CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Petition for Reassessment of the 2022 Unitary Value for:

SOUTHERN CALIFORNIA EDISON COMPANY (0148)

Petitioner

Appeal No.: SAU 22-006

Oral Hearing Date: December 13, 2022[1]

Representing the Parties:

For the Petitioner:	Mardiros H. Dakessian, Attorney Dakessian Law, LTD.
	Charles Moll, Attorney McDermott Will & Emery
For the Respondent:	Richard Moon, Attorney V Attorney for State-Assessed Properties Division
	David Lujan, Tax Counsel Attorney for State-Assessed Properties Division
	Jack McCool, Chief State-Assessed Properties Division
Appeals Attorney:	Sonya Yim, Tax Counsel IV

VALUES AT ISSUE

	Value	Penalty	Total
2022 Board-Adopted Unitary Value	$34,274,700,000	$0	$34,274,700,000
Petitioner's Requested Unitary Value	$26,996,100,000	$0	$26,996,100,000
Respondent's Appeal Recommendation	$34,274,700,000	$0	$34,274,700,000
2022 Board-Determined Value on Appeal	$34,274,700,000	$0	$34,274,700,000

[1] At the oral hearing, the Board denied the petition for reassessment and affirmed the 2022 Board-adopted unitary value, by a majority vote of the Members, with Chair Cohen, Vice-Chair Schaefer, Member Vazquez, and Controller Yee voting aye, and Member Gaines voting no.

Factual Background

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.

The CPUC establishes rates for utilities under its jurisdiction in a rate-setting procedure called the General Rate Case (GRC).[2] 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.

The State-Assessed Properties Division (SAPD or Respondent) calculated Petitioner's 2022 Board-adopted value by placing 75 percent reliance on the Historical Cost Less Book Depreciation (HCLD)[3] value indicator ($36,406,485,637) and 25 percent reliance on the Capitalized Earning Ability[4] (CEA) value indicator ($27,879,526,303). The CEA value indicator calculation is based on a perpetual life premise, where the capital investment necessary to maintain a perpetual income flow is deducted from expected revenues, reflecting the annual capital replacement allowance.

General Contentions and Background Raised by the Parties

Petitioner and Respondent each discussed general information they found relevant and raised a variety of concerns within their filings and at the Oral Hearing; this included: information related to SCE's past, current, and future financial and economic situation; the risks associated with wildfires; the context of the Board's valuation; and the state of the regulated electric generation industry as a

[2] The Commission's Rules of Practice and Procedure Article 2 and Appendix A of the Commission decision (D07-07-004) set the rules and procedures for GRC review process.
[3] The HCLD value indicator is a form of the cost approach to value. The Historical Cost Less Depreciation (HCLD) value indicator derivation includes the historical or original acquisition cost of all property less nontaxable items and property assessed elsewhere. This results in the taxable historical cost. The taxable historical cost is then reduced for the assessee's regulatory accounting depreciation of the taxable property. This results in the assessable HCLD. The value of any possessory interest and/or noncapitalized leased properties are added to arrive at the final HCLD value indicator. HCLD is one of the more important indicators of value for closely regulated public utilities. See Cal. Bd. Of Equaliz. *Unitary Valuation Methods (UVM)* (2003), pp. 1-4.
[4] The CEA value indicator is a form of the income approach to value. The income approach to value may be generally described as any method that converts future anticipated income into present value. The conversion process is commonly known as income capitalization. See Cal. Bd. Of Equaliz. *UVM*, (2003), pp. 35-37.

whole. The specific issues Petitioner raised with its 2022 Board-adopted value are addressed under headings: Legal Issue 1 through Legal Issue 5. A summary of these general contentions is provided first to provide factual context to the Board's disposition of this Petition, followed by the disposition of each Legal Issue raised.

As a prefatory matter, each party provided remarks on the overall reasonableness of SCE's 2022 Board-adopted unitary value. Petitioner contends that the mere magnitude of the $8 billion discrepancy between the HCLD and CEA value indicators is unacceptable from an appraisal standpoint, which in short, allegedly supports their claim that SAPD's appraisal is unlawful and improper. However, Respondent points out that Petitioner's requested 2022 value of $26.9 billion is $4.3 billion less than the 2021 Board-adopted value, despite $4.6 billion[5] of asset additions in calendar year 2021 now reflected in the 2022 Board-adopted unitary value.

Next, Petitioner raises four general concerns, asserting these are the various business risks and other factors affecting SCE's 2022 unitary value: 1) the context of increasing catastrophic wildfires in California; 2) California's use of "inverse condemnation[6]" which "imposes strict liability…based on the presumption that a utility has the ability and is the appropriate agency to recover such costs from customers" and uncertainty as to whether the CPUC will allow liability to be recovered in the rate base[7]; 3) the challenges and cost prohibitive nature of obtaining insurance coverage due to wildfire risk arising from its ordinary operations; 4) Wildfire Mitigation Plans and the Wildfire Insurance Fund, including specifically California's Senate Bill (SB) 901[8] (Ch. 626, Stats. 2018) and the Wildfire Insurance Fund created by Assembly Bill (AB) 1054 (Ch. 79, Stats 2019), which statutorily required Petitioner to make an initial contribution of $2.4 billion, and 10 annual contributions of $95 million each, and Petitioner's statutory requirement to maintain reasonable insurance coverage, which must be

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[5] Respondent notes the cited approximate $4.6 billion in additions is the net amount after taking into account asset retirements during calendar year 2021, and is exclusive of approximately $2 billion in construction work in progress.

[6] Inverse condemnation is a legal concept that entitles property owners to just compensation if their property is damaged by a public use. This liability rule applies to all government agencies, as well as utilities. After a wildfire, inverse condemnation is the way that victims of fires (residents, businesses, and local agencies) recover their costs. See League of California Cities "Inverse Condemnation Fact Sheet" https://www.counties.org/post/inverse-condemnation-fact-sheet.

[7] Petitioner cites 2017 CPUC ruling for San Diego Gas & Electric company (SDG&E), which held SDG&E liable for damages due to finding SDG&E had not taken reasonable actions prior to 2007 and thus not properly invoked inverse condemnation to allow cost sharing through utility rates. (CPUC, App. No. 15-09-010 and Decision 17-11-033.)

[8] SB 901 established, among other provisions, CPUC's reasonableness review of utility activities to determine whether, or not, cost recovery through the rate base is allowable when the wildfire is caused by the utility's equipment, without altering California's application of inverse condemnation.

exhausted prior to Wildfire Insurance Fund reimbursement becoming available to Petitioner. Petitioner contends that despite SAPD's claims of multiple and generous adjustments that the Board should not conflate the wildfire risk premium adjustment discussion with the specific issues raised in SCE's petition (discussed *infra*, at Issues 1-5).

Respondent notes that the risks cited are only one of many factors that affect appraisal, and that they do not acknowledge the fact that Respondent has already made multiple adjustments within Petitioner's 2022 unitary value, which total approximately $2.59 billion. Respondent highlights four specific adjustments which have already been included in SCE's 2022 Board-adopted value:

- AB 1054[9] requires SCE to pay an additional $95 million per year for 10 years into the wildfire fund. Staff has made an adjustment to account for this requirement which resulted in an approximately $136 million value reduction.

- SCE has requested a .85% wildfire risk premium be added to its capitalization rate. Staff has made an adjustment to account for this request, which resulted in an approximately $416 million value reduction.

- AB 1054 requires SCE to make $1.6 billion in capital expenditures over a three year period for fire risk mitigation purposes. The assembly bill precludes SCE from earning an equity return on these capital expenditures. As of the 2022 lien date, SCE has made $1.6 billion in capital expenditures for this purpose. Staff has made an adjustment to account for SCE's inability to earn an equity return on these expenditures, which resulted in an approximately $513 million value reduction.

- Staff made an obsolescence adjustment to the HCLD indicator to acknowledge additional obsolescence resulting from the .85% equity risk premium addition to the capitalization rate. This adjustment resulted in an approximately $1.528 billion value reduction.

(See Exhibit B attached to SAPD Analysis, Appraisal Data Report. See also Appraisal Narrative, 2022 Lien Date, for Southern California Edison Company, submitted as SAPD's oral hearing Exhibit E.)

Then, Respondent contends, these, among other arguments regarding a general increase in business risk due to wildfires, are the same arguments Petitioner made—and the Board rejected—for the last two years.[10] Further, Respondent notes these are also the same arguments the CPUC rejected in

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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 Petitioner.

[10] California State Board of Equalization, Appeal SAU 20-015, decided December 16, 2020, and Appeal SAU 21-007, decided December 14, 2021.

SCE's request for a wildfire risk premium adjustment to increase the return on equity[11] (ROE) allowed in 2019. (CPUC Decision 19-12-056 (Dec. 19, 2019), pp. 40-41.) In the CPUC case,[12] the CPUC stated:

> 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.*[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.*" (CPUC Decision 19-12-056, at p. 37; emphasis added by Respondent.) The CPUC also stated "[b]ased 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.) Respondent notes that Petitioner also recognized its significant reduction of risk of liability as Petitioner voluntarily significantly reduced its ROE increase request in the CPUC case following the passage of AB 1054. (*Id.*, at p. 28.)

In addition, Respondent notes that similar to SCE's 2021 unitary value, and even though the CPUC denied Petitioner's increased ROE request based on its conclusion that mitigation measures and AB 1054 had sufficiently addressed wildfire risk, SAPD has again allowed an increased equity risk premium of .85 percent to Petitioner's 2022 overall capitalization rate. This equity risk premium resulted in an approximately $1.9 billion value reduction, which was allowed to acknowledge risk that might not be captured in the other adjustments allowed for the Petitioner.

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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/industries-and-topics/electrical-energy/electric-costs/cost-of-capital> and <https://www.cpuc.ca.gov/industries-and-topics/electrical-energy/electric-costs/historical-electric-cost-data/rate-of-return> [As of Nov. 21, 2022.]

[12] California Public Utilities Commission Decision 19-12-056 (D1912056) (Dec. 19, 2019), p. 28 available at <https://docs.cpuc.ca.gov/DecisionsSearchForm.aspx> [as of Nov. 21, 2022].

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

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).)

Analysis and Disposition of General Contentions

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 the mere magnitude of the $8 billion discrepancy between the HCLD and CEA value indicators is unacceptable from an appraisal standpoint, which allegedly supports their claim that SAPD's appraisal is unlawful and improper. Additionally, Petitioner asserts the existence of additional business risk from wildfires was not fully reflected in the Board adopted value. However, Respondent contends risk is only one of many factors that affects appraisal and that the cited risks have already been adjusted for, as reflected in the 2022 appraisal narrative. Further, Respondent points out that Petitioner's 2021 calendar year asset additions support the year over year valuation increase. While Respondent raises Petitioner's prior CPUC proceeding as evidence that such risk was viewed as adequately captured in the rate base, we note that such a finding has relevance to the instant proceeding, particularly as it relates to the determination of the rate base utilized by Respondent in the development of the HCLD value indicator; however, we also note that Petitioner's specific factual contentions and legal issues have been fully considered by the Board, herein, as a case of first impression.

While these general risks and factors are relevant to the context of this appeal, we find that no general concern raised proves *ipso facto* that Respondent erred in the calculation of SCE's 2022 Board-adopted unitary value. Further, we also find that to the extent that Petitioner introduced these facts and contentions to provide context to the specific legal issues raised in this petition, Petitioner bears the burden of proof to show error within Respondent's calculation of the 2022 Board-adopted unitary value with regard to each specific legal issue raised before the Board.

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<u>Legal Issues 1 and 2:</u>

Whether Petitioner Has Shown that Respondent Has Failed to Reconcile the Historical Cost Less Depreciation (HCLD) Value Indicator and the Capitalized Earning Ability (CEA) Indicator of Value and/or Otherwise 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.

<u>Findings of Fact and Related Contentions</u>

Based on the two contentions described below, Petitioner claims that the Board must revise its 2022 unitary value by instead placing 25 percent reliance on the HCLD value indicator and 75 percent reliance on the CEA value indicator, as this is more reliable, in its opinion, than utilizing Respondent's reconciliation of the two value indicators.

<u>While Petitioner asserts Respondent has not reconciled the $8 billion in value difference between the HCLD and CEA value indicators in violation of the Assessors' Handbook, Respondent maintains the reconciliation of Petitioner's value indicators is appropriate and consistent with relevant legal and appraisal guidance.</u>

Petitioner asserts Respondent's appraisal is flawed as the two value approaches utilized produced widely varying results. 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 in an analytical manner based on verified market data, which, in Petitioner's opinion, is contrary to the guidance within Assessors' Handbook (AH), section 501, *Basic Appraisal* (AH 501).[14] Petitioner also asserts that the disparity in value indicators signals that Respondent has not addressed all economic and functional obsolescence or impairment, as AH 502, *Advanced Appraisal* (AH 502),[15] warns is possible. In support of this, Petitioner cites to AH 502, which states that a "CEA indicator which is much lower than HCLD may indicate that obsolescence exists in the property."

As described in greater detail under the second assertion, Respondent maintains it appropriately

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[14] Cal. Bd. Of Equaliz., Assessor's Handbook, section 501, *Basic Appraisal* (Jan. 2002)
[15] Cal. Bd. Of Equaliz., Assessor's Handbook, section 502, *Advanced Appraisal* (Dec. 1998, Reprinted Jan. 2015)

reconciled Petitioner's two value indicators within Petitioner's 2022 Board-adopted value. Respondent also contends that Petitioner's assertion that the difference between the HCLD and CEA methods is entirely attributable to economic and/or functional obsolescence is wholly unsubstantiated. Respondent therefore maintains that no adjustment is warranted as to this contention.

<u>While Petitioner asserts Respondent has improperly weighted the HCLD value indicator as 75 percent and the CEA approach at 25 percent, Respondent maintains it appropriately reconciled the two value indicators consistent with relevant legal and appraisal guidance.</u>

Petitioner asserts that Respondent has arbitrarily weighted the value indicators, which is underscored by the admission that it is the same reliance used to value Petitioner's property in each of the past 10 years, despite recent changes in circumstances and increasing risks and costs related to the ownership of Petitioner's property. Petitioner recommends that the Board instead weigh the two value indicators as 75 percent income approach and 25 percent cost approach.

Petitioner further asserts that Property Tax Rule[16] 8 indicates the income approach must be granted additional weight. Petitioner asserts that the rate base determined by the CPUC is intended to achieve a fair balance between what rate payers bear and what utility shareholders earn, and not to establish the fair market value of the utility's property. Petitioner further argues that the HCLD indicator calculated by SAPD is unreliable when Respondent includes assets not included in the rate base and does not recognize impairments due to regulatory restrictions placed on certain assets (i.e., the inability to earn a return), and as such, additional reliance placed on the income indicator captures the economic impairment due to wildfire risks and increased regulatory restrictions. Petitioner cites that the Ernst & Young, LLP (EY) report[17] it commissioned in the SAU 20-015 appeal for lien date 2020, supports this view and reconciles the two approaches appropriately, in its opinion, and considers Petitioner's perceived flaws with Respondent's approach.

Petitioner further contends that Respondent acknowledges a limited understanding of "regulatory lag"[18] but continues to argue that the CEA indicator should be given less reliance in

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[16] All references to "Property Tax Rule" or "Rule(s)" are to sections of title 18 of the California Code of Regulations.
[17] Petitioner has included a draft copy of the Ernst & Young, LLP (EY) Valuation Analysis, dated November 9, 2020 (EY Report) as Petition, Appendix B).
[18] Regulatory lag is the time delay between a utility's costs and any adjustment CPUC may make to the rate base to account for these costs. This process creates a lag between the time the assets are placed in service and the time the company begins to get a recover of and recovery on the assets.

Petitioner's overall value, contrary to Rule 8.

Petitioner asserts the changes that have taken place during the last 10 years in terms of wildfires and shifts in the business environment and regulatory restrictions, coupled with Respondent's failure to reconcile the $8 billion difference in the HCLD and CEA approaches have rendered Respondent's appraisal completely disconnected from what a willing buyer would pay.

Respondent has conducted its appraisal by calculating and reconciling the HCLD and CEA value indicators, consistent with relevant law and appraisal guidance.[19] 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.[20] 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. (*UVM,* p. 1. Emphasis added by Respondent.) 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 here, Petitioner has an established income stream.

Respondent states that consistent with the relevant HCLD and CEA value indicator considerations, and Petitioner being a utility, rate regulated by the CPUC, Respondent considered HCLD to be the most reliable indicator of value, placing 75 percent reliance on the indicator. 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." 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.

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

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[19] Assessing officers are presumed to have properly performed their duties. (Evid. Code, § 664.)
[20] Respondent cites *Unitary Valuation Methods* (*UVM*) (2003), p. 1, as well as excerpts from AH 502, p. 146, which further support the use of the HCLD approach as relevant for public utility properties.

Respondent contends, while Petitioner sees this consistency as a flaw or indication that changes have not been reflected related to the climate, utility industry, and to Petitioner specifically, Respondent asserts Petitioner ignores the fact that a change in weighting is not the sole method by which significant value adjustments can be made to reflect such factors, such as the approximately $2.59 billion downward adjustment Respondent has already made to account for wildfire risk.

Respondent notes significant differences in the two value approaches can and may occur without compromising the validity of the underlying value approach, as Assessors' Handbook, section 501 (AH 501) *Basic Appraisal,* states that although the approaches to value should *theoretically* produce identical value indicators, in practice, "*this is rarely the case, and significant differences may occur*." (AH 501 at p. 62, emphasis added by Respondent.) Respondent further notes that AH 501 goes on to state that the appraiser reconciles the indicators from each approach utilized to produce a final value estimate, and that value indicators should be reconciled considering (1) the appropriateness of the approach given the purpose of the appraisal; and (2) the adequacy and reliability of the data available to perform the appraisal. (*Ibid*.)

Specifically, Respondent notes that when analyzing and reconciling value indicators to arrive at a final value estimate, the criteria described in AH 502 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 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.

(AH 502, p. 111; Emphasis added by Respondent.)

Finally, Respondent notes it is unclear how Petitioner arrived at its requested weighting of the CEA and HCLD indicators. Respondent points out that in 2020, Petitioner requested 50 percent weighting of the CEA value indicator in its original petition, before revealing at the hearing its revised opinion of value placed 35 percent reliance on the CEA indicator, with no explanation for the change. Then in 2021, Petitioner requested a 35 percent weighting of the CEA value indicator based on the same arguments, with no explanation for the change. Now, in 2022, Petitioner requests a 75 percent weighting of the CEA value indicator based on the same arguments and presumptive risk analysis developed in 2020, without explanation for the change. Respondent concludes while Petitioner criticizes SAPD's reasoning, Petitioner has not provided a basis for the reconciliation of the value indicators it requests in this petition in an "analytical manner" that is based on a "reasoned and defensible opinion of verified market data." (AH 502, p. 62.)

<u>**Applicable Law and Appraisal Principles**</u>

<u>**Burden of Proof**</u>

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).)

<u>**Value Standard**</u>

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."

<u>**HCLD Approach to Value**</u>

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.) 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.)

<u>Depreciation and the Cost Approach</u>

In general, the cost approach recognizes three types of depreciation: physical deterioration, functional obsolescence, and external, or economic, obsolescence, through the application of the Board's replacement cost new trend factors and "percent" good factors. Obsolescence may occur when property is outmoded (functional obsolescence) or when some event has substantially diminished the future earning power of the property (economic obsolescence). (See Assessors' Handbook section 501, *Basic Appraisal* (January 2002), pp. 80-83.) Functional obsolescence is the loss of value in a property caused by the property's loss of capacity to perform the function for which it was intended. (*Id*. at p. 81.) Economic obsolescence is the diminished utility of a property due to adverse factors external to the property being appraised and is incurable by the property owner. (*Id*. at p. 82.) The existence of any additional or extraordinary obsolescence must be supported with verifiable documentation and evidence, consistent with Board Guidelines. (See Property Tax Rule 6, subds. (d) & (e); Assessors' Handbook section 502, *Advanced Appraisal* (Reprinted January 2015) (AH 502), pp. 20-21; *Unitary Valuation Methods*, (2003), p. 30; and Cal. Bd. of Equalization, *Guidelines for Substantiating Additional Obsolescence*, at p. 1.)

<u>Income Approach to Value</u>

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.)

Analysis and Disposition

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 exceeds the CEA value indicator by $8 billion, Respondent's 2022 Board-adopted unitary value is flawed, as the various approaches to value must yield approximately the same results, and differences of such a magnitude indicate the value indicators were not reconciled. Further, Petitioner contends Respondent did not reconcile the two value indicators, as required by Property Tax Rule 3 and Board Guidance, but instead "simply states that the final value estimate is an appraiser's opinion of value." However, as Board guidance and Respondent note, significant differences may occur in validly calculated indicators. Additionally, Petitioner asserts that the difference in the two valuation approaches must be due to economic or functional obsolescence, but submits no evidence to substantiate this claim. While Petitioner advances various arguments, Respondent contends that in light of all available evidence, it was reasonable and appropriate to place 75 percent reliance on the HCLD value indicator, which reflects the consideration of many factors, including: Petitioner's "regulatory lag," Petitioner's established income stream, the relative reliance placed on the value indicators of other rate-base regulated utilities, and consistency with Property Tax Rules 3, 6, and 8, as well as relevant Board guidance.

We concur with Respondent and find no error within the reconciliation of Petitioner's 2022 unitary value. Further, based on the evidence and arguments submitted to the record, we find that Petitioner has not provided specific evidence or argument to prove that its HCLD indicator is impaired, nor has Petitioner shown that its CEA value indicator must be granted additional weight. Petitioner appears to be asserting the Board should adopt the appraisal judgment of the 2020 draft EY Report or, alternatively, adjust the weighting of the indicators pursuant to its request, without putting forth any specific argument or evidence to support their request for additional weight to be placed on the CEA value indicator, despite bearing the burden of proof to show error or illegality. Finally, we note Petitioner's assertion that the difference in the HCLD and CEA value indicators being attributed to obsolescence is unsupported. Accordingly, we find Petitioner has not met their burden of proof as to this issue.

<u>Legal Issue 3:</u>

Whether Petitioner Has Shown that Respondent Must Adjust the Board-Adopted Value for SCE's $1.635 Billion Accrual for Liabilities for the 2017/2018 Wildfires and Mudslides.

<u>Findings of Fact and Related Contentions</u>

Petitioner asserts the 2022 Board-adopted value does not account for SCE's accrual for liabilities for the 2017/2018 wildfires and mudslides, erroneously disregarding costs for estimated claims and settlements pre-AB 1054, just as Respondent has done in its 2019, 2020, and 2021 assessments. Petitioner argues that Respondent has improperly made no adjustments to reflect the expected losses in SCE's unitary assessments, despite valuation of a going concern requiring consideration of forecasted future expenses, as a potential buyer would become responsible for those liabilities and factor those obligations into the purchase price. Accordingly, Petitioner requests an adjustment of $1.635 billion from both the HCLD and CEA values to account for these operating expenses above and beyond insurance recoveries.

Petitioner asserts that Respondent ignores Petitioner's wildfire-related expenses as past expenses that are not anticipated to be incurred again in the future. Petitioner refutes this by stating that its request for an adjustment of $1.635 billion represents quantifiable operating expenses which negatively impact the going concern value of its property, rather than a contractual or financing liability. Petitioner contends such expenses are ordinary and necessary parts of SCE's operation as a going concern, and even if they were not ordinary in the "new normal" of year-round wildfires in California, Respondent does not provide citation to support excluding a non-ordinary expense that is anticipated in the future.[21] Petitioner further asserts that Rule 8 and AH 502 require the inclusion of anticipated income and operating expenses, and that Respondent cites no authority to exclude a non-ordinary expense that is anticipated in the future.

Petitioner does not dispute that the liabilities at issue stem from 2017 and 2018 events, but asserts that SAPD is wrong in stating that these claims and settlements will neither continue to increase, nor be paid in the foreseeable future. In the current year, SCE claims to have incurred additional losses related to these events of $1.3 billion. Petitioner additionally notes that AB 1054's remedies do not address the losses/settlements related to the 2017 and 2018 Wildfire/Mudslide events, as it only covers wildfires occurring on or after July 2019. Thus, Petitioner asserts that while the

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[21] In support, Petitioner cites a general statement from AH 502 to support this position. AH 502, p. 67 states, "Cost trends relating to the components of operating expenses should be studied to estimate the future level of operating expenses." Petitioner 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 is exhausted.

initial liability stems from past events, that does not change that it is resulting in ongoing expenses to SCE as claims are settled and paid, and such expenses would be considered by any willing buyer, and thus, must be allowed.

Respondent notes Petitioner claims that SAPD has erroneously disregarded $1.635 billion of accrued liability related to "Wildfire-related claims" dating back to 2017 and 2018, and requests that adjustments be made to both the HCLD and CEA value indicators because a knowledgeable buyer would take these liabilities into account when valuing those assets. In general, Respondent notes that it is unclear, however, why these liabilities, which arguably reduce the value of Petitioner's *business* as a going concern, necessarily results in a reduction to the value of its *property* as a going concern or its taxable unitary value, nor why Petitioner equates the valuation of its *property* as a going concern with the value of its *business* as a going concern, as none of the authorities Petitioner cites supports that proposition.

Respondent notes that consistent with the California Constitution Article XIII, section 1, the standard of value is fair market value. 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.

(*ITT, supra*, (1985) 37 Cal.3d at 864-865, emphases added by Respondent.) Respondent notes this is explained for purposes of California property tax purposes by AH 502 as follows:

> "Going concern value" is a term that has been used in a variety of contexts, and more than one definition of the term can be found in the appraisal literature. Also, there are different meanings for California property tax purposes and more than one meaning even within California property tax law.
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> ¶ ... ¶
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> Outside the property tax arena, going concern appraisals are commonly conducted for hotels and motels, restaurants, bowling alleys, industrial enterprises, shopping centers, retail stores, and similar business operations using real property. Generally, the real property is considered an integral part of the business operation. Without an allocation among the various elements contributing value to the business operation, however, *such an appraisal is not appropriate for California property tax purposes*....

> Where the unit principle of valuation is used, it has been said that the assessable property is valued as a going concern. *This means only that the taxable property of the business should be valued as if put to beneficial or productive use.* *<u>It does not mean that the entire value of the business can be assessed or that the going concern value is assessable</u>*.

(AH 502, p. 157, emphases added by Respondent.) Accordingly, Respondent notes their appraised value reflects the total market value of all taxable *property* as a unit owned or used by Petitioner, not the "firm value," which can be thought of as an estimate of the price a potential buyer might be willing to pay for the entire *business*. Respondent contends the entire business or firm value, by itself, is not relevant to California unitary property taxation.

Respondent also remarks that this context is why the CPUC's consideration of liabilities in evaluating a proposed acquisition is irrelevant, because CPUC is instead evaluating the *entire business*.

Respondent goes on to note that Petitioner's equating of "firm value" with the value of the entire company, requiring a decline in the unitary value of taxable property when firm value declines, is reasoning that ignores the fundamental difference between the value of "*the entire company*" and the unitary value of "*the company's taxable property*." Instead, because Petitioner's "Wildfire-related claims" are for the settlement or potential settlements of litigation arising out of wildfires and mudslides that occurred in 2017 and 2018, Respondent notes it does not reduce the value of Petitioner's taxable property, making a downward adjustment inappropriate.

Additionally, Respondent contends Petitioner's request for the same deduction to be made to the CEA value indicator is also not appropriate for the same reasons. Respondent notes 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.

(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. 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.

Respondent also notes that Petitioner's argument that wildfire liabilities should now be considered ordinary expenses and that they will occur in the future, may or may not actually be true, but regardless, it is only these particular liabilities from these past events that are at issue.[22] Further, Respondent notes it is undisputed that these particular liabilities are accrued for liability related to claims that resulted from wildfires and mudslides in 2017 and 2018, all of which occurred in the past and will not recur.

Further, Respondent notes that while Petitioner appears to be arguing that since these past liabilities will actually be paid at some time in the future, they are deductible when calculating the CEA value indicator, the mere fact that they may be paid in the future, however, does not mean that such expenses qualify as deductible, ordinary expenses. Respondent also notes that to the extent Petitioner is arguing that this type of wildfire liability lawsuit settlements will occur in the future, Petitioner has stated a belief that much of that risk has been mitigated through AB 1054.

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

See Issues 1 and 2, Applicable Law, p. 11.

Income Approach to Value

See Issues 1 and 2, Applicable Law, p. 12-13.

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

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[22] Respondent also notes that 2021 was the third consecutive year without a catastrophic wildfire being associated with Petitioner's infrastructure. (Public Safety Power Shutoffs – Information for High Risk Areas Newsletter (April 2022) Southern California Edison.) <https://edisonintl.sharepoint.com/:b:/t/Public/MCRR/english/Efaq2EDHvMtAqHrYJbVuULUBiJrF3pVMBXuNmibYiHrLDg?e=ESGerI> (as of October 3, 2022).)

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*.)

Analysis and Disposition

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 unitary value inappropriately excludes Petitioner's $1.635 billion in liabilities related to the 2017/2018 wildfires and mudslides, and requests a corresponding reduction to each value indicator. Petitioner asserts such an adjustment is necessary as the liabilities reduce its firm value, or going concern as a business, and certainly would be considered by any prospective buyer or the CPUC in any proposed transaction. Further, Petitioner contends such an adjustment to the CEA value indicator calculation is necessary as such expenses are ordinary and reoccurring, as liabilities have continued to accrue in the current year related to the 2017/2018 Wildfires/Mudslides. Petitioner further contends Respondent misinterprets Property Tax Rules and Assessors' Handbooks by denying Petitioner's requested adjustments to the HCLD and CEA value indicators.

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. For purposes of the HCLD approach, Petitioner does not provide evidence or authority to support that such liabilities reduce Petitioner's property tax value. Additionally, as Respondent points out, for purposes of the CEA approach, 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 or CEA value indicators, as such expenses are undisputedly related to past events, that are unlikely to occur in the future, even if the total liability from such past events are still being finalized as remaining claims are settled, litigated, or otherwise resolved.

We concur with Respondent 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 represent ordinary and future, anticipated operating expenses. We also concur with Respondent that the disputed expenses are properly excluded from the CEA value indicator calculation, consistent with Property Tax Rule 8. Additionally, even if wildfire liabilities should now be considered ordinary expenses reasonably occurring in the future, it is undisputed that these particular liabilities are a result of liability resulting from past wildfires and mudslides (in 2017 and 2018), which are not appropriate to deduct from the future income stream to be capitalized. 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 or legal or appraisal support, and that the Board grant Petitioner's unsupported request to deduct $1.635 billion from both the CEA and HCLD value indicators. However, it is well settled that the burden of proof is on the Petitioner. Based on the foregoing, we find Petitioner has not met its burden of proof as to this issue.

<u>Legal Issue 4:</u>

Whether Petitioner Has Shown that Respondent Improperly Assessed $1.6 Billion of Wildfire Mitigation Capital Expenditures.

<u>Findings of Fact and Related Contentions</u>

Petitioner contends that Respondent improperly assessed $1.6 billion of wildfire mitigation capital expenditures in its 2022 assessment of SCE,[23] based on the incorrect assumption that these assets generate a cash flow from ratepayers, allowing SCE to realize a return on investment for these capital expenditures. Petitioner contends that under AB 1054, SCE is required to make capital expenditures to the wildfire mitigation fund but is precluded from earning either a rate of return of or a return on the investment. Petitioner asserts this inclusion results in approximately $1.228 billion that should be removed from SCE's HCLD indicator.

Petitioner further asserts that a potential buyer would not have the opportunity to recover the wildfire mitigation capital expenditures, and thus conclude that the first $1.6 billion of wildfire mitigation capital expenditures have little or no value. Petitioner cites the analysis in the draft 2020

[23] The $1.228 billion referenced appears to stem from the paid to date portion of Petitioner's total $1.6 billion in wildfire mitigation capital expenditures required under AB 1054.

EY report to support that a prospective buyer would not pay for a $1.6 billion capital expenditure that produces no return. Petitioner argues that Respondent's appraisal assumes that the expenditures are being capitalized and included in the rate base, on which utilities are permitted to earn a return, and concludes that if the capital expenditures are not included in Petitioner's rate base, they must be removed from the HCLD value indicator.

Petitioner argues that in the alternative, these capital expenditures are intangible assets exempt from taxation; as such expenditures are statutorily required by AB 1054 for Petitioner to continue to operate, the intangible value of being compliant with AB 1054 thus confers intangible rights upon Edison and any future purchaser.

Petitioner then adds that the property it spent $1.6 billion replacing has been discarded and even if Petitioner may have the right to continue to receive a return with respect to the formerly owned property, since such property is no longer owned by Petitioner and the capital expenditure assets replacing it are intangible or otherwise not assessable for property tax purposes in their opinion, for those reasons, the disputed value must be removed from the HCLD value indicator.

Petitioner further contends that SAPD's explanation excerpted from AH 502 is misleading, which states, "The HCLD for property tax appraisal purposes, therefore, differs from the rate base as established by the regulatory agency. Some items included in the rate base are not included in the HCLD and some items included in the rate base are included in the HCLD," and in context is only meant to acknowledge Construction Work in Progress (CWIP)'s exclusion from the rate base but taxability for property tax purposes. Petitioner also contends SAPD misunderstands the concept of "return of" capital in a regulatory context. Specifically, Petitioner contends that while SAPD argues that Petitioner is being paid back for its cost through a special surcharge paid by ratepayers, CPUC D.20-11-007 requires that the special surcharges collected from ratepayers will repay the bondholders of the Recovery Bond, such that Petitioner will not recover either the return of or a return on the wildfire mitigation investments. Petitioner then argues that SAPD ignores basic valuation principles, as Petitioner contends assets, to have value under a CEA approach, must produce income, or, under the HCLD approach, must be included in the rate base.

Respondent contends no adjustment is appropriate for this issue. Respondent notes Petitioner essentially argues that because these costs are not included in rate base, these assets have no value and must be excluded entirely from the HCLD value indicator. However, Respondent explains whether or not property is included in the rate base of a regulated utility is not solely determinative of whether it has "value" for property tax purposes and must or must not be included in HCLD. Respondent cites AH 502, which states that some items included in rate base are not included in the HCLD, and some items not included in the rate base are included in the HCLD. (AH 502, p. 146-147.) Therefore, Respondent maintains that Petitioner's view is incorrect that all costs excluded from rate base must be excluded from HCLD.

Specifically, Respondent notes the wildfire mitigation capital expenditures have value, as Petitioner spent $1.6 billion to purchase those assets and had they not, Petitioner (or any potential purchaser) would not be compliant with AB 1054.

Respondent notes SAPD has recognized that there is an impact on value to these capital expenditures being excluded from the rate base and has already made a proper adjustment in Petitioner's 2022 Board-adopted value.[24] Respondent notes when making capital expenditures, firms expect both a "return of" their invested capital as well as a "return on" their invested capital. Respondent notes 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. Respondent contends that because AB 1054 prohibits Petitioner from earning a return on equity but does not prohibit earning a "return of" or a debt return on its capital expenditure, SAPD made appropriate adjustments to the HCLD 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. The excluded equity portion represents the return *on* the investment, and properly leaves in the rate for return *of* the investment. Respondent then removed the difference between this present value amount and the total $1.6 billion capital expenditure, resulting in an approximately $684 million reduction to the HCLD value indicator. Respondent maintains this adjustment, which was already reflected in Petitioner's 2022 Board-adopted unitary value, appropriately values Petitioner's wildfire mitigation capital expenditures.

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[24] $684 million was deducted from the HCLD indicator of value and resulted in a $513 million reduction to the overall 2022 value.

Respondent also contends that Petitioner's alternative arguments that the capital expenditures are intangible assets exempt from taxation, and that the property Petitioner spent $1.6 billion replacing has been discarded and is no longer owned by Petitioner, are each claimed without evidence. Respondent asserts that these arguments ignore the fact that $1.6 billion dollars of tangible, depreciable equipment was purchased and is currently installed as a part of Petitioner's physical infrastructure. Respondent states that the equipment that was actually discarded will be removed from the HCLD value indicator and therefore has no unitary value, as is done with all equipment that is retired and removed from an assessee's books and records. Accordingly, Respondent maintains these alternative arguments do not support any adjustment to Petitioner's unitary value.

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

See Issues 1 and 2, Applicable Law, p. 11.

HCLD Approach to Value

See Issues 1 and 2, Applicable Law, p. 11-12.

Analysis and Disposition

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 the entire $1.6 billion wildfire capital expenditures from its HCLD value indicator because Petitioner is not allowed to earn a rate of return on the expenditures, and a prospective buyer would not pay for a $1.6 billion capital expenditure that produces zero return. Petitioner also argues that if the capital expenditures are not included in the rate base, they should also be removed from the HCLD value indicator. However, Respondent explains that the HCLD approach for property tax appraisal purposes differs from the rate base as established by the regulatory agency as AH 502 states, and that the capital expenditures have value, as Petitioner spent $1.6 billion to purchase these assets. Respondent additionally contends that it has already adjusted the HCLD value indicator appropriately for these expenditures: by calculating the present value of the income using a discount rate that excludes the equity portion of the capitalization rate, reflecting that 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. Respondent noted this calculation resulted in an approximately $684 million reduction to the HCLD value indicator, which was already reflected in Petitioner's 2022 Board-adopted unitary value. We find that Petitioner has not shown specific evidence or argument to prove error within Respondent's calculation of the existing adjustment to the HCLD attributable to these assets.

Here, while Petitioner has contended in the alternative that the capital expenditures, by being compliant with AB 1054, makes them intangible assets exempt from taxation, Petitioner provides no explanation, evidence, or legal or appraisal basis or authority to support this contention.[25] Petitioner cites no authority to support the disputed property is exempt from property taxation under the California Constitution. Further, while Petitioner has contended that the property Petitioner spent $1.6 billion replacing has been discarded and is no longer owned by Petitioner, we find that Petitioner has provided no evidence that retired property has been included as a part of Petitioner's assessment. We therefore concur with Respondent's confirmation that the $1.6 billion dollars of tangible, depreciable equipment was purchased and is currently installed as part of Petitioner's physical infrastructure. Further, we concur with Respondent that neither AB 1054, nor any other provision of law identified supports the exemption of these assets from property taxation.

Accordingly, based on the arguments raised and evidence submitted on both the primary and alternative arguments, we find that Petitioner has not met their burden of proof as to this issue.

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[25] Cal. Const. Art. XIII, section 1 states: "Unless otherwise provided by this Constitution or the laws of the United States [a]ll property is taxable and shall be assessed at the same percentage of fair market value."

<u>Legal Issue 5:</u>

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

<u>Findings of Fact and Related Contentions</u>

Petitioner notes that SCE made an initial contribution of $2.4 billion to the Wildfire Insurance Fund, which is intended to provide some insurance coverage in the event of a catastrophic wildfire event, on September 9, 2019, and Petitioner 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.[26] Petitioner asserts Respondent erred in its treatment of the Wildfire Insurance Fund-related contribution by ignoring the initial contribution of $2.4 billion, instead arguing that the initial contribution and annual payments should be treated as insurance premiums and spread ratably over Petitioner's estimated 15-year coverage period, yielding an annual estimated insurance fund expense of $215 million. Petitioner contends the proper treatment of these expenses would reduce the CEA value indicator by $1,431,010,928 and the overall unitary value by $1,073,258,196.

Petitioner claims the Wildfire Insurance Fund contributions are being treated similarly to prepaid insurance under Generally Accepted Accounting Principles (GAAP). As no period of coverage was provided in AB 1054, Petitioner is allocating the total expense ratably based on its estimated fifteen-year period of coverage.

Next, Petitioner refutes SAPD's arguments, presumably from the 2020 petition, that a prospective purchaser would not consider the $2.4 billion prepaid insurance in the company's value. Instead, 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, due to the increased estimated insurance premiums the purchaser would have to make absent these fund contributions.

Petitioner also argues that SAPD is mischaracterizing the prepaid expense as excludable amortization or depreciation expense, as the expense at issue constitutes prepaid insurance or some other intangible asset that will reduce future expenses, as the initial contribution was a legal

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[26] Petitioner cites its 2019 Form 10k, at 113. See https://edison.gcs-web.com/static-files/9fa8a391-86e9-460f-84ad-eaa0d223288e (as of November 30, 2021.)

prerequisite that gave Petitioner the right to participate in the Fund, which is an intangible right.

Additionally, Petitioner contends that AH 502 states that property insurance may be prepaid for three years, though in Petitioner's case the coverage is estimated at 15 years, and that an "appraiser would annualize this expense in direct capitalization." (AH 502, p. 71-72.)

Petitioner further contends that the $215 million annual expense should be included in the CEA value indicator because future insurance premiums are bound to increase consistent with the wildfire risk conditions in California.

Petitioner additionally notes Respondent's proper treatment of such expenses may actually increase income in future years due to reduced future expenses, and that portion of the increased income related to the initial contribution should be removed from the income approach as income from an intangible asset.

Petitioner further claims that Respondent's treatment of the fund contributions is nonuniform in its application to all state assessees, claiming that the initial contribution was allowed for another state assessee.

Petitioner further contends that SAPD incorrectly interprets *De Luz Homes, Inc. v. County of San Diego* ("*De Luz*") (1955) 45 Cal.2d 546, explaining that while *De Luz* precludes a deduction for "depreciation of the property," it does not preclude a deduction for operating and maintenance expenses, and prepaid insurance are such expenses. Petitioner cites to AH 502 to support its argument, wherein under a direct capitalization method, like the CEA, "expenses are annualized even though some expenditures may not actually occur on an annual basis" and prepaid property insurance is provided as an example.

Additionally, Petitioner references that Member Gaines' comments in the Board hearing of their 2020 petition appeared to support this treatment of such expenses as annualized expenses removable from the CEA calculation.

Petitioner argues that while Respondent is attempting to create a requirement that another future AB 1054-like contribution will occur, the guidance does not create a requirement that the deduction of the prepaid insurance is only allowed when an identical payment is guaranteed to occur in the future. Petitioner also asserts that these prepaid insurance expenses would be viewed as relevant expenses to any prospective buyer and be considered regular and reoccurring in light of wildfire likelihood in California. Additionally, Petitioner notes the requested treatment is consistent with its audited financial statements. Petitioner concludes that the adjustment of approximately $1.07 billion (CEA-adjusted present value of the annual expensing of $215 million over the remaining coverage period) for the prepaid insurance contribution of $2.4 billion and the annual contributions of $95 million is reasonable and should be allowed.

Respondent contends that consistent with Property Tax Rule 8 and Board issued appraisal guidance, Respondent appropriately disallowed the $2.4 billion initial contribution as an expense in the CEA value indicator. (*UVM* pp. 35-37 and AH 502, p. 74.) Respondent explains 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 (since it would then include past expenses); in other words, deducting either is contrary to the principles on which the CEA indicator is premised. Thus, pursuant to Property Tax Rule 8 and AH 502's interpretation thereof, Respondent did not allow the $2.4 billion initial contribution as an expense in the CEA value indicator because the contribution was made in a previous year.

Respondent contends Petitioner admits that the Wildfire Insurance Fund-related initial contribution is both a past, non-recurring expense and that it is being amortized over a 15-year period and Respondent maintains the treatment of amortized costs in the CEA indicator of value is explained in Rule 8 and AH 502. Further, in *De Luz*, the California Supreme Court made clear that amortized costs are not deducted from the anticipated income to be capitalized.[27]

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[27] 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*.)

While Respondent acknowledges the specific items which the *De Luz* Court considered were leasehold improvements, Respondent maintains the Court's logic applies to capitalized assets generally.

Additionally, Respondent notes that the accounting treatment of the initial contribution is undisputed: an asset entitled "Wildfire Insurance Fund contributions" was created on Petitioner's balance sheet and a corresponding amortized portion is deducted on SCE's income statement. Thus, Respondent asserts that consistent with AH 502, *De Luz*, and generally accepted appraisal practice, the initial contribution's treatment for property tax valuation purposes should also be undisputed.

Then, Respondent asserts Petitioner's contention that the expense be treated akin to prepaid insurance, ratably deducted over some coverage period, misses the issue, as the issue is not over whether the initial contribution is or is not prepaid insurance. Respondent confirms that Petitioner's ordinary insurance expense was allowed, but instead asserts the issue is over whether the initial contribution is an ordinary, recurring expense and Petitioner has admitted that it is not in its 2022 10-K.[28]

Next, Respondent contends Petitioner's argument that the amortized expense will be reoccurring due to the new reality of wildfires is also misframed; instead, Respondent asserts the issue is whether the Petitioner will need to make another AB 1054-like initial contribution, something no one can know at this time.

Respondent also notes that Petitioner itself does not know how long the AB 1054 fund will last, as in 2019, SCE estimated 10 years (SCE 2020 10-k, p. 65), while in 2020, the estimate was increased to 15 years in its 2020 Form 10-k (SCE 2020 10-k, p. 122.). However, Respondent notes that in 2019, the CPUC stated that "arguments positing that the fund may be exhausted before 2035 are premature." (CPUC, Decision D19-12-056, p. 37.) This has been reinforced by the fact that as of January 6, 2022, no fund participant has used the fund yet. Accordingly, Respondent concludes any deduction allowed of this initial contribution based on some likelihood that some future AB 1054-like contribution will have to be made is pure speculation. Respondent summarizes that because the $2.4 billion initial

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[28] See Edison International's 2022 Form 10-K, pp. 4-5, where SCE lists various "non-core items" that "management does not consider representative of ongoing earnings," which includes a line item under this descriptor stating, "Charges of $215 million ($155 million after-tax) recorded in 2021 and $336 million ($242 million after-tax) recorded in 2020 from the amortization of SCE's contributions to the Wildfire Insurance Fund."

contribution is a past expense that need not be paid again, and because its deduction as amortization in future years is only for the purpose of computing accounting net income, the initial contribution is not deductible from the future income stream to be capitalized for property tax purposes.

Respondent also reaffirms that while the initial contribution is not deductible, the required annual contributions to the Wildfire Insurance Fund are allowable, as they are ordinary expenses expected to be paid for a 10-year term. Respondent notes this resulted in a $545 million reduction to the CEA value indicator, which has already been included in Petitioner's 2022 Board-adopted value.

Finally, Respondent disputes inequitable treatment amongst state assessees occurred, as the allowance or disallowance of the initial contributions were based on a consistent application of the same principles to all utilities who contributed to the fund.

In sum, Respondent maintains that all other arguments made by Petitioner on this issue remain unpersuasive, particularly those that attempt to liken the initial contribution to a deductible intangible asset, as the relevant appraisal and legal authority indicates that these contributions are being appropriately treated.

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

See Issues 1 and 2, Applicable Law, p. 11.

Income Approach to Value

See Issues 1 and 2, Applicable Law, p. 12-13.

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; Emphases added.) 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>Analysis and Disposition</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 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 over a 15-year period. 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, consistent with relevant Property Tax Rule 8 and appraisal principals.

We find that Petitioner has not shown specific evidence or argument to prove error within Respondent's calculation, which deducts the present value of the future remaining annual payments of $95 million and was already reflected in Petitioner's 2022 Board-adopted value, consistent with relevant case law, Property Tax Rule 8 and relevant Board guidance in the calculation of the CEA approach. We also concur with Respondent that Petitioner has not provided explanation, evidence or legal or appraisal authority that supports the treatment of the expenses as an intangible or nontaxable right. We also find that although Petitioner claims inequitable treatment and application of relevant law compared to other state assessees, Petitioner has provided no evidence thereof.

Therefore, we find that Petitioner has not met their burden of proof as to this issue.

Decision

Accordingly, the petition for reassessment is denied, and the 2022 Board-adopted unitary value of $34,274,700,000 is affirmed.*

Malia M. Cohen, Chair

Mike Schaefer, Vice Chair

Antonio Vazquez, Member

Betty T. Yee, Controller

* The decision was rendered in Sacramento, California on December 13, 2022. This summary decision document was approved on February 22, 2023 in Sacramento, California.