

1 Louis A. Ambrose  
2 Tax Counsel IV  
3 Board of Equalization, Legal Department  
4 450 N Street, MIC:85  
5 PO Box 942879  
6 Sacramento, CA 95814  
7 Tel: (916) 261-3016  
8 Fax: (916) 324-2618

9 Attorney for Appeals Division

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

12 In the Matter of the Petition for  
13 Reassessment of the 2009 Unitary Value for:

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

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

15 Petitioner

)  
) Appeal No.: SAU 09-025  
) Case ID No.: 495665  
)

16 \_\_\_\_\_  
17 Representing the Parties:

18 For the Petitioner:

Peter Hladek  
Thomson Reuters

Andrew Davis  
Thomson Reuters

Matthew Rakela  
Thomson Reuters

23 For the Respondent:

Carole Ruwart  
Tax Counsel III (Specialist)  
Attorney for State-Assessed Properties Division

Don Jackson  
Principal Property Appraiser  
State-Assessed Properties Division

27 Counsel for Appeals Division:

Louis A. Ambrose, Tax Counsel IV

**PROPOSED VALUES**

	<u>Value</u>	<u>Penalty</u>	<u>Total</u>
2009 Board-Adopted Unitary Value	\$516,100,000	\$0	516,100,000
Petitioner's Requested Unitary Value	287,186,000	0	287,186,000
Petitioner's Revised Unitary Value at the Appeals Conference	475,400,000	0	475,400,000

**ISSUES**

- 1. Whether petitioner has shown that respondent's Historical Cost Less Depreciation (HCLD) value indicator fails to account for all forms of obsolescence in petitioner's unitary property.**
- 2. Whether petitioner has shown that equal reliance should be placed on the HCLD value indicator and the Capitalized Earning Ability (CEA) indicator to compute petitioner's 2009 unitary value.**

**BACKGROUND INFORMATION**

Golden State Water Company (petitioner) is a rate base regulated public utility, regulated by the California Public Utilities Commission (CPUC), which is engaged in the purchase, production and distribution of water. Petitioner's 2009 Board-adopted unitary value of \$516,100,000 was determined by placing 75 percent reliance on the historical cost less book depreciation (HCLD) value indicator of \$530,768,323 and 25 percent reliance on the capitalized earning ability (CEA) value indicator of \$472,051,404.

Petitioner's petition for reassessment asserts that the 2009 Board-adopted value does not recognize the increased operating costs and required capital replacement expenditures incurred over the last five years which negatively impact the market value of its personal property. The petition argues that respondent's use of book depreciation as a proxy for the capital replacement expenditure allowance is invalid because the dollar amount of depreciation is much less than the actual cost of replacements necessary to continue to keep the income stream at the current level. (Petition, pp. 1-2.) The petition also argued that the HCLD indicator is not a valid indicator of fair market value because petitioner is not earning its allowed rate of return. For that reason, the petition requests an adjustment for economic

1 obsolescence of 46.17 percent which, petitioner states, reflects the difference between petitioner's actual  
2 return of 8.20 percent on average operating property and equipment and respondent's market-derived  
3 rate of return of 15.236 percent. (Petition, pp. 6-7.)

#### 4 **Summary of Appeals Conference**

5 At the October 6, 2009, appeals conference, petitioner presented a new appraisal (Revised  
6 Appraisal) with a revised value of \$475,400,000 for its unitary property, based on its changed  
7 methodology as set forth in the statement of issues and discussion in this hearing summary. Petitioner  
8 stated that the Revised Appraisal methodology presented at the conference was intended to supersede  
9 the issues and methodology in the petition. To determine this revised value, petitioner placed the same  
10 reliance on the HCLD and CEA value indicators as respondent, 75 percent reliance and 25 percent  
11 reliance, respectively. However, petitioner then adjusted the HCLD indicator for additional obsolescence  
12 by a "loss in income" method based on the difference between the market capitalization rate of return of  
13 9.88 percent and the CPUC allowed rate of return of 8.87 percent. As an alternative method of making  
14 an appropriate adjustment for obsolescence, petitioner stated that it would consider a 2009 unitary value  
15 determined by placing 50 percent reliance on respondent's HCLD value indicator and 50 percent  
16 reliance on the CEA value indicator.

17 After the appeals conference, respondent asked petitioner to provide further information about  
18 the appraisal that petitioner presented at the conference.

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

20 The Appeals Division recommends that the Board deny the petition for reassessment because  
21 petitioner has not met its burden of proving that the 2009 Board-adopted unitary value does not reflect  
22 fair market value.

23  
24  
25  
26  
27 <sup>1</sup> Unless the Board otherwise holds, the Board shall take official notice of: the property statement filed with the Board,  
28 together with any attachments, including without limitation any reports to regulatory agencies such as the U.S. Securities and  
Exchange Commission and the California Public Utilities Commission, and any annual reports to shareholders; the Appraisal  
Data Report (ADR) prepared by the State-Assessed Properties Division (SAPD) together with any workpapers; the Notice of  
Unitary Value; and any correspondence between SAPD and petitioner.

1 Issue 1

2 **Whether petitioner has shown that respondent's Historical Cost Less Depreciation (HCLD) value**  
3 **indicator fails to account for all forms of obsolescence in petitioner's unitary property.**

4 **Petitioner's Contentions**

5 Petitioner explains that the CPUC requires water companies to provide adequate service to their  
6 customers while charging "reasonable" rates for their service, and allows water companies to earn a  
7 "reasonable" profit. The CPUC establishes an allowed rate base and authorizes a rate of return that the  
8 company can earn on its invested capital. A company's inability to earn the allowed rate of return may  
9 negatively impact the value of its assets and the lag time between the CPUC's adjustments to a  
10 company's allowed rate of return can affect the company's achieved rate of return because the income  
11 stream may remain stagnant while expenses increase.

12 Petitioner notes that under the HCLD approach to value the depreciation is the "amortized"  
13 portion of the investment in the total property which is the book depreciation as defined by the  
14 regulatory authority, and does not include the loss in value from functional and economic obsolescence.  
15 Petitioner contends that economic obsolescence is not covered in the allowed depreciation rates by the  
16 regulatory authorities. However, petitioner contends that, to a large extent, depreciation is caused by the  
17 regulatory authorities due to rate base restrictions, regulatory lag, and rates of return allowed. In support  
18 of that proposition, petitioner cites *The Valuation of Real Estate*, 3rd ed., p. 424, which states that  
19 "[m]ost railroads and practically all public utilities incur a third and often severe loss in value due to  
20 external obsolescence. This loss in value, as demonstrated... under the cost approach to value, is caused  
21 by the difference in the rate of return regulatory agencies allow and the rate of return that the investment  
22 market indicates as competitive to attract a willing, able, and informed purchaser (investor)." (Appeals  
23 Conference Submission, Executive Summary, p. III.)

24 Petitioner contends that the Board's market capitalization rate of return of 9.88 percent is the  
25 market rate of return a prospective purchaser would require, which accounts for all costs to the investor  
26 including flotation costs. Petitioner then contends that the difference between the market capitalization  
27 rate of return and the CPUC-allowed rate of return of 8.87 percent is an indication of 10.22 percent  
28 obsolescence to the HCLD value indicator due to governmental regulation. Petitioner explains that a

1 prospective purchaser would discount the purchase price until the return equaled the required 9.88  
2 percent market rate of return. By applying that 10.22 percent obsolescence adjustment, petitioner  
3 contends that the HCLD indicator less depreciation should be \$476,509,618. (Appeals Conference  
4 Submission, Revised Appraisal, Executive Summary, pp. II – III.)

5 At the appeals conference, petitioner pointed to an exhibit to the Revised Appraisal titled  
6 “comparison of cashflows” which shows a significant difference between the amounts of book  
7 depreciation as of lien dates 2004 through 2008 and the amounts of capital expenditure as of each of  
8 those lien dates. For those lien dates, the book depreciation amounts are significantly less than the  
9 capital expenditure amounts. (Appeals Conference Submission, Tab 2, p. 18.)

10 After the appeals conference, petitioner submitted as further evidence for the required  
11 obsolescence adjustment to the HCLD, two rate case examples that, petitioner asserts, indicate  
12 approximately 20% of petitioner’s invested capital is not included in rate base by the CPUC. Petitioner  
13 contends that this evidence is contrary to respondent’s suggestion that all of petitioner’s capital  
14 investment is eventually included in rate base. Petitioner also states that page 17 of the Submission  
15 shows that the CPUC has approved fewer rate increases than petitioner has requested which results in  
16 economic obsolescence. (Appeals Conference Submission, p. 17.)

### 17 **Respondent’s Contentions**

18 In its post-conference submission, respondent contends that petitioner has not shown that an  
19 adjustment for obsolescence to the HCLD indicator is justified. Respondent states that the CPUC  
20 establishes an allowed rate base and authorizes a rate of return that petitioner may earn on its invested  
21 capital. For a rate-regulated utility, an adjustment to the HCLD indicator is not appropriate when the  
22 company has a reasonable expectation of earning its allowed rate of return. Respondent notes that  
23 petitioner’s parent company’s 10-K indicates that petitioner is financially healthy and “plans to continue  
24 to seek additional rate increases in future years to recover operating and supply costs and receive  
25 reasonable returns on invested capital.” In view of that statement, respondent concludes that there is no  
26 indication that petitioner is not expecting to earn its allowed rate of return on investment. (Resp. Post-  
27 Appeals Conference Submission, p.2.)  
28

1 In addition, respondent states that the cost of capital is determined by the CPUC on an ongoing  
2 cyclical basis whereby the company submits its determination of the cost of debt and equity in its rate  
3 request for the CPUC to consider when setting the authorized rates. Thus, respondent asserts, petitioner  
4 is able to address any shortfall in the cost of capital in its next rate case. Furthermore, respondent  
5 contends that the adjustment requested by petitioner would constitute a permanent obsolescence  
6 adjustment for what is likely to be a temporary condition. (Resp. Post-Appeals Conference Submission,  
7 pp. 2-3.)

8 Respondent contends that the example of a capital expenditure disallowance provided by  
9 petitioner after the appeals conference does not support petitioner's position. First, the example is  
10 irrelevant because it is dated January 12, 2006, which is nearly three years prior to the 2009 lien date  
11 and it appears to reflect disallowances during the 2005 – 2007 period. Respondent asserts that some or  
12 all of the presumed disallowed expenses might have been allowed by later CPUC action, and in any  
13 event are not necessarily representative of petitioner's current regulatory situation. Secondly,  
14 respondent states that there is no rationale given for the disallowances, and respondent notes that in  
15 paragraph 2.02, the CPUC states that petitioner "agrees not to divert [certain funds] to other capital  
16 improvement projects and to file a report after the financial close of 2006 and 2007 to provide an  
17 accounting with supporting documentation of how the funds approved for 2006 and 2007 were spent."  
18 Respondent states that the CPUC comment suggests that "at least some, if not all, expenditures were  
19 disallowed because of poor financial management or recordkeeping, and not because the expended  
20 amounts were inappropriate to include in rate base." Respondent cites Property Tax Rule 8, subdivision  
21 (c) as providing that unitary valuation of state-assessed property assumes prudent management of the  
22 entity being valued. (Resp. Post-Appeals Conference Submission, p. 3.)

23 Respondent also contends that the second example, dated February 1, 2008, which purports to  
24 prove material disallowance of construction work in progress (CWIP) from Region I during 2006 and  
25 2007, does not support petitioner's position. Respondent contends that the document does not indicate  
26 that material amounts of expenditures were completely disallowed, but rather shows that the CPUC had  
27 questions about how certain expenditures should be accounted for and whether proposed future  
28 expenditures had been adequately justified. Respondent adds that each reference to a proposed expense

1 indicated that the CPUC would be inclined to include in the rate base all amounts actually expended by  
2 petitioner, as long as the expenses were justified and/or properly accounted for (e.g., Bay Point Purchase  
3 Hill Street Property, Simi Valley Brineline Study). Finally, respondent states that, according to  
4 paragraph 2.03, petitioner would be entitled to reimbursement for the cost of the CPUC-required audit of  
5 its CWIP accounting practices. (Resp. Post-Appeals Conference Submission, p. 3.)

6 Respondent further contends that the new evidence supports its position that the HCLD indicator  
7 is reliable in that petitioner's parent company's 10-K repeatedly advises investors and the public that as  
8 of lien date 2009 petitioner was financially healthy and makes significant capital expenditures only  
9 when it expects to be adequately compensated. The 10-K also recognizes that not all capital  
10 expenditures will be immediately or fully compensated by rates, but expresses confidence that it will be  
11 able to obtain debt and equity financing as necessary to achieve an adequate rate of return of and on  
12 investment in difficult financial markets. Respondent further notes that petitioner's parent company  
13 touts its superior investment grade rating. (Resp. Post-Appeals Conference Submission, p. 4.)

14 Respondent contends that the examples submitted by petitioner are isolated, outdated  
15 expenditures made in a portion of petitioner's service area which are not representative of all of  
16 petitioner's service area. Finally, respondent contends that the only relevant consideration is whether  
17 the CPUC ratemaking allows for an adequate return of and on investment, regardless of whether a  
18 particular rate request is granted. Thus, according to respondent, the evidence shows that the CPUC-  
19 authorized rates are not a regulatory barrier to achieving an adequate return of and on investment.  
20 Furthermore, even assuming for the sake of argument that the examples submitted by petitioner are  
21 correct, respondent contends that they do not support the magnitude of the adjustment to the HCLD  
22 indicator requested by petitioner. (Resp. Post-Appeals Conference Submission, p. 4.)

### 23 Applicable Law and Appraisal Principles

24 **Burden of Proof** Assessing officers are presumed to have properly performed their duties. (Evid.  
25 Code, § 664.) The Board has promulgated the Rules for Tax Appeals (RTA) to govern the  
26 administrative and appellate review processes for all of the tax and fee programs administered by the  
27 Board. (Cal. Code Regs., tit. 18, § 5000.) Of relevance here, RTA 5541, subdivision (a) places the  
28 burden of proof upon the taxpayer as to all issues of fact except as otherwise specifically provided by

1 law. Courts have long presumed that the Board assesses all property correctly, placing on the taxpayer  
2 the burden of proving that an assessment is incorrect. (*Trailer Train Co. v. State Bd. of Equalization*  
3 (1986) 180 Cal.App.3d 565, 584.) Therefore, petitioner bears the burden of showing that the assessment  
4 is illegal. (*ITT World Communications v. Santa Clara* (1980) 101 Cal.App.3d 246.)

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

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

25 **Income Approach to Value** Board Property Tax Rule 8, subdivision (a), states that “the income  
26 approach is used in conjunction with other approaches when the property under appraisal is typically  
27 purchased in anticipation of a money income and either has an established income stream or can be  
28 attributed a real or hypothetical income stream by comparison with other properties.” Subdivision (b)

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

### 9 Appeals Division’s Analysis and Recommendation

10 Respondent is presumed to have used a proper valuation approach and correctly determined the  
11 value of the property at issue, and respondent bears the burden of proving otherwise. Because petitioner  
12 is a rate base regulated company, the HCLD approach is a valid valuation methodology to utilize when  
13 valuing petitioner’s property. Respondent recognizes that the nature of regulatory process may entail  
14 some obsolescence and, therefore, places 25 percent reliance on the CEA indicator to allow for that  
15 measure of obsolescence.

16 Here, petitioner submits evidence which, petitioner contends, show that petitioner is not earning  
17 its allowed rate of return. However, petitioner’s parent company has represented to the public that it  
18 expects petitioner to receive reasonable returns on its invested capital and to seek rate increases when  
19 necessary. In addition, the capital expenditure examples presented do not show a consistent pattern of  
20 disallowance by the CPUC that would establish that petitioner does not have a reasonable expectation of  
21 earning its allowed rate of return. For those reasons, the Appeals Division does not find that petitioner’s  
22 evidence shows that petitioner is not earning its allowed rate of return so as to support petitioner’s claim  
23 of additional obsolescence.

24 By contrast, petitioner’s other method for determining an additional economic obsolescence  
25 adjustment *assumes* that petitioner is earning the CPUC-allowed rate of return of 8.87 percent.  
26 Petitioner contends that economic obsolescence is reflected by the difference between the Board’s 9.88  
27 percent market capitalization rate of return and the CPUC-allowed rate of return of 8.87 percent.  
28 However, petitioner has not provided any evidence that a prospective purchaser of a rate base regulated

1 utility like petitioner would discount the purchase price to achieve a higher rate of return than allowed  
2 by the regulator. In addition, petitioner has not provided any authority for the proposition that, for a  
3 rate-regulated utility, an adjustment to the HCLD indicator is appropriate when the company has a  
4 reasonable expectation of earning its allowed rate of return. Thus, the Appeals Division does not find  
5 that petitioner has presented evidence sufficient to meet its burden of proving additional economic  
6 obsolescence under this method.

7 At the hearing, petitioner should be prepared to explain why the representations made by its  
8 parent company to the public seem to be contrary to petitioner's contentions that it is not earning its  
9 allowed rate of return. Respondent should be prepared to discuss and cite appraisal authority concerning  
10 whether the Board's market capitalization rate of return has any relevance in determining additional  
11 obsolescence in the unitary property a rate-base regulated utility.

## 12 Issue 2

13 **Whether petitioner has shown that equal reliance should be placed on the HCLD value indicator**  
14 **and the Capitalized Earning Ability (CEA) indicator to compute petitioner's 2009 unitary value.**

### 15 Petitioner's Contentions

16 As an alternative method of making its proposed adjustment for obsolescence, petitioner states  
17 that it would consider a 2009 unitary value determined by placing 50 percent reliance on respondent's  
18 HCLD value indicator and 50 percent reliance on the CEA value indicator.

### 19 Respondent's Contentions

20 Respondent rejects petitioner's proposal to place equal reliance on the HCLD and CEA value  
21 indicators as an alternative to the requested obsolescence adjustment. Respondent states that more  
22 reliance has been consistently placed on the HCLD indicator for the valuation of rate-regulated utilities  
23 because that indicator more closely reflects the methodology basis used by the CPUC to set rates.  
24 Respondent finds no justification for changing the current weighting of the indicators. Rather,  
25 respondent notes that petitioner's revision of its opinion of value and the reasons that petitioner has  
26 advanced for that revision suggest that petitioner may simply be attempting to obtain an unsupported  
27 value reduction. (Resp. Post Appeals Conference Submission, pp. 4-5.)  
28

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23  
24  
25  
26  
27  
28

**Appeals Division’s Analysis and Recommendation**

In the view of the Appeals Division, petitioner has not provided supporting reasons or appraisal authority for adopting this alternative methodology. Furthermore, as stated under Issue 1, we do not believe that petitioner has shown the existence of additional economic obsolescence by either of its methods. For that reason, the Appeals Division recommends that the Board not adopt petitioner’s proposed alternative of equal reliance on the HCLD and CEA value indicators.

At the hearing, petitioner should be prepared to support this methodology with evidence showing that the resulting value reflects a documented measure of obsolescence.