GUIDELINES FOR SUBSTANTIATING ADDITONAL OBSOLESCENCE FOR STATE-ASSESSED TELECOMMUNICATION PROPERTIES

OVERVIEW

The California Constitution requires the Board of Equalization (Board) to annually assess property, except franchises, owned or used by regulated railways, telegraph or telephone companies, car companies operating on railways in the state, and companies transmitting or selling gas or electricity. It also requires the Board to annually assess pipelines, flumes, canals, ditches, and aqueducts lying within two or more counties. To accomplish these mandates, the State-Assessed Properties Division of the Property and Special Taxes Department endeavors to provide the elected Board Members with reasonable and timely estimates of the market values of property subject to state assessment for adoption. An integral part of the valuation process is the estimation of the obsolescence suffered by assessable property.

The Board directed staff to initiate a review of obsolescence of state-assessed telecommunication property. Of particular interest is the estimation of the additional obsolescence above which is already attributed to the property in the staff’s calculation of the replacement cost less depreciation indicator of value. The purpose of this document is to provide guidance to interested parties on how to substantiate additional or extraordinary obsolescence before the Board. It is not prescription for the automatic acceptance of claims to additional obsolescence. The Board may exercise discretion when determining what weight to assign to evidence and reject evidence that it considers irrelevant or unreliable.

Obsolescence or *depreciation* is defined as a decrease in utility resulting in a loss in property value; the difference between estimated replacement or reproduction cost new as of a given date and market value as of the same date. There are three principal categories of depreciation, described as:

1. *Physical Deterioration.* The loss in utility and value due to some physical deterioration in the property. Physical deterioration is considered curable if the cost to cure it is equal to or less than the value added by curing it.

2. *Functional Obsolescence.* The loss in utility and value due to deficiencies and superadequacies attributable to changes in tastes, style, or design. Functional obsolescence is curable if the cost to cure it is equal to or less than the value added by curing it.

3. *External (or Economic) Obsolescence.* The loss in utility and value caused by external negative influences outside the property itself; results from the immobility of real property. External obsolescence is typically incurable.

METHODS OF MEASURING OBSOLESCENCE

Obsolescence, while it generally can be segregated into the three main categories above, can potentially have many causes and methods of quantifying its impact on value. When claiming obsolescence, the parties should state the issues involved, identify the measurement methods used, and provide documentation and evidence to support claims. Studies, analyses, and/or statements of fact for claiming obsolescence should be substantiated with verifiable evidence to enable staff to make an informed judgment concerning the proper value to be ascribed to the property being assessed.

Some of the methods used to quantify obsolescence are presented below.

Income Shortfall Study

An income shortfall study is based on the premise that the property's obsolescence may be measured by comparing its potential or once-expected income stream with its actual or newly-projected income stream.

When estimating the income stream, the methodology must be consistent with Property Tax Rule 8.[1] Additionally, the income stream should not be based solely on one year's income, but it should also reflect the reasonably anticipated future cash flows. When using a capitalization rate or discount factor different from that derived and published by the Board, that rate should be well supported with verifiable data.

Inutility Study

An inutility study seeks to measure a property's obsolescence by comparing its potential or expected capacity and its actual or predicted use or production level.

Any inutility analysis submitted must adequately support the peak capacity used as the base for the inutility calculation. Also, the scaling factor used to determine the degree of obsolescence must be adequately documented with verifiable data.

Economic Life Study

An economic life study attempts to measure obsolescence by comparing the property's functional life with its remaining physical life.

Estimations of its functional life must be supported with verifiable data. Assertion of technological- and competition-based obsolescence should be supported by the company's investment and replacement patterns.

SUPPORTING DOCUMENTATION

An obsolescence study must be evaluated based on its merits. It must be consistent with basic economic theory, generally accepted accounting principles, sound appraisal methods, and applicable property tax statutes and regulations. That being said, there are certain documents that tend to lend general support to obsolescence studies. Any differences between the degree of obsolescence requested by an assessee in either a study submitted prior to the value setting or in a petition for reassessment and publicly available financial information should be explained and reconciled. Examples of these documents are as follows:

[1] Title 18, Public Revenues, California Code of Regulations.

- Audited financial statements – income statements, balance sheets (included fixed asset accounts), position statements, and statements of changes in owner's equity.

- Asset allocations or write-downs as prescribed by Financial Accounting Standards Board Statement No. 141 (FASB 141) – Business Combinations.

  FASB 141 requires the allocation of the purchase price paid to the assets acquired and liabilities assumed by major balance sheet caption. When the amounts of goodwill and intangible assets acquired are significant in relation to the purchase price paid, disclosure of other information about those assets is required, such as the amount of goodwill by reportable segment and the amount of the purchase price assigned to each major intangible asset class.

- Asset allocations or write-downs as prescribed by Financial Accounting Standards Board Statement No. 144 (FASB 144) – Impairment of Assets.

  This Statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets.

- Statement of Position (SOP) 90-7 – Financial Reporting by Entities in Reorganization Under the Bankruptcy Code.

  The basic premise of a bankruptcy transaction is that it is a distress sale. The sale price would generally be considered to be less than fair market value. Unless the transaction price, or that portion allocated to tangible property, can be proven to meet the definition of fair market value, the sales price should not be considered reliable.

- Securities and Exchange Commission (SEC) 10K and 10Q – Annual and Quarterly Reports

- Published articles and press releases

- Engineering reports and studies