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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Petition for Reassessment of the 2020 Unitary Value for: **SOUTHERN CALIFORNIA EDISON COMPANY (0148)** Petitioner	**APPEALS ATTORNEY'S HEARING SUMMARY FOR ORAL HEARING ON PROPERTY TAX PETITION** Appeal No.: SAU 20-015 Case ID No.: 1064117

STATE BOARD OF EQUALIZATION
PROPERTY TAX APPEAL

Representing the Parties:

For the Petitioners:	Mardiros H. Dakessian, Attorney Dakessian Law, LTD.
For the Respondent:	Richard Moon, Tax Counsel IV Attorney for State-Assessed Properties Division Jack McCool, Chief State-Assessed Properties Division
Appeals Attorney:	Sarah J. Garrett, Tax Counsel

PROPOSED VALUES

	Value	Penalty	Total
2020 Board-Adopted Unitary Value	$29,802,900,000	$0	$29,802,900,000
Petitioner's Requested Unitary Value	$24,410,636,422	$0	$24,410,636,422
Petitioner's Revised Requested Unitary Value	$22,900,000,000	$0	$22,900,000,000
Respondent's Appeal Recommendation	$29,802,900,000	$0	$29,802,900,000
Respondent's Revised Appeal Recommendation	$28,485,345,150	$0	$28,485,345,150

Appeals Attorney's Recommendation[1]

The Appeals Attorney recommends that the Board grant the petition for reassessment, in part, and reduce the 2020 Board-adopted unitary value by $1,317,554,850,[2] from $29,802,900,000 to $28,485,345,150. The Appeals Attorney notes this recommendation reflects a recommended adjustment as to Issues 5 and 6 and the denial of all other issues raised.

This appeal involves an amount in controversy that is $500,000 or more and thus is governed by Rev. and Tax. Code, section 40. Please see Staff Comment on page 38 for details.

Background Information

Southern California Edison Company (SCE or Petitioner), a wholly owned subsidiary of Edison International, is a public utility subject to rate regulation by the California Public Utilities Commission (Commission or CPUC). SCE is primarily engaged in the business of supplying electric energy in central, coastal and southern California, excluding the City of Los Angeles and certain other cities. Petitioner's service area encompasses 50,000 square miles, which includes 103,000 miles of distribution and transmission lines, serving a population of approximately 15 million people.

The CPUC establishes rates for utilities under its jurisdiction in a rate-setting procedure called the General Rate Case (GRC).[3] In establishing rates for utilities, the CPUC considers the utilities' rate base. Rate base is the value of property on which a public utility is permitted by the Commission to earn a specified rate of return. In general, the rate base consists of the cost of property as used by the utility in providing service.

Petitioner's 2020 Board-adopted value is based on 75 percent reliance on the Historical Cost Less Book Depreciation (HCLD)[4] value indicator ($31,980,069,007) and 25 percent reliance on the Capitalized Earning Ability[5] (CEA) value indicator ($23,271,463,581). Respondent calculated

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[1] Unless the Board holds otherwise, the Board shall take official notice of: the property statement Petitioner filed with the Board, together with any attachments, including without limitation any reports to regulatory agencies such as the U.S. Securities and Exchange Commission and the California Public Utilities Commission (CPUC), and any annual reports to shareholders; the Appraisal Data Report (ADR) prepared by the State-Assessed Properties Division (SAPD) together with any workpapers; the Notice of Unitary Value; and any correspondence between SAPD and Petitioner.
[2] The Appeal's Attorney's Recommendation reflects the application of the unrounded adjustments Respondent has recommended in Issues 5 and 6.
[3] The Commission's Rules of Practice and Procedure Article 2 and Appendix A of the Commission decision (D.) 07-07-004 set the rules and procedures for GRC review process.
[4] The HCLD value indicator is a form of the cost approach to value.
[5] The CEA value indicator is a form of the income approach to value.

Petitioner's CEA value indicator based on a perpetual life premise, where an amount is deducted from the income stream each year for an annual capital replacement allowance.

Petitioner filed a timely 2020 petition for reassessment, initially requesting a value of $24,410,636,422. (Petitioner's BOE-529-B and Petition.) Less than two hours prior to the Appeals Conference on November 12, 2020, Petitioner requested the submission of an EY Report, which revised Petitioner's requested value to $22,900,000,000.[6]

Respondent has reviewed the contentions and issues raised by Petitioner in the context of this appeal and is recommending a revised unitary value of $28,485,345,150, reflecting an adjustment for self-insured retention expenses and for economic obsolescence present in the HCLD value indicator. (SAPD Supplemental Analysis, pp. 5-6.)

Petitioner has not indicated agreement as to either adjustment Respondent is recommending (Issues 5 and 6), and, as such, is pursuing a full hearing on the issues it has raised before the Board.

General Concerns Raised by the Parties

Petitioner and Respondent each discussed general information they found relevant and raised a variety of concerns within their filings, including information related to SCE's past, current, and future financial and economic situation, including the risks associated with wildfires, the context of the Board's valuation, and the state of the regulated gas and electric industry as a whole. The specific issues Petitioner has raised with its 2020 Board-adopted values are addressed under headings: Issue 1 through Issue 6. The Appeals Attorney will first provide a summary of these general concerns to provide context to the consideration of this Petition, but notes that none of the general concerns raised show, on their face, that Respondent erred in the calculation of the 2020 Board-adopted unitary value.

First, Petitioner contends that the mere magnitude of the $4.2 billion increase from its 2019 Board-adopted unitary value to the 2020 Board-adopted unitary value represents not only the highest recent increase of assessed value, but also generally demonstrates that economic and other

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[6] Respondent and the Appeals Attorney were made aware of Petitioner's intent to submit the EY Report on November 6, 2020 (Petitioner's Pre-Conference Statement). Respondent noted that while Petitioner's late submission was in violation of the Rules for Tax Appeals, sections 5323.4, subdivision (b)(3) and 5324.6, Respondent would not object to its submission. The Appeals Attorney admitted the document at the November 12, 2020 Appeals Conference, noting that in the future, Petitioner should take care to submit such a Report at the appropriate time, with the original Petition filing. The Appeals Attorney further notes that Petitioner did not engage in the Statement of Work with EY to produce the Report, until October 12, 2020, several months after the original petition deadline.

uncertainties were not fully considered by the Board. (Petition, pp. 2-3.) However, Respondent points out that in 2019, Petitioner added over $6 billion in new assets (including Construction Work in Progress (CWIP)) and only had $700 million in retirements, equating to a net increase of over $5 billion in taxable assets acquired by Petitioner since its 2019 assessment, easily supporting the $4.2 billion increase that Petitioner claims is inappropriate.[7] (SAPD Analysis, p. 2) In its Reply, Petitioner contends that this is not a meaningful response or explanation for the sheer magnitude of this tax increase and that a dollar for dollar tax increase is inappropriate on its face, as historically Petitioner contends "there has been no direct correlation between asset additions and overall value increases."(Reply, p. 2.) The Appeals Attorney notes Petitioner is merely providing a general assertion that its assessment is overstated on its face, drawing misplaced comparisons not directly related to the substance of the underlying assessment, e.g. without addressing its asset additions in the past year. The Appeals Attorney notes the Appraisal Data Report (ADR) is included as Exhibit 2 of the SAPD Analysis; the ADR summarizes Petitioner's 2019 asset additions, CWIP, and retirements and provides a high-level comparison with Petitioner's 2019 assessment.

Second, Petitioner asserts Respondent did not account for or fully appreciate the increased business risk resulting from increasing wildfires, stating "rather than properly accounting for this significant threat to Edison's business, the [SAPD] appraisal simply ignores it." (Petition, p. 4.) Petitioner also asserts three general justifications for a lower assessed value: 1) the wildfires of 2017 and 2018 being unprecedented in size and amount of damage (Petition, p. 6.); 2) the risk of inverse condemnation, and California's application of inverse condemnation with strict liability to utilities[8](Petition, pp. 6-7, 9.); and the credit rating agencies, which investors use to assess risk, perceiving risk from wildfires in California. (Petition, p. 8.) Respondent contends that Petitioner is failing to recognize that increased risk is only one of many factors that affects appraisal (another example being asset additions), and that Respondent has already made multiple adjustments to account for wildfire risk, as detailed in the 2020 appraisal narrative. (SAPD Analysis p. 3.). Respondent highlights three specific adjustments:

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[7] See Respondent's Appraisal Data Report, SAPD Analysis, Exhibit 2.
[8] Petitioner asserts that the CPUC's review of costs "can result in precluding utilities from recovering its costs through rates, thereby creating material potential financial exposure for the affected utilities, without clear guidelines or standards for when and to what extent such liability can occur." (Petition, p. 6.)

- AB 1054[9] requires SCE to pay an additional $95 million per year for 10 years into the wildfire fund. Respondent made an adjustment to account for this requirement which resulted in an approximately $156 million value reduction.

- SCE has requested a 0.85% wildfire risk premium be added to its capitalization rate. Respondent made an adjustment to account for this request, which resulted in an approximately $325 million value reduction.

- SCE made $400 million in capital expenditures for fire risk mitigation as of the 2020 lien date, as required by AB 1054. AB 1054 precludes SCE from earning an equity return on these capital expenditures. Respondent made an adjustment to account for this expenditure, which resulted in an approximately $128 million value reduction.

(SAPD Analysis, p. 3.) Together, Respondent notes these adjustments resulted in a $609 million reduction to Petitioner's unitary value and are already reflected in the 2020 Board-adopted value. (SAPD Analysis, p. 3.) In its Reply, Petitioner contends that certain risks, like the inverse condemnation risk, credit rating downgrade, and adverse response of the insurance industry have not been fully acknowledged by Respondent. (Reply, pp. 3-4.) Petitioner also points to the AB 1054 wildfire mitigation fund, noting that if it is depleted, Petitioner is at risk of being liable for the excess. (Reply, p. 4.) The Appeals Attorney notes Petitioner is merely providing a general assertion that Respondent did not consider, or fully consider, the risk Petitioner faces as a part of its 2020 assessment; however, Respondent considers many factors in its assessment, including risk, and Respondent details certain adjustments have already been made within the 2020 valuation to reflect increased wildfire risk, including the allowance of a 0.85% wildfire risk premium added to the capitalization rate.[10] The Appeals Attorney notes specific claims related to this context are addressed, where relevant, in Issues 1 through 6. Additionally, the Appeals Attorney notes Respondent has included the ADR and Appraisal Narrative, as Exhibit 2 of the SAPD Analysis, and the Appraisal Narrative summarizes the particular risks considered by Respondent in the calculation of Petitioner's 2020 Board-adopted unitary value.

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[9] Assembly Bill 1054 (Ch. 79, Stats. 2019) (AB 1054) created a $21 billion fund funded by contributions from investor-owned utilities, including Petitioner, and from ratepayers. This fund is available to pay certain wildfire claims made against specific regional electric generation corporations, like Petitioner. At the time of passage, the Legislature estimated Petitioner would be allocated almost 1/3 of the total fund.
[10] Note this risk premium is above what the CPUC was willing to entertain for Petitioner; discussed infra, p. 6. See also California Public Utilities Commission Decision 19-12-056 (CPUC Decision 19-12-056) (Dec. 19, 2019) available at <https://docs.cpuc.ca.gov/DecisionsSearchForm.aspx > [as of Nov. 30, 2020].

Finally, Respondent notes Petitioner is raising the same arguments it made recently before the CPUC to request an increase on its allowed return on equity (ROE).[11] (SAPD Analysis, pp. 3-4) Respondent contends in the CPUC proceeding Petitioner recognized AB 1054 significantly reduced its risk of liability and voluntarily reduced its request of the CPUC from a 6.3 percent increase in ROE to a 0.85 percent increase.[12] However, CPUC rejected even the revised request, leaving Petitioner's ROE unchanged at its original 10.30 percent, stating:

> After considering the evidence on market conditions, trends, creditworthiness, interest rate forecasts, quantitative financial models, additional risk factors including business risk [which includes wildfire risk], and interest coverage presented by the parties and applying our informed judgment ... We find that SCE's authorized test year 2020 ROE should be 10.30%. *This ROE is reasonably sufficient to assure confidence in the financial soundness of the utility and to maintain investment grade credit ratings while balancing the interests between shareholders and ratepayers*. We further observe that the 10.30% authorized ROE is significantly higher than the 9.60%[fn omitted] average ROEs granted to United States electric utilities during 2018.[13]

Further, Respondent notes that CPUC's final conclusion was that "*We find that the passage of AB 1054 and other investor supportive polices in California have mitigated wildfire exposure faced by California's utilities.*" (SAPD Analysis, p. 4 citing CPUC Decision 19-12-056, at p. 37; *emphasis added* by Respondent.) The CPUC also stated "Based on the above financial, business, and regulatory risks discussion, we conclude the ROE ranges adopted in the proceedings…adequately compensate the utilities for these risks." (*Id.* at p. 40.) While Respondent notes that Petitioner's request was already denied by the CPUC, Respondent has allowed an increased equity risk premium of 0.85 percent to Petitioner's overall capitalization rate, which resulted in an approximately $325 million value reduction already reflected in the 2020 Board-adopted unitary value. (SAPD Analysis, p. 4.) Respondent contends this adjustment acknowledges risk that might not be captured in other

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[11] A utility's Rate of Return, or Cost of Capital, is the weighted average cost of debt, preferred equity, and common stock, a utility has issued to finance its investments. Return on Equity (ROE) is the return to common equity. The CPUC attempts to set the authorized ROE at a level that is adequate to enable the utility to attract investors to finance the replacement and expansion of its facilities so it can fulfill its public utility service obligation. In practice, this level is determined by estimating market returns on investments for other companies with similar levels of risk. In general, a higher ROE allows greater earnings and would be appropriate to reflect increased risks and uncertainties. See generally: <https://www.cpuc.ca.gov/General.aspx?id=10457> and <https://www.cpuc.ca.gov/uploadedFiles/CPUC_Public_Website/Content/About_Us/Organization/Divisions/Policy_and_Planning/PPD_Work/PPDReturnonEquityDCFmethodology_2.pdf> [As of Nov. 30, 2020.]

[12] California Public Utilities Commission Decision 19-12-056 (CPUC Decision 19-12-056) (Dec. 19, 2019), p. 28 available at <https://docs.cpuc.ca.gov/DecisionsSearchForm.aspx> [as of Nov. 30, 2020].

[13] *Id.* at pp. 40-41, emphasis added by Respondent.

adjustments allowed for Petitioner. (*Ibid.*) The Appeals Attorney notes Respondent has included the ADR and Appraisal Narrative, as Exhibit 2 of the SAPD Analysis, and the Appraisal Narrative summarizes the particular risks considered by Respondent in the calculation of Petitioner's 2020 Board-adopted unitary value.

The Appeals Attorney finds no particular contention raised within these general background concerns prove that Respondent erred in the calculation of the 2020 Board-adopted unitary value. Further, the Appeals Attorney notes Petitioner appears to attempt to shift the burden of proof to Respondent to address or defend several of Petitioner's claims, despite it being well settled that Petitioner has the burden of showing that Respondent's underlying assessment is incorrect or illegal. (*ITT World Communications v. Santa Clara* (1980) 101 Cal.App.3d 246; see also Cal. Code Regs., tit. 18, § 5541, subd. (a).) Accordingly, to the extent that Petitioner is using these general contentions to assert specific errors within Respondent's assessment, Petitioner has the burden of providing evidence and proving the existence of such alleged specific errors within Respondent's calculation of the 2020 Board-adopted unitary value. At the hearing, the parties should be prepared to discuss these general contentions as they relate and provide context to the specific issues raised in this petition.

ISSUES

1. **Whether Petitioner Has Shown that Respondent Erred in Placing 75 Percent Reliance on the Historical Cost Less Depreciation (HCLD) Value Indicator and 25 Percent Reliance on the Capitalized Earning Ability (CEA) Indicator of Value.**
2. **Whether Petitioner Has Shown that Respondent Must Adjust the Board-Adopted Value for SCE's $4.5 Billion Accrual for Liabilities for the 2017/2018 Wildfires and Mudslides.**
3. **Whether Petitioner Has Shown that Respondent Improperly Assessed $400 Million of Wildfire Mitigation Capital Expenditures.**
4. **Whether Petitioner Has Shown that Respondent Erred in Its Treatment of Wildfire Insurance Fund Related Contributions.**
5. **Whether Petitioner Has Shown that Respondent Failed to Properly Allow $23 Million in Self-Insured Retention Expenses.**
6. **Whether Petitioner Has Shown that Respondent Failed to Account for All Obsolescence Within the HCLD Value Indicator, After Respondent's Application of the Equity Risk Premium.**

ISSUE 1

Whether Petitioner Has Shown that Respondent Erred in Placing 75 Percent Reliance on the Historical Cost Less Depreciation (HCLD) Value Indicator and 25 Percent Reliance on the Capitalized Earning Ability (CEA) Indicator of Value.

Petitioner's Contentions

Petitioner asserts Respondent's appraisal is flawed as the two value approaches utilized produced widely varying results. (Petition, p. 12.) Petitioner alleges that due to this disparity, and as Respondent's analysis does not explicitly state the value approaches were reconciled, Respondent must have decided to simply weigh the HCLD value indicator as 75 percent and the CEA value indicator 25 percent, without any reconciliation or reason for doing so. (Petition, pp. 12-13.) Petitioner asserts an equal weighting would result in a more consistent and reasonable value. (Petition p. 13.)

Additionally, Petitioner asserts the difference between the CEA value indicator and HCLD value indicator indicates additional obsolescence exists within in Petitioner's property, and as such, Respondent should make an appropriate obsolescence adjustment to bring the HCLD value indicator more in line with the CEA value indicator. (Petition, p. 13.) Essentially, Petitioner argues that the difference between the two value indicators indicates that the HCLD value indicator is less reliable and proves the existence of additional obsolescence impacting Petitioner's property[14]; thus, (presumably) supporting additional weight for the CEA value indicator approach.

In its Reply, Petitioner renews its contention that Respondent failed to reconcile the approaches to value, and that the $8.7 billion difference in approaches indicates the HCLD approach has not addressed all obsolescence adjustments needed to validate both approaches. (Reply, pp. 4-5.) Petitioner further contends Respondent has provided no analysis or citation to support the 75/25 weighting. (Reply p. 5.) Petitioner further contends that Respondent concedes "regulatory lag" exists and that SCE is not earning a return on certain capital expenditures, but instead of qualifying that impact, Respondent has not explained why the 25 percent weighting of the CEA value indicator accurately captures the impact of regulatory lag. (Reply p. 6.) Petitioner concludes that Respondent's failure to reconcile the $8.7 billion difference in the HCLD and CEA approaches renders the appraisal invalid.

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[14] See Issue 6; Petitioner's additional obsolescence argument is discussed therein.

(Reply, p. 6.)

In the EY Report,[15] Petitioner renews the contention that the CEA value indicator should be provided additional weight in the reconciliation, noting the HCLD value indicator does not reflect all of the external market conditions impacting SCE. (EY Report, November 16, 2020, p. 35.) Petitioner further contends that Property Tax Rule[16] 8, subdivision (a), supports this additional weighting of the CEA value indicator, as SCE "experience[es] restrictions on income from disallowance of operating and capital expenses from rate recovery and requires numerous forms of obsolescence adjustments that are derived from the CEA analysis." (*Ibid*.) The EY Report concludes "our combined asset value is based on our understanding of the strengths and weaknesses of each approach and ultimately a reflection of the approach we best believe reflects the impacts of the wildfires." [17] (*Ibid.*)

<u>Respondent's Contentions</u>

Respondent confirms the HCLD and CEA value indicators were reconciled, consistent with relevant appraisal guidance and law, and that significant differences in the two value approaches can and may occur, as stated in Assessors' Handbook, section 501 (AH 501) *Basic Appraisal,* without compromising the validity of the underlying value approach. (SAPD Analysis, p. 5; citing AH 501, p.62.) Specifically, Respondent notes that when analyzing and reconciling value indicators to arrive at a final value estimate, the criteria described in Assessors' Handbook section 502 (AH 502), *Advanced Appraisal*, p. 111 should be considered:

> The final value estimate is an appraiser's *opinion of value*. There is no mathematical formula or statistical technique to which the appraiser can ultimately refer in order to reach the final value estimate. It is an opinion that should be based on the appraiser's application of generally accepted appraisal methods and procedures. It is generally inappropriate to use the arithmetic mean of the value indicators as the final value estimate. Simply calculating an average implies that all the value indicators have equal validity. While this may occur in certain instances, it is

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[15] Petitioner requested the EY Report be submitted as a revised opinion of value, as discussed in Background Information.

[16] All references to "Property Tax Rule" or "Rule(s)" are to sections of title 18 of the California Code of Regulations.

[17] The Appeals Attorney notes, that similar to Petitioner's Petition and Reply brief, the EY report never explicitly states what reliance is placed on the CEA value approach, nor was a calculation reflecting the weighting used in the EY Report provided. When Respondent questioned Petitioner as to that fact, an EY representative employed by Petitioner's counsel responded that the weighting is "More weight to the CEA relative to what SAPD has historically considered…ultimately based on our appraisal judgment." (Email November 19, 2020). The Appeals Attorney notes she accepted the EY Report at the November 12, 2020 Appeals Conference with the caveat that Petitioner must engage in good faith explanations and prompt responses of questions raised as to the EY Report, given the abbreviated timeline of review prior to the Oral Hearing. Accordingly, the Appeals Attorney notes the lack of clarity in Petitioner's issue and submitted calculations in the EY Report make it difficult to ascertain what calculation supports Petitioner's opinion of value, much less whether it was correctly calculated. Further, Petitioner appears to request the Appeals Attorney and the Board to find the EY Report's appraisal judgment as more reliable than Respondent's, without being able to independently verify the underlying calculation, despite Petitioner bearing the burden of proof.

usually not the case. Appraisers must follow Rule 3, noted above, and consider the appropriateness of the value approaches, the relative accuracy of the value indicators, and the quantity and quality of the data available when reconciling value indicators to reach the final value estimate.

(SAPD Analysis, p. 5; citing AH 502, p. 111; Emphasis added by Respondent.)

Respondent notes the HCLD approach is a reliable indicator of market value for closely regulated public utilities, like Petitioner, as HCLD, with some modification, approximates the rate base that regulators use in establishing revenue requirements.[18] (SAPD Analysis, p. 5; citing *Unitary Valuation Methods* (*UVM*) (2003), p. 1.) Further, HCLD is,

> **one of the more important indicators of value for closely regulated public utilities**. The general practice of the California Public Utilities Commission (CPUC) and most other regulatory agencies is to use historical or original cost less depreciation (with various adjustments) as the rate base. The regulatory agencies establish a rate base and a rate of return; utilities are permitted to earn at this established rate on the rate base.

(SAPD Analysis, p. 6; citing UVM (2003), p. 1. Emphasis added by the Appeals Attorney.)

Respondent also notes that Property Tax Rule 8, subdivision (a), indicates the CEA value indicator is appropriate to use when the property has "an established income stream…," and Petitioner has an established income stream.[19] (SAPD Analysis, p. 6.)

Respondent states that consistent with the relevant HCLD and CEA value indicator considerations, and Petitioner being a utility, rate base regulated by the CPUC, Respondent considered HCLD to be the most reliable indicator of value, placing 75 percent reliance on the indicator. (SAPD Analysis, p. 6.) Respondent notes that due to Petitioner's significant growth in actual and planned capital expenditures to replace and expand distribution and transmission infrastructure, and to construct and replace generation assets, Petitioner is experiencing "regulatory lag."[20] (*Ibid.*) Accordingly, in Respondent's opinion, it is appropriate to weight the CEA value indicator 25 percent to account for regulatory lag in rate adjustment for items on which Petitioner is not currently earning a return.(*Ibid.*)

Respondent also notes the 75/25 percent reliance on HCLD and CEA respectively is the same

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[18] Respondent also cites excerpts from AH 502, p. 146, which further support the use of the HCLD approach as relevant for public utility properties. (SAPD Analysis, pp. 5-6.)
[19] Petitioner concedes that it has an established income stream. (Reply, p. 5.)
[20] Regulatory lag is the time delay between Petitioner's costs and any adjustment CPUC may make to the rate base to account for these costs.

reliance used by SAPD to value Petitioner's property in each of the past 10 years, as well as the same reliance Respondent places on the value indicators of other investor-owned, rate-regulated utilities. (SAPD Analysis, p. 6.)

In its Supplemental Analysis, Respondent contends none of the factors noted by Petitioner in its filings or the submitted EY Report provide a specific explanation as to why the CEA value indicator should receive more weight than already given when the HCLD value indicator is the basis on which the rate-regulating agency allows the company to earn considering all business risks and circumstances, including wildfires. (Supplemental SAPD Analysis, pp. 2-3.) Particularly in light of the fact that the CPUC already reviewed Petitioner's rate increase requests and based on the financial, business, and regulatory risks cited, the CPUC "concluded that the ROE ranges adopted in the proceedings…adequately compensate the utilities for these risks." (*Id*. at 3, citing CPUC Decision 19-12-056, at p. 37.) Further, Respondent notes that Petitioner's EY Report does not state a specific request, i.e. the quantity of increased reliance sought on the CEA value indicator, and did not provide a clear explanation after clarification was sought by staff. (Supplemental SAPD Analysis, p. 3.) Accordingly, based on the information Petitioner has provided, Respondent does not recommend any change to reliance placed on the HCLD and CEA value indicators. (*Ibid.*)

Respondent notes that if Petitioner believes its weighting is more reliable than the 75/25 percent reliance on HCLD and CEA respectively used by Respondent, Petitioner must provide specific evidence and argument to support that assertion, including the specific weighting of the value indicators Petitioner is requesting, so that Respondent can review and analyze such contentions. (SAPD Supplemental Analysis, p. 3.)

Appeals Conference and Post-Conference Clarifications Sought

At the Appeals Conference on November 12, 2020, Petitioner described the approach to value taken in the EY Report at a high level and reasserted that it believed additional weight should be placed on the CEA value indicator given the increased risks SCE faces, regulatory lag, and other factors affecting SCE, as described within its filings.

After the Appeals Conference, Respondent requested clarification on what reliance Petitioner is requesting be placed on the CEA value approach within the EY Report, as it is not explicitly stated.

An EY representative employed by Petitioner's counsel responded that the weighting is "More weight to the CEA relative to what SAPD has historically considered…ultimately based on our appraisal judgment." (Email November 19, 2020).[21]

Applicable Law and Appraisal Principles

Burden of Proof

Assessing officers are presumed to have properly performed their duties. (Evid. Code, § 664.) Therefore, Petitioner has the burden of showing that the assessment is incorrect or illegal. (*ITT World Communications v. Santa Clara* (1980) 101 Cal.App.3d 246; see also Cal. Code Regs., tit. 18, § 5541, subd. (a).)

Value Standard

Property Tax Rule 2, subdivision (a) states that "in addition to the meaning ascribed to them in the Revenue and Taxation Code, the words "full value," "full cash value," "cash value," "actual value," and "fair market value" mean the price at which a property, if exposed for sale in the open market with a reasonable time for the seller to find a purchaser, would transfer for cash or its equivalent under prevailing market conditions between parties who have knowledge of the uses to which the property may be put, both seeking to maximize their gains and neither being in a position to take advantage of the exigencies of the other."

HCLD Approach to Value

Property Tax Rule 3, subdivision (d) provides the HCLD approach to value shall be considered "[i]f the income from the property is regulated by law and the regulatory agency uses historical cost or historical cost less deprecation as the rate base, the amount invested in the property or the amount invested less depreciation computed by the method employed by the regulatory agency." HCLD, with some modification, approximates the rate base that regulators use in establishing revenue requirements. (See *UVM*, p. 1.) HCLD reflects the market value contribution of all taxable property including the depreciated historical cost of plant in service, possessory interests, construction work in progress, and materials and supplies. (AH 502, p. 146.) HCLD is,

> one of the more important indicators of value for closely regulated public utilities. The general practice of the California Public Utilities Commission (CPUC) and most other regulatory agencies is to use historical or original cost less depreciation (with various adjustments) as the

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[21] See ftn. 17.

> rate base. The regulatory agencies establish a rate base and a rate of return; utilities are permitted to earn at this established rate on the rate base.

(UVM (2003), p. 1.)

Income Approach to Value

Property Tax Rule 8, subdivision (a), states that "the income approach is used in conjunction with other approaches when the property under appraisal is typically purchased in anticipation of a money income and either has an established income stream or can be attributed a real or hypothetical income stream by comparison with other properties." Subdivision (b) describes the income approach to value as the valuation method whereby, "an appraiser values an income property by computing the present worth of a future income stream. This present worth depends upon the size, shape, and duration of the estimated stream and upon the capitalization rate at which future income is discounted to its present worth." Subdivision (c) provides that "the amount to be capitalized is the net return which a reasonably well-informed owner and reasonably well informed buyers may anticipate on the valuation date that the taxable property existing on that date will yield under prudent management and subject to legally enforceable restrictions as such persons may foresee as of that date."

Reconciliation of Value Indicators

Property Tax Rule 3 requires that, in estimating value, the assessor shall consider one or more of the approaches to value "as may be appropriate for the property being appraised," which includes the comparative sales approach, the cost approach (e.g., HCLD valuation methodology), or the income approach (CEA valuation methodology). The appropriateness of an approach is often related to the type of property being appraised and the available data. (AH 502, p. 109.) In addition, the validity of a value indicator will depend upon the accuracy of data and adjustments made to the approach. That is, the accuracy of a value indicator depends on the amount of available comparable data, the number and type of adjustments, and the dollar amount of adjustments. Finally, if a large amount of comparable data is available for a given approach, the appraiser may have more confidence in that approach. For example, if income, expense, and capitalization rate data can be obtained from many properties comparable to the subject, the appraiser may attribute significant accuracy to the income approach. The greatest reliance should be placed on that approach or combination of approaches that best measures the type of benefits the subject property yields. The final value estimate reflects the relative weight that the appraiser assigned, either implicitly or explicitly, to each approach. (AH 502, p. 112.)

Appeals Attorney's Analysis and Conclusions

Respondent is presumed to have correctly determined the value of the property at issue, and Petitioner bears the burden of proving otherwise.

Here, Petitioner contends that because Respondent's calculated HCLD value indicator suggests a value of approximately $32 billion, while the CEA value indicator suggests a value of just over $23 billion, Respondent's 2020 Board-adopted unitary value is flawed, as the various approaches to value must yield approximately the same results, and differences of such a magnitude must be reconciled. (Petition, p. 5.) Further, Petitioner contends Respondent did not reconcile the two value indicators, as required by Property Tax Rule 3 and Board Guidance, but instead "decided to simply weight historical cost 75% and income only 25%" without reason. (Petition, p. 13.) Petitioner appears to be asserting the Board should adopt the appraisal judgment of the EY Report, without putting forth any specific argument or evidence to support its unclear request for additional weight to be placed on the CEA value indicator, despite bearing the burden of proof.

Respondent contends that Board guidance clearly states that significant differences may occur in validly calculated indicators. (SAPD Analysis, p. 5; citing AH 501, p. 62.) Further, Respondent notes that the HCLD value indicator is a reliable indicator of value for closely regulated public utilities, like Petitioner, because HCLD, with some modification, approximates the rate base that regulators use in establishing revenue requirements. (SAPD Analysis, p. 5; citing UVM, p. 1.). Accordingly, Respondent contends, in light of all available evidence, it was reasonable to place 75 percent reliance on the HCLD value indicator, as it is the best indicator of value. Respondent asserts that in light of Petitioner's "regulatory lag," Petitioner's established income stream, and the relative reliance placed on the value indicators of other rate-base regulated utilities, Respondent believes it was appropriate to place 25 percent reliance on the CEA value indicator, consistent with Property Tax Rule 3 and relevant Board guidance. Further, Respondent contends Petitioner has already raised the additional risk concern in the instant petition with the CPUC and the Commission concluded no further adjustment to Petitioner's ROE was warranted. Respondent concludes Petitioner has provided no evidence or argument to support a revised weighting of the value indicators.

Based on the evidence and arguments submitted to the record to date, the Appeals Attorney finds that Petitioner has not shown specific evidence or argument to prove that its HCLD indicator is impaired, nor has Petitioner shown that its CEA value indicator should be granted additional weight, much less has Petitioner clarified what additional weight Petitioner is requesting be placed on the CEA value indicator. Petitioner's contention instead appears to rest on its request that the Board find Respondent's appraisal judgment and valuation approach flawed, without Petitioner providing any specific evidence, and that the Board instead adopt the appraisal judgment of the EY Report, without Petitioner providing any calculation to support its reconciliation of the value indicators. However, it is well settled that the burden of proof is on the Petitioner.

At the hearing, the parties should be prepared to discuss the issue; further, Petitioner should be prepared to explain: what specific reliance Petitioner is requesting be placed on the CEA and HCLD value indicators; why, as a rate-base regulated utility, it believes Respondent's HCLD indicator is less reliable, despite HLCD being considered to be one of the more important indicators of value for closely regulated utilities, based on relevant appraisal principals and Board Guidance; why, specifically, it believes its CEA value should be granted more relative reliance in comparison to the HCLD value indicator; and why Petitioner's value indicators should be weighted differently compared to other similarly situated investor-owned, rate-regulated utilities.

ISSUE 2

Whether Petitioner Has Shown that Respondent Must Adjust the Board-Adopted Value for SCE's $4.5 Billion Accrual for Liabilities for the 2017/2018 Wildfires and Mudslides.

Petitioner's Contentions

Petitioner asserts the Board-adopted value does not account for SCE's $4.5 billion accrual for liabilities for the 2017/2018 wildfires and mudslides, erroneously disregarding costs for estimated claims and settlements pre-AB 1054. (Petition, p. 13.) Petitioner argues that Respondent has improperly made no adjustments to reflect the expected losses in SCE's unitary assessment, despite valuation of a going concern requiring consideration of forecasted future expenses, whether or not they originate from prior events. (Petition, p. 14.) To address this issue, Petitioner requests an adjustment of $1.825 billion be made because its "Wildfire-related claims" liability reduces its "firm value," [22] as reflected on its year end 2018 and 2019 audited financial statements. (Petition, pp. 14-18; Petition, Exhibit C.) Petitioner's Exhibit B appears to apply the requested $1.825 billion as a reduction to both the HCLD and CEA indicators, then weights each indicator 50 percent, to arrive at a total requested reduction of $1.825 billion.[23] (Petition, Exhibit B.)

In its Reply, Petitioner refutes that its wildfire-related expenses are past expenses and not anticipated to be occurred again in the future. (Reply, p. 7.) First, Petitioner asserts the $1.825 billion adjustment requested represents a future, anticipated operating expense to cover liabilities beyond all expected insurance recoveries. (*Ibid.*) Petitioner further contends it is not a financing liability, nor a contractual liability, but instead an estimated amount of necessary operating expense above and beyond insurance recoveries, which negatively impacts its going concern value. (*Ibid.*) Second, Petitioner asserts that Rule 8 requires the inclusion of anticipation income, and similarly anticipated operating expenses must be considered and deducted. (*Ibid.*) Third, if assuming for the sake of argument that this is a non-ordinary expense, Respondent provides no support for the exclusion of a non-ordinary expense anticipated in the future.[24] Fourth, Petitioner contends there is no material difference between "firm value," "fair market value," "full cash value," or "going concern value." (Reply, p. 8.) In conclusion, Petitioner notes that while the initial liability claim accrual may normally be a "historical" expense accrual from an accounting standpoint, that the liability is still an ongoing cash cost to SCE as claims are settled and paid, and as such it must be accounted for, as any willing buyer would account for it. (*Ibid.*)

Petitioner's EY Report asserts the appropriate adjustment is instead $2.1 billion, based on the present value of settlement payments estimated in 2021 based on SCE management and EY's

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[22] "Firm value" is an economic measure reflecting the market value of a business, which reflects a sum of claims on the company by all claimants, i.e. both equity and non-equity claims. Consistent with this definition, Petitioner contends that its firm value is impaired by the existence of claims on the company, i.e. the liability from lawsuits. (Petition, p. 16).

[23] As discussed in Issue 1, Petitioner's filings provide no argument or support for the 50/50 weighting of the value indicators in Exhibit B.

[24] In support, Petitioner cites a general statement from AH 502 to support this supposition. AH 502, p. 67, "Cost trends relating to the components of operating expenses should be studied to estimate the future level of operating expenses." Petitioner also asserts such costs are anticipated to continue in the future, but does not address the likelihood of such claims in the context of AB 1054, which is designed to reduce the likelihood of such expenses if and until the wildfire mitigation fund were exhausted.

understanding, and that this $2.1 billion should be deducted from both the HCLD and CEA value indicators. (EY Report, pp. 21-22; EY Report, Exhibit 3, p. 54-55.) The EY report states the $2.7 billion is not a liability, it is an accrual of a future expense, but is recognized as a liability for accounting purposes. (EY Report, p. 21.) In support of this request, Petitioner states "Based on our understanding of the assessor[s'] handbook, this expense does not align to any of the non-allowable operating expense as defined in assessor[s'] handbook Advanced Appraisal Manual." (EY Report, p. 21, citing AH 502, pp. 73-74.)

<u>Respondent's Contentions</u>

Respondent notes Petitioner lists $4.5 billion "Wildfire-related claims" as a long-term liability on its Balance Sheet as of December 31, 2019[25] and shows a "Wildfire-related claims, net of insurance recoveries" expense of $255 million for year-ended December 31, 2019.[26] (SAPD Analysis, p. 7.) Respondent notes Petitioner requests an adjustment of $1.825 billion, which appears to be the after-tax, wildfire-related expense for 2018,[27] but it is unclear why Petitioner is asserting a reduction in "firm value" necessarily results in a reduction to its taxable value. (SAPD Analysis, p. 7.) Respondent contends such a reduction in taxable value is unsupported, as the expenses claimed represent past expenses and expenses which are not anticipated to be incurred again in the future. (SAPD Analysis, p. 8.)

Respondent notes that consistent with Cal. Const. Article XIII, section 1, the standard of value is fair market value. (SAPD Analysis, p. 7.) Further, for state-assessed properties, the California Supreme Court has stated:

> From our review of the relevant constitutional and statutory provisions, we conclude that unit taxation is properly characterized not as the taxation of real property or personal property or even a combination of both, but rather as the taxation of *property as a going concern.* First, what the Board assesses is the value of the public utility *property* as a going concern; it considers the earnings of the *property* as a whole, and does not consider, less still assess, the value of any single real or personal asset.

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[25] Petitioner's Consolidated Balance Sheet, Attached to SAPD's Analysis, Exhibit 3.

[26] Petitioner's Consolidated Statement of Income, Attached to SAPD's Analysis, Exhibit 4.

[27] Southern California Edison Annual Report, p. 110-112, attached as Exhibit 5. Petition, Exhibit B appears to apply $1.825 billion as a reduction to both the cost and income indicators, then weights each indicator 50 percent to arrive at a total unitary value reduction of the same $1.825 billion. Respondent notes that it is unclear how this calculation was determined or why this methodology was chosen; further, Respondent contends it appears that Petitioner has simply averaged the two indicators of value, as Petitioner accused Respondent of doing in Issue 1, "without any cogent reason for doing so."

(*ITT Communications vs. City of San Francisco* (1985) 37 Cal.3d 859, 864-865, emphases added.) Respondent notes it performs its valuation duties, as explained above, by calculating and reconciling different indicators of value, where Respondent's final appraisal value reflects the value of all taxable property, owned or used by Petitioner, as a unit. (SAPD Analysis, p. 7.)

Respondent notes that it does not calculate "Firm Value" and that this concept is irrelevant to the valuation of taxable property as a going concern. (SAPD Analysis, pp. 7-8.) Further, Property Tax Rule 8, subdivision (c), explicitly excludes debt payments within an income approach. (SAPD Analysis, p. 8.) Additionally, Respondent cites AH 502, p. 73, which states that "Rule 8 (c) explicitly excludes certain items as expenses. Excluded from 'gross outgo' are property taxes, amortization, depreciation, debt payments, (i.e. both the interest on debt and the retirement, or repayment, of debt) and corporate and personal income taxes." Additionally, AH 502 states

> Debt payments reflect the return on and return of the debt, or mortgage, interest in a property. They reflect the contractual share of property income received by creditors. However, the amount of income that a property is capable of producing is not affected by the way in which the returns to the property are allocated between debt and equity interests. *Since, for property tax purposes, the entire interest in the property is being appraised (i.e., the value of both debt and equity interests), and not the equity interest only, debt payments are not an allowable expense*.

(AH 502, p. 74; Emphasis added.)

Respondent also contends that while Petitioner has pointed to CPUC's consideration of liabilities in evaluating a proposed acquisition as evidence SAPD must make a reduction in unitary value for liabilities, CPUC is engaged in evaluating the entire business, or the "Firm Value," and this "Firm Value," by itself, is not relevant to California unitary property taxation. (SAPD Analysis, p. 9.)

Finally, Respondent contends the premise of the CEA value indicator calculation is to convert (or capitalize) a *future* income stream into present worth (Rule 8, subd. (a).), and the amount to be capitalized is,

> the net return which a reasonably well informed owner and reasonably well informed buyers may *anticipate* on the valuation date that the taxable property existing on that date will yield under prudent management and subject to such legally enforceable restrictions as such persons may foresee as of that date.

(SAPD Analysis, p. 9; citing Rule 8, subd. (c), emphasis added.) Thus, Respondent contends it is clear that neither past nor non-ordinary expenses may be deducted from the future income stream to be capitalized. (SAPD Analysis, p. 9.) Accordingly, as Respondent notes the costs for which Petitioner seeks a reduction are both past expenses and expenses which are not anticipated to be incurred again in the future, Respondent concludes no adjustment for these liabilities is appropriate. (*Ibid.*)

Respondent notes Petitioner did not present any new information on this issue within the EY Report that changed Respondent's position, as stated in its Analysis. (Supplemental SAPD Analysis, p. 3.)

Appeals Conference

At the Appeals Conference on November 12, 2020, Petitioner described the approach to value taken in the EY Report at a high level, reasserting this contention.

Applicable Law and Appraisal Principles

Burden of Proof

Assessing officers are presumed to have properly performed their duties. (Evid. Code, § 664.) Therefore, Petitioner has the burden of showing that the assessment is incorrect or illegal. (*ITT World Communications v. Santa Clara* (1980) 101 Cal.App.3d 246; see also Cal. Code Regs., tit. 18, § 5541, subd. (a).)

Value Standard

Property Tax Rule 2, subdivision (a) states that "in addition to the meaning ascribed to them in the Revenue and Taxation Code, the words "full value," "full cash value," "cash value," "actual value," and "fair market value" mean the price at which a property, if exposed for sale in the open market with a reasonable time for the seller to find a purchaser, would transfer for cash or its equivalent under prevailing market conditions between parties who have knowledge of the uses to which the property may be put, both seeking to maximize their gains and neither being in a position to take advantage of the exigencies of the other."

Income Approach to Value

Property Tax Rule 8, subdivision (a), states that "the income approach is used in conjunction with other approaches when the property under appraisal is typically purchased in anticipation of a money income and either has an established income stream or can be attributed a real or hypothetical income stream by comparison with other properties." Subdivision (b) describes the income approach to value as the valuation method whereby, "an appraiser values an income property by computing the present worth of a future income stream. This present worth depends upon the size, shape, and duration of the estimated stream and upon the capitalization rate at which future income is discounted to its present worth." Subdivision (c) provides that "the amount to be capitalized is the net return which a reasonably well-informed owner and reasonably well informed buyers may anticipate on the valuation date that the taxable property existing on that date will yield under prudent management and subject to legally enforceable restrictions as such persons may foresee as of that date." Net return is the difference between gross return and gross outgo. (Rule 8, subd. (c).) Amortization, depreciation, and debt retirement are explicitly excluded from gross outgo. (*Ibid*.)

Appeals Attorney's Analysis and Conclusions

Respondent is presumed to have correctly determined the value of the property at issue, and Petitioner bears the burden of proving otherwise. Here, Petitioner contends that Respondent's 2020 Unitary Value inappropriately excludes Petitioner's $4.5 billion accrual for liabilities related to the 2017/2018 wildfires and mudslides, requesting a $2.8 billion reduction to each value indicator. In the EY Report, Petitioner asserts the appropriate present value adjustment for such claims is $2.1 billion to each value indicator, to reflect the payments expected in 2021. However, as Respondent points out, Petitioner has provided no specific argument, evidence, or legal or appraisal authority to support its proposed deduction of the past and non-ordinary expenses related to its pre-AB 1054 liabilities for property tax purposes. In fact, as Respondent points out, such a deduction would be directly contrary to Property Tax Rule 8 and relevant Board guidance. Further, no legal or appraisal support is provided with respect to the proposed deduction to the HCLD value indicator.

Based on the evidence and arguments submitted to the record to date, the Appeals Attorney finds that Petitioner has not shown specific evidence or argument to prove that the claimed expenses must be deducted from both the CEA and HCLD value indicators, nor has Petitioner shown that such expenses are ordinary or ongoing.[28] Further, the Appeals Attorney notes such expenses are explicitly

[28] Even if one were to accept that it is "ordinary" for power generating companies to be regularly liable for contributing to wildfire incidents, the California Legislature has designed AB 1054 to mitigate the likelihood of this type of expense going forward.

excluded from the CEA approach under Property Tax Rule 8, as Respondent contends. Petitioner's argument appears to rest on the Board finding Respondent's appraisal judgment and approach to these wildfire liabilities as flawed, without providing any specific evidence, and adopting the appraisal judgment of the EY Report to deduct $2.1 billion from both the CEA and HCLD value indicators, without providing any legal or appraisal support that such an adjustment is appropriate or allowable. However, it is well settled that the burden of proof is on the Petitioner.

At the hearing, the parties should be prepared to discuss the issue; further, Petitioner should be prepared to explain: what legal and appraisal support exists to support the deduction of these liability expenses from the CEA and HCLD value approaches; and how Petitioner's requested adjustment can be reconciled with Property Tax Rule 8 and other Board issued guidance.

ISSUE 3

Whether Petitioner Has Shown that Respondent Improperly Assessed $400 Million of Wildfire Mitigation Capital Expenditures.

Petitioner's Contentions

Petitioner contends that Respondent improperly assessed $400 million of wildfire mitigation capital expenditures in its 2020 assessment of SCE, based on the incorrect assumption that these assets generate a cash flow from ratepayers, allowing SCE to realize a return on investment.[29] (Petition p. 18.) Petitioner contends that under AB 1054, SCE is required to make capital expenditures to the wildfire mitigation fund, including the initial $1.6 billion, which will not be included in SCE's rate base, nor will SCE be allowed to earn a return on the investment. (Petition, p. 18.)

Instead of the traditional approach of Petitioner financing infrastructure investments by adding the assets in its rate base and retaining the opportunity to earn a rate of return on its investment, Petitioner states that the $1.6 billion wildfire mitigation spend will be recovered through a securitizable dedicated-rate component through a financial product known as securitization.[30] (Petition, p. 18.) Petitioner asserts that this securitization structure provides no assessable value to a

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[29] Petitioner cites Petition, Exhibit D, correspondence with SAPD regarding the wildfire-related mitigation expend, and Petition, Exhibit E, reflecting the reduction in value attributable to AB 1054 capital expenditures.
[30] Petitioner later described this securitization process at the Appeals Conference. Petitioner noted that a special purpose entity as created, separate and apart from SCE, which lent SCE the funds, and recovered the debt over time through securitized utility bond (re)payments collected directly from ratepayers. (See also Petition p. 18-19)

willing buyer/seller transaction, as there is no opportunity to earn an investment return on the assets whatsoever, i.e. they are nonperforming assets. (Petition, pp. 19-20.) Accordingly, Petitioner asserts a buyer would value the first $1.6 billion of wildfire mitigation capital expenditures ($400 million as of 12/31/19) at zero, and Respondent should do the same and remove these costs from the HCLD value indicator. (Petition, p. 20.)

In its Reply, Petitioner reasserts that SCE is not allowed to earn a return on this $400 million spend, and thus it has no value to SCE as a going concern. (Reply, pp. 8-9.) Further, Petitioner reasserts that if it is not permitted to earn a return on investment, the amount of that investment must be removed from SCE's HCLD value indicator. (*Ibid.)*

In the EY Report, Petitioner reasserts that the full $400 million in capital expenditures will be securitized and fully removed from SCE's rate base. (EY Report, p. 19.) Petitioner concludes it is reasonable to assume, from an appraisal perspective, that the full $400 million in capital expenditures would be fully impaired and should be removed from the HCLD, as SCE will not be able to realize a return on these investments. (*Ibid.*)

Respondent's Contentions

Respondent contends no adjustment is appropriate for this issue. Respondent notes when making capital expenditures, firms expect both a "return of" their invested capital as well as a "return on" their invested capital. (SAPD Analysis, pp. 9-10.) A "return of" capital accounts for a recovery of the investment while a "return on" capital accounts for a reward for making an investment. (AH 502, p. 62.) Both of these components are captured in the capitalization rate, which provides explicitly or implicitly for both the return of and the return on capital. (*Ibid*.)

Respondent notes Petitioner is arguing the entire $400 million in capital expenditures incurred in 2019 for wildfire mitigation amount should be excluded from HCLD because it is not allowed to earn a return on the expenditure and, thus, derives no benefit from the expenditure. (SAPD Analysis, p. 9.) However, Respondent notes while it is true that Petitioner will not earn a *return on* this capital expenditure, it is not true that they derive no benefit. (*Ibid.*) Respondent contends Petitioner will earn a *return of* its capital expenditure through depreciation and the reimbursement of interest paid for debt service. (*Ibid.*)

Respondent contends it made appropriate adjustments to the cost indicator to account for this by calculating the present value of the income using a discount rate that excludes the equity portion of the capitalization rate. (SAPD Analysis, pp. 9-10.) The excluded equity portion represents the return *on* the investment, and properly leaves the rate for return *of* the investment. Respondent then removed the difference between this present value amount and the total $400 million capital expenditure, resulting in an approximately $171 million reduction to the HCLD value indicator, which was already reflected in Petitioner's 2020 Board-adopted unitary value. (SAPD Analysis, p. 10.) Therefore, Respondent recommends no adjustment as to this issue.

Appeals Conference

At the Appeals Conference, Petitioner described SCE as being in the process of creating a special purpose entity to securitize the $400 million in capital expenditures required by AB 1054. An SCE employee explained, the special purpose entity will issue a recovery bond to finance the $400 million in capital expenditures. Petitioner's EY Report also explains that the $400 million investment will be repaid by ratepayers via a surcharge called a "fixed recovery charge." (EY Report, p. 19.)

After a supplemental data request, Petitioner provided Petitioner's application and testimony from SCE's Application to the CPUC for authorization to securitize certain costs, explaining the structure of the securitization, bond transaction structure, capital structure of securitization, and the transaction's structure. (Petitioner's Email, Dated Nov. 19, 2020 and attachments.)

Respondent's Supplemental Analysis

After a review of Petitioner's EY Report and supplemental information and testimony, Respondent contends while Petitioner's description of this financing mechanism illustrates a different special purpose entity, purportedly separate from SCE, the financing structure is not relevant to the taxable value of the assets and the EY Report itself acknowledges that Petitioner will earn a return of its capital investment. (Supplemental SAPD Analysis, p. 4; also citing EY Report, p. 19.) Accordingly, Respondent reaffirms that the additional information has not changed its view that SAPD has already made appropriate adjustments to the cost indicator to account for the return of Petitioner's investment, while acknowledging Petitioner's level of return on this capital expenditure is impaired. (Supplemental SAPD Analysis, p. 4.)

Applicable Law and Appraisal Principles

Burden of Proof

Assessing officers are presumed to have properly performed their duties. (Evid. Code, § 664.) Therefore, Petitioner has the burden of showing that the assessment is incorrect or illegal. (*ITT World Communications v. Santa Clara* (1980) 101 Cal.App.3d 246; see also Cal. Code Regs., tit. 18, § 5541, subd. (a).)

Value Standard

Property Tax Rule 2, subdivision (a) states that "in addition to the meaning ascribed to them in the Revenue and Taxation Code, the words "full value," "full cash value," "cash value," "actual value," and "fair market value" mean the price at which a property, if exposed for sale in the open market with a reasonable time for the seller to find a purchaser, would transfer for cash or its equivalent under prevailing market conditions between parties who have knowledge of the uses to which the property may be put, both seeking to maximize their gains and neither being in a position to take advantage of the exigencies of the other."

HCLD Approach to Value

Property Tax Rule 3, subdivision (d) provides the HCLD approach to value shall be considered "[i]f the income from the property is regulated by law and the regulatory agency uses historical cost or historical cost less deprecation as the rate base, the amount invested in the property or the amount invested less depreciation computed by the method employed by the regulatory agency." HCLD, with some modification, approximates the rate base that regulators use in establishing revenue requirements. (See *UVM*, p. 1.) HCLD reflects the market value contribution of all taxable property including the depreciated historical cost of plant in service, possessory interests, construction work in progress, and materials and supplies. (AH 502, p. 146.) HCLD is,

> one of the more important indicators of value for closely regulated public utilities. The general practice of the California Public Utilities Commission (CPUC) and most other regulatory agencies is to use historical or original cost less depreciation (with various adjustments) as the rate base. The regulatory agencies establish a rate base and a rate of return; utilities are permitted to earn at this established rate on the rate base.

(UVM (2003), p. 1.)

Appeals Attorney's Analysis and Conclusions

Respondent is presumed to have correctly determined the value of the property at issue, and Petitioner bears the burden of proving otherwise. Here, Petitioner contends that Respondent should deduct $400 million of wildfire capital expenditures from the rate-base because Petitioner is not allowed to earn a rate of return on the expenditures and the expenditures will be securitized through a special purpose entity, who will collect bond repayments directly from rate payers, providing no benefit to Petitioner. However, Respondent contends it has already adjusted the HCLD value indicator for these expenses, by calculating the present value of the income using a discount rate that excludes the equity portion of the capitalization rate, reflecting Petitioner will not receive a *return on* the investment, but properly leaves the rate for *return of* its capital expenditure, which Petitioner will receive the benefit of through depreciation and the reimbursement of interest paid for debt service.[31] Respondent noted this calculation resulted in an approximately $171 million reduction to the HCLD value indicator, which was already reflected in Petitioner's 2020 Board-adopted unitary value.

Based on the evidence and arguments submitted to the record to date, the Appeals Attorney finds that Petitioner has not shown specific evidence or argument to prove error within Respondent's adjustment calculation, but instead Petitioner continues to assert the full $400 million should be removed from the HCLD value indicator based on its appraisal judgment.

At the hearing, the parties should be prepared to discuss the issue; further, Petitioner should be prepared to explain: what legal and appraisal support exists to show Respondent erred in its calculation; why, specifically, Petitioner asserts there is no assessable value attributable to the capital expenditure, despite Petitioner receiving a *return of* its capital expenditure via the securitization structure; and what legal or appraisal principals support the deduction of the full $400 million from the HCLD approach.

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[31] Petitioner appears to acknowledge this difference and acknowledge SCE will recover a return *of* SCE's investment in ftn. 41 of its Petition; however, Petitioner argues there is no benefit to shareholders, despite the acknowledgment of recovery of SCE's capital expenditure cost and related interest.

ISSUE 4

Whether Petitioner Has Shown that Respondent Erred in Its Treatment of Wildfire Insurance Fund Related Contributions.

Petitioner's Contentions

Petitioner asserts Respondent erred in its treatment of the Wildfire Insurance Fund-related contribution by only allowing an annual operating expense of $95 million, instead of the $323 million annual operating expense, which accounts for the initial contribution to the fund, and by ignoring the initial contribution of $2.4 billion to the fund in general, which should properly be included in the income indicator as part of SCE's annual operating cost for wildfire insurance. (Petition, p. 20.)[32] Petitioner notes SCE made the initial contribution of $2.4 billion to the Wildfire Fund on September 19, 2019, and will make 10 annual contributions of approximately $95 million per year to the fund, consistent with section 3292, subdivision (a) of the California Public Utilities Code. (Petition, p. 21.) Petitioner notes the Wildfire Insurance Fund contributions are being treated similarly to prepaid insurance: such assets are amortized over ten years[33] at $323 million per year and reflected as an expense in the "Operation and Maintenance" section of its income statement. (Petition p. 21.) Accordingly, Petitioner contends Wildfire Insurance Fund contributions are equivalent to the payment of insurance premiums, and that a potential purchaser would be willing to pay more for a utility that had prepaid this annual contribution, as compared to a utility that had not done so. (Petition, p. 22.)

Further, Petitioner contends if AB 1054 had required ten annual payments of the same amount ($323 million) instead of an initial payment of $2.4 billion, the full annual payment amount would be deducted from the income indicator to reflect annual operating costs. (Petition p. 23.) Petitioner also disputes Respondent's characterization of the prepaid expense as an excludable amortization or depreciation expense, asserting depreciation is irrelevant because the annual cost reflects amortization of a prepaid asset, not depreciation of a capital asset. (*Ibid*; citing *State Assessment Manual (SAM),* p. 74 for the definition of "Amortization.") Additionally, Petitioner adds its prior year wildfire insurance

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[32] Petitioner cites Petition, Exhibit F as reflecting the reduction in value attributable to the disallowed expenses.

[33] Petitioner notes the Wildfire Insurance Fund does not have a defined life and will terminate when the administrator determines the fund has been exhausted. Management estimates that the wildfire fund will provide insurance coverage for 10 years, but could vary depending upon several factors, including future occurrence and magnitude of wildfires; the involvement of SCE or other electric corporations in the ignition of wildfires; the probable future outcome of CPUC cost recovery proceedings for wildfire claims; the participation of PG&E in the fund, and the use of the contributions by the administrator of the fund.

expenses further support that the annual expense of $323 million for insurance premiums as an expense in the income indicator is reasonable. (*Ibid.*) Finally, Petitioner contends that Respondent is treating state assesses inconsistently, as such contribution expenses were allowed for another state assessee. (Petition, pp. 24-25.) Accordingly, Petitioner reaffirms that the $323 million annual insurance expense should be reflected in the CEA model, absent a drastic change to wildfire projections in California or a change to insurance markets. (*Ibid.*)

In its Reply, Petitioner contends SAPD's citation to *De Luz Homes v. County of San Diego (De Luz)* (1955) 45 Cal.2d. 546, while it precludes a deduction for depreciation of property, it does not preclude a deduction for operating and maintenance expenses, which Petitioner contends the Wildfire Insurance Fund Contributions are. (Reply, p. 9.) Further, Petitioner contends the annual Wildfire Insurance Fund Contributions are not "past, non-recurring expense[s]" as wildfires are here to stay and only getting progressively worse. (Reply, pp. 9-10.) Additionally, Petitioner notes its audited financial statements, prepared pursuant to GAAP, show that these prepaid insurance expenses are being reflected as operating expenses over a 10-year period ($323 million per year), and as such, any prudent buyer would consider such expenses as regular and reoccurring. (Reply, p. 10.)

In the EY Report, Petitioner renews its earlier arguments in support of this request to allow for a revised deduction of $340 million from its annualized operating expenses in the CEA value indicator calculation to reflect for the annualized Wildfire Insurance fund Contributions, and cites AH 502, in support of its claim:

> The treatment of some operating expenses may vary depending on whether direct capitalization or yield capitalization (i.e., discounted cash flow analysis) is used. In direct capitalization, expenses are annualized, even though some expenditures may not actually occur on an annual basis. This is a slight deviation from the typical cash flow basis of real estate income and expense analysis. It is necessary because in direct capitalization only a single year's income is capitalized. For example, property insurance may be prepaid for three years, but the appraiser would annualize this expense in direct capitalization.

(EY Report, pp 28-29; citing AH 502, pp 71-72.) Further, Petitioner concludes it is reasonable to include the annualized expenses associated with the full contribution to the wildfire insurance fund and that it is reasonable to capitalize this amount in the CEA expenses. (EY Report, p. 29.) Petitioner's EY Report, Exhibit 2 provides a calculation to support its requested adjustment. (EY

Report, Exhibit 2, pp. 52-53.)

<u>Respondent's Contentions</u>

Respondent contends that consistent with Property Tax Rule 8 and Board issued appraisal guidance, Respondent appropriately did not allow the $2.4 billion initial contribution as an expense in the CEA Value indicator. (SAPD Analysis, pp. 10-11; citing UVM pp. 35-37 and AH 502, p. 74.)

Respondent notes Petitioner admits the Wildfire Insurance Fund-related initial contribution is both a past, and non-reoccurring expense and that it is being amortized over a 10-year period; yet, Petitioner insists this amortized cost should instead be deducted as an ordinary expense because it is intended to reflect anticipated annual operating costs and because, here, the relevant amount is "amortization of a prepaid asset, not depreciation of a capital asset." (SAPD Analysis, p. 11, citing Petition, p. 23.) Respondent contends Petitioner does not explain how this amortized, non-ordinary expense becomes a deductible, ordinary, cash expense. (SAPD Analysis, p. 11.) Further, Respondent notes while Petitioner has cited SAM for the definition of "amortization," Petitioner's cited definition does not explain or support Petitioner's requested treatment of amortized costs within the CEA indicator of value. (SAPD Analysis, p. 11.) Instead, Respondent asserts the treatment of amortization is provided in Rule 8 and AH 502, which support Respondent's underlying assessment. (*Ibid.*) Further, Respondent asserts in *De Luz,* the California Supreme Court has also made clear that amortized costs are not deducted from anticipated income to be capitalized.[34] Respondent concludes that as the $2.4 billion initial contribution is a past expense that need not be paid again, the initial contribution is not deductible from Petitioner's future income stream to be capitalized. (SAPD Analysis, p. 12.)

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[34] Respondent includes selected excerpts to support its summary of *De Luz.* (SAPD Analysis, pp. 11-12.) In determining what costs would be considered in valuing a leasehold interest under a capitalization of income method, the Court stated that:

> ...anticipated net earnings equal expected gross income less necessary expenditures for maintenance, operation, and taxes.[fn omitted] *No deduction is made for the cost of the lease to the present lessee, i.e., his charges for rent and amortization of improvements*, for to a prospective assignee the value of a leasehold is measured solely by anticipated gross income less *expected necessary* expenditures.

(*De Luz Homes, Inc. v. County of San Diego, supra*, p. 566, emphasis added.) The Court concluded:

> Furthermore, in determining the income to be capitalized to establish value for appraisal purposes, *no deduction can be made for amortization*. [Citation.] '[N]o concept of income which includes ... depreciation in capital value as a positive or negative item of income, is acceptable as a basis of valuation under the 'capitalized income' method.' [Citation.]

(*Ibid*.)

However, Respondent notes that Petitioner's required annual contributions to the Wildfire Insurance Fund are allowable, ordinary expenses expected to be paid for a 10-year term. (SAPD Analysis, p. 12.) Accordingly, Respondent allowed this deduction for annual contribution payments by taking the present value of nine[35] future payments (each of $95 million), which resulted in a $624 million reduction to the CEA value indicator and was already reflected in Petitioner's 2020 Board-adopted value. (*Ibid.*)

Additionally, Respondent states that it has treated state-assessees equally, based on a consistent application of the same principals to all utilities contributing to the fund. (SAPD Analysis, p. 12.)

In response to Petitioner's EY Report, Respondent contends that the cited text from AH 502 is misapplied, as the $2.4 billion payment is not prepaid property insurance, but instead a single, one-time, required payment. (Supplemental SAPD Analysis, p. 5.)

Accordingly, Respondent recommends no adjustment as to this issue.

Appeals Conference

At the Appeals Conference on November 12, 2020, Petitioner described the approach to value taken in the EY Report at a high level, reasserting this contention.

Applicable Law and Appraisal Principles

Burden of Proof

Assessing officers are presumed to have properly performed their duties. (Evid. Code, § 664.) Therefore, Petitioner has the burden of showing that the assessment is incorrect or illegal. (*ITT World Communications v. Santa Clara* (1980) 101 Cal.App.3d 246; see also Cal. Code Regs., tit. 18, § 5541, subd. (a).)

Value Standard

Property Tax Rule 2, subdivision (a) states that "in addition to the meaning ascribed to them in the Revenue and Taxation Code, the words "full value," "full cash value," "cash value," "actual value," and "fair market value" mean the price at which a property, if exposed for sale in the open market with a reasonable time for the seller to find a purchaser, would transfer for cash or its

[35] Respondent explains this is because one payment was already rendered in 2019 (past expense), and thus only 9 payments remain to be made in the future. (SAPD Analysis, p. 12.)

equivalent under prevailing market conditions between parties who have knowledge of the uses to which the property may be put, both seeking to maximize their gains and neither being in a position to take advantage of the exigencies of the other."

Income Approach to Value

Property Tax Rule 8, subdivision (a), states that "the income approach is used in conjunction with other approaches when the property under appraisal is typically purchased in anticipation of a money income and either has an established income stream or can be attributed a real or hypothetical income stream by comparison with other properties." Subdivision (b) describes the income approach to value as the valuation method whereby, "an appraiser values an income property by computing the present worth of a future income stream. This present worth depends upon the size, shape, and duration of the estimated stream and upon the capitalization rate at which future income is discounted to its present worth." Subdivision (c) provides that "the amount to be capitalized is the net return which a reasonably well-informed owner and reasonably well informed buyers may anticipate on the valuation date that the taxable property existing on that date will yield under prudent management and subject to legally enforceable restrictions as such persons may foresee as of that date."

The Income Approach: Amortization and Depreciation

The income approach to value is generally described as any method that converts future anticipated income into present value. (UVM, p. 35.) It is premised on the assumption that investors will buy and sell property based on the income it is *expected* to yield. (*Ibid*.) The income that is converted into present value is appraisal income, or "net return" as defined by Rule 8. (UVM, pp. 35-37; Rule 8, subd. (c).) Net return is the difference between gross return and gross outgo. (Rule 8, subd. (c).) Amortization and depreciation are explicitly excluded from gross outgo. (*Ibid*.) AH 502 explains why this is the case:

> The reference to depreciation and amortization in subdivision (c) [of Rule 8] refers to the accounting concept of depreciation (in this context, amortization is a synonym for depreciation). Accounting depreciation and amortization charges are non-cash expenses designed to spread, or match, the cost of a previously incurred cash expenditure over future accounting periods. There are at least two theoretical reasons for the exclusion of accounting depreciation charges as expenses. First, doing so incorporates the recognized cash flow concept of the amount of income to be capitalized. Second, accounting depreciation is a means of capital recovery based on past expenditures. However, in real estate valuation the point is not to recover past expenditures, but rather to estimate the value that future income will be able to recover.

(AH 502, p. 74.) In other words, amortization and depreciation are not deducted when computing the future income stream to be capitalized because doing so would artificially lower that future income stream by subtracting non-cash expenses and would also cause the future income stream to no longer be a *Future Income* stream, as it would include past expenses. The *Supreme Court* has confirmed this understanding in *De Luz*; the Court concluded,

> Furthermore, **in determining the income to be capitalized** to establish value for appraisal purposes, ***no deduction can be made for amortization***. [Citation.] '[N]o concept of income which includes ... depreciation in capital value as a positive or negative item of income, is acceptable as a basis of valuation under the 'capitalized income' method.' [Citation.]

(*De Luz Homes, Inc. v. County of San Diego, supra*, p. 566, emphasis added.)

<u>Appeals Attorney's Analysis and Conclusion</u>

Respondent is presumed to have correctly determined the value of the property at issue, and Petitioner bears the burden of proving otherwise. Here, Petitioner contends that Respondent's calculated present value deduction for the 9 remaining, future Wildfire Insurance Fund payments understates the annualized and prepaid-expenses associated with the full contribution to the wildfire insurance fund; instead, Petitioner asserts the initial contribution of $2.4 billion and the 10 annualized payments should be treated as prepaid, insurance expenses, and capitalized within the Respondent's CEA value indicator calculation as expenses, as such treatment is reasonable in its opinion. However, Respondent notes Petitioner admits the initial contribution has been amortized, and contends amortized or past, non-ordinary expenses are not properly deducted from the CEA Value calculation, as a capitalized earning approach only correctly reflects future, ordinary expenses, not past expenses.

Based on the evidence and arguments submitted to the record to date, the Appeals Attorney finds that Petitioner has not shown specific evidence or argument to prove error within Respondent's calculation, which deducts the present value of the nine future remaining annual payments of $95 million, and is already reflected in Petitioner's 2020 Board-adopted value. Instead, Petitioner continues to assert the full $2.4 billion initial fund should be annualized and deducted as 10 ordinary, operating, prepaid insurance expenses ($323 million as asserted in Petition; or $341 million as later asserted in the EY Report[36]) as it is "reasonable." However, Petitioner fails to reconcile its request with Property Tax Rule 8 and relevant Board guidance, which explicitly disallows amortized expenses from being deducted in the CEA approach.

At the hearing, the parties should be prepared to discuss the issue; further, Petitioner should be prepared to explain: how Respondent specifically erred in its calculation and treatment of Petitioner's remaining Wildfire Insurance Fund annual payments in Petitioner's 2020 Board-adopted unitary value; why, specifically, Petitioner asserts the amortized, initial contribution, must be capitalized and reflected as an annualized ordinary expense, despite *De Luz,* Property Tax Rule 8, and relevant Board guidance; and what legal or appraisal principals, if any, support the allowance of past, amortized expenses in a capitalized earning approach to value, as Petitioner asserts.

<u>ISSUE 5</u>

Whether Petitioner Has Shown that Respondent Failed to Properly Allow $23 Million in Self-Insured Retention Expenses.

<u>Petitioner's Contentions</u>

Petitioner asserts Respondent improperly disallowed $23 million in self-insured retention[37] (SIR) expenses, as such expenses are ordinary operating expenses that must be deducted from its earnings. (Petition, p. 25.) As of the 2020 lien date, Petitioner asserts it has incurred $23 million in SIR expenses for fires that occurred in Southern California in 2019 and this SIR expense must be reflected in Respondent's value indicator calculations. (*Ibid.*) In support of this claim, Petitioner attached Exhibit G to reflect the reduction in value it is claiming attributable to this issue. (Petition, Exhibit G.)

In its Reply, Petitioner renewed its contention, insisting the SIR expenses are ordinary expenses associated with the wildfires that SCE incurs, or expects to incur every year. (Reply, p. 10.)

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[36] No explanation of the difference between the two amounts Petitioner claimed has been provided by Petitioner's briefings or the EY Report.

[37] Petitioner notes SIR can be used in conjunction with a general liability policy to minimize insurance premiums, i.e. a company will pay for losses as they occur, rather than paying for them in advance via insurance premiums. SIRs are similar to an insurance deductible, in a sense. SIRs are determined by the company itself based on the amount of risk it wants to retain, which then becomes the SIR. If a loss is sustained less than the SIR, the company pays the entire amount of the loss rather than pursuing recovery via an insurance claim.

In the EY Report, Petitioner revised its requested adjustment to $211 million, based on capitalizing the annual $23 million SIR expense into perpetuity.[38] (EY Study, pp 32-33; EY Study, Exhibit 4, pp.56-57.)

Respondent's Contentions

Respondent initially contended SIR expenses are not ordinary in nature, and are not recurring future annual expenses, and thus are properly not deducted when calculating the CEA value indicator, under Rule 8. (SAPD Analysis, p. 12.)

Appeals Conference

At the Appeals Conference on November 12, 2020, Petitioner described the approach to value taken in the EY Report at a high level, reasserting this contention. At the close of the Appeals Conference, Respondent requested Petitioner provide additional detail about the SIR expenses, including evidence to support whether the SIR expenses are recoverable within Petitioner's rates.

The Appeals Attorney facilitated this data request and Petitioner provided the requested data on November 19, 2020.

Respondent's Supplemental Analysis and Recommendation

Respondent's Supplemental Analysis renewed its position that SIR expenses related to wildfire issues are not allowable expenses. (Supplemental SAPD Analysis, p. 5.) However, after review of Petitioner's supplemental information, Respondent is satisfied that SIR expenses are recoverable in Petitioner's rates and, thus, can reasonably assume they are also included in SCE's Revenues.[39](*Ibid.*) Accordingly, Respondent is recommending the removal of these expenses from the lien date 2020 appraisal and from Petitioner's revenue. (*Ibid.*) Based on this adjustment, Respondent recommends removing $23 million from revenues, resulting in an overall value reduction of $52,774,025. (*Ibid.*)

Applicable Law and Appraisal Principles

Burden of Proof

Assessing officers are presumed to have properly performed their duties. (Evid. Code, § 664.) Therefore, Petitioner has the burden of showing that the assessment is incorrect or illegal. (*ITT World*

[38] Petitioner does not appear to provide a supporting calculation within the EY Report or other exhibits.
[39] While Petitioner has made a showing as to 2020, Respondent intends to verify whether SIR expenses are included in Petitioner's revenues for lien date 2021.

Communications v. Santa Clara (1980) 101 Cal.App.3d 246; see also Cal. Code Regs., tit. 18, § 5541, subd. (a).)

Income Approach to Value

Property Tax Rule 8, subdivision (a), states that "the income approach is used in conjunction with other approaches when the property under appraisal is typically purchased in anticipation of a money income and either has an established income stream or can be attributed a real or hypothetical income stream by comparison with other properties." Subdivision (b) describes the income approach to value as the valuation method whereby, "an appraiser values an income property by computing the present worth of a future income stream. This present worth depends upon the size, shape, and duration of the estimated stream and upon the capitalization rate at which future income is discounted to its present worth." Subdivision (c) provides that "the amount to be capitalized is the net return which a reasonably well-informed owner and reasonably well informed buyers may anticipate on the valuation date that the taxable property existing on that date will yield under prudent management and subject to legally enforceable restrictions as such persons may foresee as of that date."

Appeals Attorney's Analysis and Conclusions

Respondent is presumed to have correctly determined the value of the property at issue, and Petitioner bears the burden of proving otherwise. Here, Petitioner contends that Respondent improperly disallowed $23 million in SIR expenses; further, Petitioner contends such expenses should be capitalized annually in perpetuity, resulting in a reduction of $212 million, as calculated by EY. (EY Report, pp. 32-33.). Respondent contends that such expenses are not properly treated as annual, ordinary expenses under Rule 8; however, based on further review of Petitioner's supplemental information, Respondent has established that the SIR expenses are recoverable in Petitioner's rate, and as such, the $23 million should be removed from Petitioner's revenue. Accordingly, Respondent is recommending an overall value reduction of $52,774,025 as to this issue. Petitioner has not indicated agreement with Respondent's adjustment and, thus, continues to assert that its requested adjustment of $211 million, based on capitalizing the $23 million of SIR expenses annually in perpetuity, more accurately reflects the overstated value within Petitioner's assessment.

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Based on the evidence and arguments submitted to the record to date, the Appeals Attorney finds that Respondent's recommendation is reasonable and supported by the pleadings, evidence, and relevant legal and appraisal principals asserted as to this issue. Further, the Appeals Attorney finds Petitioner has not shown specific evidence or argument to prove error in Respondent's recommended reduction submitted within Respondent's Supplemental Analysis.

At the hearing, the parties should be prepared to discuss the issue; further, Petitioner should be prepared to explain: whether Petitioner agrees with Respondent's recommendation; if not, how Respondent's recommended adjustment specifically errs in its treatment of Petitioner's SIR expenses; why, specifically, Petitioner asserts the SIR expenses must be capitalized and reflected as an annual ordinary expense, in light of Property Tax Rule 8 and relevant Board guidance; and what legal or appraisal principals support the allowance of non-ordinary, non-recurring expenses in a capitalized earning approach to value, as Petitioner asserts.

<u>ISSUE 6</u>

Whether Petitioner Has Shown that Respondent Failed to Account for All Obsolescence Within the HCLD Value Indicator, After Respondent's Application of the Equity Risk Premium.

<u>Petitioner's EY Report</u>

In Petitioner's EY Report, Petitioner requests a $1.289 billion economic obsolescence adjustment to the HCLD value indicator. (EY Report, pp. 25-26.) Petitioner asserts this will account for the fact that SAPD allowed a 0.85 percent equity risk premium adjustment to the capitalization rate used in the CEA value indicator calculation, which resulted in a reduction of Respondent's calculated CEA value of approximately $1.3 billion. (EY Report, pp. 25-26.) Petitioner appears to argue that the difference in the CEA value, i.e. before and after the equity risk premium adjustment is applied, is equal to the amount of economic obsolescence that should be adjusted for in the HCLD value indicator.

<u>Respondent's Contentions</u>

Respondent notes it did allow a 0.85 percent equity risk premium, over and above that allowed by the CPUC in determining the CPUC rate of return; the increased equity risk premium resulted in an increased capitalization rate to determine Petitioner's CEA value indicator. (Supplemental SAPD

Analysis, pp. 5-6.)

After review and consideration of Petitioner's request for a $1.289 billion economic obsolescence adjustment to the HCLD indicator to account for the equity risk premium adjustment applied within the increased capitalization rate, SAPD agrees an adjustment should be made to the HCLD indicator, as with the risk premium added, assets are considered underearning and, therefore, suffering from economic obsolescence. (Supplemental SAPD Analysis, p. 6.) However, Respondent does not agree with Petitioner's proposed calculation, as it incorrectly equates the CEA adjustment to the HCLD adjustment. (*Ibid.*) Instead, Respondent determined the recommended obsolescence adjustment percentage to the HCLD value indicator by comparing the effect on the HCLD of the CPUC-approved capitalization rate with the capitalization rate used by staff. (Supplemental SAPD Analysis, p. 6 and Exhibit 1.) Respondent asserts applying this percentage to the assessable assets yields the level of economic obsolescence suffered by the assets, which resulted in a $1.686 billion economic obsolescence adjustment to the HCLD indicator. (*Ibid.*) Accordingly, Respondent recommends an overall unitary value reduction of $1,264,780,825, reflecting its recommended economic obsolescence adjustment to the HCLD indicator. (*Ibid.*)

Applicable Law and Appraisal Principles

Burden of Proof

Assessing officers are presumed to have properly performed their duties. (Evid. Code, § 664.) Therefore, Petitioner has the burden of showing that the assessment is incorrect or illegal. (*ITT World Communications v. Santa Clara* (1980) 101 Cal.App.3d 246; see also Cal. Code Regs., tit. 18, § 5541, subd. (a).)

Value Standard

Property Tax Rule 2, subdivision (a) states that "in addition to the meaning ascribed to them in the Revenue and Taxation Code, the words "full value," "full cash value," "cash value," "actual value," and "fair market value" mean the price at which a property, if exposed for sale in the open market with a reasonable time for the seller to find a purchaser, would transfer for cash or its equivalent under prevailing market conditions between parties who have knowledge of the uses to which the property may be put, both seeking to maximize their gains and neither being in a position to take advantage of the exigencies of the other."

HCLD Approach to Value

Property Tax Rule 3, subdivision (d) provides the HCLD approach to value shall be considered "[i]f the income from the property is regulated by law and the regulatory agency uses historical cost or historical cost less deprecation as the rate base, the amount invested in the property or the amount invested less depreciation computed by the method employed by the regulatory agency." HCLD, with some modification, approximates the rate base that regulators use in establishing revenue requirements. (See *UVM*, p. 1.) HCLD reflects the market value contribution of all taxable property including the depreciated historical cost of plant in service, possessory interests, construction work in progress, and materials and supplies. (AH 502, p. 146.) HCLD is,

> one of the more important indicators of value for closely regulated public utilities. The general practice of the California Public Utilities Commission (CPUC) and most other regulatory agencies is to use historical or original cost less depreciation (with various adjustments) as the rate base. The regulatory agencies establish a rate base and a rate of return; utilities are permitted to earn at this established rate on the rate base.

(UVM, p. 1.) Further, Board guidance states,

> Appraisal depreciation in the form of obsolescence may be present in utility property and deducted from HCLD. Such deductions may be proper when the utility's economic income has been impaired and the rate or tariff-setting regulators have recognized such impairment.

(UVM, p. 1.)

Appeals Attorney's Analysis and Conclusions

Respondent is presumed to have correctly determined the value of the property at issue, and Petitioner bears the burden of proving otherwise. Here, Petitioner contends that Respondent has failed to fully adjust for economic obsolescence present in the HCLD value indicator, after Respondent's adjustment to the capitalization rate used in the CEA value approach, to account for the 0.85 percent equity risk premium. Petitioner asserts the economic obsolescence present is equal to and proven by the difference in the CEA value approaches, as calculated before and after the equity risk premium adjustment. While Respondent acknowledges there is additional economic obsolescence present in the HCLD approach, Respondent contends this economic obsolescence is correctly quantified by instead comparing the effect on HCLD of the CPUC-approved capitalization rate with the capitalization rate utilized by staff, after the equity risk premium was applied. Based on Respondent's calculation, Respondent recommends an economic obsolescence adjustment to the HCLD value indicator of $1.686 billion, resulting in a recommended overall value reduction of $1,264,780,825.

Based on the evidence and arguments submitted to the record to date, the Appeals Attorney finds that Respondent's recommendation is reasonable and supported by the pleadings, evidence, and relevant legal and appraisal principals asserted as to this issue. Further, the Appeals Attorney finds Petitioner has not shown specific evidence or argument to prove error within Respondent's recommended economic obsolescence adjustment submitted within Respondent's Supplemental Analysis.

At the hearing, the parties should be prepared to discuss the issue; further, Petitioner should be prepared to explain: whether Petitioner agrees with Respondent's recommendation; and, if not, how Respondent's calculation specifically errs or fails to account for any additional economic obsolescence.

Staff Comment: Rev. & Tax. Code, Section 40

As noted above, this matter is subject to Rev. & Tax Code, section 40. The Board's decision on this petition is final. (Cal. Code Regs., tit. 18, § 5345, subd. (a)(1).) Thus, within 120 days from the date of the Board's vote to decide the appeal, a written opinion (i.e., Summary Decision or Formal Opinion) must be published on the Board's website. (Cal. Code Regs., tit. 18, § 5552, subds. (b), (f).)

Following the conclusion of this hearing, if the Board votes to decide the appeal, but does not specify whether a Summary Decision or a Formal Opinion should be prepared, staff will expeditiously prepare a nonprecedential Summary Decision and submit it to the Board for consideration at a subsequent meeting. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(2).) Unless the Board directs otherwise, the proposed Summary Decision would not be confidential pending its consideration by the Board (Cal. Code Regs., tit. 18 § 5551, subd. (b)(5)); accordingly, it would be posted on the Public Agenda Notice for the meeting at which the Board will consider and vote on the Summary Decision.

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