" of the losses incurred by petitioner ($1.4 billion for 2008). (Pet. Reply, p. 2.)

Petitioner contends that it tried to create an income approach as a benchmark to the ReplCLD created by respondent. Petitioner contends that it offered its property and operations for sale at auction, but the bids were so low that the parent company, Qwest International, decided to end the auction. Petitioner contends that the bids received support the concept of obsolescence in that a prospective purchaser would only pay an amount for the property and business that would support a certain level of income. However, petitioner contends that respondent ignored these facts and circumstances and incorrectly relied on an unadjusted ReplCLD in computing petitioner's assessed value. (Pet. Reply, pp. 2-3.)

Summary of Appeals Conference

At the appeals conference, petitioner was asked to explain how it came up with the industry average return on assets (ROA) rate of 8 percent. Petitioner claimed that it looked at the average for the industry based on guideline companies. Respondent argued that petitioner's CEA value indicator is not a reliable indicator of value because petitioner has had a negative income stream for the last five years. Additionally, respondent claims that it does not know whether respondent used comparable companies to compute the industry average ROA. Petitioner was asked to provide information regarding what guideline companies it used.

Petitioner's Post Conference Submission

Petitioner submitted the industry average ROA analysis. (Petitioner's Post Conference Submission email, attachment p. 5.) Petitioner claims that it prepared the industry average ROA analysis using the same set of guideline companies that respondent used to calculate telecommunications industry equity rates. (Petitioner's Post Conference Submission email, attachment pp. 6-7.) Petitioner notes that while the guideline industry average ROA is 8 percent, petitioner has not achieved a positive ROA in the last 5 years. (Petitioner's Post Conference Submission email.) Petitioner contends that even though petitioner has had negative earnings in the last five years, it imputed Qwest International's 9.41 percent ROA which produces a revised CEA value indicator of $125,780,708. (Petitioner's Post Conference Submission email, attachment p. 4.)

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Applicable Law and Appraisal Principles

Replacement Cost Approach

Property Tax Rule 6,[5] subdivision (a) provides, in part: "The reproduction or replacement cost approach to value . . . is preferred when neither reliable sales data . . . nor reliable income data are available . . . ." In general, the Replacement Cost Less Depreciation (ReplCLD) valuation methodology is estimated by applying trend factors—price level changes, including the application of "current prices to the labor and material components of a substitute property capable of yielding the same services and amenities, with appropriate additions as specified . . . ." (Property Tax Rule 6, subd. (d).) Then, the resulting adjusted cost amount is Replacement Cost New (RCN), which is "reduced by the amount that such cost is estimated to exceed the current value of the reproducible property by reason of physical deterioration, misplacement, over- or underimprovement, and other forms of depreciation or obsolescence. The percentage that the remainder represents of the reproduction or replacement cost is the property's percent good." (Property Tax Rule 6, subd. (e).)

Income Approach to Value

Property Tax Rule 8, subdivision (a) provides in relevant part that "[t]he income approach to value is used in conjunction with other approaches when the property under appraisal is typically purchased in anticipation of a money income and either has an established income stream or can be attributed a real or hypothetical income stream by comparison with other properties." The three fundamental assumptions of the income approach are that: "(1) value is a function of income; (2) value depends on the size, shape, duration, and risk of the income stream; and (3) future income is less valuable than present income." If the nature of the property being appraised does not conform to these assumptions, the income approach to value should not be given great weight. (Assessors' Handbook section 502, *Advanced Appraisal* (1998) (AH 502), p. 55.) The [income] approach requires careful application because small variations in its key variables can be mathematically leveraged into a wide range of estimated value. (Ibid.) The accuracy of the approach depends on the validity of the assumptions used to estimate its key variables. (Ibid.)

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[5] All Property Tax Rules or Board Rules of Practice reference those numbered sections and subsections of title 18 of the California Code of Regulations.

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.)

Appeals Division's Analysis and Conclusion

Petitioner requests that the Board place 25 percent reliance on its CEA value indicator but respondent contends that no reliance should be placed on petitioner's CEA value indicator because petitioner does not have a reliable income stream and petitioner's imputed income projections are unreliable. Respondent also contends that the CEA value indicator is inappropriate because petitioner has added significant plant capacity in the last 2 years.

Petitioner developed its CEA value indicator by imputing the estimated net operating revenue that a prospective purchaser would anticipate if the property were utilized at an industry average rate. Petitioner originally based its CEA value on an industry average ROA of 8 percent and then changed its assessment of value by imputing Qwest International's ROA of 9.41 percent which produced a revised CEA value indicator of $125,780,708. It is unclear to the Appeals Division why petitioner even considered Qwest International's ROA of 9.41 percent when petitioner has argued that it should be valued separate from Qwest International which is, as petitioner has stated, a multi-media service provider of voice, video, internet, and data services whereas petitioner is solely a long distance service provider (see Issue 2 below). At the hearing, appellant should be prepared to explain its rationale for using Qwest International's 9.41 percent ROA to calculate its revised CEA value indicator.

The Appeals Division finds that since petitioner has had a negative operating income for the last 5 years, it is difficult to anticipate what its future income will be. Additionally, it is generally

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recognized that intense competition and current technological and regulatory forces in the telecommunications market make it difficult to determine a reliable income stream. Finally, it is unclear whether the unitary property of the guideline companies used by petitioner to estimate petitioner's ROA are similar or comparable to petitioner's unitary property. For the foregoing reasons, the Appeals Division recommends that no weight should be given to the CEA value indicator.

Issue 2

Whether petitioner has shown that the 2009 Board-adopted unitary value which is based entirely on the Replacement Cost New Less Depreciation (ReplCLD) value indicator, fails to adequately account for economic obsolescence.

Petitioner contends that the Board should place 25 percent reliance on the ReplCLD value indicator reduced by an amount determined under petitioner's "loss in income method" to account for economic obsolescence and should place 25 percent reliance on the ReplCLD value indicator reduced by an amount determined under petitioner's "inutility method" to account for economic obsolescence. For purposes of clarity, each methodology will be discussed separately.

a. Whether petitioner has shown that the ReplCLD should be adjusted for additional economic obsolescence by using its "Loss in Income Method."

Petitioner's Contentions

Petitioner contends that its assets are not earning the market rate of return which in turn has limited the interest of prospective purchasers. In support of this contention, petitioner submitted an article quoting Cogent Communication's Chief Executive Officer, Dave Schaeffer who states with respect to petitioner's sale offer: "The combination of the management's expectation of valuation coupled with [its] negative cash flow quickly led us to conclude that we were not going to be an active bidder on that asset." (Petition p. 2.)

Petitioner states that for appraisal purposes, depreciation is defined as the loss in value due to any cause, including internal and external factors. Petitioner contends that using the ReplCLD, the depreciation is the "amortized" portion of the investment in the total property and does not include the loss in value from functional and economic obsolescence. Petitioner cites Property Tax Rule 6, subdivision (e) which states that: "Reproduction or replacement cost shall be reduced by the amount that such cost is

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estimated to exceed the current value of the reproducible property by reason of physical deterioration, misplacement, over- or underimprovement, and other forms of depreciation or obsolescence." Furthermore, petitioner cites the Code of Professional Ethics and Standards of Professional Practice for the proposition that appraisers are required to consider obsolescence by using generally accepted appraisal principles and are required to investigate and take into account not only that loss of value that results from deterioration due to age but also loss of value due to functional and economic obsolescence. (Petition, pp. 2-3.)

Petitioner contends that the difference between respondent's adjusted capitalization rate of 14.68 percent and petitioner's achieved rate of return on property and equipment of 8.82 percent is 5.86 percent, which translates to a 39.90 percent downward adjustment for economic obsolescence. Petitioner contends that when the 39.90 adjustment is applied to respondent's ReplCLD, it results in an adjusted ReplCLD value indicator of $109,596,000.[6] (Petition, pp. 2-3.)

Respondent's Contentions

Respondent contends that petitioner's loss of income methodology which represents the differences between respondent's capitalization rate and petitioner's calculated average return on operating property and equipment, does not accurately measure obsolescence because it is based on unreliable income projections. Respondent then quotes *The Appraisal of Real Estate* which states that, "[e]xternal obsolescence, the diminished utility of a structure due to negative influences from the outside on site, is incurable on the part of the owner…" Respondent explains that petitioner's calculation of its rate of return is based on the income it estimated in its CEA value indicator. Respondent does not believe that petitioner's estimates of projected income are reliable. Respondent contends that since the income projections that petitioner used to determine the rate of return are unreliable, the projections yield a rate of return that is also unreliable. Therefore, respondent contends that any comparison of petitioner's rate of return to respondent's adjusted capitalization rate is meaningless. (Resp. Analysis, pp. 4-5.)

Additionally, respondent contends that it has already made a downward adjustment to petitioner's unitary value for economic obsolescence. Respondent explains that it applied industry

[6] This number is rounded up from $109,468,392. (Petition "Summary of Value Indicators")

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specific trend factors to petitioner's historical/original costs to calculate replacement cost new (RCN), which was then depreciated based on industry-specific service lives. Thus, respondent contends that its adjustments to petitioner's unitary value using ReplCLD already accounts for economic obsolescence and is consistent with Property Tax Rule 6, subdivision (e). (Resp. Analysis, p. 6.)

Petitioner's Reply

Petitioner contends that respondent fails to explain how external or economic obsolescence is measured. Petitioner states that Arlo Woolery, a noted appraiser and author of Utility Valuation expressly recommends the methodology employed by petitioner. Petitioner contends that respondent uses "inane" quotes from Property Tax Rules as proof of correct methodology, when no methodology has actually been offered. (Pet. Reply, p. 3.)

Petitioner contends that respondent's assertion that its ReplCLD factors include economic obsolescence is incorrect. Petitioner argues that respondent describes (and has valued) petitioner as a multimedia provider of voice, data, and video (Qwest International) while petitioner is only a long distance service provider. Thus, petitioner contends that respondent's factors are not based on comparable properties and that respondent does not recognize the external factors (economic obsolescence) affecting petitioner's value. (Pet. Reply, p. 3.)

Summary of Appeals Conference

At the appeals conference, petitioner was asked to explain how its achieved rate of return on average property and equipment of 8.82 percent was calculated. Petitioner explained that it was calculated by using the income calculated in the CEA value indicator which was then divided by its plant, property and equipment. (See Petition Tab 2: Replacement Cost Less Depreciation: Loss in Income Method.) Respondent argued that petitioner's methodology is circular because it depends on the income calculation of the assets and not the income of the property. Respondent also restated that petitioner's achieved rate of return is flawed because it is based on unreliable income projections.

At the appeals conference, petitioner also argued that it should be valued separately from Qwest International. Petitioner stated that respondent's analysis incorrectly described petitioner as a "multi-media service provider of voice, video, internet and data services." Petitioner contended that commingling the attributes and businesses appears to have led respondent to faulty conclusions about

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petitioner. Respondent agrees with petitioner that its description of petitioner in its analysis is incorrect, however, respondent states that it correctly valued petitioner as an inter-exchange company and considered all obsolescence.

Petitioner's Post Conference Submission

Petitioner submitted the industry average ROA analysis. (Petitioner's Post Conference Submission email, attachment p. 5.) Petitioner claims that it prepared the industry average ROA analysis using the same set of guideline companies respondent used to calculate telecommunications industry equity rates. (Petitioner's Post Conference Submission email, attachment pp. 6-7.) Petitioner notes that while the guideline industry average ROA is 8 percent, petitioner has not achieved a positive ROA in the last 5 years. (Petitioner's Post Conference Submission email.) Petitioner contends that even though petitioner has had negative earnings in the last five years, it imputed Qwest International's 9.41 percent ROA which produces a 28.04% obsolescence adjustment, or a $131,231,632 indicated value (Petitioner's Post Conference Submission email, attachment p. 2.)

b. Whether petitioner has shown that the ReplCLD should be adjusted for additional economic obsolescence by using its "Inutility Method."

Petitioner's Contentions

Petitioner contends that its equipment suffers from obsolescence due to underutilization. Petitioner's contends that only 36 percent of its network is being utilized and that it continues to lose money. Petitioner contends that the heart of its system is its electronics and fiber network system. Petitioner explains that its engineers analyzed inutility by determining the lit fiber usage, which in turn measures the electronic usage as an integrated system, and determined that only 36 percent of its long distance network is being utilized. Based on this estimate, petitioner requests an inutility adjustment of 40 percent. Petitioner contends that the inutility adjustment of 40 percent was calculated using the methodology endorsed by the American Society of Appraisers. (Petition, pp. 3-4.)

Petitioner contends that the full effect of economic obsolescence is the primary weakness of the cost approach. Petitioner cites *Appraising Machinery and Equipment* which states that economic obsolescence is best measured through the use of the income approach, however if adequate earnings are not available to support the value resulting from the cost approach, then additional obsolescence is

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indicated and additional analysis is needed. Petitioner explains that according to *Appraising Machinery and Equipment*, "[w]henever the operating level of an asset or an entire plant is less than its rated capability, an inutility penalty exists. The penalty reduces the capital investment from rated capability to the actual operating levels to 'balance' the plant." (Petition pp. 3-4.) (For a more detailed explanation of petitioner's calculation of the inutility percentage, see petition p. 4; see also petition - Tab 3.)

Petitioner contends that it adjusted respondent's ReplCLD value indicator for obsolescence pursuant to Rule 6, using an inutility calculation as shown in the Board's Assessors' Handbook section 504, *Assessment of Personal Property and Fixtures* (AH 504). The estimated loss in value due to economic obsolescence is calculated to be approximately 40 percent. Deducting this percentage from respondent's ReplCLD yields an adjusted ReplCLD value indicator of $109,468,000.[7] (Petition, p. 4.)

Respondent's Contentions

Respondent contends that petitioner's inutility methodology and request for a 40 percent inutility adjustment is inconsistent with the fact the petitioner has continued to make substantial investments in similar telecommunications property in recent years. Additionally, respondent contends that petitioner has not submitted adequate documentation to supports its claim of additional obsolescence or a shorter economic life. Finally, respondent recognizes that obsolescence has impacted the value of petitioner's taxable unitary property and has already reduced petitioner's ReplCLD value indicator by 47 percent to allow for physical, functional, and economic obsolescence. Moreover, respondent contends that it starts with petitioner's booked costs as a starting point for recognition of petitioner's obsolescence. Respondent explains that petitioner took a write-down of 89 percent of its assets in 2002 in accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144), which requires companies to report any material impairment in assets in their financial statements. Respondent then applied industry-specific trend factors to petitioner's historical/original costs to calculate replacement cost new, which was then depreciated, based on industry-specific service lives and is consistent with Property Tax Rule 6, subdivision (e). Thus,

[7] This number is rounded down from $109,468,392. (See Petition - Summary of Value Indicators.)

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respondent does not recommend any additional obsolescence adjustment based on petitioner's inutility methodology. (Resp. Analysis, p. 6.)

Petitioner's Reply

Petitioner agrees that substantial investment has been made to maintain the integrity of its system and keep up with the technological change. However, petitioner contends that with the massive migration from wireline local exchange telecommunications to wireless communications (which includes long distance) and to IP telecom, the market for stand-alone long distance service has diminished substantially. Petitioner contends that respondent fails to account for lack of usage and demand, and price diminishment and that these factors can only be measured by an inutility study and analysis of financial returns. (Pet. Reply, pp. 3-4.)

Summary of Appeals Conference

At the appeals conference petitioner was asked to explain why it continues to make substantial investments if the long distance network in underutilized. Petitioner responded that it only has two viable options: (1) to walk away; or (2) to continue to make substantial investments in the hope that it will keep current customers and acquire new customers with the hope of making money over the next five years.

Respondent requested that petitioner provide information regarding whether the cost of petitioner's "owned" fiber had been written off in 2002 and whether petitioner has put in any additional fiber since that time. Respondent explained that if the owned fiber (used in the inutility calculation) is the cost of the owned fiber that has been written off, then no further adjustment is warranted because the cost on petitioner's books was reduced by 89 percent in 2002.

Finally, petitioner requested any and all information regarding respondent's calculation of petitioner's 2009 Board-adopted ReplCLD value indicator. In response to petitioner's request, respondent provided the following information:

- Reproduction Trend Indices Calculations
- Replacement Cost New Factors (Interexchange Specific Industry)
- Computer Equipment Valuation Factors

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Respondent also referred petitioner to the BOE website (www.boe.ca.gov) for the following:

- 2009 RCN Factors
- 2009 Condition Percent Good Factors
- 2009 Equipment Index and Percent Good Factors (AH 581)

Respondent, however, did not disclose confidential taxpayer information it received from other state assesses that it used to derive its opinion of petitioners 2009 unitary value. Respondent contends that other taxpayers' information is confidential and exempt from disclosure. Petitioner did not dispute this contention.

Petitioner's Post Conference Submission

Petitioner continues to argue that, based on respondent's adjustment for economic obsolescence, it appears that the ReplCLD factors used by respondent still contain attributes of Qwest International. Petitioner also contends that 89 percent of its assets were written-down in 2002 (pursuant to SFAS 144) and since that time, the company has lost approximately $1 billion per year. Petitioner contends that it has had negative earnings in the last five years and even if a prospective purchaser were to assume that petitioner's financial outlook would improve to the point where petitioner could earn its cost of capital within five years, using the Board's current capitalization rate of 14.68 percent, the 2009 assessed value would be $91,957,000, not $182,400,000. (Petitioner's Post Conference Submission email.)

Petitioner contends that pursuant to respondent's comments during the appeals conference regarding petitioner's inutility calculation, petitioner adjusted the analysis to apply the 40% inutility percentage to only the assets placed in service after the 2002 impairment. Petitioner contends that the assets added subsequent to the 2002 SFAS 144 write-down were recorded at their full historical cost and, therefore, subject to the obsolescence adjustment using the inutility method. The resulting ReplCLD indicator of value is $142,870,802. (Petitioner's Post Conference Submission email, attachment p. 3.)

Finally, petitioner contends that respondent has made several invalid arguments. First, respondent suggests that petitioner's booked costs represent the appropriate value because they were previously written down in 2002 to reflect functional and economic obsolescence. This statement completely ignores any property added subsequent to the 2002 impairment. Second, respondent

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suggests its depreciation factors include ALL forms of obsolescence. Petitioner submits that it would be virtually impossible for any depreciation factor/table to fully account for economic obsolescence, particularly considering what has occurred in the economy in the last two years. Petitioner contends that respondent has failed to consider any other approaches to value to validate its cost indicator.

Applicable Law and Appraisal Principles

Replacement Cost Approach

Property Tax Rule 6,[8] subdivision (a) provides, in part: "The reproduction or replacement cost approach to value . . . is preferred when neither reliable sales data . . . nor reliable income data are available . . . ." In general, the Replacement Cost Less Depreciation (ReplCLD) valuation methodology is estimated by applying trend factors—price level changes, including the application of "current prices to the labor and material components of a substitute property capable of yielding the same services and amenities, with appropriate additions as specified . . . ." (Property Tax Rule 6, subd. (d).) Then, the resulting adjusted cost amount is Replacement Cost New (RCN), which is "reduced by the amount that such cost is estimated to exceed the current value of the reproducible property by reason of physical deterioration, misplacement, over- or underimprovement, and other forms of depreciation or obsolescence. The percentage that the remainder represents of the reproduction or replacement cost is the property's percent good." (Property Tax Rule 6, subd. (e).)

Obsolescence.

Obsolescence may occur when property is outmoded (functional obsolescence) or when some event has substantially diminished the future earning power of the property (economic or external obsolescence). As discussed in the American Institute of Real Estate Appraisers handbook, The Appraisal of Real Estate (AIREA, 9th Ed.): "External [i.e., economic] obsolescence, the diminished utility of a structure due to negative influences from outside the site, is incurable on the part of the owner. … External obsolescence can be caused by a variety of factors—e.g., neighborhood decline; the property's location in a community, state, or region; or market conditions."[9] According to the Board

[8] All Property Tax Rules or Board Rules of Practice reference those numbered sections and subsections of title 18 of the California Code of Regulations.

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Assessor's Handbook, *Section 502: Advanced Appraisal* (December 1998), at page 30, economic or external obsolescence is generally estimated either by capitalizing net income loss or by a market comparison (i.e., paired sales analysis).

In general, there is no requirement that a petitioner claiming extraordinary obsolescence for property tax purposes also have undertaken an asset impairment write-down for financial statement purposes. However, whether or not a petitioner has taken the step of disclosing the alleged impaired assets and/or obsolescence losses to its shareholders and lenders in financial statements generally is considered an evidentiary factor the Board may take into consideration.

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 County* (1980) 101 Cal.App.3d 246.)

Appeals Division's Analysis and Conclusion

The 2009 Board-adopted unitary value was determined by placing 100 percent reliance on the ReplCLD value indicator which respondent has already been reduced by 47 percent to allow for physical, functional, and economic obsolescence. At the hearing, respondent should be prepared to discuss how the ReplCLD value indicator takes into account all of petitioner's economic obsolescence.

Loss in Income Method

Petitioner originally argued that the difference between respondent's adjusted capitalization rate of 14.68 percent and petitioner's achieved rate on average property and equipment of 8.82 percent is 5.86 percent, which translates to a 39.90 percent downward adjustment for economic obsolescence, resulting in an adjusted ReplCLD of $109,596,000. Petition now applies Qwest International's 9.41% ROA which it

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claims would result in an adjusted ReplCLD of $131,231,632. The ROA used by petitioner is important in this calculation because it is used to determine an imputed income which petitioner then divides by its California property and equipment. However, as previously stated in Issue 1, it is unclear to the Appeals Division why petitioner imputed Qwest International's ROA of 9.41 percent rather than the alleged industry average of 8 percent when petitioner argues that it should be valued separate from Qwest International. Also it is unclear to the Appeals Division whether the guideline companies to which petitioner refers are actually comparable properties. In view of those concerns, the Appeals Division finds that petitioner's loss in income method does not establish the existence of additional obsolescence and, thus, petitioner has not met its burden of proof on that issue. At the hearing, petitioner should be prepared to address both of those issues and to provide evidence to support its position.

Inutility Method

Petitioner proposes that the Board use its inutility methodology for calculating extraordinary economic obsolescence and applying it to the ReplCLD value indicator. Originally, petitioner claimed that its 40 percent inutility calculation should be applied to all its assets. Petitioner then adjusted the analysis to apply the 40% inutility percentage to only the assets placed in service after the 2002 impairment. The resulting ReplCLD indicator of value is $142,870,802. At the hearing, petitioner should be prepared to explain its method of calculating this adjustment, describe its supporting evidence of inutility and cite appraisal authority for using this method. Petitioner should also be prepared to explain why it continues to invest in similar types of property when, as petitioner asserts, its existing property is significantly underutilized.

Respondent should be prepared to discuss the evidence that petitioner has submitted in support of its claimed inutility and whether it shows that only 36 percent of petitioner's long distance network is being utilized. Respondent should also be prepared to explain its statement that a 40 percent additional obsolescence adjustment for inutility is inconsistent with petitioner's substantial investments in similar telecommunications property in recent years.

Issue 3

Whether petitioner has shown that 25 percent reliance should be placed on its "market approach" value indicator.

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Petitioner's Contentions

Petitioner states that in early June petitioner conducted an auction for its underperforming long distance system. Petitioner contends that it hoped to sell for somewhere between $2-$3 billion but that the bids came in substantially lower at less than $1 billion. Petitioner contends that this is due to the lack of value in the fiber networks and cites the Wall Street Journal for this contention. Based on the foregoing, petitioner calculated a comparable sales value indicator based on the upper end of all the bids received and allocated that value to its California property to arrive at an opinion of unitary value of $99,960,000. Petitioner cites Property Tax Rule 2, subdivision (a) in support of its contentions. (Petition p. 4.)

Respondent's Contentions

Respondent contends that petitioner's "market approach" should not be used because there is neither an active market for nor a sale of the subject property. Respondent contends that petitioner has estimated the value of its California property based on unsubstantiated and unverifiable bids which were not accepted. Thus, respondent contends that petitioner's proposed valuation is not based on actual sales of comparable property and therefore does not satisfy the requirements of Property Tax Rule 2, subdivision (a) and Property Tax Rule 4. (Resp. Analysis, p. 8.)

Petitioner's Reply

Petitioner was offered for sale on June 1, 2009, and numerous knowledgeable parties were interested in purchasing petitioner for a price at which they could earn an adequate return on and of the investment. Although petitioner had expected between $2-$3 billion, telecommunication companies such as Level 3 Communications and AT&T refused to make offers at that level. The offers made were less than a billion. Petitioner contends that this was a public sale, in which knowledgeable parties participated, with both sides seeking to maximize their gains and neither in a position to take advantage of the other. Petitioner states that it withdrew the property because the offers were too low. However, petitioner contends that the offers are reflective of the property's earning capabilities in the hands of prospective purchasers, which constitutes a fair market value transaction. (Pet. Reply, p. 4.)

Summary of Appeals Conference

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At the appeals conference, petitioner was unable to provide the exact number of offers but claimed that between 5-10 purchase offers were made and the highest was approximately $1 billion. Respondent argued that petitioner's "market approach" is not reliable because there are no comparables and there was not an actual sale. Additionally, respondent states that petitioner's allocation of value to California was based on route miles and not property. Respondent contends that if the allocation was based on property (rather than route miles) the number in petitioner's calculation would be more like 12.33 percent.

Petitioner's Post Conference Submission

Although petitioner believes its value is in the range of $2-$3 billion, the market believes its value is less than $1 billion. Petitioner contends that it does not matter what a seller believes the value is – the market is the final judge of value. Pursuant to respondent's suggestion to use 12.33 percent California Interstate Allocation Factor, the factored $1 billion offer would indicate a CA market value of $123,300,000 (Petitioner's Post Conference Submission email, see attachment p. 8.)

Applicable Law and Appraisal Principles

Property Tax Rule 4 provides that, "[w]hen reliable market data are available with respect to a given real property, the preferred method of valuation is by reference to sales prices."

Property Tax Rule 2, subdivision (a) provides in relevant part that:

> In addition to the meaning ascribed to them in the Revenue and Taxation Code, the words "full value", "full cash value", "cash value", "actual value", and "fair market value" mean the price at which a property, if exposed for sale in the open market with a reasonable time for the seller to find a purchaser, would transfer for cash or its equivalent under prevailing market conditions between parties who have knowledge of the uses to which the property may be put, both seeking to maximize their gains and neither being in a position to take advantage of the exigencies of the other.

Appeals Division's Analysis and Conclusion

The comparative sales approach is reliable in an active market in which there are recent sales of comparable properties available or when the subject property has been sold in an arm's length transaction. Here it is important to note that there was no actual sale, petitioner did not accept any of the offers and there are no recent sales of comparable property. An arms'-length transaction contemplates a willing buyer and a willing seller. Here, we do not have a willing seller as evidenced by the fact that

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petitioner did not actually sell its property. Based on the foregoing, the Appeals Division does not believe that petitioner's "market approach" is a valid indicator of value and that petitioner has not met its burden of proof on this issue.

At the hearing, the parties should be prepared to discuss and cite any appraisal authority for the proposition that the sales comparison approach contemplates reliance on purchase offers rather than actual prices from consummated sales transactions.