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PROPERTY TAX APPEAL

CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Petition for Reassessment of the 2014 Unitary Value for: **Verizon California Inc. (0201)** Petitioner	Appeal No.: SAU 14-031 Case ID No.: 837518 Nonappearance Hearing Date: November 19, 2014

Representing the Parties:

For the Petitioner: Peter W. Michaels, Attorney at Law

For the Respondent: Leslie Ang, Tax Counsel
Attorney for State-Assessed Properties Division

Richard Reisinger, Business Taxes Administrator III
State-Assessed Properties Division

Counsel for Appeals Division: Louis A. Ambrose, Tax Counsel IV

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VALUES AT ISSUE

	Value	Penalty	Total
2014 Board-Adopted Unitary Value	$2,936,500,000	$0	$2,936,500,000
Petitioner's Requested Unitary Value	$2,256,066,000	$0	$2,256,066,000
Respondent's Recommendation On Appeal	$2,609,100,000	$0	$2,609,100,000

LEGAL ISSUE 1

Whether petitioner has established that the 2014 Board-adopted unitary value is excessive due to reliance on BCRI Valuation Services (BCRI) percent-good factors.

FINDINGS OF FACT AND RELATED CONTENTIONS

Verizon California, Inc. (petitioner) is the second largest incumbent local exchange carrier in the State of California. Petitioner is a wholly owned subsidiary of Verizon Communications Inc. Petitioner is regulated by the California Public Utilities Commission (CPUC) and, like other

state-assessed incumbent local telephone companies, is designated as a telephone service provider of last resort (POLR). Prior to the Board's adoption of the 2014 unitary value, petitioner submitted a "Full Cash Value Appraisal, as of January 1, 2014, performed by Duff & Phelps for petitioner's properties in California (2014 D&P Study), in collaboration with CostQuest Associates (CostQuest) and Technologies Futures, Inc. (TFI). The 2014 Board-adopted unitary value of $2,936,500,000 was based on 100-percent reliance on the Replacement Cost Less Depreciation (ReplCLD) value indicator.

In the petition, petitioner maintains that the "depreciation estimates" used in the 2014 D&P Study are reliable and that this Board has accepted D&P's depreciation estimates with relatively minor adjustments since 2009. Petitioner contends that the Board rejected D&P's percent-good factors as of the 2014 lien date and used percent-good factors developed by BCRI, the consulting firm of the expert hired by the Board in pending tax refund actions between petitioner and the Board. Petitioner asserts that respondent has not disclosed the factual or methodological bases, or the assumptions and calculations upon which the BCRI percent-good factors were determined or upon which D&P's depreciation estimates were rejected. Petitioner states that respondent's explanation for using the BCRI factors reflects that respondent believes these percent-good factors are more representative of the depreciation incurred by the property used by large local exchange telephone companies.

In its reply brief, petitioner contends that respondent fails to provide a "meaningful substantive or quantitative explanation" for its position that the BCRI percent-good factors are more reliable. Petitioner states that respondent has relied on the D&P depreciation estimates for five years, which estimates petitioner contends are reliable. Petitioner further states that respondent rejected the D&P percent-good factors for 2014 noting that these factors were "significantly lower" than for prior years based on respondent's assumption that the D&P percent-good factors were "predicated on an unacceptable Fiber-to-the-Premises (FTTP) and fixed wireless hybrid network." Petitioner asserts that respondent should not have rejected D&P's FTTP/fixed wireless model and that the D&P's percent-good factors are "inherently based on market data." Petitioner contends that the 2014 Board-adopted unitary value is excessive because it is based on less reliable BCRI percent-good factors.

Respondent states that petitioner submitted the 2014 D&P Study based on a FTTP/fixed

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wireless hybrid network that includes percent-good factors significantly lower than those in studies provided by petitioner and used by respondent for previous years. Respondent explains that a FTTP network is a form of fiber-optic communication delivery in which a fiber-optic cable is run to the premises occupied by the subscriber and that a fixed wireless network uses wireless systems to connect two fixed locations (instead of using fiber-optic cables). Respondent further states that fixed wireless is recognized as a more cost-effective alternative to an FTTP network, but petitioner has not demonstrated that a fixed wireless architecture is a feasible and realistic replacement for its existing network (see Issue 3 below). Respondent states that the 2014 D&P Study includes percent-good factors significantly lower than those in studies provided by petitioner and used by respondent for previous years. Respondent notes that, from 2009 through 2011, respondent accepted the percent-good factors used in petitioner's D&P Studies, which were based on a 100-percent FTTP replacement model. Respondent states that the 2012 and 2013 D&P Studies proposed an FTTP/fixed wireless hybrid network replacement model and, for that reason, respondent rejected the D&P Study percent-good factors for those years and instead used the 2011 percent-good factors with some adjustments.

Respondent states that petitioner has not explained why the percent-good factors developed by the D&P Studies were lower than prior years, but respondent believes it is the result of using an FTTP/fixed wireless hybrid replacement cost model. Because respondent does not accept the FTTP/fixed wireless hybrid network as a viable replacement model for petitioner's property, respondent states that it did not accept the corresponding lower percent-good factors and sought more reliable percent-good factors. Respondent states that it used percent-good factors developed by BCRI because respondent determined that these percent-good factors represent the most accurate and reliable information with respect to telecommunications property. Respondent contends that the BCRI percent-good factors are the most accurate and reliable because these percent-good factors are based on market evidence of actual replacements of technology in contrast to the 2014 D&P Study percent-good factors, which are more heavily based on a methodology that relies on forecasts about hypothetical changes in telecommunications technology, rather than actual market data.

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APPLICABLE LAW AND APPRAISAL PRINCIPLES

Percent-Good Factors

Percent-good factors are the basis for adjusting the replacement cost new (RCN) into an indicator of fair market value. The factors are complements of physical deterioration and functional obsolescence and are used to determine the remaining value of a property. The factors used for a given property type are derived from the expected economic life of that property type and are based on service life studies that help determine the applicable percent-good factors. Service life studies survey industry participants that own specific types of property and can measure some, but not all, economic obsolescence. Examples of economic obsolescence include: increased competition, unexpected technological innovation, legal limitations on use, and environmental factors. (*Unitary Valuation Methods* (March 2003) (UVM), p. 30.)

In addition to economic life, there are four other variables that have an effect on percent-good factors. These are: the rate of return, the method of calculation, the survivor curve, and the presence of an income adjustment factor. Respondent determines these variables as follows: rate of return annually established by the Property Tax Department; single-life calculation method; R-3 survivor curve; and the use of an income adjustment factor reflecting a 10-percent decline over average life. Petitioner has the burden of establishing the existence of any additional or extraordinary obsolescence. (See Property Tax Rule 6, subds. (d) & (e); Assessors' Handbook section 502, *Advanced Appraisal* (December 1998) (AH 502), pp. 20-21; UVM, p. 30.)

ANALYSIS AND DISPOSITION

The Board is presumed to have correctly determined the value of the property at issue, and petitioner bears the burden of proving otherwise. (Cal. Code Regs., tit. 18, § 5541, subd. (a).) Petitioner contends that respondent has not provided an explanation for using the BCRI percent-good factors rather than those developed by D&P. However, respondent explains that, beginning in 2012, the D&P percent-good factors were significantly lower than in prior years, which apparently was attributable to the FTTP/fixed wireless hybrid network replacement model first proposed in the 2012 D&P Study. In response, petitioner merely asserts that D&P's percent-good factors are "inherently based on market data," but does not provide any evidence or argument to support petitioner's

contention that those factors are more reliable than the BCRI percent-good factors used by respondent. Thus, petitioner has not met its burden of proof to overcome the presumption that the 2014 Board-adopted unitary value, which relied on the BCRI percent-good factors, was correctly determined.

LEGAL ISSUE 2

Whether petitioner has shown that the 2014 Board-adopted unitary value did not properly allocate fiber and copper in the ReplCLD value indicator of petitioner's FiOS[1] account.

FINDINGS OF FACT AND RELATED CONTENTIONS

Petitioner states that it submitted D&P and CostQuest data in support of its allocation of RCN to non-metallic (fiber) and metallic (copper) cable. Petitioner asserts that respondent has relied on this data for many years and, during the development of the value indicators, respondent stated that it would evaluate the D&P and CostQuest data to determine the RCN allocation. Petitioner asserts that the information submitted allocates replacement fiber in FiOS areas and petitioner's "transport ring," which is depreciated based on the fiber's effective age and allocates replacement fiber in non-FiOS areas that is depreciated based on the copper's effective age. Petitioner states that the information assigns zero RCN to duplicate copper in FiOS areas and assigns a cost to cure for transitioning "duplicate copper customers" to the FiOS network.

In a reply brief, petitioner maintains that its data supports the RCN allocation to fiber and copper cable in FiOS areas and petitioner's transport ring because the allocation in FiOS areas is depreciated based on the fiber's effective age, the allocation of replacement fiber in non-FiOS areas is depreciated based on the copper's effective age, and the D&P Study assigns zero RCN to duplicate copper in FiOS areas and assigns a cost to cure for transitioning "duplicate copper customers" to the FiOS network.

Respondent states that petitioner provided a D&P Study based on a 100-percent FTTP, which made an unreasonable allocation of fiber to copper cable in the development of the RCN and depreciation factors. Respondent states that the study's replacement model consisted entirely of fiber and, thus, copper is assigned a zero RCN. Even though no copper cable was included in the RCN

[1] FiOS is a bundled Internet access, telephone, and television service that operates over a fiber-optic communications network.

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portion, respondent states that the study includes copper within the FiOS footprint for depreciation purposes, which results in a significant undervaluation of the fiber network because copper cable depreciates at a much faster rate than fiber-optic cable.

Respondent states that it requested, and petitioner provided, a revised analysis reallocating the fiber-optic cable RCN within the FiOS footprint only to fiber-optic cable. Respondent states that the revised analysis was used to determine the 2014 Board-adopted unitary value, but after respondent made this adjustment petitioner submitted a second revised analysis in support of a lower value. Respondent states that, on September 18, 2014, petitioner provided corrections to the second revised analysis that made allocation adjustments to the various copper and fiber accounts in calculating the RCN, thereby resulting in several other adjustments, including depreciation, which respondent found to be reasonable. Due to the complexity of the study's allocation of cable RCN, respondent states that it will continue to evaluate the validity and reliability of the cable RCN allocation in future studies. For this year, based on this analysis, respondent recommends an adjustment to the ReplCLD value indicator that results in a $327,400,000 reduction to the 2014 Board-adopted unitary value (i.e., an adjustment of the unitary value from $2,936,500,000 to $2,609,100,000). We agree that such an adjustment is reasonable based on the record of this petition.

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LEGAL ISSUE 3

Whether petitioner has established that a fixed wireless network is the most probable replacement model for rural service areas.

FINDINGS OF FACT AND RELATED CONTENTIONS

Petitioner states that the 2014 D&P Study RCN estimate recognizes that petitioner's legacy copper network would likely be replaced with a fiber-optic cable network in densely populated areas and a fixed wireless network in more remote areas. Petitioner states that respondent rejected the premise that fixed wireless architecture is the most probable replacement network and questioned whether petitioner could legally or practically replace all or a portion of its wireline network with a fixed wireless architecture and whether petitioner intends to offer fixed wireless services to its customers. Petitioner asserts that, currently, in rural areas where fiber is not deployed, cable providers and independent wireless Internet service providers are using fixed terrestrial wireless networks to offer

Internet, video, and voice services, including advanced services like Voice over Internet Protocol (VoIP) and bandwidth-heavy applications. Petitioner further asserts that, as of the 2014 lien date, fixed wireless providers offered a compelling service alternative to Fiber-to-the-digital (FTTd) loop architecture. Petitioner maintains that fixed wireless provides cost advantages over copper wires, particularly in lower density regions where large amounts of copper miles are required to reach potential customers, which results in higher capital network construction costs and maintenance expenses. Petitioner also maintains that fixed wireless network architecture provides the same or better utility and functionality than a copper based network, but with significantly lower combined capital and operational expenses.

Petitioner contends that it is not legally restricted by the California Public Utilities Commission (CPUC) or by any other regulator from serving its wireline customers through the most effective means, including appropriate fixed wireless alternatives. Specifically, petitioner contends there are no legal restrictions limiting a provider of last resort (POLR), such as petitioner, from employing fixed wireless networks to provide local exchange service. Petitioner notes that, prior to the 2014 lien date, the CPUC adopted an updated definition of "basic telephone service" that is designed to allow telecommunications providers to service their customers on a technology-neutral basis using all forms of communications technology, including, but not limited to, wireline, wireless, VoIP, and any other future technology that may be used in the provision of telephone service. Petitioner further notes that the CPUC specifically acknowledged, as long as the specified elements are met, "[a]ny carrier may use any technology to satisfy any obligation to provide basic service." Thus, petitioner contends that a "key fact" asserted by respondent is inaccurate.

Petitioner further asserts that for two decades the CPUC has encouraged the deployment of alternative technology by POLRs. Petitioner states that, in 1993, the CPUC issued a report entitled "Enhancing California's Competitive Strength: A Strategy for Telecommunications Infrastructure" (Infrastructure Report), which recommended including the promotion of "a technology-neutral infrastructure policy to the maximum extent possible." Petitioner notes that the Infrastructure Report stated that telecommunications providers in California, including local exchange carriers, should be allowed to make their own investment decisions, including the type of technology employed. Petitioner

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also states that, in Decision 94-08-029, the CPUC affirmed that POLRs should be free to choose technologies to bring advanced telecommunications to California.

Petitioner further contends that federal law provides support for a "technology-neutral infrastructure policy" and cites the Telecommunications Act of 1996 which provides that "each state with regulatory jurisdiction over telecommunications services shall encourage deployment of advanced telecommunications capability on a reasonable and timely basis." Petitioner also cites Decision 97-06-090 in which the CPUC held that "[t]he pursuit of a technology-neutral policy finds support in the Telecommunications Act of 1996." Petitioner concludes that the CPUC specifically approved the use of wireless technologies through its recognition that "[a]dvancements in technology have also affected the telephone industry" and that "wireless technology offers providers an alternative to placing wires or cables into the ground." Petitioner asserts that the CPUC reaffirmed its commitment toward a technology-neutral telecommunications infrastructure policy as expressed in the Infrastructure Report, which allows "the telecommunications providers to make their own investment decisions, including the type of technology they employ." Finally, petitioner states that fixed wireless service is already available in California by several providers and that petitioner plans to utilize fixed wireless in "areas that are more rural and sparsely populated, where LTE [Long-Term Evolution] wireless will provide services instead of copper."

Petitioner states that respondent's appraisal narrative questions the amount of time required to design and construct the replacement network and whether the D&P Study includes all of the costs associated with engineering, permitting, and construction. Petitioner asserts that the D&P Study's RCN model includes all costs, and particularly engineering costs, necessary to construct the network and put the plant into productive and beneficial operation.

Respondent states that the 2014 D&P Study proposes a fixed wireless network as a replacement model for petitioner's current legacy copper networks located in remote areas. Respondent contends that a hypothetical fixed wireless network is not an appropriate replacement network model because it does not meet the criteria of the Board's *Guidelines for Substantiating Additional Obsolescence for State-Assessed Telecommunications Properties* (Guidelines), which provide that "[i]n developing a replacement cost, the substitution with technologically superior property

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must be more than a theoretical exercise; the proposed replacement must be available, implementation should follow a realistic time frame, and include all associated costs." With regard to petitioner's assertion that there are no legal restrictions preventing it from employing fixed wireless networks, respondent contends that the issue is not whether petitioner can establish fixed wireless networks, but whether petitioner may legally provide only fixed wireless structures in rural or remote areas as a POLR. Respondent contends that petitioner has not provided any evidence to demonstrate that, at this time, such a network would be consistent with petitioner's duty as a POLR to provide rural areas with services that are reasonably comparable to those offered in urban areas and available at rates that are reasonably comparable to rates charged for similar services in urban areas, citing 47 U.S.C. section 254(b)(3). Respondent contends that, in order for a substitute property to be the only service available, such service must be legal and petitioner has provided no evidence that it can legally substitute entire rural area copper networks with fixed wireless networks.

Respondent further contends that petitioner has provided no evidence that it is currently providing fixed wireless service to its California customers, or that it plans to provide fixed wireless service to its California customers in the near future. Respondent states that petitioner has attempted to offer wireless networks as a replacement for copper line networks to POLR customers outside of California but, upon being met with complaints related to wireless service, decided to implement a fiber-optic-based service instead.

In its reply brief, petitioner contends that respondent's reliance on the Guidelines is "misguided because the underlying issue presented is replacement architecture, not extraordinary obsolescence." Petitioner maintains that, as of the 2014 lien date, fixed wireless providers offered a compelling service alternative to the FTTd loop architecture owing to the cost advantages over copper wire in lower density regions with the same or better utility and functionality than a copper-based network, but with significantly lower combined capital and operational expenses. Thus, petitioner contends that fixed wireless was its most probable replacement network in sparsely populated service areas as of the 2014 lien date.

Petitioner contends that, contrary to respondent's representations, there were no legal restrictions as of the 2014 lien date to limit POLRs from employing fixed wireless networks or other

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wireless technologies to provide local exchange service. Petitioner asserts that wireless technology has been deployed by incumbent local exchange carriers in California for many years to serve wireline customers. Petitioner cites Decision 92-01-016, in which the CPUC authorized POLRs to use the Basic Exchange Telephone Radio Service spectrum to provide basic digital telephone service to subscribers in rural areas. Petitioner repeats its claim that in 2012 the CPUC adopted an updated definition of "basic telephone service." Petitioner maintains that it is not legally restricted by the CPUC or any other regulator in making network infrastructure decisions that will best serve its wireline customers through the most effective means, including fixed wireless alternatives.

APPLICABLE LAW AND APPRAISAL PRINCIPLES

ReplCLD Value Indicator

Property Tax Rule 6,[2] subdivision (a) provides, in pertinent part, that: "The reproduction or replacement cost approach to value . . . is preferred when neither reliable sales data . . . nor reliable income data are available . . . ." In general, the ReplCLD valuation methodology is estimated by applying the appropriate trend factors, 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 . . . ." (Property Tax Rule 6, subd. (d).) The resulting adjusted cost amount 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).)

Replacement Cost New

The replacement cost new (RCN) is an estimate of the current cost to replace a property with a new property *of equivalent utility*, which should include all economic costs necessary to put the property to productive and beneficial use. The RCN is calculated by applying an index factor, which is acquired from industry data, to the historical acquisition cost of the unitary property of the assessee, segregated by year of acquisition. The use of index factors applied to historical cost data is the

[2] All references to Property Tax Rules are to sections of title 18 of the California Code of Regulations.

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preferred method of calculating the RCN for mass appraisal purposes. The historical cost of property is adjusted (in the aggregate or by groups) for replacement cost level changes by multiplying the cost incurred in a given year by the appropriate replacement cost index factor. RCN should reflect the current cost a knowledgeable person or company would pay if it were necessary to replace the subject property with a new property of equivalent utility. RCN is considered an excellent starting point for estimating the value of newer property that is not regulated for rate of return because the property owner has the freedom, with competitive constraints, to adjust revenues to current costs based on market factors. (UVM, p. 23.)

Development of RCN Trend Factors

With respect to RCN trend factors that are the bases for converting the historical cost of property into current replacement cost levels, the UVM, at page 28, further provides:

> These factors measure the current cost of replacing the existing property with a substitute property having *equivalent utility*.
>
> In developing replacement cost index factors, staff currently relies on two sources: (1) studies submitted by industry participants and (2) studies performed by the Policy Planning and Standards Division (PPSD) of the Property Taxes Department. The PPSD studies at present pertain only to general purpose computer equipment and peripherals.

Economic Principle of Substitution

The rationale for the use of the cost approach is based on the economic principle of substitution, which holds that a rational person will pay no more for a property than the cost of acquiring a satisfactory substitute, assuming no costly delay. If the condition of no costly delay is not satisfied, the cost of the delay must be added to the cost of a substitute property. If the delay in acquiring a substitute is too costly so that it would not be worthwhile to replace the property, then the cost of replacement cannot be said to represent the property's market value. (AH 502, p. 12.)

ANALYSIS AND DISPOSITION

The Board is presumed to have correctly determined the value of the property at issue, and petitioner bears the burden of proving otherwise. (Cal. Code Regs., tit. 18, § 5541, subd. (a).) Petitioner's RCN model assumes that a fixed wireless network is a satisfactory substitute for the existing copper network based on petitioner's assertion that fixed wireless networks: (1) are in use by

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cable providers and Internet service providers; (2) provide the same or better utility and functionality; and (3) are more cost effective in terms of capital construction costs and maintenance expenses. Petitioner also asserts that there are no legal restrictions on the deployment of a fixed wireless network to provide local exchange service in view of the fact that the CPUC's definition of "basic telephone service" allows petitioner to use such technology, subject to certain requirements, to satisfy its obligation to provide basic service.

While petitioner correctly states that fixed wireless networks are in use by other cable and Internet providers, petitioner has not demonstrated that those networks provide the same or better utility and functionality than a copper wireline network. In fact, technology writers and telecommunications analysts have pointed out the functional shortcomings of petitioner's wireless-based Voice Link service as compared with the existing copper network.

In this regard, petitioner's attempt to replace the copper wireline network destroyed by Hurricane Sandy on Fire Island, New York with its Voice Link service was opposed by residents who claimed that it provided spotty service during emergencies and did not support Internet service, fax machines, or alarm systems. As a result, appellant changed its planned deployment of its wireless-based system and instead decided to rewire the western part of Fire Island with fiber optic cable[3] Thus, petitioner's experience in Fire Island suggests that a fixed wireless network does not have equivalent utility with a copper wireline network such that it would be considered a satisfactory substitute for purposes of a replacement cost valuation model. In addition, petitioner has not presented any evidence of an intention to deploy a fixed wireless network in rural and remote areas of California (e.g., an application with the CPUC to authorize such deployment). For the foregoing reasons, petitioner has not met its burden of proof on this issue.

<u>LEGAL ISSUE 4</u>

Whether petitioner has shown that 2014 Board-adopted unitary value reflects all functional and economic obsolescence.

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[3]See *Verizon Backing Off Plans for Wireless Home Phones* <http://nytimes.com/2013/09/13/nyregion/verizon-abandons-plans-for-wireless-home-phones-in-parts-of-new-york.html> (as of November 26, 2014).

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FINDINGS OF FACT AND RELATED CONTENTIONS

Petitioner contends that the 2014 Board-adopted unitary value should not have disallowed certain obsolescence adjustments in the 2014 D&P Study. Petitioner asserts that continuing access line losses, combined with its ongoing legal duty to serve as a POLR, will result in excess network capacity and less revenue to pay for fixed costs. Petitioner asserts that it incurred excess operational and maintenance costs, including excess power costs, for maintaining a duplicate copper network when compared to a replacement fiber network, as well as the obsolescence attributable to non-working, non-revenue-generating POLR assets.

Petitioner states that its property has suffered significantly more incurable functional obsolescence "due to intense marketplace competition, particularly wireless substitution"; and to remain economically viable petitioner will make large capital expenditures to replace its copper network with a fiber-optic cable and fixed wireless network. Petitioner asserts that it will lose a significant percentage of its switched access line customers over the next five years, resulting in further erosion of its traditional voice-only services revenue. As a result, petitioner argues that the Board-adopted value fails to account for obsolescence attributable to the capital expenditures that are necessary to address network deficiencies and to offset losses in revenues from voice services.

Petitioner states that its FTTP deployment is an overlay of its current copper legacy network and, until its current customers migrate from the legacy network to the FTTP-based network, petitioner's reported property, plant and equipment (PP&E) fixed asset historical costs will reflect the excess capital costs of the copper network. Petitioner also disagrees with respondent's position that a portion of this obsolescence associated with excess operating costs has been accounted for in the normal depreciation adjustment and with respondent's disallowance of the percent-good factors utilized in the 2014 D&P Study. Finally, petitioner states that respondent's 2014 Appraisal Narrative questions the time required to design and construct the replacement network and whether the 2014 D&P Study includes all costs, including costs associated with engineering, permitting, and construction. Petitioner contends that, based in part on CostQuest's analysis, D&P's RCN model addresses all costs necessary to construct the network and to put the plant into productive and beneficial operation.

Petitioner further disputes respondent's assertion that petitioner's excess operating costs

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are attributable to "normal wear and tear" that has already been accounted for as part of normal depreciation. Petitioner contends that respondent should not have disallowed the 2014 D&P Study obsolescence adjustments, particularly access line losses, "taken together with the Company's ongoing legal duty to serve as a POLR." Petitioner also disagrees with respondent's conclusion that POLR assets do not incur functional and economic obsolescence because a prospective purchaser would have the same POLR requirements.

Petitioner argues that the 2014 D&P Study shows that petitioner incurred excess operational and maintenance costs, including excess power costs, for maintaining duplicate copper network and non-working, non-revenue-generating POLR assets. Petitioner repeats its argument that, due to wireless competition and the foreseeable loss of a significant percentage of its switched access line customers, petitioner's property has suffered from more incurable functional and economic obsolescence than was reflected in the 2014 Board-adopted unitary value. Petitioner also asserts that the Board-adopted value does not properly account for the obsolescence attributable to petitioner's capital expenditures necessary to transform its outdated copper-based network to a fiber-optic cable and fixed wireless network.

Respondent contends that petitioner's proposed method for comparing the maintenance and repair costs of copper and fiber networks fails to recognize the age difference between the two types of property. Respondent asserts that its analysis shows that the weighted average age of fiber is significantly lower than the weighted average age of copper and concludes that the difference in maintenance and repair costs is attributable to normal wear and tear that respondent has already accounted for as part of normal depreciation. Respondent states that petitioner provided no response to respondent's request for additional support for its claim.

Respondent estimates that 35 percent of the claimed functional obsolescence from excess operating costs was double-counted and was disallowed for that reason. With respect to petitioner's request for an additional obsolescence adjustment attributable to its POLR assets, respondent maintains that the POLR assets are an integral part of petitioner's network and are required by the CPUC as a condition of conducting business as a POLR. For that reason, respondent contends that any purchaser of the property or investor in the business would be bound by those requirements.

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Respondent also contends that petitioner has provided no documentation, work papers, or studies to substantiate any additional obsolescence beyond that already allowed for the claimed obsolescence attributable to capital expenditures to address the deficiencies in petitioner's network.

APPLICABLE LAW

ReplCLD Value Indicator

Please see Applicable Law and Appraisal Principles under Legal Issue 3 above.

Replacement Cost New

Please see Applicable Law and Appraisal Principles under Legal Issue 3 above.

Development of RCN Trend Factors

Please see Applicable Law and Appraisal Principles under Legal Issue 3 above.

Depreciation and the Replacement Cost Approach

In general, the ReplCLD value indicator recognizes three types of depreciation: physical deterioration, functional obsolescence, and external, or economic, obsolescence, through application of the Board's replacement cost new trend factors and percent-good factors. Obsolescence may occur when property is outmoded (functional obsolescence) or when some event has substantially diminished the future earning power of the property (economic obsolescence). (See Assessors' Handbook section 501, *Basic Appraisal* (January 2002), pp. 81-83.) Functional obsolescence is the loss of value in a property caused by the property's loss of capacity to perform the function for which it was intended. (*Id.* at p. 81.) Economic obsolescence is the diminished utility of a property due to adverse factors external to the property being appraised and is incurable by the property owner. (*Id.* at p. 82.)

Percent-Good Factors

Please see Applicable Law and Appraisal Principles under Legal Issue 1 above.

ANALYSIS AND DISPOSITION

The Board is presumed to have correctly determined the value of the property at issue, and petitioner bears the burden of proving otherwise. (Cal. Code Regs., tit. 18, § 5541, subd. (a).) Petitioner claims excess operational and maintenance costs for maintaining a duplicate copper network when compared to a replacement fiber network. However, petitioner has not presented any evidence to demonstrate that those costs were not reflected by the normal depreciation and obsolescence

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adjustments made to the RCN of the unitary property. Thus, petitioner has not met its burden of proving the existence of additional depreciation attributable to these costs.

Petitioner also claims that, during the migration from its legacy copper network to its fiber-based network, it will incur excess capital costs of the redundant copper network. As stated above, petitioner's RCN is an estimate of the current cost to replace a property with a new property of equivalent utility, which should include all of the economic costs necessary to put the property to productive and beneficial use. Obsolescence related to excess capital costs is already accounted for in the RCN. Accordingly, no additional adjustment is appropriate for these alleged costs.

With respect to petitioner's claim of additional obsolescence attributable to its POLR assets, those assets are required by the CPUC for the operation of the network as a POLR, and any prospective purchaser of petitioner's unitary property would be required to maintain POLR assets and would assume those operational costs. Moreover, petitioner has not provided any evidence to substantiate the existence of additional obsolescence attributable to capital expenditures necessary to address network deficiencies. Finally, petitioner has not provided any evidence to support its claim that respondent's percent-good factors fail to reflect all forms of obsolescence. Therefore, petitioner has not met its burden of proof and no additional adjustment is appropriate for this issue.

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LEGAL ISSUE 5

Whether petitioner has shown that the 2014 Board-adopted unitary value fails to account for additional claimed exempt software.

FINDINGS OF FACT AND RELATED CONTENTIONS

Petitioner contends that the Board-adopted unitary value fails to properly recognize nontaxable custom application software. Petitioner contends that respondent failed to segregate the costs associated with bundled software, purchased together with computer equipment, hardware components, and subcomponents, from the hardware equipment, including digital circuit equipment, analog circuit equipment, digital switching equipment, packet switching equipment, and operator systems. As a result, petitioner contends that the ReplCLD indicator is overstated.

Respondent states that it accepted the amount of nontaxable application software included in the 2014 D&P Study and that amount was taken into account in the determination of the

2014 Board-adopted value.

APPLICABLE LAW AND APPRAISAL PRINCIPLES

Rule 152, subdivision (a), provides, in relevant part, that:

> Computer programs shall not be valued for purposes of property taxation, except with respect to the valuation of storage media [encoded with basic operational programs] as provided in section 995 of the Revenue and Taxation Code.

(Cal. Code Regs., tit. 18, § 152, subd. (a), bracketed insertion added.)

ANALYSIS AND DISPOSITION

The Board is presumed to have correctly determined the value of the property at issue, and petitioner bears the burden of proving otherwise. (Cal. Code Regs., tit. 18, § 5541, subd. (a).) Petitioner makes bare assertions that the Board-adopted unitary value fails to properly recognize nontaxable custom application software. Respondent states that the entire amount of nontaxable application software identified in the 2014 D&P Study has been removed from the value of petitioner's unitary property. Because petitioner has presented no evidence to support any further adjustment, petitioner has not met its burden of proof on this issue.

LEGAL ISSUE 6

Whether the 2014 Board-adopted unitary value properly accounts for legal restrictions on alternate uses of petitioner's fee-owned land interests.

FINDINGS OF FACT AND RELATED CONTENTIONS

Petitioner contends that the Board-adopted unitary value fails to account for land use restrictions and obsolescence due to the superadequacy of fee-owned land interests that are no longer necessary for petitioner's operations. Petitioner argues that as a matter of law the land use restrictions prevent petitioner from putting its fee-owned land interests to their highest and best use. Petitioner asserts that the Board-adopted unitary value fails to recognize the effect on the value of enforceable restrictions imposed by the CPUC that prohibit petitioner from disposing of or making alternate uses of its fee-owned land interests. As a result, petitioner maintains that legal and regulatory restrictions reduce the value of those land interests and should be reflected in the Board-adopted unitary value. Petitioner argues that it would be able to provide the same services to its customers without its

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"extensive land holdings" and could significantly reduce those holdings or move its central offices to less expensive locations but regulatory restrictions prevent petitioner from exercising those options. Petitioner contends that respondent should make an adjustment for this form of obsolescence.

Respondent states that petitioner cites Public Utilities Code section 851 (section 851) as the statutory authority that allows purportedly excess land to be put to its highest and best use only with the approval of the CPUC. Thus, according to respondent, petitioner essentially argues that the procedural constraints imposed by the section 851 approval process prevent any value from being attributed to the allegedly superadequate portion of petitioner's fee-owned land interests.

Respondent cites a portion of the statute which provides that section 851 "does not prevent the sale, lease, encumbrance, or other disposition by any public utility of property that is not necessary or useful in the performance of its duties to the public." Based on that provision, respondent concludes that, although section 851 requires a telecommunication company to obtain approval before it can sell a necessary or useful piece of real estate, there is no restriction on the use of the land itself once it is sold. Furthermore, respondent presumes that any land that is superadequate would not be necessary or useful for the performance of duties to the public and, thus, would not be subject to this sale approval requirement. Finally, respondent asserts that, if any land owned or leased entirely by petitioner is available for sale, it will be sold at the market price determined by its highest and best use since the CPUC has no authority to limit the new owner (assuming it is not another regulated telecommunications company) in the use of the property.

Respondent also argues that petitioner has not provided information sufficient to demonstrate obsolescence due to superadequacy of its land. Moreover, respondent argues that superadequacy may exist in the floor space of buildings but petitioner has provided no documentation demonstrating superadequacy in the land on which the buildings are located. Respondent also states that petitioner has also not provided detailed descriptions of its owned or leased land that it believes has suffered economic obsolescence in addition to the amount allowed by respondent and has not provided any evidence to suggest that the land it owns or leases was not assessed at its fair market value.

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APPLICABLE LAW AND APPRAISAL PRINCIPLES

Public Utilities Code section 851

Section 851 provides, in relevant part, that a public utility (other than a common carrier by railroad) must secure approval from the CPUC before it may sell or otherwise dispose of "property necessary or useful in the performance of its duties to the public." However, section 851 further provides that:

> Nothing in this section shall prevent the sale, lease, encumbrance, or other disposition by any public utility of property that is not necessary or useful in the performance of its duties to the public, and any disposition of property by a public utility shall be conclusively presumed to be of property that is not useful or necessary in the performance of its duties to the public, as to any purchaser, lessee, or encumbrancer dealing with that property in good faith for value . . . .

ANALYSIS AND DISPOSITION

The Board is presumed to have correctly determined the value of the property at issue, and petitioner bears the burden of proving otherwise. (Cal. Code Regs., tit. 18, § 5541, subd. (a).) Petitioner asserts that it is subject to CPUC legal restrictions on the disposal of or alternative use of its fee-owned land interests that are no longer necessary for petitioner's operations. According to petitioner, such restrictions reduce the value of those land interests and an appropriate obsolescence adjustment should be made to the Board-adopted unitary value. However, section 851 expressly provides that the CPUC approval process is required for "property necessary or useful in the performance of its duties to the public"; and if, as petitioner alleges, the fee-owned land interests for which petitioner seeks an adjustment are superadequate, then they do not meet this requirement. Moreover, once fee-owned land interests are disposed of, they are not subject to such restrictions in the hands of a good faith purchaser, lessee, or encumbrancer for value. Finally, petitioner has presented no evidence of superadequacy in any of its fee-owned land interests and, therefore, has not met its evidentiary burden on this issue.

LEGAL ISSUE 7

Whether petitioner has shown that the 2014 Board-adopted unitary value improperly includes value attributable to non-assessable, intangible costs of optional extended warranties.

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FINDINGS OF FACT AND RELATED CONTENTIONS

Petitioner asserts that the replacement cost indicator on which the 2014 Board-adopted value is based improperly includes value attributable to non-assessable, intangible warranty costs "embedded" in petitioner's purchase price for certain telecommunications equipment. Petitioner states that it requests the exclusion only for costs of extended warranties that provide coverage in addition to base standard warranties.

Respondent cites Property Tax Rule 10, subdivision (b), which excludes the costs of extended service plans and extended warranties from the definition of "full economic cost" and asserts that this exclusion implies that the cost or value of standard or express warranties is includible in "full economic cost." Respondent states that standard and express warranties are marketing devices used by manufacturers to encourage the sale of their products and that the value of such warranties is usually not capable of being excluded, subtracted, or negotiated away when the product is purchased. Thus, according to respondent, an express or standard warranty is part of the "cost of bringing the property to a finished state," which determines full economic cost under Rule 10, subdivision (b).

Respondent agrees with petitioner that costs for optional extended warranties should be excluded from petitioner's unitary value but states that petitioner has not submitted any evidence or other information to substantiate the existence of extended warranty costs, and has not provided detailed documentation supporting or quantifying these costs. Respondent asserts that petitioner's characterization of the costs as "embedded in Petitioner's purchase price" is consistent with respondent's understanding that the warranties for which petitioner seeks an adjustment are the standard or express warranties that are not subject to a separate charge or negotiation. As evidence, respondent points to petitioner's representation that the price of the warranty coverage is automatically included or "embedded" in the purchase price of the product.

APPLICABLE LAW AND APPRAISAL PRINCIPLES

Full Economic Cost

Property Tax Rule 10, subdivision (b) provides, in relevant part, that:

> Full economic cost does not include extended service plans or extended warranties, supplies or other assets or business services that may have been included in a purchase contract.

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Petitioner has not presented any evidence to show that it purchased optional extended warranties, nor has petitioner provided any documentation to support or quantify the cost of such warranties. In addition, petitioner makes a representation that those costs are "embedded" in the purchase price of its property, but petitioner fails to identify the specific property for which those extended warranties provide coverage. For the foregoing reasons, petitioner has failed to meet its burden of proof on this issue.

DECISION

Accordingly, the petition for reassessment is granted in part and the 2014 Board-adopted unitary value is reduced from $2,936,500,000 to $2,609,100,000.*

_____, Chairman

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* The decision was rendered in Sacramento, California on November 19, 2014. This summary decision document was approved on December 18, 2014, in Sacramento, California.

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