BEFORE THE MONTANA STATE TAX APPEAL BOARD

PACIFICORP,	)	
	)	
Appellant,	)	***ORDER***
	)	
v.	)	
	)	
STATE OF MONTANA,	)	Cause Nos. CT-2006-5
DEPARTMENT OF REVENUE,	)	CT-2007-7
	)	
Respondent.	)	

PacifiCorp challenged the DOR assessment of its Montana property for tax years 2006 and 2007. This matter came before the Montana State Tax Appeal Board (the "Board") for formal hearing June 4 and June 7 through 11, 2010. David J. Crapo and Daniel J. Whyte represented PacifiCorp. Peter Crossett and Derek Bell represented the Department of Revenue ("DOR" or "Department"). Testimony was presented, exhibits were received, and proposed findings and conclusions were submitted. The parties submitted stipulated exhibits and agreed facts in advance of the trial. The following witnesses testified: Angelia Haller, Thomas K. Tegarden, Norman K. Ross, Steven R. McDougal, Douglas K. Stuver, Robert Reilly, Brent Eyre, Dr. A. James Ifflander, Dr. John Wilson, and Dr. Antonio Bernardo. The Board having fully considered the testimony, exhibits, and submissions, hereby finds and concludes as follows.

In this case the Taxpayer, PacifiCorp, challenges the Department of Revenue's property tax appraisal. PacifiCorp claims that the value should be reduced because the company's earnings are below the rate allowed by regulators. PacifiCorp also objects to market value data, including the sale of

the subject company itself, being considered in the valuation process. We find both claims lacking in merit and uphold the Department's assessed value.

Background and Evidence Presented

PacifiCorp

1. The hearing addressed two tax years: 2006 and 2007. PacifiCorp has challenged the Department's assessments of PacifiCorp's operating property located in the state of Montana for both of these years. Agreed Facts A.
2. PacifiCorp is a regulated electricity company serving customers in portions of the states of Utah, Oregon, Wyoming, Washington, Idaho and California. Agreed Facts B.
3. Although PacifiCorp has no customers in Montana, it does own an interest in some electric generation properties in Montana. Specifically, PacifiCorp owns (1) a 10% interest in the Colstrip Units 3 and 4 located in Colstrip, Montana, (2) the Big Fork Hydro-electric project located in Flathead County, Montana, (3) limited transmission facilities and certain transmission rights, and (4) miscellaneous supplies, tools, vehicles and such. Agreed Facts C.
4. PacifiCorp's electric operating property is categorized as Class 5, 9 and 13 property, and is subject to unitary assessment by the Department as of January 1 of each year. Sections 15-6-135, 141, and 156 and 15-8-201, MCA. Agreed Fact D.

Process and Legal Standards for the State's Appraisal

5. All taxable property must be assessed at 100% of its market value except as otherwise provided. Section 15-8-111, MCA.
6. Pursuant to § 15-23-101, MCA, "The Department shall centrally assess

each year: . . . (2)property owned by a corporation or other person operating a single and continuous property operated in more than one county or more than one state. . . ."

7. DOR administrative regulations require it to appraise the value of property owned by "centrally assessed companies," such as utilities, with the unit method of valuation whenever appropriate. Rule 42.22.111(1), ARM. DOR explains that it appraises utilities as a unit in light of the fact that the individual properties owned by utilities have no value, over and above their salvage value, except as integral parts of the very business in which they operate. *PPL v. DOR*, 2007 Mont. 310; 172 P.3d 1241, ¶ 7.
8. Rule 42.22.101(31), ARM provides "'Unit or system value' is the value of all tangible and intangible property that is reasonable and necessary to the maintenance and operation of a centrally assessed company's interstate or inter-county business."
9. Rule 42.22.101(30), ARM provides "'the unit method of valuation' is a method for determining the market value of a centrally assessed company. This involves appraising, as a going concern and as a single entity, the entire unit, wherever located, then deducting the intangible personal property value and then ascertaining the part thereof in this state. The resulting value is referred to as the state allocated value."
10. DOR combines three valuation methods to appraise the utility's value as a unit: the cost method, the income method, and the market method. Rule 42.22.111(1), ARM. The cost method generally reflects what a utility paid for its assets or what it would have to pay to replace those assets. Rule 42.22.112, ARM. The income method reflects the current value of the utility's historical or future income streams. Rule 42.22.114(1), ARM. The market method looks to the utility's stock value or the sale price for

similar utilities in the past. Rule 42.22.113, ARM. DOR uses its discretion to combine these various methods to arrive at a single value that best reflects the utility's fair market value. DOR determines what weight to give to each method's result depending on such discretionary factors as whether the data that particular method uses is sufficiently reliable. Rule 42.22.111(2), ARM. DOR then, as described above, allocates to the utility's Montana-based assets that portion of the company's "unit value" that "represents the state's proper share of the market value of the centrally assess company's operating property." Rule 42.22.121(1), ARM; *PPL v. DOR*, 2007 Mont. 310; 172 P.3d 1241, ¶ 9.

11. Intangible personal property is not subject to taxation. Section 15-6-218, MCA. Intangible personal property is defined as that which has no intrinsic value but is the representative or evidence of value, such as stocks, bonds, copyrights, patents, contracts and goodwill. Section 15-6-218(2)(a),(b), MCA; Rule 42.22.110, ARM.
12. Electric utilities are allowed a default deduction of 10%. Rule 42.22.110 (1)(a)(v), (b)(v) and (c)(v), ARM. If any taxpayer believes that the value of its intangible personal property is greater than that allowed under (1), the taxpayer may propose alternative methodology or information at any time during the appraisal process and the department will give it full and fair consideration. Rule 42.22.110(2), ARM.
13. DOR assigns a portion of the utility's total value to the utility's assets located in Montana based on the proportion of the utility's assets located in Montana as compared to the utility's total assets. Rule 42.22.101(30),(31), ARM. DOR considers that portion of the utility's value that it assigns to the utility's Montana-based assets to represent the "fair market value" of those assets for purposes of property taxes. *See*

Rule 42.22.121(1), ARM; *PPL v. DOR*, 2007 Mont. 310; 172 P.3d 1241, ¶ 8.

14. If the Department concludes that the value of intangible personal property is greater than default amount, the unit value will be decreased accordingly. In this instance, the Department removed the standard 10% for intangible personal property, but did not make any additional adjustment.

Department of Revenue Appraisals

15. The Department prepared and issued preliminary appraisals for both 2006 and 2007 tax years. In each year, PacifiCorp requested and was granted an informal review of the preliminary appraisals. Agreed Facts E.

16. On June 9, 2006 and July 13, 2007, respectively, the Department issued its Final Appraisal Reports for the 2006 and 2007 years in which it asserted the following assessments against PacifiCorp's operating property:

Year	Correlated Unit Value before 10% Intangible Adjustment	Correlated Unit Value After 10% Intangible Adjustment	Allocation Factor	Additional Adjustments	Montana Allocated Value
2006	$8,762,128,000	$7,885,915,000	1.5502%	$5,584,323	$127,193,318
2007	$9,642,473,000	$8,678,226,000	1.4308%	$5,810,554	$128,873,030

Agreed Fact F.

17. On January 17, 2007 and November 8, 2007, PacifiCorp timely filed its complaints with this Board initiating these actions. PacifiCorp does not dispute the allocation factor or other adjustments for either tax year. Agreed Facts G.

18. Following discovery in this proceeding on April 8, 2010, Ms. Haller has proposed making corrections to the original assessments issued in 2006

and 2007 by preparing revised Final Appraisal Reports for the 2006 and 2007 tax years which would have slightly increased the unit values and allocated values. Stipulated Exhs. 39 and 40. The values asserted in these revised reports are as follows:

Year	Correlated Unit Value before 10% Intangible Adjustment	Correlated Unit Value After 10% Intangible Adjustment	Allocation Factor	Additional Adjustments	Montana Allocated Value
2006	$8,973,444,000	$8,049,100,000	1.5502%	$5,699,881	$129,825,358
2007	$9,742,703,000	$8,768,433,000	1.4308%	$5,234,404	$130,216,685

Agreed Facts G.

19. The DOR does not claim the adjusted values be used for tax purposes but rather as a confirmation of their values set in the 2006 and 2007 appraisals set forth above in EP 16. Testimony of Crossett and Crapo, Tr. pp. 1297 - 1300.

Methods for Appraisal

20. Angelia Haller, Montana Department of Revenue, is the appraiser for the Department who prepared the appraisal reports dated June 9, 2006 and June 13, 2007. Ms. Haller testified concerning these appraisal reports, as well as the Department's practices and procedures. The relevant specifics are set out below.
21. Ms. Haller's calculations were based on data provided by PacifiCorp as well as data from federal regulatory filings of the company. Stipulated Exhs. 1 – 14.
22. For tax year 2006, Ms. Haller developed seven indicators of value. She placed weight on five indicators: 45% on the cost approach, 20% on the direct capitalization of net operating income, 15% each on two different

stock and debt approaches, and 5% on the direct capitalization of gross cash flow. Stipulated Exh. 35, p. PC-DOR 00809.

23. For tax year 2007, Haller developed seven indicators of value, and placed weight on five indicators: 45% on the cost approach, 20% on the direct capitalization of net operating income, 15% on a sales comparison method, 15% on a stock and debt approach, and 5% on the direct capitalization of gross cash flow. Stipulated Exh. 36.

24. PacifiCorp did not request any additional deductions during the appraisal process or informal appeal for 2006. Stipulated Exh. 71. In 2007, PacifiCorp requested $1.1 billion of non-taxable goodwill be removed from the value. Stipulated Exh. 72, p. PC-DOR 001650.

1. Cost Method

25. Ms. Haller placed 45% weight on the cost indicator of value. In calculating that indicator, she identified the historic cost of PacifiCorp's assets as listed on the company's FERC Form 1 as $14,300,047,855 (2006) and $15,278,438,144 (2007). Tr. p. 56, ll. 13-20; Stipulated Exhs. 35, p. PC-DOR 00797 and 36, p. PC-DOR 000926.

26. Ms. Haller deducted $6,118,407,980 and $6,391,763,067 to account for the reduction in value attributable to depreciation. Stipulated Exhs. 35, p. PC-DOR 00797 and 36, p. PC-DOR 000926.

27. The Uniform System of Accounts prescribed for electric utilities by the Federal Energy Regulatory Commission (FERC), and quoted by PacifiCorp in its own depreciation study, states that:

> "Depreciation," as applied to depreciable electric plant, means the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of electric plant in the course of service from causes

> which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities. Stipulated Exh. 61, p. PAC-MT0607-002342

28. The foregoing definition of depreciation, particularly with respect to its final sentence clearly states that the FERC definition of depreciation includes physical depreciation, functional obsolescence, and economic obsolescence which would be associated with changes in demand and the requirements of public authorities.
29. In addition to reviewing the depreciation/obsolescence listed on PacifiCorp's federal reports, Ms. Haller considered other factors which may have indicated the presence (or lack thereof) of additional economic obsolescence. Ms. Haller testified that the following represented some of the factors that she considered:

    (a) Dr. Wilson's report , which showed a market-to-book ratio in excess of one for electric utilities, which demonstrated that electric utilities were, in his view, selling in excess of their respective book values. Tr. p. 76, ll. 11-14;

    (b) No changes occurred in market conditions or demand. Tr. p. 705, l. 23, through p. 706, l. 5;

    (c) MEHC's purchase of PacifiCorp shortly after the 2006 tax year lien date for an amount in excess of the carrying (net book) value of the property, plant and equipment assets. Tr. p. 707, ll. 10-16.

    (d) The market-to-book ratio found in her sales comparison approach was in excess of one, Tr. p. 708, ll. 3-18. *See also* Tr. p. 74, l. 20 through p. 76, l. 16; p. 672, l. 24, through p. 673, l. 9; and pp. 704-709.

30. PacifiCorp never provided the Department with any quantification of what additional obsolescence should be deducted from Ms. Haller's OCLD estimates during the appraisal or informal appeals process. Ross Testimony, p. 286, l. 23, through p. 287, l. 22.

31. Based on the foregoing considerations, together with her belief that the FERC definition of depreciation expressly included all forms of depreciation/obsolescence, Ms. Haller saw no evidence of additional economic obsolescence and determined that no further obsolescence adjustment was warranted for either of the tax years at issue before this Board. Tr. p. 76, ll. 14-15 and p. 708, ll. 14-15.

a. PacifiCorp's Challenge to the DOR Cost Approach

32. Thomas K. Tegarden, MAI, Tegarden & Associates, Inc., an appraiser with Tegarden & Associates, Inc., prepared two appraisals relating to PacifiCorp's operating property for the subject valuation years. Stipulated Exh. 43, pp. PAC-MT0607-000016 – 000124, Exh. 44, pp. PAC-MT 0607-000161 - 000315. Mr. Tegarden's 2006 values were $6.589 million by the cost approach and $6.552 million by the income approach, with a final correlated value of $6.560 million. Stipulated Exh.43, pp. PAC-MT0607-000111 -113. For 2007, his income approach value was $7.425 million and his income approach was $7.213 million, with a correlated value of $7.250 million. Stipulated Exh.44, pp. PAC-MT0607-000262-65.

33. Mr. Tegarden valued PacifiCorp's operating property under the same OCLD approach that was used by the Department. He looked to PacifiCorp's FERC Form 1 to determine that the value of the electric plant in service was $14 billion in 2006. He then made adjustments for acquisition costs, construction work in progress, etc., and subtracted book depreciation for a value of $8.9 billion of net electric plant. Tr. p. 432-

433. He agreed that, at this point in the appraisal process, his value and that of Ms. Haller and Mr. Eyre[1] were very close. Tr. p. 434:7-21.

34. It was Mr. Tegarden's opinion that the OCLD method requires additional consideration for external or economic obsolescence. In an effort to determine whether there is additional obsolescence, Mr. Tegarden compared a "required" rate of return with the actual return of the company, known as the capitalized income loss or the income shortfall method. Averaging the actual rate of return for a five year period, he determined that PacifiCorp was earning 6.25% as a representative return. He testified that PacifiCorp was earning less than its "required" rate of return of 8.7%. The required rate of return is based on a return on equity of 10.75% allowed by regulators for the equity part of the capital structure (55%) and 5.75% for the debt portion (45%). Stipulated Exh. 43, p. PAC-MT0607-000062. By dividing his estimate of the actual return of 6.25% by the 8.7% required rate of return, Mr. Tegarden stated that PacifiCorp was earning 71.84% of its required rate of return, or stated in the obverse, 28.16% less than required. As a result, Mr. Tegarden deducted 28.16% from the book value of the assets resulting in the overall rounded value, under the cost approach, of $6.589 billion. Tr. pp. 436-440.

35. Mr. Tegarden testified that the capitalized income loss method is an accepted method for measuring obsolescence and is used throughout the industry. Tr. p. 440, ll.7-25. He attributed the low rate of earning to the exclusion of deferred income taxes from the rate base on which allowed earnings are calculated. Stipulated Exh. 43, p. PAC-MT0607-000046.

36. Mr. Steven R. McDougal, PacifiCorp's director of revenue requirements, testified that for the year immediately preceding the valuation dates,

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[1] On behalf of the DOR, Mr. Eyre provided a review appraisal. *See* EP 41 below.

PacifiCorp achieved a return of 6.8% on its plant in service. Tr. p. 1318, ll.20-23. This was a significant under-earning of the approved regulatory rate of return. Tr. p. 1319, ll.2. Rate regulation negatively impacted PacifiCorp's earnings as a result of deferred income taxes that are not allowed in rate base, allocation issues, outstanding rate cases, and the timing of rate cases. Tr. pp. 1317, ll.24, 25 through 1318, ll.1-6. Further, Mr. McDougal stated that one of the biggest reasons for the shortfall is the under-recovery of power costs. Tr. p. 1319, l. 11.

37. Mr. Douglas Stuver, PacifiCorp's senior vice president and chief financial officer, testified that the company's underearning was due to the complexity of operating under six different state regulatory commissions with the company in growth mode. Tr. pp. 1178 -1179. He explained that new customers increase the revenue stream but may be dilutive of PacifiCorp's earnings due to the need to access or purchase power to serve those customers at higher prices than they can charge. Tr. pp. 1205-1206.

38. Norman K. Ross, CPA, ABV, Tax Director for PacifiCorp testified that there is a difference between accounting ("book") depreciation and appraisal depreciation. Tr. p. 212, ll. 17-23 and Stipulated Exh. 59, p. PAC-MT0607-002387. Book depreciation is the allocation of the original cost of the asset over a period of time whereas appraisal depreciation is the loss in the value of an item due to all causes. Tr. p. 216.

39. To summarize the evidence above, the only significant difference between Ms. Haller's OCLD estimates and those calculated by Mr. Tegarden result from the additional depreciation Mr. Tegarden deducted for economic obsolescence.

b. DOR Response to Economic Obsolescence Argument

40. Brent Eyre is an Accredited Senior Appraiser with the American Society of Appraisers (ASA) who testified in support of the Department's valuation. He is also a Certified General Appraiser with Utah, Washington and Idaho. During the course of his career with the Utah State Tax Commission and later as a self-employed appraiser and consultant, Mr. Eyre maintained professional affiliations with recognized organizations such as Western States Association of Tax Administrators (WSATA), The National Conference of Unit Valuation States (NCUVS), the International Association of Assessing Officers (IAAO), and the ASA. Stipulated Exh. 46, pp. 70-77. Mr. Eyre was certified as an expert witness in these proceedings.
41. Mr. Eyre submitted two expert reports titled *Review Appraisal of 'Appraisal of the Operating Properties of PacifiCorp as of January 1, 2006 [and 2007]' by Tegarden & Associates, Inc.* In these reports, not only did Mr. Eyre review Mr. Tegarden's appraisals, but he also reviewed the Department's appraisals and rendered his own independent opinion of market value for the years in dispute. His cost approach for 2006 was $9,172,125,757, exactly the same as Mr. Tegarden's cost before the deduction for economic obsolescence. Stipulated Exh. 46, p. PC-DOR 003618. Mr. Eyre also calculated a market approach value of $9,471,300,000 (before I.P.P. deduction). Stipulated Exh. 46, p. PC-DOR 003687. For 2007, Mr. Eyre calculated a cost approach value of $10,064,631,766 and a market approach value of $10,229,500,000 (before I.P.P. deduction). Stipulated Exh. 47, pp. PC-DOR 003773 and 3788.
42. In his reports, Mr. Eyre estimated that the historic cost of PacifiCorp's assets in 2006 totaled $14,532,898,825 and increased to $15,526,911,439 in

2007. Mr. Eyre then reduced those figures by the depreciation/obsolescence reflected on PacifiCorp's FERC Form 1 ($6,129,967,945 and $6,408,699,464) to arrive at a value under his OCLD approach (before deducting for intangible personal property) of $9,172,125,757, and $10,064,631,766. Stipulated Exh. 46, p. 25 and Ex.1; Stipulated Exh. 47, p. 26 and Ex. 1; Tr. p. 836, ll. 15-25.

43. Mr. Ross submitted two exhibits criticizing Mr. Eyre's calculations for failing to deduct economic obsolescence, for using market data to value tangible operating assets, for using market data from companies not comparable to PacifiCorp, for not including flotation costs in his cost of equity, for failing to deduct goodwill from the sale price of PacifiCorp, and for failing to discount the sale price for the three months between the lien date and the closing date. Stipulated Exhs. 59 & 60.

44. Mr. Eyre also submitted two surrebuttal reports that addressed the criticisms lodged by Norman Ross. He denied the existence of economic obsolescence, stated that market data is widely used to value companies, and claimed that flotation costs are not generally added to opportunity costs in calculating business valuations. He also pointed out that the goodwill is carried by the purchaser of PacifiCorp, MEHC, on its books and is not on PacifiCorp's books, so did not need to be removed from his calculations. Stipulated Exhs. 48 and 49.

45. Mr. Eyre criticized Mr. Tegarden's income shortfall calculations for a number of reasons. Mr. Eyre explained that Mr. Tegarden's income shortfall methodology is not found in traditional appraisal texts and that it is not the same capitalization of income loss method outlined in *The Appraisal of Real Estate*, and has been rejected in other jurisdictions.

Stipulated Exh. 46, pp. 22-23, and Stipulated Exh. 47, pp. 23-24; Tr. p. 831, l. 15, through p. 832, l. 23.

46. Mr. Eyre noted that property acquired by deferred income taxes(DITs) is not part of the regulated rate base. He pointed out that Mr. Tegarden is, therefore, comparing a rate-base income stream to an OCLD property base which is larger than the property in the rate base. Doing so, Mr. Eyre explained, creates a mismatch between the income stream and the plant used to generate that income. Stipulated Exh. 46, p. 21, and Stipulated Exh. 47, p. 22; Tr. pp. 833, l. 20, through p. 834, l. 15.

47. Mr. Eyre also detailed the circularity inherent in Mr. Tegarden's income shortfall methodology which converts the cost approach to an income approach, rather than considering them as two diverse ways of valuing the company. Stipulated Exh. 46, p. 21, and Stipulated Exh. 47, p. 22; Tr. p. 831, ll. 4-14.

48. Dr. John W. Wilson testified in favor of the Department. He received his Ph.D. in Economics and has testified in numerous regulatory proceedings across the United States during the course of his career. Stipulated Exh. 50. Dr. Wilson is an expert on public utility company issues, particularly as it relates to rate regulation. Stipulated Exh. 50. Dr. Wilson was certified as an expert in the field of economics and public utility regulatory issues. Tr. p. 732, ll. 9-24.

49. Dr. Wilson criticized Mr. Tegarden's economic obsolescence deductions. Dr. Wilson explained that this is not a true measure of obsolescence, but rather, the mathematical difference between Mr. Tegarden's "understated" projected earnings and his overstated "required" earnings. Stipulated Exh. 51, pp. 4-5; Tr. p. 737, l. 6, through p. 742, l. 8.

50. Dr. Wilson also stated that economic obsolescence, like physical and

functional obsolescence, is "regularly reflected in depreciation accrual rates, which are approved by regulatory authorities, and they would be recoverable from ratepayers, they would be reflected in the company's rates. So the idea that there is unrecouped obsolescence is invalid." Tr. p.736. ll. 3 – 12.

51. Dr. James Ifflander testified on behalf of the Department. Dr. Ifflander earned his Ph.D. in Finance, with a minor in accounting economics and statistics. In addition, Dr. Ifflander has earned the designation of Chartered Financial Analyst (CFA). Stipulated Exh. 52. Dr. Ifflander was certified as an expert in the areas of corporate finance, valuation and valuation methodologies. Tr. p. 1218, ll. 7-21.

52. Based on Dr. Ifflander's independent analysis, he did not find evidence of additional economic obsolescence that was not already accounted for in the Department's OCLD approach. Tr. p. 1267, l. 4; Stipulated Exh. 53, p. PC-DOR 003463.

53. In Dr. Ifflander's opinion, Mr. Tegarden's income shortfall method is not a valid or accepted method of measuring obsolescence. In addition to the inherent circularity of this method, Dr. Ifflander noted that Mr. Tegarden improperly attempts to compare a rate of return on booked accounting assets when in actuality it is calculated on the rate base. This creates a mismatch. Moreover, Mr. Tegarden's comparison, Dr. Ifflander notes, is in no way a measure of obsolescence. Tr. p. 1267, l. 18, through p. 1269, l. 3; Stipulated Exh. 53, p. 8.

54. Dr. Ifflander pointed out the purchase price allocation reported on the company's financial statements does not report economic obsolescence or calculate an income shortfall for the company. Tr. p. 1236, l. 20 through p. 1239, l. 8.

55. Dr. Ifflander also stated that Houlihan Lokey Howard & Zukin (Houlihan & Lokey), the investment bankers hired by MEHC for valuing the purchase of PacifiCorp, did not use the income shortfall method, nor did they find any additional external obsolescence above normal depreciation. Stipulated Exhs. 16 and 53, p. PC-DOR 003457.

56. Mr. Tegarden's reports, Stipulated Exhs. 43 and 44, acknowledge that PacifiCorp's unit value increased substantially between 2006 and 2007, from $9.2 billion to $10 billion. Stipulated Exh. 43, p. PAC-MT0607-000042, Stipulated Exh. 44, p. PAC-MT0607-000190.

57. In addition, PacifiCorp's reports to the Federal Energy Regulatory Commission (FERC) illustrate that: (a) the company's property, plant, and equipment is increasing; (b) customer growth is occurring; (c) anticipated capital expenditures are rising; and (d) net operating income is increasing, among other things. *See, e.g.,* Stipulated Exh. 2, p. PC-DOR 001316; Exh. 3, p. PC-DOR 001440; Exh.43, p. PC-MT 0607 – 000043; Exh.44, p. PAC-MT 0607 - 000190.

2. Income Methods

58. For both 2006 and 2007, Ms. Haller calculated three different income capitalization methods: direct capitalization of net operating income (NOI), direct capitalization of gross cash flow (GCF), and yield capitalization. The NOI calculation was weighted 20% each year and the GCF calculation was weighted 5%. The yield capitalization received 0% weight in both years. Stipulated Exhs. 35, 36.

a. Direct Capitalization

59. Direct capitalization is a standard method used in the income capitalization approach; it capitalizes a single year's income into a

valuation of a subject property. In some cases, the incomes for several years may be averaged to obtain a representative income to capitalize. *See* Appraisal Institute, *Appraisal of Real Estate*, Twelfth Ed.[2], p. 530; Stipulated Exh. 46, pp. 48-49.

I. Capitalization Rate Study

60. A capitalization rate used in the direct capitalization approach is typically derived from comparable sales of similar properties. The Department did not have comparable sales so it utilized an earnings-to-price ratio from similar companies derived through their capitalization rate study. Stipulated Exhs. 37 and 38; Tr. p. 97; Stipulated Exh. 46, p. PC-DOR 003644. *See also PacifiCorp v. DOR*, CT-2005-3 7/07 (*on appeal*).

61. In that study, the Department used the band of investment method to calculate the capitalization rates for its direct capitalization approaches as set forth in Rule 42.22.114(2), ARM. In this method, the typical industry rate for each source of capital, *i.e.*, common equity, preferred stock, and debt, was weighted according to its proportion in the typical capital structure for an industry. The result is a weighted average direct capitalization rate. Stipulated Exh. 37 and 38. *See also PacifiCorp v. DOR*, CT-2005-3 7/07 (*on appeal*).

62. The equity rate used by DOR in the direct capitalization approach was an earnings-to-price (E/P) ratio for comparable electric utility companies. Stipulated Exh. 37, p. PC-DOR 003795. The Department drew companies from the electric utility industry group in the Value Line Investment Survey and Yahoo. Stipulated Exhs. 37 and 38.

63. The Department calculated earnings per share divided by price for each

[2] We cite the Twelfth Edition because that was the edition in use at the time of the lien dates at issue in this case. The parties frequently cited the Thirteenth Edition (2008). No significant distinctions between those editions were identified so we consider the difference unimportant.

company listed, and then calculated a simple average of those figures. *See* Exh. 37, p. PC-DOR 003802. *Also* Tr. pp. 100-102.

64. The use of E/P ratios to derive an equity rate is described in the Standards of the NCUVS. *PacifiCorp v. DOR*, CT-2005-3 7/07 (*on appeal*), #57.

65. Mr. Eyre testified that 35 of the 50 states perform unitary appraisals and are members of NCUVS, which publishes the standards referenced above. Tr. p. 806.

66. The Department has used this method for over ten years and possibly much longer. *See PacifiCorp v. DOR*, CT-2005-3 7/07 (*on appeal*) # 30, 31.

<u>II. Net Operating Income</u>

67. In the NOI model for 2006, Ms. Haller capitalized income of $480,984,517 by using a four year simple average of PacifiCorp's net operating income. For 2007, Ms. Haller capitalized $550,128,648 by using a two-year simple average of PacifiCorp's net operating income. She also added Expansion Construction Work in Progress (CWIP) to account for any expansionary CWIP. This resulted in a 2006 value of $8,046,702,983 and a 2007 value of $9,062,600,425. Stipulated Exh. 35, p. PC-DOR 00799; Stipulated Exh. 36, p. PC-DOR 000928.

<u>III. Gross Cash Flow</u>

68. To calculate a direct capitalization of gross cash flow for both years at issue, Ms. Haller capitalized PacifiCorp's gross cash flow. She developed a gross cash flow capitalization rate by applying Value Line's price to gross cash flow multiple to the guideline companies in the DOR capitalization rate study. She converted the multiple to a gross-cash-flow-to-price ratio. She further added CWIP and subtracted the default 10% for intangible personal property, which resulted in a $8,958,555,960 value for 2006 and a

$9,538,083,747 value for 2007. Stipulated Exh. 35, p. PC-DOR 00800; Stipulated Exh. 36, p. PC-DOR 000929.

b. PacifiCorp Challenge to the E/P Ratio

69. PacifiCorp challenges the DOR use of E/P ratios in calculating the equity component of the direct capitalization rate applied to net operating income as not being a "commonly accepted method or technique" under Rule 42.22.111(1), ARM. This is very similar to the 2005 challenge which is currently on appeal with the Montana Supreme Court. *PacifiCorp v. DOR*, CT-2005-3 7/07 (*on appeal*), Montana Supreme Court DA-10-0182.
70. Mr. Ross testified that only a couple of states used a P/E ratio in this way. None of the ten states in which PacifiCorp does business uses the P/E ratio. Tr. pp. 242, 251-255.
71. Mr. Robert Reilly, CPA, testified on behalf of PacifiCorp. He has an M.B.A. and is an Accredited Senior Appraiser and accredited in business valuation, a member of the Appraisal Institute and the author of numerous professional articles. He was admitted as an expert witness. Tr. p. 342.
72. Mr. Reilly testified that he was unaware of any appraisal treatise that recognizes the Department's use of P/E ratios. Tr. p. 358. He also testified that several nationally accredited appraisal organizations that set appraisal standards have not recognized the method either. Tr. pp. 414-416
73. Mr. Reilly admitted that the Western States Association of Tax Administrators (WSATA) and the National Conference of Unit Valuation States (NCUVS) are organizations that set guidelines and principles and have approved the use of P/E ratios. Tr. pp. 413-416.

74. Mr. Reilly testified that stock prices should not be used in the process of valuing operating properties because the stock price includes more than the operating assets of a company. Tr. p. 359, l. 4 through p. 361, l. 9.

c. DOR Response to E/P Ratio

75. Mr. Eyre specifically disagreed with Mr. Reilly, stating that stock prices "represent fundamental claims to the underlying assets and to the income that is generated by those assets. To value those claims is a very good indication of the value of the assets." Mr. Eyre also pointed out that Mr. Reilly said the stock and debt approach to value is an approved valuation method and that is also based on the stock market. Tr. p. 827, l. 17 through p. 828, l. 11.
76. Mr. Eyre stated "there are no published texts out there that tell you how to do a unit appraisal. You can't go to Amazon.com and find a book that tells you, as a state appraiser, how I'm going to appraise my large utility on a unitary basis." Tr. p. 808, ll. 4-8.
77. Dr. Antonio Bernardo, Ph.D., is a Professor of Finance at UCLA and the author of many articles on corporate finance in professional journals. Stipulated Exh. 54. He testified on behalf of the Department and was accepted as an expert on corporate finance and business valuation.
78. Dr. Bernardo stated that the Department's method of calculating its direct capitalization approach was valid and that he had never seen a corporate textbook used at the MBA level that did not support the use of E/P ratios in the manner used by the Department. Tr. p. 1061.
79. Dr. Bernardo directly disagreed with Mr. Reilly on the use of stock prices to value operating assets, stating that it is a commonly accepted practice in corporate finance and valuation. Tr. p. 1090.

80. Both Mr. Eyre and Dr. Ifflander pointed out that the use of stock prices to calculate ratios is common in other methods of valuation, such as discounted cash flow and dividend growth models. Eyre: Tr. p.854; Ifflander: Tr. p. 1277.

81. Mr. Eyre pointed out that Houlihan & Lokey, investment bankers hired by MEHC to value PacifiCorp for the purchase, used E/P ratios to arrive at a market value and used them in a direct capitalization model similar to the Department's. Tr. pp. 876 – 877.

82. Dr. Ifflander testified that the use of an E/P ratio to develop the direct capitalization rate is commonly used and appropriate. Tr. pp. 1225-1226.

83. Dr. Ifflander testified that in his examination of other electric utility sales transactions occurring in the last ten years, the direct capitalization approach is widely used by both buyers and sellers. Stipulated Exh. 53, p. 2.

84. Ms. Haller, Mr. Eyre and Mr. Tegarden each used essentially the same market capital structure in their calculations. *See* Stipulated Exh. 35, pp. PC-DOR 00799-0001; Stipulated Exh.36, pp. PC-DOR 000928-000930; Stipulated Exh. 46, p. PC-DOR 003624, Stipulated Exh. 47, p. PC-DOR p. 003722-003724.

d. Challenge to Comparable Companies

85. PacifiCorp also challenges the selection of the comparable companies used in the determining both direct capitalization rates. Appendix A.

86. Ms. Haller selected 20 guideline companies; 14 of those were western electric companies. The majority of the companies had significant coal fired generation and little if any nuclear generation. Stipulated Exh. 46, p. PC-DOR 003624.

87. All of Ms. Haller's guideline companies are included in Mr. Tegarden's selected guideline companies. Stipulated Exh. 46, p. PC-DOR 003623.

88. Ms. Haller testified that the guideline companies all have electric operations. Some of the companies also have other operations. Tr. p.104.

89. PacifiCorp challenged the comparability of the companies used in the rate study by noting some of the companies had more than just electric generation. For example, PacifiCorp demonstrated that MDU has earnings on its electric utility of $13 million out of $274 million. Haller Testimony, Tr. p. 116, Exh. 67, p.78 of 151. Black Hills has less than half of its income from its electric utility. Exh. 65, Haller Testimony, Tr. p. 112.

90. Mr. Eyre, in turn, criticized the list of guideline companies used by PacifiCorp in the income approach calculated by Mr. Tegarden, pointing out that Tegarden used three different lists of guideline companies. One list includes every electric company followed by Value Line, including many that have significant nuclear generation (unlike PacifiCorp), have no coal generation (unlike PacifiCorp), are on the east coast with different economic factors (unlike PacifiCorp) and had other lines of business included in the company. Mr. Tegarden had two other lists, one all non-nuclear but with many east coast companies, the other all western companies but with many nuclear or non-coal. Stipulated Exh. 46, p.30, PC-DOR 003623.

91. Mr. Eyre, Dr. Ifflander and Dr. Bernardo all testified that the standards of comparability are no different for the direct capitalization models Ms. Haller performed than for the yield capitalization models Mr. Tegarden performed. Tr. pp. 849, l. 4; 1270, l.19; 1153, l21.

IV. Yield Capitalization Method

92. Yield capitalization converts future income flows to a present value, which is then discounted as in the direct capitalization methods, to calculate a value for the company. The major difference is that instead of using a current year's income, an appraiser must estimate future cash flows. The reliability of the method, therefore, depends on the validity of the assumptions about future income streams. Direct capitalization, in comparison, relies on historic observable data. Stipulated Exh.46, p. PC-DOR 003620.
93. Ms. Haller calculated a yield capitalization model but placed no weight on it in either year. Tr. p. 139, l.6.
94. Mr. Tegarden used only the yield capitalization method, of the income methods, and calculated a value of $6,552,000,000. Stipulated Exh. 43, p. PAC-MT 0607 000057. For 2007, Mr. Tegarden calculated a value of $7,213,000,000. Stipulated Exh. 44, p. PAC-MT 0607 000203.
95. Mr. Eyre criticized Mr. Tegarden's calculations as having a mistake which artificially reduced the value by more than $400 million, but also as based on a set of assumptions about the company that he claimed are clearly not true. Mr. Tegarden's method assumes, for example, zero growth into the future whereas PacifiCorp projects 11.4% income growth in each of the next seven years. Mr. Tegarden also assumes that capital expenditures will equal depreciation, but according to Houlihan & Lokey, capital expenditures will be more than double depreciation in some of the next seven years. Tegarden further assumes that net operating income will equal net cash flow which the company's own projections clearly refute. Stipulated Exh. 46, pp. PC-DOR 003647 – 3648.

A. Flotation Costs

96. Mr. Eyre also challenged Mr. Tegarden's adjustment for flotation costs by which Mr. Tegarden increased the cost of capital (WACC) used in his valuation by 1.2% for debt and 3.25% for equity. Stipulated Exh. 43, pp. 78 -79, PAC-MT0607 000097 - 98. Mr. Eyre argued that the costs of floating debt and equity issues should be deducted from income at the time they are incurred. Stipulated Exh.46, pp.45 – 47, PC-DOR 003639. Both cited textbook authorities to support their positions.
97. Dr. Bernardo testified that the flotation costs should not be added to the cost of capital. Tr. p. 1091.
98. Dr. Ifflander testified that the flotation costs are inappropriate because they are not a part of the opportunity cost of capital, which is the rate used in a yield capitalization calculation. He also stated that they are usually trivial costs and that Mr. Tegarden's rates were calculated incorrectly and "overstated to a significant degree." Tr. p. 1272.
99. Mr. Eyre stated that the yield capitalization model is the method most dependent on accurate predictions about the future of the company and the markets, and therefore, the least reliable when compared to calculations based on audited financial statements of actual earnings, as the other two methods are. He argued that the results should be compared to other income capitalization methods to check veracity, which Ms. Haller did but Mr. Tegarden did not. Mr. Eyre concluded that the yield capitalization approach was proven invalid in this case and approved of the DOR's decision to not put any weight on that indicator. Stipulated Exh. 46, PC-DOR 003646.

3. Market Approaches

a. Stock and Debt Approach to Valuation

100. Ms. Haller prepared three stock and debt approaches in 2006. Stipulated Exh. 35, p. PC-DOR 00809. She put no weight on her first stock and debt model, so it is not addressed here. As the numbers differ between the two years, they are addressed separately.

I. 2006 Method #2

101. In her second approach, Ms. Haller estimated the value of PacifiCorp's stock by capitalizing the equity earnings of the company (from the March 2005 Form 10-K) by the same equity component rate she derived in her direct capitalization approach using P/E ratios from other companies. ($245 million divided 5.74%[3] = $4.343 billion). Tr. pp. 128-129.

102. Ms. Haller added the above equity estimate to PacifiCorp's debt as set out in its March 2005 10-K ($4.209 billion) to derive a value estimate of $8.552 billion prior to the standard 10% intangible personal property deduction. Stipulated Exh. 35, p. PC-DOR 00803.

103. Ms. Haller placed a 15% correlation weight on her second stock and debt model. Stipulated Exh. 35, p. PC-DOR 00809.

II. 2006 Method #3

104. In her third stock and debt approach, Ms. Haller multiplied PacifiCorp's book equity by a market-to-book ratio derived from the same industry stocks she used in her direct capitalization approach which resulted in an equity value of $5,701,991,408. To this, Ms. Haller added the market value of long term debt from PacifiCorp's 10-K filing, $4,209,500,000, for a

[3] This number appears variously in the transcript as 7.54, 5.74, and 5.47. The actual percentage used in the calculation was 5.74. Stipulated Exh. 35, p. PC-DOR 00803.

total stock and debt value of $9,911,491,408[4]. Ms. Haller deducted the 10% default for intangible personal property and placed a 15% weight on this approach. Stipulated Exh. 35, p. PC-DOR 00803, 00809.

105. Ms. Haller added this equity estimate to the book value of PacifiCorp's debt ($4.209 billion) to derive a value estimate of $8.702 billion prior to any adjustment for intangible properties. Exh. 35, p. PC-DOR 00803.

106. Ms. Haller placed 15% correlation weight on her third stock and debt model. Stipulated Exh. 35, p. PC-DOR 00809.

III. 2007 Method # 1

107. For 2007, Ms. Haller prepared stock and debt approaches similar to the second and third approaches in her 2006 analysis. In addition she prepared a sales comparison, similar to her first approach in 2006. Stipulated Exh. 36.

108. In her first stock and debt approach, Ms. Haller estimated the value of the stock by capitalizing the equity earnings using a P/E ratio derived from other companies, added the value of the long term debt, to arrive at a value of $8,961,860,000. Stipulated Exh. 36, p. PC-DOR 000933.

109. Ms. Haller placed 15% weight on this approach. Tr. p. 140, l. 3.

IV. 2007 Method #2

110. In her second stock and debt approach, Ms. Haller took the book equity shown on PacifiCorp's balance sheet and multiplied it by a market-to-book ratio taken from the Department's direct capitalization study. Haller then added the value of long term debt taken from PacifiCorp's 10-K, to arrive at a value of $11,219,411. Stipulated Exh.36, p. PC-DOR 000933.

[4] M. Haller testified that she had an error in her stock & debt approach #3, which would have increased the indicator of value. Tr. p. 667, l. 15-17. As noted in EP 8 and 9, we will not consider this error.

111. Ms. Haller placed 0% weight on the second stock and debt approach. Tr. p. 140, ll. 18, 19.

b. Sales Comparison Approach

112. For both tax years, Ms. Haller also calculated a sales comparison approach, labeled as such in 2007 but called Stock and Debt Approach #1 in 2006. Ms. Haller placed 0% weight on it in 2006 and 15% weight in 2007. Stipulated Exh. 35, p. PC-DOR 00809; Tr. p. 139, l. 13.
113. During the relevant timeframe, Scottish Power announced and culminated a sale of PacifiCorp to MEHC, a subsidiary of Berkshire Hathaway, for approximately $9.4 billion. Stipulated Exh. 1, p. PC-DOR 0037; *See evidence presented and discussion below.*
114. For 2006, Ms. Haller used data from PacifiCorp's 3/31/05 Form 10-K, adding the long term debt, preferred stock and current liabilities to the announced price of PacifiCorp's equity of $5.1 billion to reach a value of $10,704,900,000. Stipulated Exh. 35, p. PC-DOR 00802.
115. For 2007, Ms. Haller took the data from PacifiCorp's 10-K. She added the equity value to the long-term debt, preferred stock and current liabilities. She then subtracted current assets to reach a value of $9,471,300,000 from which 10% was deducted for intangible personal property. Stipulated Exh. 46, p. PC-DOR 000932.
116. Mr. Eyre also calculated a value based on the market approach for 2006. He added the announced purchase price of the securities to the market value of the long-term debt and preferred stock of $4.179 billion to reach a total figure of $10,274,500,000, before the 10% deduction for intangible personal property. Stipulated Exh. 46, p. PC-DOR 003654.

Sale of Subject Property

117. "All taxable property must be assessed at 100% of its market value except as otherwise provided." Section 15-8-111(1), MCA. "Market Value" means "the value at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Section 15-8-111(2)(a), MCA.
118. Rule 42.22.101(11), ARM provides "market value" is the exchange value of a property in a competitive market." Market value, therefore, is the value of property sold on the open market. Thus, the sale price is, by definition, the market value.
119. On May 23, 2005, the sale of PacifiCorp for approximately $9.4 billion was announced, ten months prior to the transaction's closing on March 31, 2006. As of January 1, 2006, the lien date for the tax year 2006, it was, therefore, commonly known by the public that Scottish Power had entered into a sales agreement seven months before with MEHC (a wholly owned subsidiary of Berkshire Hathaway) for the transfer in ownership of PacifiCorp. Stipulated Exh. 1, p. PC-DOR 0037.
120. The analysis of independent investment firm of Houlihan & Lokey who advised MEHC's Board of Directors indicated the consideration to be paid for PacifiCorp, amounting to $5.1095 billion in cash and $4.4615 billion for the assumption of debt and preferred stock for a total of $9.571 billion, was "fair to the Buyer from a financial point of view." Stipulated Exh.19.
121. PacifiCorp's purchaser, MEHC, shows on its 10-K filing that the reported fair value of PacifiCorp's property plant and equipment and recorded as part of the transaction was $10.05 billion in 2007. Stipulated Exh. 9, p.

PC-DOR 004161.

122. Based on the evidence presented, the total approximate value of MEHC's acquisition of PacifiCorp was $9.4 billion. More specifically, MEHC acquired all of the equity in PacifiCorp for approximately $5.1 billion and assumed all of PacifiCorp's debt and preferred stock for approximately $4.3 billion. Stipulated Exh. 29, p. PAC-MT0607-001542; Tr. p. 1208, ll. 4-6.

123. The testimony of Mr. Stuver, PacifiCorp's senior vice president and chief financial officer, admitted that the transaction between Scottish Power and MEHC was an arms length transaction between a willing buyer and seller, neither under any compulsion and both apprised of the facts. The transaction, therefore, satisfied the definition of market value found at § 15-8-111(2)(a), MCA. Tr. p. 1174, l. 23, through p. 1175, l. 23; p. 1211, ll. 9-13.

124. No credible evidence was introduced that would demonstrate that the transaction occurring between MEHC and ScottishPower occurred in a non-competitive environment.

125. The $9.4 billion sale of PacifiCorp in March 2006 is a higher value than the DOR's correlated unit value for PacifiCorp for 2006, which was $7,885,915,000. The 2007 value was calculated as $8,678,226,000. Stipulated Exh. 35, p. PC-DOR 0795; Stipulated Exh. 36, p. PC-DOR 000924.

126. Dr. Ifflander criticized Mr. Tegarden's appraisal for his failure to consider the sale as an indicator of value. He stated "his omission of any significant analysis of the transaction is in complete contradiction to the most fundamental premises of the economic, financial, and valuation fields." Stipulated Exh. 53, PC-DOR 003459. Dr. Ifflander went on to state

"These assets were sold in a competitive market with the approval of two different and completely independent Boards of Directors, supported by the analysis of various investment banks and jointly approved by thousands of individuals. This is the definition of market value." Stipulated Exh. 53, PC-DOR 003461.

127. It is also true the DOR did not use the sale price to value the company for tax year 2006. Ms. Haller testified that she had originally proposed putting 30% weight on the stock and debt approach #1, but changed it after meeting with Mr. Ross because of pressure from the Taxpayer and uncertainty about the timing of the transaction. Tr. p. 66, l. 14 to p.67, l. 20. The DOR did use the sale price in its market indicator for 2007. Stipulated Exh. 36, PC-DOR 00932.

128. There was no evidence presented to the Board proving that the unit acquired by MEHC when it bought PacifiCorp was in any way different than the unit required to be valued by Ms. Haller.

<u>Investment Value</u>

129. Mr. Tegarden argued the sale price was an investment value price rather than a market value price and therefore was not a suitable basis for calculating a value. Tr. p. 525, l. 6.

130. At trial, Mr. Tegarden quoted from *The Appraisal of Real Estate*, *Thirteenth Edition,* page 29.

> Investment value reflects the subjective relationship between a particular [investor] and a given investment. It differs in concept from market value, although investment value and market value indications sometimes may be similar. If the investor's requirements are typical of the market, investment value in this case will be the same as market value.
> Tr. p. 536.

131. Dr. Ifflander stated that the criteria for such a judgment are missing from Mr. Tegarden's opinion in that he did not examine the opinions of the Boards of Directors or the many shareholders who were party to the transaction. Stipulated Exh. 53, p. PC-DOR 003461

132. Mr. Tegarden submitted a selection of news clips with speculations about the purchase but admitted at trial that he had never read the internal valuation memo, prepared for MEHC management by Mr. Goodman, which might have provided direct insight into the purchaser's motive. Stipulated Exh. 44, pp. PAC-MT0607-000253 - 257; Tr. p. 570.

133. Mr. Tegarden stated he based his conclusion on several factors: the first is that purchasers were not typical in that they were long term investors and, uniquely, did not require PacifiCorp to pay dividends. "Virtually every electric company in the country is paying quarterly dividends, not all of them but most of them." Tr. pp. 526-529.

134. The Department pointed to Value Line lists in Mr. Tegarden's appraisal that show 20 to 25% of electric companies don't pay dividends. Stipulated Exh. 43, p. PAC-MT0607-000079.

135. Mr. Tegarden asserted the reason MEHC (owned by Berkshire Hathaway) paid more than the market value of the company was that its owner, Warren Buffet, had $40 billion in cash that he needed to invest because it was not earning a return. Stipulated Exh. 43, p.83 PAC-MT0607-000102.

136. Dr. Ifflander testified that having cash to invest does not make the purchaser atypical in that several big companies have large cash holdings for purchases such as this. Tr. p. 1248, l. 7, through p. 1249, l. 16.

137. Dr. Ifflander stated the amount of cash the purchaser has does not change the value of the item purchased. Tr. p. 1249, l. 17, through p. 1250, l. 3.

138. At the time, the average rate on 30-day Treasury Bills was 4.05 percent,

according to Mr. Tegarden's testimony based on market data included in his appraisal. Stipulated Exh. 45, p. PAC-MT 0607 000661; Tr. p. 576, l.13.

139. According to Department witnesses, a desire to earn a reasonable return when owning a rate regulated utility represents a typical or ordinary investment requirement. Tr. p. 757, ll. 7-9, 14-16. An intention to hold the to-be-acquired utility as a long-term investment is not unusual or atypical. Tr. p. 760, l. 10; p. 761, l. 14; Tr. p. 910, ll. 15-21. A purchaser's desire to enjoy "synergies" is not atypical. Tr. p. 761, l. 21; p. 762, l. 14; p. 911, ll. 15-24. *See also* Tr. p. 1254, ll. 10-19.

140. PacifiCorp's geographic diversification was viewed as a positive attribute and one that would have existed for any potential purchaser. Tr. p. 1173, l. 21, through p. 1174, l. 16; p. 1212, ll. 8-12; p. 1213, ll. 3-16.

141. According to Mr. Stuver, PacifiCorp's official company position respecting MEHC's motivations for acquiring PacifiCorp are found in its Form 10-K filings. Stuver Testimony, p. 1167, l. 5. MEHC reported the fair value of PacifiCorp's tangible assets as $10.05 billion as of March 31, 2006. Stipulated Exh. 53, Exh. A, p. PC-DOR 003467. The joint application and testimony submitted to the Utah Public Service Commission about the sale is also indicative of PacifiCorp's position on the sale. Stipulated Exhs. 29-33.

142. Dr. Wilson stated merely because MEHC paid more than book value does not indicate an atypical price. He presented evidence based on the sales of more than thirty vertically integrated electric utility companies like PacifiCorp over the last ten years which showed that in every one of the acquisitions, the transaction price was equal to or greater than the book value of the acquired company. In fact, the market prices averaged 150%

of the book value. The comparable sales evidence was a major consideration in MEHC's analyses of the acquisition. Stipulated Exh. 51, pp. PC-DOR 003509-3513.

II. Timing of the Valuation data

143. The internal valuation memo by Mr. Goodman and the analysis done by Houlihan & Lokey were released approximately 5 months before the lien date and were known or knowable as of the appraisal date. Stuver Testimony, Tr. pp. 1167 -68

III. Correlation Process

144. PacifiCorp claims that the correlation used by the DOR to weigh and combine the several value indicators is erroneous and not based on sound appraisal practices. Appendix A. PacifiCorp, however, submitted no evidence or testimony challenging the weighting decisions made by the DOR.

Issues Governing the Challenge

145. Prior to the hearing, the parties agreed, and the Board ordered that the pre-trial Order would govern the course of the trial. *See* Pre-trial Order. Thus, this Board will address all of the issues raised in the pre-trial order, and shall consider those to be the "issues essential to the decision as set out in §2-4-704, MCA. *See also DeVoe v. Department of Revenue*, 233 Mont. 190, 759 P.2d 991 (1988) and *Department of Revenue v. Paxson*, 205 Mont. 194, 666 P.2d 768 (1983).

Findings of Facts, Conclusions of Law and Board Discussion

Standard of Review

We are tasked with determining whether the DOR set the proper value for PacifiCorp for tax years 2006 and 2007. The Supreme Court has recognized that tax appeal boards are particularly suited for settling disputes over the appropriate valuation of a given piece of property. *DOR v. Grouse Mtn.*, 281 Mont. 353, 355-56, 707 P.2d 1113, 1115 (1985). The Court noted in the same paragraph that assessment formulations are within the expertise of the State Tax Appeal Board. Id.

Further, the district court has determined that the Board's authority is "to hear the evidence, find the facts, apply the law, and arrive at a proper taxable value." In fact, the Court noted that the Board's role is not merely to review the DOR appraisal but to examine the facts and make a determination of the proper taxable value as of the lien date. *See PacifiCorp v. Department of Revenue,* 2009 Mont. Dist. LEXIS 594 (1st Judicial District Court, 2010.)

The Department's assessment is entitled to a presumption of correctness provided its assessments are in accordance with Montana statutes, administrative rules and regulations, and those statues, rules, and regulations are not arbitrary, capricious, or otherwise unlawful. *Department of Revenue v. Burlington Northern, Inc.*, 169 Mont. 202, 545 P.2d 1083 (1976).

The taxpayer may overcome the presumption of correctness associated with the Department's assessments by showing by a preponderance of the evidence that the assessment does not reflect the market value of the property. *See Wells Fargo Service Co. v. Department of Rev.*, STAB PT-2003-126 June 6, 2005; citing *Western Airlines, Inc. v. Catherine Michunovich, et al.,* 149 Mont. 347, 428 P.2d 3 (1967).

Valuation Method

Initially, we note that a common theme throughout the Taxpayer's complaint is a challenge to the process of valuation under Montana law.

PacifiCorp argues that the Montana DOR is authorized by statute to determine only the value of the "taxable property" owned by PacifiCorp, and that selecting the entire company of PacifiCorp as its valuation unit is inappropriate because the DOR failed to properly remove non-taxable items from its assessments. Appendix A. Much of PacifiCorp's criticism about valuation methods focuses on the consequences of valuing more than the operating assets, and this is a fundamental difference in the market value asserted by the Department and PacifiCorp. PacifiCorp's definition of the proper assets to value, and their urging of our acceptance of this definition, is an attack on the traditional use of unit valuation in Montana. We specifically reject this attack.

Under Montana law, the starting point of any competent tax valuation of a complex, multi-jurisdictional company is the overall value of the company. From that figure, the assets not subject to tax (including intangible assets) are subtracted and the value is then apportioned to Montana.

As we stated in *Northwestern v. DOR*, SPT-2006-1 (9/15/07) *affirmed by 1st Judicial District Court*, 2008 Mont. LEXIS 360, the unit method values an entire operating system as a going concern: an integrated, organized whole without functional or geographic division of the whole into its component parts. The unit approach relies on the proposition that each part of an organization is indispensable to the existence of the whole and contributes, proportionally, to its principal earnings. The valuation pursuant to the unit method is meant to capture all of the operating assets, both tangible and intangible, as a going business concern. Id.

PacifiCorp argues that the appropriate unit for valuation is the "value of all tangible and intangible property that is reasonable and necessary to the maintenance and operation of a centrally assessed company's interstate or intercounty business." They argue the goal of valuation is not the going-concern value of the business, but rather some collection of pieces and parts, limited to bricks and mortar, that constitute the "operating property" of the company. This is functionally an argument to value the company using only a cost methodology.

Using solely a cost-based methodology for valuation, as PacifiCorp argues in this case, was discounted by the Montana Supreme Court thirty five years ago in *DOR v. Pacific Power and Light,* 171 Mont. 334; 558 P.2d 454, 458 (1976). The Court held that the actual cost of the physical plant within Montana alone does not equal the value of the allocated portion of a utility company. The unitary method determines not only the appropriate share of the entire enterprise which may be taxed by each state but also determines the "enhanced value" attributable to the equipment used by virtue of its being a component *part* of the system. The unitary method assumes the value of the entire system, as a going concern, is somewhat greater than the total fair market value of its equipment. Id. at 340.

The concept of unitary assessment has been firmly established in a series of historical decisions of the Supreme Court of the United States. *Pullman Co.* v. *Richardson,* 261 U.S. 330, 338, 43 S.Ct. 366, 368, 67 L.Ed. 682 (1923); *Fargo* v. *Hart,* 193 U.S. 490, 24 S.Ct. 498, 48 L.Ed. 761 (1904); *Galveston, Harrisburg* & *San Antonio Ry. Co.* v. *State of Texas,* 210 U.S. 217, 28 S.Ct.638, 52 L.Ed. 1031(1912); *United States Express Co.* v. *State of Minnesota,* 223 U.S. 335, 32 S.Ct. 211, 56 L.Ed. 459; *Union Tank Line Co.* v. *Wright,* 249 U.S. 275, 39 S.Ct. 276, 63 L.Ed. 602. (1919).

In addition, for nearly 80 years, the Montana Supreme Court has consistently approved the unitary valuation approach for appraisal of interstate utility properties. *See Western Union Tel. Co v. State Board of Equalization*, 91 Mont. 310, 7 P.2d 551 (1932); *Yellowstone Pipeline Co.* v. *State Board of Equalization,* 138 Mont. 603, 358 P.2d 55 (1960); *Western Airlines, Inc.* v. *Michunovich,* 149 Mont. 347, 428 P.2d 3 (1967); *DOR* v. *Pacific Power and Light,* 171 Mont. 334; 558 P.2d 454 (1977). In fact, the Court stated:

> [T]he true and actual value of plaintiff's property is somewhat more than an aggregation of the values of separate parts of it, operated separately, "it is the aggregate of those values, plus that arising from a connected operation of the whole; and each part contributes, not merely the value arising from its independent operation, but its mileage proportion of that flowing from a continuous and connected operation of the whole."

Western Union, 91 Mont. at 324, 7 P.2d at 553 (quoting *Western Union Tel. Co. v. Taggart*, 163 U.S. 1, 16 S. Ct 1054 (1896)). This was quoted again with approval by the Montana Supreme Court in the more recent *PPL* case. *See DOR v. PPL*, 2007 MT 310, 172 P.3d 1241 ¶27, and in-depth discussion of unit valuation from ¶7 to ¶ 31. Further, see our discussion in *Qwest v. DOR*, SPT 2008-02 (Nov. 2009.)

State law explicitly supports the concept of a unit reaching across state lines to encompass a full corporate entity. *See* §15-23-101[5], MCA. The Montana Supreme Court's "precedents recognize that the fair market value of a piece of property, that is an integral part of a larger system, derives from its value as a part of the larger system." *PPL*, ¶31 citing *Western Union*, 91 Mont. at 324, 7 P.2d at 553.

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[5] This section of code was in existence prior to the change from the Revised Code of Montana (R.C.M.) to the current codification methods. Section 15-23-101, MCA, En. 84-7801 by Sec. 1, Ch. 98, L. 1977; R.C.M. 1947, 84-7801.

By administrative rule, the Department has directed that the unit method of valuation involves appraising, as a going concern and as a single entity, the entire unit of the company, wherever located. Rule 42.22.101(30), ARM. The valuation thus determined is intended to capture all the assets of the company, both tangible and intangible, as a starting point for valuation. This legal concept is well supported by appraisal literature:

> Going concern value is the value of a proven property operation. It includes the incremental value associated with the business concern, which is distinct from the value of the real estate. Going-concern value includes an intangible enhancement of the value of the operating business enterprise, which is produced by the assemblage of the land, buildings, labor, equipment, and the marketing operation. This assemblage creates an economically viable business that is expected to continue.

Appraisal of Real Estate, Thirteenth Edition, p. 26. The treatise further states:

> Traditionally, the term *going-concern value* has been defined as the value of a proven property operation. The current definition of the term highlights the assumption that the business enterprise is expected to continue operating well into the future (usually indefinitely). In contrast, liquidation value assumes that the enterprise will cease operations. Going-concern value includes the incremental value associated with the business concern, which is distinct from the value of the tangible real property and personal property.

Appraisal of Real Estate, Thirteenth Edition, p. 29

This Board, in alignment with the decisions of the Montana Supreme Court, has consistently upheld unit value and discussed the concept of unit value, including the recent cases of *PPL v. DOR*, SPT-2002-4 & 6, *PacifiCorp v. DOR*, CT-2005-3, *Northwestern Corp. v. DOR*, SPT-2006-1, and *Qwest v. DOR*, SPT-2008-2. This Taxpayer's challenge frequently reiterates the commonly

asserted challenge that only the tangible assets of the company are the appropriate starting point for tax calculations and appraisal methods that capture the going-concern values of a company are incorrect.

The Taxpayer's goal at every step is to deny unit valuation, or any methodology that achieves it. Thus, any methods using stock prices or market based multiples are challenged, despite those methods being the most direct path to finding fair market value, as required by Montana law. The law, however, is long-settled and straightforward. We fail to see any benefit to continued discussion of this issue.

We now turn to reviewing the specific valuation of PacifiCorp for 2006 and 2007. We would first note the Department appraises numerous centrally assessed companies each year. As part of that process, the Department uses standard valuation techniques and calculations which are applied to the particular companies being assessed. After the initial appraisal is performed using these techniques, each company may request an informal review of the valuation to address any specific concerns. After the informal review process, a company may commence with formal challenge to the appraisal. During this formal process, we decide if the Department's methodologies properly valued PacifiCorp. With this framework in mind, we now turn to the issues surrounding PacifiCorp's valuation.

Sale of PacifiCorp as a Measure of Market Value.

On May 24, 2005, PacifiCorp's parent company, Scottish Power, announced that it would sell all of the common shares it owned in PacifiCorp to MidAmerican Energy Holdings Corporation (MEHC) which also assumed PacifiCorp's debt for a total purchase price of approximately $9.4 billion. The sale of the common stock ultimately closed on March 31, 2006, after the lien date for tax year 2006. EP 17.

PacifiCorp argues that the unadjusted sale price paid for PacifiCorp's common stock in 2006 cannot be used as a valid proxy for the market value of PacifiCorp's tangible taxable operating property. The Department contends that the $9.4 billion sale of PacifiCorp validated the Department's unit values.

The Department did not place any reliance on this stock sale in preparing its valuation for the 2006 tax year, but did use the sales price in its 2007 appraisal. PacifiCorp argues the sale of the stock does not have a direct correlation to the taxable tangible property owned by PacifiCorp. PacifiCorp also argues that the sale price indicates not a fair market value, but rather an investment value higher than the market value. Moreover, PacifiCorp argues the Department has failed to make any adjustments to account for intangible properties, non-operating utility properties, and other appropriate adjustments associated with the stock purchase.

Market Value Definition

We first address whether the sale is indicative of market value, or somehow a differing "investment value." It is axiomatic that the sale price of a particular property is indicative of the market value of that property. The evidence demonstrates the PacifiCorp/MEHC sale is relevant, compelling, and admissible evidence for purposes of both the 2006 and 2007 appraisals. Indeed, it is the best evidence that could be presented on the issue.

Market value is defined in Montana law as "the value at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all the relevant facts." Section 15-8-111(2)(a), MCA.

PacifiCorp's own chief financial officer, Douglas K. Stuver, who actively participated in the sale, testified that MEHC and Scottish Power met the "technical definition of a willing buyer and willing seller both being

knowledgeable about the property and neither being under duress."[6] EP 123. Under law, the Department may not adopt a lower or different standard of value from market value in making the official assessment and appraisal of the value of property except as otherwise authorized by law. Section 15-8-111(3), MCA. Thus, the Department must consider evidence of market value of the subject property.

Mr. Tegarden argued that the MEHC purchase of PacifiCorp's common stock was not representative of market value, but rather represented investment value. EP 129. He also argued that the interests of MEHC, and its parent company Berkshire Hathaway, were unique in that MEHC and Berkshire Hathaway do not require dividends be paid, they had significant amounts of cash that was not earning, and that they were long term investors.

Evidence showed, however, that 20-25% of the electric utilities do not pay dividends, that purchasers of an entire company are typically long-term investors, and that the buyer could have earned 4% in 30 day T-bills, if investment cash was an issue. EP 134-139. Further, the fact that Berkshire Hathaway may have had a large amount of cash to deploy when it (or MEHC) acquired PacifiCorp is irrelevant for purposes of determining market value or investment value.

The textbook definition of "investment value" is based on the subjective relationship of the investor to the investment where buyer's motives differ from those of the typical investor. EP 130 - 132. That definition is not met here.

Mr. Tegarden admitted he had not read MEHC's internal valuation memo to understand their motivation. EP 132. The investment bankers who

[6] Mr. Stuver also argues "the sale involved the sale of common stock which therefore included value of more than the property subject to assessment by the Department." Once again, this is an attack on the unit valuation method which we reject.

analyzed the terms of the sale for the purchasers considered the sale price a fair price, without any limitations about motives or special circumstances. The evidence demonstrates that the sale was entered into by a willing buyer and seller, knowledgeable about the property and neither under duress.

Ultimately, the Board finds that Mr. Tegarden's testimony relative to the issue of investment value was not credible. Mr. Tegarden would have this Board believe that MEHC (which is wholly owned by Berkshire Hathaway) paid nearly $3 billion dollars in excess of market value for PacifiCorp. Such an assertion is illogical on its face and was not supported by any evidence presented. The Board concludes that ordinarily a rational investor would not willingly pay more than market value because that would unnecessarily reduce the investor's expected return and finds that the offer, acceptance and purchase of Pacificorp set a market value. Exh.51, p. PC-DOR 003519; Wilson Testimony, p. 755, l. 21; p. 756, l. 14.

The Board also does not find the testimony of Mr. Tegarden or Mr. Ross credible in regards to an "investment expectation" differing from market value in this instance. *See* Exh. 51, p. PC-DOR 003519; Exh. 53; pp. PC-DOR 003460-003461. To the contrary, the more credible evidence presented during these proceedings proved that MEHC's investment expectations were those of a typical and ordinary investor.

We find the investment value argument unpersuasive, and that MEHC's investment expectations have not been proven to be other than those of a typical investor. We find that the evidence is clear and credible that the sale of the subject property met the definition of market value.

Timing of the Sale

The evidence indicates that the public announcement of the sale, including the terms and the sale price, was made on May 23, 2005. Certain

conditions were required before closing and ultimately, the sale was consummated on March 31, 2006. Exh.19. While the sale had not been fully consummated by the appraisal date for the 2006 tax year, there was clearly sufficient information available to assist in determining a market value for the subject property, and the evidence supports the fact that the valuations and negotiations for setting value commenced long before the public statement of a sale.

Use of the Sales Price as Probative Evidence for 2006

We are aware of the prohibitions against using post-lien date information in valuing property for tax purposes. *See PacifiCorp v. Department of Revenue,* 2009 Mont. Dist. LEXIS 594 (1st Judicial District Court, 2010.) We note, however, that significant public information was available on the purchase price and the commitments on the part of the buyers before the sale was consummated. Further, a large amount of confidential information and fair value analyses were also available to the Department indicating a valuation range prior to the lien date. *See* EP 143. While this is not as definitive as a consummated sale, it does indicate at a bare minimum, a negotiated value that was acceptable to both buyer and seller in a sale which meets the market value definition (see above). The valuation information generated by the buyer and the seller of the asset is some of the most credible evidence of value. In May 2005, materials were internally released which set forth an extensive review of PacifiCorp to determine whether the offered price of $9.4 billion accurately and adequately set a value for the assets of PacifiCorp. A variety of complex confidential valuation documents were developed internally. *See* Exh. 16, 18, 19, 20. Due to the confidential nature of the documents, this Board will not discuss those documents in detail. The documents all support the announced sale price of the company.

The public announcement of a $9.5 billion sale seven months before the lien date is not merely an offering price, without a commitment from a buyer. The stock purchase agreement referenced was a specific agreement between a buyer and seller, in May 2005, to purchase the stock for $5.1095 billion and assume debt of $4.4615. Further, extensive fair valuation analysis required by the purchaser had already been done. In fact, the report of the independent firm of Houlihan & Lokey, stating that the price was "fair to the Buyer from a financial point of view," was issued to the MEHC Board of Directors on May 23, 2005 supporting the initial announcement. In addition, audited financial statements of PacifiCorp were available as well as filings with FERC and the SEC. Stipulated Exh. 46, p. PC-DOR 003654; Confidential Exh. 16, 18, and 19, providing specific valuation information for PacifiCorp as of May 2005. This is information that was known and knowable, and could have been properly used in calculating an indication of value. We find that this is probative evidence to be considered when assessing market value.

The Department did not use this sales information as an indicator of value for tax year 2006. We question why the Department failed to use any sales information. As the Courts have repeatedly stated, the sale of the subject property is the most accurate valuation of the property. Thus, the material relating to valuation for sales purposes is especially relevant.

Use of the Sales Price as Probative Evidence for 2007

For the 2007 tax year, the sale had been consummated prior to the lien date and there is no doubt that the information should be utilized in determining market value. *See, e.g., PPL v. DOR,* 2007 Mont. 310. We do note, however, that any sale price must, of course, be analyzed to determine whether it requires adjustment. In *PPL v. DOR*, ¶ 39, the Court supported the concept that Department considered the sale of PPLM assets, the income earned from

those assets, and what similar assets might sell for on the open market.

Adjustments of Price as Indicator of Value

PacifiCorp argues that the sale price must be adjusted for time differences, market differences, and any difference between the property acquired in the transaction and the property being valued for tax purposes. Appendix A. PacifiCorp also argues that the DOR failed to make any adjustments to account for intangible properties, non-operating utility properties, and any other appropriate adjustments associated with the stock purchase. Appendix A. PacifiCorp argues that the Department did not provide to the Board any evidence in regards to these adjustments.

Mr. Tegarden testified that he did not believe that he could adjust a stock purchase price in a valuation estimate because it captures intangible values that should not be subject to taxation. This is simply another disagreement with the unit valuation goal of capturing the going-concern value which we have already overruled. We do not believe the analysis is so simplistic as to merely review the final multi-billion dollar sales price to determine market value for tax purposes. While the final sales price figure is certainly indicative of a range of value for the subject property, a deeper analysis is required to determine what, if any, adjustments must be made for tax purposes.

The evidence presented to this Board, however, does not demonstrate that any major reductions are necessitated beyond those required by Montana law.

Section 15-6-218(2), MCA, defines intangible personal property which is exempt from taxation in Montana. By administrative rule, the DOR makes a standard deduction in value to account for intangible personal property unless the taxpayer can prove a greater amount. Rule 42.22.110(1), ARM. For PacifiCorp, the standard reduction of 10% was used to reduce each indicator of

value to account for intangible personal property. PacifiCorp did not challenge the use of the 10% default deduction during the appraisal process and brought no evidence to the Department that the deduction failed to properly remove the intangible personal property from the appraisal. EP 24, Stipulated Exhs. 13, 14. Further, the FERC and SEC 10 K filings do not indicate any goodwill on PacifiCorp's books. At trial, PacifiCorp contended that a $1.074 billion goodwill adjustment was warranted to adjust the 2007 sales price. Tegarden, Testimony, pp.508 – 511; Stipulated Exh. 45, p. PAC-MT0607-000644. The goodwill referred to, however, is tracked on the parent company books, not PacifiCorp's. Stuver Testimony p. 1181, ll. 16-20. All non-taxable intangible personal property such as franchises, monies and credits should have been properly recorded and submitted to the DOR for the relevant tax years. As PacifiCorp consistently requests the 10% deduction to account for their intangible personal property, we conclude that the 10% deduction is proper, and that the goodwill listed on the parent company's books shall not be removed from the sales price valuation.

DOR Appraisal

We now turn to an examination of the DOR appraisal for tax years 2006 and 2007. PacifiCorp challenges all of the indicators of value used by the Department, and we specifically address those below.

First however, we will address the overarching challenge to the Department's use of the capitalization studies. PacifiCorp essentially claims the information used for calculating the capitalization rates is not specific enough to PacifiCorp to be used in its valuation. As we have stated before:

> The Department is tasked with mass appraisal valuation. Annually, a small number of Department employees must centrally assess a large number of companies in a compressed time period. In addition, the

> financial information needed to set a value for a specific company is often not available to the Department in a timely fashion, if provided at all. While all of those factors do not relieve the Department of their obligation to conduct accurate, professional appraisals, those factors do make it necessary for the DOR to use mass appraisal methods that enable the Department to complete its assigned task in a timely fashion. Consequently, there is an appropriate role for industry-wide analysis in deriving capitalization rates.

PacifiCorp v. DOR, CT – 2005 -3 (7/07)(*on appeal*)*; See also Puget Sound Energy v. DOR,* CT -2007-5 (6/09)*(on appeal)*.

The Department must value all electric utility companies in a consistent and fair manner, and using standard capitalization rates for the industry is one method to do this[7]. An electric utility company must use its initial filing with the Department and the informal review process to inform the Department if there is something unique or different that would require an adjustment from the standard methodologies used for all electric utility companies. In this instance, we find that PacifiCorp failed to bring sufficient evidence to show that the standard valuation methodologies did not work for valuing this particular company.

Price to Earnings Ratio

As part of its valuation of centrally assessed properties, the DOR uses a capitalization study to apply standard capitalization rates in specific industry valuations. In that study, the DOR developed an average earnings-to-price ratio from the sale of common stock from a list of other electric utility companies for use in a direct capitalization approach. The DOR then applied that ratio to PacifiCorp's estimated net income and/or cash flows to derive an

[7] Using standard capitalization rates for particular industries is standard valuation practice for tax purposes in many states.

estimate of value for the company. PacifiCorp claims this is not a "commonly accepted method" in the United States and thus violated Montana administrative rules. EP 69 - 72, Appendix A.

We first note that all of the basic indicators of value used by the DOR are commonly accepted methodologies. Cost, sales comparison or market, and income have long been approved by the Montana Supreme Court, the U.S. Supreme Court, and all appraisal treatises. The parties do not contest these general methods. Further, the use of a capitalization study in valuing centrally assessed companies is common in many states.

By rule, the DOR is required to "use commonly accepted methods and techniques of appraisal to determine market value." Rule 42.22.111(1) ARM. In analyzing the 2005 tax valuation, the First Judicial District Court noted that a "commonly accepted" method or technique is one that is used on an "industry-wide" basis[8]. In that 2005 PacifiCorp case, the testimony indicated that the DOR has used the direct capitalization method to value centrally assessed companies for over 20 years.

In developing that capitalization rate, several factors support our decision to accept the use of P/E ratios. First, a fact to which we give great weight, the Western States Association of Tax Administrators[9] and the National Conference of Unit Valuation States, which includes 35 states, recommend the use of the P/E ratios in their courses and materials. EP 73. PacifiCorp's witness, Mr. Reilly, testified that the Appraisal Foundation, the Appraisal Institute, the American Society of Certified Public Accountants, the

[8] This question of commonly accepted methods and techniques is currently on appeal to the Montana Supreme Court for the valuation for the prior tax year for PacifiCorp. *See PacifiCorp v. DOR,* Montana Supreme Court 91-242.

[9] Oregon's Department of Revenue has adopted WSATA as its official valuation guide. OAR 15—308.205-(B); *Northwest Natural Gas Co. v. Department of Revenue*, 347 Ore. 536, 226 P.3d 28 (2010); *Delta Air Lines, Inc. v. Department of Revenue*, 328 Ore. 596, 984 P.2d 836 (1999). This is further confirmation that WSATA methodologies are commonly accepted for appraisal purposes.

Institute of Business Appraisers and the American Society of Appraisers have not recognized or accepted the Department's P/E ratio method. EP 72. The appraisal organizations listed by Mr. Reilly, however, are primarily composed of appraisers who generally have the luxury of valuing a single property for a fee appraisal. This is, in fact, a significantly different practice than the state's appraisers must perform. Mr. Reilly also notes that WSATA and NCUVS do accept the P/E ratio methodology, but he dismissed them as made of assessors from local and state taxing jurisdictions and lacking authority to set and enforce standards. We find his testimony not to be persuasive on this issue because it is exactly those assessors who must determine how to value centrally assessed companies in a mass appraisal context and who deal with these exact issues every day. "Commonly accepted" does not mean a practice must be universally mandated. With the requirements for annual valuation of a large number of companies, in a very short timeframe, and in a manner that guarantees equal treatment, it is necessary to determine some common methodologies which can be applied to all companies for appraisal purposes. The fact that these two organizations approve such methods indicates they are not unusual and that, in the universe of property tax valuation methodologies for centrally assessed properties, the Department used a "commonly accepted method," as required by law.

The Department also presented witnesses who are qualified experts in the field of corporate finance who testified that the use of stock prices and stock price in comparison to earnings for such valuation purposes is commonly used and widely accepted. Dr. Ifflander testified that use of stock price was common. EP 80. Dr. Bernardo claimed that he had never seen a textbook used at the MBA level that did not support the use of these calculations. EP 78. Mr. Eyre made the same point and said that one widely used authoritative text

devoted an entire chapter to it. EP 80. Dr. Ifflander stated that the method is widely used by both buyers and sellers of electric utilities. EP 83. Mr. Eyre also pointed out there is no course or textbook that teaches an appraiser how to value a large utility, so there is not one correct method. EP 76.

It is also very significant that Houlihan & Lokey, the investment bankers hired by PacifiCorp's parent company, MEHC, to develop a fair price for the purchaser, used market data and performed a capitalization analysis similar to the one done by the Department. EP 81. This can hardly be a methodology unfamiliar to PacifiCorp and is obviously not considered "uncommon" in the arena of corporate finance[10].

Last but not least, the DOR has long used this capitalization rate calculation. Until last year, Montana cases have never questioned whether the direct capitalization method, with a capitalization rate study, was a "commonly accepted method or technique" though the method has been in use in Montana for many, many years. Because we know that approximately 130 companies are appraised by the central assessment bureau each year over a minimum of ten years, and no legal challenge has been brought before last year, we must conclude that there is some level of common acceptance of the methods and techniques used in the DOR valuation. [11]

While there is significant expert opinion regarding the proper use of the E/P ratios, we find the Department witnesses are most persuasive in their testimony. We find that the use of the E/P and P/E ratios by Houlihan & Lokey persuasively demonstrate that the method is commonly used when

[10] In valuing large, multi-billion centrally assessed companies, the valuation methodologies are advanced, complex corporate valuation methodologies not traditionally used in simple valuations. Thus, defining the term "commonly accepted" methodologies must be viewed within the framework of corporate finance valuation.

[11] The statutory framework for valuing centrally assessed companies for tax purposes is distinctly different for each state, so there is little use in comparing the statutory framework in other states because there will be no universal rules for valuation.

appraising a corporation. *See* Stipulated Exhs. 19-27.

We find that this methodology is not unusual or uncommon and uphold the Department's use of this methodology. We do note that merely finding methodology to be commonly used does not, however, negate the need for appraisers to use appraisal judgment. As with any valuation methodology, using an E/P ratio to determine a capitalization rate is merely one tool available to the DOR and must be compared and correlated with other market indicators to determine whether it is a valid indicator for an individual company for a particular tax year.

<u>Direct Capitalization and Comparable Companies</u>

PacifiCorp also challenges the Department's use of comparable companies in the direct capitalization method. They note that even if P/E ratios from publicly traded stocks can be used to derive an equity component in a direct capitalization model, the Department did not make the necessary adjustments to account for the differences between the operations of the comparable companies and PacifiCorp's operating properties. The Department contends that the companies used in its capitalization rate study were reflective of the industry and sufficiently comparable to PacifiCorp to be used for valuation purposes.

Both sides accused the other of failing to use comparable companies. We note that PacifiCorp has not submitted a list of companies it considers more appropriate and we further note that all of the comparables used by Ms. Haller were included in Mr. Tegarden's calculations. EP 87.

We find that the electric utility industry comparable companies are sufficiently comparable to determine a capitalization rate to use for all electric utility companies. First, we note that the "comparable companies" are derived to provide a capitalization rate for all electric utility companies valued in

Montana, not solely for use in valuing PacifiCorp. Thus, the companies should properly represent the industry being valued. Ms. Haller testified that the companies she selected are generally electric utility companies with electric utility holdings in the West (as are those companies valued in Montana). EP 86. Thus, we find the companies to be comparable for purposes of valuing electric utility companies in Montana.

The electric utility companies used by the DOR are substantially the same as those used by Mr. Eyre and Mr. Tegarden in USPAP certified appraisals that they prepared for this case, and this alone is sufficient evidence to demonstrate that the companies are sufficiently comparable to determine a capitalization rate for use in valuing PacifiCorp.

<u>The Stock and Debt Valuation Models</u>

PacifiCorp attacks the use of the stock and debt method. They first assert that the DOR selected the entire company of PacifiCorp as its unit of valuation and used stock market prices, the resulting value includes property excluded under law, such as monies, credits, franchises, intangible properties and, further, that the DOR has failed to properly remove those non-taxable items from its assessment. Appendix A. PacifiCorp argues that it would be more proper to merely look to value the operating property (as in the cost approach). Taxpayer cites Ms. Haller's development of a cost indicator to argue that the Department used an operating-property approach. *See* Post Hearing Br. 59, Tr. pp. 55, 56. This is simply another attack on unit value methodology which we have already rejected.

The stock and debt approach serves as a substitute for the sales comparison approach and is used when there are no sales of comparable properties from which to extract market data. Calculating a company's value by totaling the value of its own stock and debt has been upheld as an

appropriate valuation technique since the creation of the Montana Board of Equalization, the predecessor to the Montana Tax Appeal Board. *See, e.g., Yellowstone Pipeline v. DOR*, 138 Mont. 603, 611, 358 P.2d 55, 60 (1960). There is no doubt that the stock and debt approach to valuation has also been accepted across the nation since the late nineteenth century. *See, e.g., Adams Express v. Ohio State Auditor,* 166 U.S. 185, 220; 17 S. Ct. 604, 606, 41 L. Ed. 965, 977(1897); *Porter v. Rockford, R. I. &St. L. R. Co.,* 76 Ill. 561 (1874); *State Railroad Tax Cases,* 92 U.S. 575 (1875).

This Board has consistently accepted the use of a stock and debt approach by the Department. *Montana-Dakota Utilities v. DOR*, 1986 Mont Tax LEXIS 264, SPT-84-24 and 85-21 (July 1986); *Puget Sound Energy v. DOR*, CT - 2007-5 (June 2009; *on appeal*)(accepting the stock and debt approach, but noting that the Department had too many errors for the value to be acceptable.) *See also Qwest v. DOR,* SPT 2008-2 (Nov 30, 2009, *on appeal); PPL Montana v. DOR,* SPT 2002-4, 2002-6 (Feb 2005*); Pacific Power & Light v. DOR* SPT-1988-4, 5, 6, 8, 9, 11 & SPT 1989-4 (Aug 1990). There has been no evidence or law presented that would change our acceptance of the use of the stock and debt method.

PacifiCorp claims the stock and debt approaches used by the Department are erroneous by claiming that the DOR used ratios from sales of common stock from other companies that are not comparable to PacifiCorp, with the result that the DOR severely overestimated the value of PacifiCorp's taxable operating property. Appendix A. Again, we would first note that PacifiCorp's use of the term "taxable operating property" attacks the unit valuation process, which we specifically reject. Further, we have already addressed the claim of comparable companies and whether there is a role for the use of comparable companies to develop certain factors used in mass

appraisal.

PacifiCorp claims that the use of the stock and debt approach can be problematic if the company is not publically traded. We find the DOR's stock and debt methodologies to be appropriate for PacifiCorp, which is a subsidiary of a publically traded company with public regulatory filings and SEC filings. It is not an indistinguishable part of a closely held corporation. Stipulated Exhs. 1-14, Eyre Testimony, p. 926, l. 11 through 927, l. 2.

The DOR experts Mr. Eyre, Dr. Bernardo, and Dr. Ifflander all support the use of the DOR methodology. Eyre Testimony, 1019, l. 16 through 1021, l. 4; Bernardo 1067, l. 18 through 1068, l. 23, Stipulated Exh. 55; Ifflander, 1224, l. 5-18. The Houlihan & Lockey due diligence report also used a market multiple by equity earnings to determine an equity value. Stipulated Exh. 16, p. PC-DOR 3134.

We find the use of common stock from other electric utility companies to be acceptable methodology in developing ratios for valuing electric utility companies. We also find no evidence that the use of those standard methodologies is improper in this particular instance.

Income Approaches to Value

The Department's income approach was broader than Mr. Tegarden's. Ms. Haller used three different income models to calculate the value of the company, all based on the assumption that the value of a company is a multiple of the income it produces. Two of these methods use actual net operating income or gross cash flow totals from the company's financial statements. The third method (yield capitalization) capitalizes projected future income and is, therefore, considerably more speculative because it requires estimations of future income and market data which are difficult to predict. Both Mr. Tegarden and the Department performed yield capitalization models but the

Department decided the method was not reliable and did not put any weight on the result. Mr. Tegarden did not use any other income models, so he relies heavily on his yield capitalization calculations.

Mr. Eyre analyzed Mr. Tegarden's calculations and concluded that the method is not valid because of the underlying assumptions about the future of the company which are not, in this case, true. Stipulated Exh. 46, p. PC-DOR 003646. For example, the method assumes zero income growth for the next seven years over which the projections are made, but the internal documents project better than 11% growth. The method also assumes that capital expenditures and depreciation will be about the same. Evidence demonstrated, however, that PacifiCorp is projecting capital expenditures that are nearly double their depreciation in some of the upcoming years. EP 95. Mr. Tegarden's value estimate under this method was even lower than his OCLD with the income shortfall adjustment.

As demonstrated by all of the evidence presented, PacifiCorp has a rapidly shifting income stream. Thus, it is challenging to determine a valid projected future income without great speculation. We find the argument against using the yield capitalization calculations in this instance persuasive and find that the Department's decision to not use the yield capitalization valuation was a valid exercise of appraiser judgment. As a result, the one remaining issue here, the use of flotation costs by Mr. Tegarden in his yield capitalization calculations, need not be decided.

External Obsolescence in the DOR Original Cost Less Depreciation ("OCLD") cost approach

As PacifiCorp's appraisals used only two models, income and cost, the major remaining difference between the parties is their conflicting calculation of the cost approach. PacifiCorp claims the DOR's cost approach to value is

erroneous and excessive because it failed to account for all forms of obsolescence. Section15-8-111(2)(b), MCA, requires the DOR to "fully consider reduction in value caused by depreciation, whether through physical depreciation, functional obsolescence, or economic obsolescence." PacifiCorp claims the DOR failed to adjust the book depreciation for obsolescence and thus confused book values and market values. Appendix A. PacifiCorp argues that it suffers from 28.16% economic obsolescence in 2006 and 26.23% in 2007, numbers calculated by Mr. Tegarden as the difference between a "required rate of return" and the actual rate of return earned by PacifiCorp. EP 34. Before examining the details of the claim, two key factors deserve mention.

First, there is absolutely no empirical evidence of economic obsolescence in this case. PacifiCorp provided no evidence of economic obsolescence beyond the mere mention of regulatory lag and drag, with no supporting detail or financial information. PacifiCorp did not report economic obsolescence to the Department in its filings, nor to any federal regulators. No economic obsolescence was reported to shareholders or in SEC filings. There is no evidence surrounding the sale of the company that indicates any level of economic obsolescence. Evidence was presented of more than a year of research by the parties, valuation determinations, Houlihan & Lokey's fairness analysis and the actual sale, but we have seen no evidence that indicated the buyer or the seller believed that economic obsolescence existed for PacifiCorp. A mere claim of regulatory lag and drag by two PacifiCorp employees is insufficient to demonstrate economic obsolescence.

Second, the evidence demonstrates that PacifiCorp is a strong growing company. According to its own data, PacifiCorp is a growing company, the largest electricity producer in the northwest, claiming a growing customer base (Stipulated Exhs. 1, 2, 3), an asset base that expanded by over $1 billion from

2006 to 2007 (with plans to increase that to $1.244 billion per year in the next seven years), and reported earnings similarly increased from $689 million in 2006 to $695 million in 2007. EP 56, 57. This trend was true in the last PacifiCorp tax case and we see no change in the two years before us.

Even PacifiCorp acknowledges that PacifiCorp's value grew a minimum of $690 million from 2006 to 2007. See Appendix A. Economic obsolescence, by definition, does not occur to a strong and growing company, but rather in one that is a victim of external forces which hamper its income earning capacity.

Economic Obsolescence

Economic or external obsolescence is defined as a temporary or permanent impairment of the utility or salability of an improvement or property due to negative influences outside the property. *The Appraisal of Real Estate, 392 (*13th ed. 2008). Black's Law Dictionary defines it as "[o]bsolescence that results from external economic factors, such as decreased demand or changed governmental regulations." *Black's Law Dictionary* 1105 (7th ed. 1999). PacifiCorp's evidence met none of these criteria.

PacifiCorp argues economic obsolescence is responsible for low income returns for this company and that $2.583 billion in additional depreciation (28.16 percent) is required to lower the value of the company to the value which would hypothetically produce the "required" rate of return. Thus, the sole proof of economic obsolescence presented was the difference between their required rate of return and their actual rate of return.[12] There are many reasons a company might earn less than is hoped for but PacifiCorp asks us to assume economic obsolescence despite the lack of any supporting evidence.

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[12] We note that the "allowed" rate of return for regulated utilities is not a "required" rate of return. There is no requirement that investors receive the full allowed rate of return set by utility commissions.

The claim for economic obsolescence was presented by Mr. Tegarden who prepared an alternate valuation of the company which, after removing the claimed additional obsolescence of $2.58 billion for 2006 and $2.64 billion in 2007, claimed a value for the company of $6.589 billion and $7.425 billion respectively. EP 34. The company sold for $9.4 billion, fully 43% more than the value PacifiCorp now says it was worth at the time. The purchaser, MEHC, reported the company's fair value as $10.05 billion, 53% more than the company now claims its value to have been at the time. EP 121; Stipulated Exh. 9, p. PC-DOR 004161. Mr. Tegarden asserted that as a result of exclusions from the rate base, PacifiCorp's earnings are expected to be just 6.25 percent instead of the 8.7 percent "required" by investors.

According to Mr. Eyre's testimony, the income shortfall method used by Mr. Tegarden is not mentioned in any traditional appraisal texts. EP 45.[13]

Significantly, PacifiCorp did not submit any evidence of economic obsolescence to the DOR during the appraisal process. EP 30. There was no economic obsolescence reported on the FERC form from which Ms. Haller took the company's depreciation figures, nor did PacifiCorp submit additional evidence. Because PacifiCorp failed to provide the Department with any evidence of economic obsolescence during the appraisal process, we find it reasonable and proper that Ms. Haller did not include any additional economic obsolescence in her cost approach. *See discussion and law on a similar point in Qwest v. DOR,* SPT 2008-2 (Nov 30, 2009, *on appeal).* It is incumbent upon the

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[13] In cases in which the income shortfall method has been approved by courts, a detailed analysis of the types of problems suffered is provided by the taxpayer. For example, in *Canal Square Limited Partnership v. State Board of Tax Commissioners,* 694 N.E.2d 801(Indiana, 1998), the apartment building at issue had design flaws due to government regulations which diminished its desirability and increased the capital investment, and the specific evidence of those flaws was presented to the court. In cases involving telephone companies and railroads, the taxpayers submitted extensive "blue chip" analyses comparing their companies to the industry leaders and comparing their output and earnings. See *GTE North Incorporated v. Indiana Board of Tax Commissioners*, 634 N.E.2d 882 (1994), and *Burlington Northern, Inc. v. Dept of Revenue,* 291 Ore. 729 (1980).

companies being valued to bring the proper valuation information to the attention of the Department prior to instituting prolonged litigation on new claims that have not been considered in the due course of administrative process.

PacifiCorp witnesses also failed to present detailed evidence during the hearing of any external forces or changes in governmental regulations impacting the company.

The usual causes of obsolescence were presented in the instant case by Mr. Norman Ross, tax director for PacifiCorp, in his opening statement. Examples of the causes of external obsolescence given by Mr. Ross in his testimony are changes in demand, operating costs, zoning, consumer preferences, changes in government regulation, changing interest rates, and political unrest. No actual evidence, however, of changes in demand, costs, zoning, consumers or political unrest was presented.

We do not deny that a change in government regulations may cause external obsolescence by changing the ability of a company to compete in the marketplace. For example, if a state limited the use of a certain type of power generation, a company with that power generation may lose value in the marketplace, but no such claim is made here. No evidence of a negative change in government regulations was presented to this Board.

Several of PacifiCorp's witnesses mentioned regulatory lag and drag as an impairment to earnings but acknowledged other negative impacts as well. Mr. Douglas Stuver, senior vice president and chief financial officer of PacifiCorp, explained that allocation issues arise because of the diversity of locations in which the company operates, making it difficult to allocate assets to the states. He mentioned other challenges: "[B]y operating in six states, especially now with the company in a growth mode as it is, to sustain or

improve our returns we have to file rate cases routinely and filing a minimum of six cases per year is a logistical challenge and not practical to always do, empirically just from a resource constraint standpoint. So lag occurs as a result of having to sequence these rate cases." Tr. p. 1179; EP 37. No further details were provided to the Board.

Steven R. McDougal, director of revenue requirements for PacifiCorp, identified the income shortfall as coming from a variety of sources, including regulatory lag and allocation problems although, again, no further evidence of those issues was presented beyond the mention of them.

According to Mr. McDougal, the largest deduction from the rate base, and, therefore, the major cause of the "underearning" is attributable to deferred income taxes.[14] He also stated that one of the biggest reasons for PacifiCorp's "under-earning," is the under-recovery of the cost of power to the company. EP 36. Mr. Tegarden agreed with Mr. McDougal, attributing the income shortfall to the exclusion from the rate base of deferred income taxes (DITs) by the regulatory commissions of other states. EP 35. That regulation cited by PacifiCorp, however, is not a change in treatment by the government but is a standard practice of regulatory commissions because DITs are an interest-free loan from the government. Eyre Testimony, p. 833, l. 20, through p. 834, l. 15. To include assets purchased with DITs in the rate base would allow PacifiCorp to charge the ratepayers for assets purchased with the very funds those ratepayers have contributed through the DITs.

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[14] Deferred tax balances result from the difference between accelerated depreciation and book depreciation, which essentially is the use of two separate accounting methodologies by regulated companies in calculating taxable income. Accelerated depreciation allows a larger deduction for plant investment in the early years than the straight line deductions used by corporations and regulators. This reduces income taxes in the short term by offsetting taxable income, postponing those taxes until later years when the straight line deductions catch up with the accelerated. The deferred taxes are, however, collected from customers because rates are calculated using straight line depreciation, providing the company with a stream of "excess" cash to fund investments. It is called an interest-free loan from the government and, while those taxes are due in the future, a company such as PacifiCorp, with an aggressive expansion strategy, can easily have an increasing deferred tax liability fund for many years in the future.

It is also critical to note that the rate base is not an indicator of value in any calculations performed by the DOR and so exclusions from it are not necessarily relevant to the valuation calculations. The point of the cost indicator is to value the operating assets with all of the productive equipment it owns, however it was acquired, in reaching original cost less depreciation (OCLD) and that includes equipment purchased by the company with deferred income taxes. By arguing for this reduction in value PacifiCorp is, in essence, now asking to be relieved of property taxation on assets bought for the company with interest-free government loans. We do not find this to be evidence of economic or external obsolescence.

It is also notable that the thorough analysis of PacifiCorp done by the investment bankers Houlihan & Lokey for the MidAmerican Energy Holding Company Board of Directors prior to the finalizing of the purchase of the company did not mention an income shortfall, nor did they find any additional external obsolescence above normal depreciation. EP 55. It is also clear that the purchasers of PacifiCorp were fully aware of the advantages of interest –free loans from the government in the form of deferred income taxes. Warren Buffett in Berkshire Hathaway' s 2008 Annual Report stated:

> Berkshire has access to two low-cost, non-perilous sources of leverage that allow us to safely own far more assets than our equity capital alone would permit: deferred taxes and "float," the funds of others that our insurance business holds because it receives premiums before needing to pay out losses. Both of these funding sources have grown rapidly and now total about $68 billion.
>
> Better yet, this funding to date has been cost-free. Deferred tax liabilities bear no interest. . . Neither item, of course, is equity; these are real liabilities. But they are liabilities without covenants or due dates attached to them. In effect, they give us the benefit of debt – an ability to have more assets working for us – but saddle us with none of its drawbacks.
>
> Quoted by Dr. Wilson. Stipulated Exh. 51, p. PC-DOR 3504.

The "shortfall" in PacifiCorp's income is primarily because the company, according to its own financial officers, is expanding and has, therefore, large deferred income taxes and unrecovered expenses related to purchasing power to satisfy its growing customer base. The evidence presented demonstrates that PacifiCorp, as a growing company, would be buying power to service new customers not yet in rate base, which may increase revenues, but not wholly cover costs. EP 37. This temporary cash flow problem imposed by the company's growth does not meet the definition of economic obsolescence.

The Department's witnesses refuted the economic obsolescence argument. As described by DOR expert witness, Dr. John Wilson,

> While Mr. Tegarden calls this reduction in value "obsolescence," it is . . . not that at all, but simply the mathematical difference between his "projected earnings" (which tend to be significantly understated) and his substantially overstated "required" earnings. Stipulated Exh. 51, p. PC-DOR 003494.

Dr. James Ifflander, an expert in corporate finance and valuation, found no economic obsolescence and stated that Mr. Tegarden's methodology was incorrect. He also referred to the company's own filings and valuations as refuting the claim. EP 51-55.

Mr. Eyre noted that the cost indicator of value should stand on its own in the valuation process, separate from income indicators, as one of many methods of calculating value. It is an important value indicator as it calculates the total actual investment in plant made by the company. Comparing a historical stream of income that is calculated as a return on rate base to the historical cost less depreciation is, in essence, a mismatch. EP 46. Dr. Ifflander also noted that the calculation "effectively converts his cost approach to an income approach leaving but one indicator of value." Ifflander, Stipulated Exh. 53, p. PC-DOR 003463.

Finally, Dr. Wilson testified that if there really was economic obsolescence, PacifiCorp would include it in its rate base and recover it from the ratepayers, so there is no unrecovered loss.[15] EP 50.

Thus, we find no empirical evidence demonstrating that economic or external obsolescence impaired the value of PacifiCorp for tax year 2006 and 2007. We find that the company does not suffer from economic obsolescence. Thus, we cannot find Mr. Tegarden's value of PacifiCorp to be market value. Further, we find Mr. Tegarden's appraisal less credible than other evidence presented to this Board.

Computational Issues

Several expert witnesses also contested Mr. Tegarden's computations. One of the problems with the income shortfall calculations is that it introduces a discount rate and income estimates into what should be a straightforward cost accounting procedure, raising the possibility of potential errors of forecasting. Indeed, both the income projections and the cost of capital were criticized as erroneous.

Mr. Tegarden projected income estimates for 2006 of $570 million, producing a rate of return of 6.215%, which is only 71.4% of the "required return" of 8.7% that he estimated to be the cost of capital for that year. For 2007, he projected $660 million, a rate of return of only 6.56% on net book investment, which is only 71.66% of the "required return." This is the source of the "income shortfall."[16] He then reduced the value of the company to 71.4% of net book value for 2006 and 71.66% of net book value for 2007 to reflect those income shortfalls. EP 34.

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[15] The FERC definition of depreciation includes economic obsolescence, and thus PacifiCorp could report any economic obsolescence on its regulatory filings.

[16] As further evidence of the lack of economic obsolescence, we note that Mr. Tegarden himself indicates an income stream that grew $90 million from 2006 and 2007. This increase refutes the external or economic obsolescence arguments.

PacifiCorp's income for both those years, however, was actually substantially higher than projected by Mr. Tegarden: $689 million in 2006 and $695 million in 2007. Stipulated Exh. 51, p. PC-DOR 003500. While we do not use post-appraisal date information for valuation purposes, it does demonstrate the problems with using projections of data, which can be easily manipulated or grossly miscalculated.

Further, Mr. Tegarden's "required return" is the estimated cost of capital which is overstated for several reasons. Dr. Wilson testified that Mr. Tegarden mistakenly assumed that regulators calculate return levels based on the market value of the company's common stock. In fact, all state regulators and the Federal Energy Regulatory Commission calculate return on capital in relation to the book value of a company's common equity rather than market price. Stipulated Exh. 51, p. PC- DOR 003500. If book value rather than market value is used in Mr. Tegarden's calculations, the "required return" drops.

> Using a conventional regulatory capital structure of 55% debt and 45% equity, Mr. Tegarden's indicated capital costs decline from 8.7% to 8.2% in 2006 and from 9.15% to 8.35% in 2007.

Stipulated Exh. 51, p. PC-DOR 003501.

Dr. Wilson's second criticism of Mr. Tegarden's cost of capital calculation is that it assumes that all the company's plant investment is funded only with debt and equity capital, which is not the case. A substantial portion of the plant is funded with deferred tax balances, which are basically an interest-free loan from the government which can be used for capital expansion and for which, therefore, there is no cost of capital. Stipulated Exh. 51, p. PC-DOR 003502.[17]

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[17] Mr. Tegarden disputes the removal of the DITs from the cost-of-capital calculations by quoting a text on financial management that suggests depreciation-generated funds do not need to be considered. Stipulated Exh. 43, p. PAC-MTDOR0607-000064. Dr. Wilson points out, however, that a considerable

According to Dr. Wilson, if the DITs were removed from Mr. Tegarden's calculations, the "required return" for 2006 drops to 7.27 (instead of 8.5) percent and 7.4 (instead of 9.15) percent for 2007. If Mr. Tegarden had used those lower cost-of-capital figures and more accurate operating income figures, his calculations of the income approach would have yielded a value of $9,477 million and $9,392 million for 2006 and 2007 respectively.

We find that determining a "required return" should certainly be based on actual requirements for the subject property, and not, therefore, include interest-free loans of public funds that fund plant investment. Mr. Tegarden himself admitted that the income shortfall results from the failure to include those interest-free loans in the rate base, which reduces the return allowed on total plant investment by regulatory commissions. EP 35. Thus, we find his asserted low rate of return is not primarily due to "regulatory lag" or "regulatory drag" but to the high rate of deferred taxes excluded from the rate base and miscalculations of income and the cost of equity.

In tandem with the clear and convincing lack of evidence of external obsolescence, and the clear and convincing evidence that this company, in fact, is expanding and growing at a rapid rate, that any "income shortfall" is largely the product of this expansion, we cannot condone the use of the income shortfall method to "mathematically" prove what, by all review of the evidence, does not exist.

<u>DOR's Correlated Unit Value</u>

In its pre-trial pleadings, PacifiCorp claimed the Department's correlation is erroneous, and not based on sound appraisal practices. Appendix

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portion of the actual quotation from that text has been omitted in Mr. Tegarden's excerpt, including the sentence "In effect, deferred taxes represent an interest-free loan from the federal government, so they constitute zero cost capital" which undermines Mr. Tegarden's point.

A. Specifically, PacifiCorp claims that the Department was not justified in placing 45% reliance on the OCLD cost approach to derive its valuation estimate.

Ms. Haller placed the majority of her correlated weight on the cost approach. EP 22. Mr. Tegarden gave greater weight to the income approach (approximately 80%) and lesser weight on the cost approach (approximately 20%), which is similar to Mr. Eyre's weighting of income and cost approach. Tr. p. 520. PacifiCorp urges this Board to determine that, due to the Department's failure to consider economic obsolescence, the evidence does not support placing such weight on the cost approach. We disagree.

The weight assigned to a particular appraisal method during the correlation process is based on appraisal judgment. *See, e.g., PPL v. DOR*, ¶ 9. *See also* Rule 42.22.111(2), ARM. In this instance, PacifiCorp is a growing company, and the income streams are changing rapidly due to growth and the effects of regulation. The cost approach, while not the preferred method to determine market value, is a stable indicator of value and useful in determining a conservative estimate of market value. The cost approach may be used when other market indicators are also considered. It is certainly not the first time that the DOR has given the cost approach a significant weight in its appraisal. (For example, the Supreme Court upheld the DOR valuation with a 90% cost approach and 10% income approach correlation in the PPL case due to a lack of income normalization. *See PPL v. DOR*, ¶ 13. The Department is required to use the most accurate indicators of value. Rule 42.22.111(1), ARM. That indicator may be cost (*PPL v. DOR*, ¶ 13) or even sale price (*Id*, ¶ 39). The cost approach, however, does have the disadvantage of not capturing the full going-concern value as required by case law and statute so it must be used in tandem with market-based methodologies.

As we have previously written, the sale price is the clearest indication of fair market value and sufficient information was available on January 1, 2006 to make the method reliable, so we find it unfortunate that the Department's appraiser did not utilize that indicator of value, but we find that her appraiser judgment was not so unreasonable as to warrant overturning her decision.

Summary

PacifiCorp asserts that the market value of its operating system should be reduced to $6,560,000 for the 2006 tax year prior to the intangible personal property exemption of 10% for a market value of its operating system set at $5,904,000,000. PacifiCorp asserts that the market value of its operating system should be reduced to $7,250,000,000 for the 2007 tax year prior to the intangible personal property exemption of 10% for a market value of its operating system of $6,525,000,000. Appendix A. We find that PacifiCorp has not borne its burden of proof that the DOR calculations and methods are incorrect. Based on the evidence presented and for all of the reasons discussed above we reject the value asserted by PacifiCorp, and uphold the Department's values for 2006 and 2007.

Appendix A

The following contentions from the pre-trial briefing shall govern this matter.

PacifiCorp's Contentions:

1. Unless expressly admitted, PacifiCorp denies each of the Department's contentions.
2. The Department's assessment of PacifiCorp's taxable property for the January 1, 2006 and 2007 assessment dates are not based on commonly accepted valuation methods, are significantly in excess of the market values of PacifiCorp's Montana property, and must be reduced in accordance with Montana law.
3. The Department's cost approach to value is erroneous and excessive because it failed to account for all forms of obsolescence. § 15-8-111(2)(b), MCA requires the Department to "fully consider reduction in value caused by depreciation, whether through physical depreciation, functional obsolescence, or economic obsolescence." The Department failed to adjust the book depreciation for obsolescence and thus confused book values and market values.
4. Montana law requires that the Department determine the value of the "taxable property" owned by PacifiCorp. Montana law expressly excludes monies, credits, franchises, intangible properties and assets not yet in existence from the definition of "taxable property." In its direct capitalization and stock and debt indicators, the Department has selected the entire company of PacifiCorp as its unit of valuation and has used inappropriate methods to include not only all of the above, identified excluded items in its valuation, but to also include intangible values from the comparable companies it uses. The Department has failed to properly remove these non-taxable items from its assessments.

5. The direct capitalization approaches used by the Department are erroneous. In these approaches the Department developed an average earnings to price ratio from the sale of common stock from a series of other companies and then applied that ratio to PacifiCorp's estimated income and/or cash flows to derive an estimate of value for use in a direct capitalization. This is not a "commonly accepted method" in the United States. Moreover, the companies used by the Department are not comparable to PacifiCorp and cannot be accurately used to develop an assessment of PacifiCorp's property are not comparable to PacifiCorp.
6. Stock and debt approaches used by the Department are erroneous. The Department has used ratios from the sales of common stock from other companies that are not comparable to PacifiCorp and thus have severely overestimated the value of PacifiCorp's taxable operating property.
7. The Department's correlation is erroneous and is not based on sound appraisal practices.
8. On May 24, 2005, PacifiCorp's parent company, Scottish Power, announced that it would sell all of the common shares it owned in PacifiCorp to MidAmerican Energy Holdings Corporation. The sale of the common stock ultimately closed on March 21, 2006. The Department was correct to not place any reliance on this stock sale in preparing its valuation for the 2006 tax year. The Department's use of the sales price in its 2007 appraisal and recent desire to use this stock sale as a "sanity check" to its valuations are misplaced. The sale of the stock does not have a direct correlation to the taxable tangible property owned by PacifiCorp. Moreover, the Department has failed to make any adjustments to account for intangible properties, non-operating utility

properties, and other appropriate adjustments associated with the stock purchase.

9. Mr. Eyre's review appraisals contain serious factual and methodological flaws that cause his reports to drastically over-estimate the value of PacifiCorp's operating property. His direct capitalization indicators are not commonly accepted valuation models and his discounted cash flow and stock and debt models have been previously rejected, are not consistent with prior reports he has submitted to this Board, and are otherwise seriously flawed.

10. PacifiCorp asserts that the market value of its operating system should be reduced to $6,560,000,000 for the 2006 tax year prior to the intangible personal property exemption of 10%. After applying the 10% intangible personal property adjustment, the market value of its operating system should be set at $5,904,000,000. Consequently, the Montana allocated value of PacifiCorp's operating property prior to adjustments is $91,523,808 ($5,904,000,000 x 1.5502%).

11. PacifiCorp asserts that the market value of its operating system should be reduced to $7,250,000,000 for the 2007 tax year prior to the intangible personal property exemption of 10%. After applying the 10% intangible personal property adjustment, the market value of its operating system should be set at $6,525,000,000. Consequently, the Montana allocated value of PacifiCorp's operating property prior to adjustments is $93,359,700 ($6,525,000,000 x 1.4308%).

Department's Contentions:

1. Unless expressly admitted, the Department denies each of PacifiCorp's contentions.
2. The Department's assessments of PacifiCorp as of January 1, 2006 and January 1, 2007 are based on accepted valuation methodologies and are reflective of the property's fair market value as of those dates.
3. PacifiCorp's property is subject to unit valuation. The unit rule values an entire operating system as a going concern and integrated whole regardless of where it is located and without functional or geographic division of the whole into its component parts. The valuation determined pursuant to the unit rule is meant to capture all the operating assets both tangible and intangible as a going concern. Unit valuation is firmly established law in Montana. *State of Montana, Department of Revenue v PPL Montana*, 2007 MT 310, ¶ 41, 340 Mont. 124, ¶ 41, 172 P.3d 1241, ¶41.
4. In accordance with Montana law, the Department considered multiple indicators of value all of which are widely recognized and generally accepted appraisal methods. The methods considered by the Department included: cost, direct capitalization, yield capitalization, sales comparison and stock and debt approaches which were then correlated to an overall system unit value.
5. The unit value appraisals for 2006 and 2007 prepared by Mr. Tegarden in support of PacifiCorp's claims are seriously flawed and result in a drastic under-valuation of the operating property's actual fair market value. Mr. Eyre's independent review appraisal identifies and describes the various errors contained in Mr. Tegarden's appraisals. Further, Mr. Eyre's ultimate conclusion of market value supports the Department's assessments.

6. Mr. Tegarden erroneously characterizes his income approach as a yield capitalization method when, in fact, it is a direct capitalization approach, albeit one that is incorrectly calculated.
7. No expert for PacifiCorp has rendered an opinion concerning a specific intangible personal property value or a Montana allocated value for the subject lien dates.
8. Mr. Tegarden prepared a business valuation appraisal report to estimate the market value of the operating electric properties of PacifiCorp as of January 1, 2006 and January 1, 2007. As set forth in the appraisals, the subject property of the reports is the fee simple interest in all of the operating electric properties, tangible and intangible, used in the operation of PacifiCorp. The operating properties consist of a broad spectrum of properties of a diverse nature, which include real, personal, tangible, and intangible property operated collectively by PacifiCorp to provide electric services in its operating service area. (p.1) The properties analyzed by Mr. Tegarden, therefore, is directly comparable to the unit subject to appraisal or analysis by the Department and its witnesses and acquired by MEHC for $9.4 billion.
9. There are no significant non-operating or non-taxable properties that have not already be accounted for by the Department or its experts.
10. The sale of PacifiCorp's tangible and intangible assets to MidAmerican at an agreed upon purchase price of $9.4 billion validates the Department's assessments as reasonable.
11. The cost approach employed by the Department and its experts properly and fully accounted for, or considered, all forms of depreciation or obsolescence. The Department and its experts independently looked at

other factors to consider whether additional obsolescence existed and found none to exist.

12. Further, in its analysis of the sales transaction, MEHC's retained, independent third party experts concluded that the net book values of property plant and equipment were stated at fair value, thus suggesting that no additional obsolescence existed.
13. The stock and debt method is a reliable and objective way to determine the market value of a publically traded company. Stock prices are forward looking and reflect the discounted value of the expected cash flows to stock holders from current and future operations in the company. The market value of equity plus the market value of debt is the market's assessment of the value of the company.
14. The direct capitalization method can be implemented by applying a blended capitalization rate for equity and debt to the company's net operating income (NOI) to estimate the value of the company. The blended capitalization rate is a weighted average of the capitalization rate on equity (the E/P ratio for appropriately chosen comparables) and the capitalization rate on debt (the ratio of current interest to market value of debt for appropriately chosen comparables).
15. Stock and debt prices reflect the claims on the cash flows produced by PacifiCorp's operating assets. Both parties utilized stock and debt prices when valuing PacifiCorp's operating assets, and without doing so, the appraisals could not have been calculated.
16. PacifiCorp is not entitled to the exemption identified in § 15-6-204, MCA. Moreover, any exemption for "money and credits" has already been accounted for in the Department's cost, income and market approaches to value and no further exemption or reduction is permitted.

17. PacifiCorp is not entitled to an additional exemption for "franchises." Franchises are considered intangible personal property. The reported value of PacifiCorp's franchises was therefore subsumed within the default 10% intangible personal property deduction.

ORDER

IT IS THEREFORE ORDERED the Department's 2006 and 2007 appraisals of PacifiCorp are upheld.

Dated this 13th day of January, 2011.

BY ORDER OF THE
STATE TAX APPEAL BOARD

/s/________________________________
KAREN E. POWELL, Chairwoman

(S E A L)

/s/________________________________
DOUGLAS A. KAERCHER, Member

/s/________________________________
SAMANTHA SANCHEZ, Member

Notice: You are entitled to judicial review of this Order in accordance with Section 15- 2-303(2), MCA. Judicial review may be obtained by filing a petition in district court within 60 days following the service of this Order.

Certificate of Service

The undersigned hereby certifies that on this 13th day of January, 2011, the foregoing Order of the Board was served on the parties hereto by depositing a copy thereof in the U.S. Mails, postage prepaid, addressed to the parties as follows:

Michael Green Attorney at Law CROWLEY FLECK PLLP P.O. Box 797 Helena, Montana 59624-0797	_x_ U.S. Mail, Postage Prepaid __ Hand Delivered __ E-mail
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David Crapo WOOD CRAPO LLC 60 East South Temple Suite 500 Salt Lake City, Utah 84111	_x_ U.S. Mail, Postage Prepaid __ Hand Delivered __ E-mail

/s/________________________
Donna Eubank, paralegal