

THE SUPERIOR COURT OF THE STATE OF ARIZONA  
IN THE ARIZONA TAX COURT

TX 2016-000931

02/04/2019

HONORABLE CHRISTOPHER WHITTEN

CLERK OF THE COURT  
T. Cooley  
Deputy

TRANSWESTERN PIPELINE COMPANY

PAUL J MOONEY

v.

ARIZONA DEPARTMENT OF REVENUE, et al. LISA A NEUVILLE

JUDGE WHITTEN

FINAL ORDER

In these consolidated appeals, Transwestern Pipeline Company, LLC (“Transwestern”) appeals the 2016 and 2017 full cash values of its natural gas pipeline and related property (“the Property”), as determined by the Arizona Department of Revenue (“ADOR”). For the 2016 tax year, ADOR set the full cash value at \$639,690,000. For 2017, it set the full cash value at \$614,375,000.<sup>1</sup>

Transwestern owns natural gas pipelines that travel interstate across the southwestern United States, and which run through seven Arizona counties. Gas pipelines are initially valued under a statutorily prescribed method according to A.R.S. §42-14201 *et. seq.*. If full cash value derived using the statute is greater than the fair market value, however, then the fair market value must be adopted as the full cash value for taxation. A.R.S. §42-11001(6).

Each party presented compelling evidence related to the fair market value of the Property, most of which took the form of expert opinion.<sup>2</sup> Transwestern’s expert opined that the 2016 fair

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<sup>1</sup> ADOR attempted to “error correct” these values during the pendency of this litigation. On May 11, 2018 this Court held that the information which was the basis for that attempted “error correction” was known to it when it originally set the statutorily derived full cash value, and therefore precluded the “error correction.”

<sup>2</sup> The two valuation experts, Brent Eyre for ADOR and Robert Reilly for Transwestern, both have very impressive credentials. Both are well qualified to offer expert opinions on the unitary valuation of public utility property. The Court notes, however, that the background, education and qualifications of Mr. Reilly are more extraordinary than those of Mr. Eyre. The Court considers this in weighing the credibility of the experts.

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market value of the Property was \$362,000,000 and the 2017 fair market value was \$368,000,000. ADOR's expert opined that the 2016 fair market value of the Property was \$774,942,735 and the 2017 fair market value was \$733,987,070. Although the two experts' valuation are dramatically different, their overarching methodology was similar in many ways.

Both of the experts undertook a unitary valuation, meaning that they both agreed that the highest and best use of the Property was as a bundle of assets that are physically, functionally and economically integrated across several states. Their basic method of valuing the Property was the same. Each expert:

1. determined the value the total unit of all Transwestern property ("the Unit"),
2. removed property which is not taxable, and
3. apportioned part of the resulting taxable value to represent Transwestern's property in Arizona.

Each of the experts gave credible evidence in each area. In some areas, the Court found Transwestern's expert to be more credible, and in others it found ADOR's expert to be more credible.

### **I. Unitary Value**

Each expert used similar appraisal techniques, and similar indicators, to estimate the fair market value of the Unit. Each used cost approaches and income approaches. Both considered, and ADOR's expert employed, a market approach. In more areas than might be expected, the experts agreed, or mostly agreed. There were some major differences, however, in the experts' analysis. The Court addresses a few of the major differences without attempting to resolve every difference of opinion they had.

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Mr. Reilly possesses a Master's degree in Business Administration and a Bachelor of Arts degree in economics from Columbia University. Among other things, he is certified by the Institute of Management Accountants as a Certified Management Accountant (CMA), by the States of Ohio and Illinois as a CPA, by the National Association of Real Estate Appraisers as a Certified Real Estate Appraiser, by the National Association of Certified Valuators and Analysts as a Valuation Analyst, by the Certified Financial Analyst, as a CFA and by the Association of International Certified Professional Accountants as a Chartered Global Management Accountant. He has been inducted into the American Institute of Certified Public Accountants Business Valuation Hall of Fame. He has authored or co-authored sixteen peer reviewed books, twenty-nine chapters in other peer-reviewed books and authored literally hundreds of peer reviewed articles on the subject of valuations. Many of these publications have received awards from notable national accounting, appraisal or valuation associations.

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Some of the primary differences in the experts' analysis stem from: (1) the method in which they calculated the discount rate, (2) how they calculated Transwestern's income, (3) whether the value of the Unit should be reduced because of economic, or external, obsolescence, (4) whether "intangible property" should be removed from the Unit value, and (5) whether a market approach should be used. As to four of these issues, the Court finds the expert testimony offered by Transwestern to be more credible.<sup>3</sup> As to the inclusion of "intangible property," the Court agrees with ADOR's expert.

**A. Discount Rate and Calculation of Income in Income Approach**

In conducting their income approach analysis, both experts applied a discount rate to future income. The rate they choose to apply was critically different. Transwestern's expert used a discount rates of 10.2% and 9.8% for the 2016 and 2017 tax years, respectively. ADOR's expert used discount rates of 7.11% and 7.8%. Each applied this rate to different income streams.

The principle difference in the calculation of income was the treatment of tax refunds received by Transwestern in 2014. On this issue, the Court found the testimony of Transwestern's expert to be more credible.

Although the experts calculate income differently, a significant reason for their differing opinions is their disagreement about the discount rate that should be applied to that income to reduce it to present value, and, more specifically, whether that discount rate should include a size equity premium and/or a company-specific equity premium. On both counts, the Court again found Transwestern's expert, who included both premiums in the calculation of his discount rate, to be more credible.

**B. Economic Obsolescence in Cost Approach**

Although they arrive at their cost approach conclusions differently, the experts both start their analysis with very similar opinions of the historical costs less depreciation (HCLD) of the

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<sup>3</sup> One of the more troubling hurdles to accepting Transwestern's expert's opinion on the value of the Unit were two other valuations, completed by KPMG and BVA for different purposes, completed close in time to the dates of valuation. The KPMG and BVA evaluations use much of the same methodology as both experts in this case used. Both arrive at conclusions that tend to support ADOR's valuation.

Neither of those evaluations, however, attempted to estimate the "fair market value." Instead, both the KPMG and the BVA evaluations were of the "fair value" of Transwestern. Although there is only one word of difference in the titles of the two types of evaluations, there is a world of difference between the two. In fact, both the KPMG and the BVA evaluations warn against using the results for tax purposes. In addition, the financial projections used for the KPMG and BVA evaluations were based upon different, more favorable, projections of income.

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Unit. ADOR's expert opines that the HCLD for the 2016 tax year was \$1,802,710,000 and for the 2017 tax year was \$1,809,292,000. Transwestern's expert opines that the HCLD for the 2016 tax year was \$1,817,101,000 and for the 2017 tax year was \$1,811,773,000.

The experts differ on whether these amounts should be reduced to reflect extrinsic or economic obsolescence (the terms seem to be used interchangeably).

One of the factors to be considered in estimating fair market value under a cost approach is depreciation. The most common form, depreciation due to the age of the asset, is easily derived from purchase records, is well-analyzed in the case law, and needs no further comment.

In recent years, adding depreciation due to obsolescence has become more common. To date, however, there has been no consensus among the state courts as to the metes and bounds of that broad category. Arizona courts were among the first to formally recognize the admissibility of economic obsolescence in reporting property values for tax purposes. *Eurofresh Inc. v. Graham County*, 218 Ariz. 382 (2007).

*Eurofresh* begins by quoting the definition of external or economic obsolescence used in *The Appraisal of Real Estate*: "a temporary or permanent impairment of the utility or salability of an improvement or property due to negative influences outside the property."

Only if the value or usefulness of the asset is actively diminished by an external economic factor like available financing, loss of materials or labor sources, passage of legislation, changes in ordinance, increase cost of new materials, labor, or utilities without an offsetting increase in product price, reduced demand for product, increased competition, inflation, high interest rates, can there be economic obsolescence.<sup>4</sup>

*Eurofresh* imposes a three-pronged test for economic obsolescence: "a taxpayer claiming external obsolescence must offer probative evidence of the cause of the claimed obsolescence, the quantity of such obsolescence, and that the asserted cause of the obsolescence actually affects the subject property." *Id.* at 538 ¶ 37.

### 1. The cause of the claimed obsolescence

Brad Whitehurst, the Executive Vice-President of Taxation of Transwestern's parent company and Beth Hickey, its Senior Vice-President, both testified credibly that there are a number of external factors which resulted in the obsolescence of its property, including

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<sup>4</sup> The American Society of Appraisers, *Valuing Machinery and Equipment: The Fundamentals of Appraising Machinery and Technical Assets* (3rd ed. 2011).

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unexpected increases in the cost of labor and material during the construction of the “Phoenix lateral” resulting in massive cost overruns for which Transwestern was unable to increase its price<sup>5</sup> and dramatic downturns in the economy and related decrease in demand for its services.

**2. The asserted cause of the obsolescence actually affects value**

Transwestern has proved through the testimony of its witnesses and expert that the value of the Property suffered from economic obsolescence.

Among other evidence that the property lost value because of external forces, was the fact that The Natural Gas Supply Association ranked the return on equity of Transwestern pipeline in 2014 at 29<sup>th</sup> of the 32 pipelines it measured. Mr. Whitehurst testified that “we would tell anybody that this (Transwestern) was a big miss ... a huge miss... wrong place, wrong time.” While there could be other reasons for this underperformance, the testimony was compelling that the reasons described above caused it.

Transwestern’s expert confirmed that these external factors actually caused Transwestern to underperform using objective data. He performed a capitalization of income analysis using both a comparison to yield capitalization and a comparison to FERC allowed return on equity to confirm the presence of economic obsolescence. Both tests were indicative of economic obsolescence.

**3. The quantity of such obsolescence**

Transwestern’s expert was also able to quantify the economic obsolescence, again by using the capitalization of income loss method, but this time by comparison to historical returns and comparison to the returns earned by other pipeline companies. Using these two comparisons, he determined that Transwestern’s unitary valuation suffered from a 59% obsolescence in the 2016 tax year 60% obsolescence in the 2017 tax year.

**C. Market Approach**

The experts agree that, where reliable data can be found, a market approach to valuation is appropriate. They disagree, however, about whether reliable data exists.

ADOR’s expert used a “stock and debt” method to conduct his market approach. This method focuses on the value of the stock of Transwestern’s parent company, Energy Transfer

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<sup>5</sup> The original anticipated cost of the Phoenix lateral was \$584 million. At the time FERC set the maximum cost Transwestern could charge to recover the cost of this project, the cost had increased to \$711 million. In the end, the total construction costs exceeded \$870 million.

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Partnership (“ETP”). By multiplying the value of one share of ETP’s stock by the number of outstanding shares, ADOR’s expert derives a value for ETP. To determine how much Transwestern’s value contributes to ETP’s value, he compares the total revenues of the two companies, their operating income, their net plant in service and their total assets. Although the resulting individual ratios vary wildly (between .45% and 7.23% in the 2016 tax year, and between .62% and 4.72% in the 2017 tax year), ADOR’s expert simply averages the four resulting ratios to arrive at Transwestern’s contribution to ETP’s value.

In addition to the inherent unreliability of simply averaging four such disparate ratios, the method employed by ADOR's expert assumes that ETP values each of the hundreds of companies it controls in exactly equal manner, an assumption that is unsupported by any evidence.

Even ADOR’s expert recognizes that this method of determining value was not very reliable. He weighed the “stock and debt” approach at between 0-5% in calculating his value for the Unit. The Court agrees with Transwestern’s expert that this method of valuation is completely unreliable and should be given no weight.

**D. Conclusion on Unit Value**

Based upon the above, and subject to the "intangible property" discussion below, the Court finds the opinion of Transwestern's expert to be credible - that the value of the Unit in the 2016 tax year was \$728,000,000 and in the 2017 tax years was \$716,000,000.

**II. “Intangible” Property**

After determining the total unit value of Transwestern’s property, both of the experts excluded that property which was not taxable. Transwestern’s expert excluded “intangible property." He should not have.

A.R.S. § 42-14204(H)(3) defines the base value, the primary portion of assessed value, as “the final full cash value of the system *plant in service* in the preceding valuation year” (emphasis added). A.R.S. § 42-14204(G) provides that “[a]ll terms and applications of terms shall be interpreted as nearly as possible, under the circumstances, according to the Federal Energy Regulatory Commission uniform system of accounts for pipelines in effect on January 1, 1989.”

Under the referenced Federal Energy Regulatory Commission regulations, the type of “intangible property” which was removed by Transwestern’s expert is included under the definition of “plant in service.” Because the Arizona legislature has determined that the full cash

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value of pipelines should be based on the value of the plant in service, as Federal Energy Regulatory Commission defines that term, these intangibles should not have been excluded.

Thus, Transwestern's expert undervalues the Unit by \$4,646,000<sup>6</sup> in the 2016 tax year and \$4,766,000<sup>7</sup> in the 2017 tax year. With these amounts added to his conclusion, the total Unit value for the 2016 tax year was \$732,646,000 and for the 2017 tax year was \$720,766,000.

### III. Allocation of Property to Arizona

The experts disagree about how to allocate a portion of the unitary value, so that only that portion that is located in Arizona is included in determining the fair market value of the Property in Arizona.

After a unitary value is determined, Arizona statutes contemplate an allocation of the total property value by comparing the gross invested cost of all taxable property to the gross cost of all taxable property located in Arizona. A.R.S. §14-14204(H)(1). During trial, the parties stipulated that ADOR's expert allocated Transwestern's unitary value in a method contemplated by ARS 42-14204(H)(1). The apportionment, using this method, for the 2016 tax year is 54.9872% and for the 2017 tax year is 54.4233%.

### IV. Conclusion

For the 2016 tax year, the unitary value is \$732,646,000, which represents the \$728,000,000 value opined by Transwestern's expert plus the \$4,646,000 of intangible property as described above. Applying the proper apportionment of 54.9872% to that unitary value, the Court finds the fair market value of the Property for the 2016 tax year was **\$402,861,521**.

For the 2017 tax year, the unitary value is \$720,766,000, which represents the \$716,000,000 value opined by Transwestern's expert plus the \$4,766,000 of intangible property as described above. Applying the proper apportionment of 54.4233% to that unitary value, the Court finds the fair market value of the Property for the 2017 tax year was **\$392,264,642**.

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<sup>6</sup> Calculated as intangible asset value of \$11,332,000 minus economic obsolescence of 59%.

<sup>7</sup> Calculated as intangible asset value of \$11,916,000 minus economic obsolescence of 60%.