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*** Electronically Filed ***
07/03/2018 8:00 AM

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

TX 2015-000095 06/28/2018

HONORABLE CHRISTOPHER WHITTEN

CLERK OF THE COURT
T. Cooley
Deputy

STATE OF ARIZONA DEPARTMENT OF REVENUE — KENNETH J LOVE

v.

MESQUITE POWER L L C — BART WILHOIT

MINUTE ENTRY

This case involves two separate, consolidated appeals. The appeals challenge the full cash value of Plaintiff's electric generation facility for the 2016 and 2017 tax years.

Procedural History

A. 2016 Tax Year

The Arizona Department of Revenue ("ADOR") appeals from a decision by the Arizona State Board of Equalization (the "Board"), reducing ADOR's tax year 2016 statutory valuation of Mesquite Power, LLC's ("Mesquite") property, identified by taxpayer identification number 50-676 (the "Subject Property"), from a full cash value of $230,593,000 to $188,646,735.

ADOR contends the Board erroneously reduced the statutory value of the Subject Property based on "obsolescence," under A.R.S. §42-14156(A)(4).

Mesquite cross-appeals the Board's 2016 valuation, alleging that the statutory value of the Subject Property – even after making an adjustment for obsolescence – still exceeds the market value of the Subject Property, in violation of A.R.S. §42-11001(6).

B. 2017 Tax Year

ADOR set the full cash value of the Subject Property at $217,134,000 for tax year 2017. Mesquite directly appeals that valuation. Mesquite contends that (1) the statutory value of the Subject Property exceeds the market value of the Subject Property and (2) that ADOR again failed to properly adjust for any obsolescence under the statutory formula.

The parties' appeals for tax years 2016 and 2017 have been consolidated for trial.

Factual Background

On October 29, 2014, ArcLight Capital, LLC ("ArcLight") signed an agreement to purchase Mesquite from Sempra Generation ("Sempra") for $356,938,000. The parties agree that the sale was an "arms-length transaction." It was the result of ArcLight prevailing in a competitive, two-stage, open auction organized by the investment bank of Goldman Sachs on behalf of Sempra. The sale did not close until April 9, 2015.

The sale included all of the tangible real and personal property at issue in these appeals, and certain intangible assets that are not taxable.[1] The principal non-taxable, intangible asset is a "Power Purchase Agreement" ("PPA"), a contract with Southwest Public Power Resources Group ("SPPR") which reserves for SPPR 271 megawatts of Mesquite's generating capacity in exchange for approximately $34 million dollars annually for the next 24 years (until 2039). [2] Those payments guarantee recovery of all costs Mesquite incurs to produce electricity (including the price of natural gas and all operating costs), plus a profit. They are paid regardless of the amount of actual electricity that is sold under the PPA. Thus, these contracted payments under the PPA generate predictable, reliable cash flows that provides ArcLight with significant downside protection on its invested capital. The PPA is an asset which has some value.[3]

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[1] Pursuant to A.R.S. §42-14156, the taxable property of an electric generation facility includes land, tangible personal property and real property improvements.

[2] In addition to the $356,938,000 sales price, ArcLight was required as part of the sale to pay an additional sum of $2 million dollars per year to a third party, British Petroleum, in order to guarantee to SPPR that ArcLight would perform its obligations under the PPA. As an alternative to this liability, ArcLight could have increased the purchase price by approximately $15 million dollars, with Sempra retaining that quasi-performance-bond. This additional cost, however, is related only to the PPA, not the value of the tangible, taxable property.

[3] Even ADOR's witness, Jeffrey Bodington, admitted that the PPA was an intangible asset, separate from the power generation facility, which had a value.

In addition to the 271 megawatts of pledged capacity under the PPA, Mesquite has approximately 354 megawatts of "merchant capacity," which represents potential sales of electricity into the wholesale power market at whatever price the market will bear. This merchant capacity enables ArcLight to earn an additional return on its investment.

Notably, the electricity needed to fulfill the PPA need not be produced by Mesquite. Instead, it can be purchased by Mesquite on the open market. Additionally, it is important to note that the PPA is severable and can be transferred separately from the ownership of the tangible personal property.

In order to comply with federal law, applicable accounting standards, and the purchase agreement, Mesquite was required to "allocate" the total $356,938,000 purchase price between the land, the tangible personal property and the PPA. In order to do so, it retained Daniel Beaulne, a very credible expert with a twenty-five year history of valuing power production facilities.[4]

Mr. Beaulne concluded that, as of the April 9, 2015 closing date, the real property and tangible personal property included in the transaction had a total value of $118,925,000, and the intangible PPA had a value of $238,013,000.

Valuation

Market value is "that amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts." *Business Realty of Arizona, Inc. v. Maricopa County*, 181 Ariz. 551, 553 (1995).

"Market value is generally determined through three common appraisal approaches: capitalizing the income stream ('income method'), estimating replacement cost less depreciation ('cost method'), and estimating market value by comparable sales ('sales comparison method')." *Bus. Realty of Arizona, Inc. v. Maricopa County*, 181 Ariz. 551, 553–54, 892 P.2d 1340, 1342–43 (1995). Any of these, or some hybrid of them, may be applied by the taxing authority or the courts. *Magna Inv. & Development Corp. v. Pima County*, 128 Ariz. 291, 293-95 (App. 1981). However, if the taxpayer challenges the assessor's choice of method, it must show that its alternative method is appropriate under the circumstances. A.R.S. § 42-16212(B); *Eurofresh, Inc. v. Graham County*, 218 Ariz. 382, 386 ¶ 17 (App. 2007).

[4] ADOR makes much of the fact that Mr. Beaulne's reports did not conform to the Uniform Standards of Professional Appraisal Practice ("USPAP"). It is clear that his report was not required to comply with USPAP and ADOR does not suggest how any areas of noncompliance with USPAP had a negative effect on his analysis.

A. Determining the Proper Valuation Method

While the replacement method and the sales comparison method might be used to arrive at the fair market value of a power generating facility in theory, Mesquite has shown that the best, most accurate method to approximate a real-world value of the Subject Property is the income approach.

Mesquite's expert, Mr. Beaulne, has valued over one hundred power generating facilities in his career. In the vast majority of those valuations, he has done so using the income approach.

The buyer (ArcLight), the seller (Sempra) and the seller's broker (Goldman Sachs) in the April 9, 2015 transaction were all very sophisticated traders in power generation facilities. All three used the income approach to value Mesquite.

Mark Tarini, a partner at ArcLight who was directly involved in the decision to purchase Mesquite, testified that, as a member of ArcLight's "transaction team," he has purchased approximately one hundred power generating facilities and sold between fifty-five and sixty. In assessing each of these transactions, he has almost always valued the property using the income approach because it best reflects the amount at which the property will actually sell in an open market. He used the income approach to value the Subject Property in late 2014.

Mesquite's proffer that an income approach is most reliable for valuation is more than litigation posturing; it is more than a litigant choosing the valuation method that yields the best result for it. In the real world, within months of the two relevant dates for valuation,[5] the Subject Property was actually transferred between two very sophisticated players in an arms-length exchange. The valuation approach used by both the buyer and seller in that transaction was, in fact, the income approach. The Court puts a great deal of weight on the fact that, outside the ethereal, hypothetical world of lawyers and experts in courtrooms and in academia debating appropriate valuation methods, outside the vacuum of learned treatises commenting on accepted practices, and with hundreds of millions of dollars at stake, two very sophisticated real-world actors both used the income approach to determine Mesquite's value.

The cost approach is not generally used by buyers or sellers to value power generation facilities for many reason. Among those are that it focuses too much on the sunk costs of building the facility and not enough on the potential future value to an owner or potential buyer

[5] The sale closed approximately three months after the tax year 2016 valuation date and nine months before the tax year 2017 valuation date.

and that adjusting a cost method based value for obsolesce is very difficult and yields unreliable results. [6]

Similarly, the sales comparison method is rarely used in these type of transactions because finding similar transactions is difficult. None of the experts in this case advocate, to any degree at all, a valuation of the Subject Property using the sales comparison method.

B Applying the Income Approach to the Subject Property

ArcLight retained Mr. Beaulne to determine the market value of the Subject Property as of January 1, 2015 and January 1, 2016, the relevant dates for the tax years in this case. Mr. Beaulne used an income approach, and, more specifically, a discounted cash flow method, in determining that the fair market values of the Subject Property were $130,876,000, as of January 1, 2015, and $99,714,000, as of January 1, 2016. He considered using the cost method and the sales comparison method, but determined that neither would yield reliable results.

Mr. Beaulne’s conclusions about the value of the Subject Property for the 2016 and 2017 tax years are credible. While his opinions are, by their nature, dependent upon matters which are subject to differences of opinion – such as appropriate discount rates, the accuracy of projected operating expenses and revenues and similar judgments - none of the assumptions made by Mr. Beaulne are problematic. The fact that Mr. Beaulne mixed the sources of information he relied upon in making assumptions about future operating expenses and future revenue is of only slight concern to the Court, as his explanation for doing so is reasonable.

ADOR retained Steven Barreca to give an opinion on the market value of the Subject Property. Mr. Barreca is also a very competent appraiser, with an impressive history of valuing various types of property, including property related to telecommunications and utility companies. Although he has valued approximately twenty power generation facilities, mostly in rate regulated jurisdictions,[7] he does not have nearly as extensive a background or as much experience in the valuation of such facilities as do Mr. Beaulne, Mr. Reilly or Mr. Tarini. He admits that he has little to no knowledge about the valuation methods used by actual buyers and sellers of power generation facilities.

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[6] Kevin Reilly, Mesquite’s rebuttal witness, has valued between one and two hundred power generation facilities. He values such facilities using an income approach. Infrequently he also uses the cost approach, but only to verify the reliability of the results arrived at using an income approach. He has never valued a power generation facility using a cost approach.

[7] Mesquite is not regulated by the Arizona Corporation Commission.

Mr. Barreca performed three variations of a cost approach to value the Subject Property for each of the two tax years.[8] These included (1) replacement cost new less depreciation ("RCNLD") using the U.S. Energy Information Agency's ("EIA") overnight capital costs, (2) RCNLD using trended historical cost, and (3) original cost less depreciation ("OCLD").[9] Mr. Barreca also performed a direct capitalization income approach to obtain a value.

For the reasons above, the Court does not find opinions based upon the use of the three variations of a cost method to be persuasive, as the cost approach is not the valuation method employed, even in small part, by actual buyers and sellers of power generation facilities in a real world setting. Specifically, the value of the Subject Property, on the relevant dates, is clearly best determined using the income approach.

Mr. Barreca's opinion of the value of the Subject Property using the income approach is unpersuasive.[10] He used the "direct capitalization" method in employing the income approach. That is one of four standard and accepted methods of computing value under the income approach generally, but is problematic as applied in the Subject Property for several reasons. The discounted cash flow method is more appropriate than a direct capitalization methodology in determining value for properties with less stable cash flow streams, such as power generation facilities.[11] Additionally, the direct capitalization method assumes a stable cash flow for the property that will extend in perpetuity, but (1) Mr. Barreca did not account for any of the long

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8 Mr. Barreca's values, using these cost methods were:

RCNLD using EIA for 2016 tax year – $496,009,952
RCNLD using EIA for 2017 tax year – $499,772,685
RCNLD using trended historical cost for 2016 tax year – $417,322,407
RCNLD using trended historical cost for 2017 tax year – 418,355,386
OCLD in 2016 tax year – $297,019,483
OCLD in 2017 tax year – $352,022,000

9 The source of the original cost information used by Mr. Barreca, although the Court has determined that it is the cost information that must be used in computing the value under the statutory valuation method pursuant to A.R.S. under A.R.S. §42-14156(A)(6)(d)(i), was suspect. No investigation as to its accuracy was undertaken.

During discovery Mesquite produced a five-page document that it identified as the "Mesquite Power Fixed Asset Listing." Although this information seems highly relevant to determining the original cost information, the origin of this information is completely unknown. Who created it, why, when and using what information are all unanswered questions.

10 Mr. Barreca's value of the Subject Property using the income approach were $377,069,846 for the 2016 tax year and $405,066,223 for the 2017 tax year.

11 Even ADOT's witness, Jeffrey Bodington testified that the incremental income method (aka discounted cash flow method) was better than the direct capitalization method in valuing the Subject Property.

term capital expenditures that would be required to keep Mesquite operational, and (2) power generation facilities such as the Subject Property do not operate in perpetuity, they have finite life-spans. Finally, although the PPA clearly has some value, Mr. Barreca did nothing to adjust the cash flow he used to remove income attributable to the PPA.

Mr. Barreca used a weighted combination of the differing valuation approaches to conclude that the fair market value of the Subject Property was $428,000,000 in tax year 2016 and $416,000,000 in tax year 2017.[12] For the above reasons, the Court declines to accept these opinions.

ACCORDINGLY, The Court finds the "market value" of the Subject Property to be $130,876,000 for the 2016 tax year and $99,714,000 for the 2017 tax year.

Statutory Valuation Issues

Electric generating facilities are statutorily valued pursuant to A.R.S. § 42-14156, which is similar, but not identical, to a cost approach valuation. For the 2016 and 2017 tax years, the task of determining the value of the Subject Property under A.R.S. § 42-14156 was given to Frank Dudley. The parties dispute whether Mr. Dudley correctly performed this task.

The parties' disputes about whether the assessed value for the 2016 and 2017 tax years, using the statutory method, are moot. Under any argument by either party, the statutorily derived value exceeds the market value. Pursuant to A.R.S. §42-11001(6), "[f]ull cash value shall not be greater than market value regardless of the method prescribed to determine value for property tax purposes."

Conclusion

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[12] There are several examples that, although not individually determinative, illustrate the unreliability of Mr. Barreca's analysis:

1. Mr. Barreca opined values were $71 million and $59 million more, respectively, then the actual base price paid for all of the tangible property **and** the PPA, combined, in an arms-length transfer within months of the tax valuation dates.

2. No matter the approach he used, Mr. Barreca found that the value of Subject Property actually increased by millions or tens of millions of dollars from the 2016 to the 2017 tax year, even though he ultimately agrees with the Plaintiff that the value of the Subject Property decreased over that time.

3. The variations in value found by Mr. Barreca was immense. Under the three different cost assumptions Mr. Barreca used, his values varied from $297 million to $496 million dollars for the 2016 tax year and from $352 million to $499 million dollars in the 2017 tax year.

ACCORDINGLY, the Court finds the full cash value of the Subject Property to be $130,876,000 for the 2016 tax year and $99,714,000 for the 2017 tax year.