Ohio | Department of Taxation

Office of the Tax Commissioner
30 E. Broad St., 22nd Floor • Columbus, OH 43215

FINAL DETERMINATION

Date:

JUL 10 2020

Nexus Gas Transmission, LLC
c/o Enbridge, Inc.
ATTN: Tax Department
5400 Westheimer Court
Houston, TX 77056

Re: Assessment No. 19-01150
Public Utility Personal Property Tax
Various Counties
Tax Year: 2019

This is the final determination of the Tax Commissioner with regard to a petition for reassessment filed pursuant to R.C. 5727.47 concerning a public utility personal property tax assessment.

PROCEDURAL BACKGROUND

Nexus Gas Transmission, LLC (hereinafter "petitioner" or "NEXUS") originally filed its 2019 Annual Report with the Department on March 29, 2019. In July 2019, NEXUS provided the Commissioner with an Appraisal of its property prepared by Tegarden & Associates, Inc. (hereinafter the "Appraisal" or "Tegarden Appraisal"). NEXUS filed an amended Annual Report for tax year 2019 on September 24, 2019. After reviewing the amended Annual Report, the Department sent NEXUS a 2019 assessment. In the assessment, the Department did not allow NEXUS to use the value for its property determined in the Tegarden Appraisal. Rather, the Department set the value based upon the statutorily-prescribed valuation method, which establishes the value of public utility property based on the cost as capitalized on the petitioner's books, less composite annual allowances as set by the Commissioner.

The Tegarden Appraisal estimated a systemwide total value of NEXUS' public utility property as $1,182,000,000. The total value allocated to Ohio under the Appraisal, as part of the pipeline is located within Michigan, was $996,410,634. The Department's assessed taxable value is $1,425,915,660.

In response to the assessment, the petitioner filed a timely petition for reassessment in which it contends that the prima facie statutory valuation did not accurately reflect the true value of its taxable Ohio property and argues that the Tegarden Appraisal that it submitted should be used instead to set the true value of the property.

FACTUAL BACKGROUND

The petitioner indicates that it has two owners, DTE Energy and Enbridge, Inc., which each own fifty percent of NEXUS. The petitioner describes its operations on its website as follows:

> Nexus Gas Transmission (NEXUS) is an approximately 256-mile, 36-inch interstate natural gas transmission pipeline designed to transport up to 1.5 billion cubic feet per day

> (Bcf/d) of cleaner burning natural gas from receipt points in eastern Ohio to existing pipeline system interconnects in southeastern Michigan. The full path of NEXUS allows for the delivery of natural gas supplies directly to consumers in northern Ohio; southeastern Michigan; and the Dawn Hub in Ontario, Canada.
>
> By expanding access to natural gas in these markets, NEXUS provides consumers across the region with affordable, cleaner-burning and domestically-abundant natural gas to help meet the growing demand for cleaner power generation, industrial and commercial use, and home heating.[1]
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> * * *
>
> NEXUS Gas Transmission is a 50/50 partnership between DTE Energy and Enbridge, Inc. NEXUS transports much needed, cleaner-burning and affordable natural gas to Ohio, Michigan and Ontario. NEXUS will help the region meet the growing demand for natural gas-fired generation, a cleaner and more versatile fuel for powering the region's homes and businesses.[2]

In its First Amended Petition for Reassessment, submitted to the Department in January 2020, the petitioner describes the construction of the pipeline as follows:

> NEXUS originally projected that it would cost approximately $2.2 billion to build its pipeline. In the end, however, NEXUS spent about $2.6 billion on the project. There was also $180 million of scope reductions including $120 million to reduce the pipe from 42 inches to 36 inches and $60 million for the deferral of the Waterford Compressor Station. The portion of the NEXUS Pipeline that is in Ohio represents approximately 84.3% of the entire project based on pipeline miles.
>
> The $400 million disparity between the original projected cost and the final cost to build the NEXUS Pipeline is attributable to significant overruns that occurred during construction as well as $180 million of scope reductions.

After receiving FERC authorization on August 25, 2017[3], the petitioner began construction of the pipeline in October 2017.[4] In August 2018, the pipeline was in the final stages of construction,[5] and NEXUS commenced service on the majority of its pipeline on October 13, 2018.[6] In its 2019 annual report to shareholders, Enbridge, Inc., a 50% owner of the petitioner, described NEXUS as follows:

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[1] Nexus Gas Transmission. *Homepage*. Retrieved from nexusgastransmission.com (accessed on July 2, 2020).
[2] Nexus Gas Transmission. *Nexus Partners*. Retrieved from https://www.nexusgastransmission.com/content/nexus-partners (accessed on July 2, 2020).
[3] *Nexus Gas Transmission, LLC*, 160 FERC ¶ 61,022 (Aug. 25, 2017). FERC reviews applications for construction and operation of interstate natural gas pipelines under the authority of section 7 of the Natural Gas Act. FERC review ensures that applicants certify that they will comply with Department of Transportation safety standards. Federal Energy Regulatory Commission. *Natural Gas Pipelines – Overview.* Retrieved from: https://www.ferc.gov/industries-data/natural-gas/overview/natural-gas-pipelines (last accessed July 8, 2020).
[4] WOSU Public Media. *Nexus Pipeline Will Begin Construction Through Ohio*. October 12, 2017. Retrieved from: https://radio.wosu.org/post/nexus-pipeline-will-begin-construction-through-ohio (last accessed on July 8, 2020).
[5] Cousino, D. The Monroe News. *Nexus gas pipeline now in final stages of construction.* August 22, 2018. Retrieved from: https://www.monroenews.com/news/20180822/nexus-gas-pipeline-now-in-final-stages-of-construction (last accessed July 8, 2020).
[6] Federal Energy Regulatory Commission. *NEXUS Gas Transmission, LLC; Notice of Extension of Time Request*. June 30, 2020. Retrieved from https://www.federalregister.gov/documents/2020/07/07/2020-14527/nexus-gas-transmission-llc-notice-of-extension-of-time-request (last accessed on July 8, 2020).

> We successfully brought $7 billion of projects into service, including two highly strategic natural gas pipeline projects: the NEXUS pipeline, which connects growing production in the Marcellus and Utica basins to key markets in the upper U.S. Midwest and serves our utility franchise in Ontario. * * * All of these projects are underpinned by long-term contracts, which support our low-risk business model.[7]

THE PETITIONER'S CONTENTIONS

The petitioner contends that the Tax Commissioner should use the value estimated in the Appraisal as the true value of the petitioner's property in Ohio. More specifically, the petitioner argues that, in accordance with *Texas E. Transm. Corp. v. Tracy*, 78 Ohio St.3d 83 (1997), the Tax Commissioner must deviate from the statutorily prescribed method of valuation and instead accept the Tegarden Appraisal as the measure of true value for the pipeline. The Appraisal provided two methods for valuing the pipeline: one cost approach and one income approach.[8] The petitioner's Appraisal provides a cost approach based on an income-shortfall methodology and an income approach based on estimated future net income and cash flows.

The petitioner contends that if the Department will not accept the Appraisal as the measure of the property's true value, the Department should revise the preliminary assessment certificates to account for the purported obsolescence of NEXUS' Ohio property. The petitioner further argues that Federal Energy Regulatory Commission ("FERC")-related conditions and delays as well as escalated contractor costs resulted in additional costs that significantly increased its total investment in and cost of the NEXUS Pipeline. As a result, the petitioner contends that the assessed taxable value is overstated due to the inclusion of these unforeseen construction costs that occurred mostly from the delay in getting FERC approval to proceed with pipeline construction.

For the reasons explained below, the petitioner's contentions are not well taken.

DETERMINING THE TRUE VALUE OF PROPERTY

STATUTORY COST VALUATION

Pursuant to R.C. Chapter 5727, public utilities must pay property tax on their personal property. *Ohio Bell Tel. Co. v. Levin*, 124 Ohio St.3d 211, 2009-Ohio-6189, 921 N.E.2d 212, ¶ 2 (2009). The property tax is an ad valorem tax, and the Tax Commissioner must determine the value of the utility's property. R.C. 5727.10 provides the process under which the Tax Commissioner assesses the value of public utility personal property stating, in pertinent part, that:

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[7] Enbridge Inc. 2018 Annual Report, page 1. Retrieved from https://www.enbridge.com/~/media/Enb/Documents/Investor%20Relations/2019/ENB-AR-2019-English.pdf (accessed on July 2, 2020).

[8] The Appraisal also briefly considers 1) a sales comparison approach, which could not be used in the ordinary manner as there are no actual arms-length sales of truly comparable properties; and 2) a stock and debt approach under which it provides no valuation. *Tegarden & Associates, Inc. Appraisal of the Operating Properties of Nexus Gas Transmission, LLC as of January 1, 2019* at 80-81.

> Annually, the tax commissioner shall determine, in accordance with section 5727.11 of the Revised Code, the true value in money of all taxable property * * * to be assessed by the commissioner. * * * The commissioner shall be guided by the information contained in the report filed by the public utility and such other evidence and rules as will enable him to make these determinations.

The Tax Commissioner's valuation forms the base for the ultimate determination of the amount of the tax. R.C. 319.30, 319.301, 5705.02-5705.05, 5705.19.

The Ohio Supreme Court has recognized that it is "impractical for the commissioner to personally value all personal property in Ohio" and, therefore, the commissioner "may resort to a predetermined formula to ascertain value." *Snider v. Limbach*, 44 Ohio St.3d 200, 201, 542 N.E.2d 647 (1989). The Ohio General Assembly provided the Tax Commissioner with a predetermined formula for valuing personal property in R.C. 5727.11(A), which states, in pertinent part, that:

> [T]he true value of all taxable property . . . required by section 5727.06 of the Revised Code to be assessed by the tax commissioner *shall* be determined by a method of valuation using cost as capitalized on the public utility's books and records less composite annual allowances as prescribed by the commissioner. If the commissioner finds that the application of this method will not result in the determination of true value of the public utility's taxable property, the commissioner *may* use another method of valuation. (Emphasis added.)

The Ohio Supreme Court long has held that use of the word "shall" in a statute followed by a permissive exception using the word "may" such as in the wording of R.C. 5727.11(A), indicates the General Assembly's grant of discretionary authority. "Ordinarily, the word 'shall' is a mandatory one, whereas 'may' denotes the granting of discretion." *Dennison v. Dennison*, 165 Ohio St. 146, 149 (1956). "[T]he word 'may' shall be construed as permissive and the word 'shall' shall be construed as mandatory unless there appears a clear and unequivocal legislative intent that they receive a construction other than their ordinary usage." *Dorrian v. Scioto Conservancy Dist.*, 27 Ohio St.2d 102 (1971), accord, *Dept. of Liquor Control v. Sons of Italy Lodge 0917*, 65 Ohio St.3d 532, 534 (1992), and *State ex rel. Adams v. Aluchem, Inc.*, 104 Ohio St.3d 640 (2004). The Ohio Supreme Court has also recognized that "'[m]ay' is generally construed to render optional, permissive, or discretionary the provision in which it is embodied." *J.M. Smucker, L.L.C. v. Levin*, 113 Ohio St.3d, 337 at ¶14, 2007 Ohio 2073 (quoting *State ex rel. Niles v. Bernard* (1978), 53 Ohio St.2d, 31, 34). Also see, *Interstate Motor Freight System v. Bowers*, 170 Ohio St. 483 (1960); and *General Motors Corp. v. Tracy*, 73 Ohio St.3d 29 (1995).

By its terms, R.C. 5727.11(A) expressly requires use of the capitalized cost of taxable property, as shown on the taxpayer's books, as the basis of the property's true value calculation, except as otherwise provided. In providing for the use of booked cost less annual allowances to determine the true value of public utility personal property, the General Assembly has statutorily prescribed the same approach to value public utility personal property as has been applied for years in determining true value for purposes of R.C. 5711.18 for the former general personal property tax. Applied simply, the true value of a pipeline is the cost of the pipeline as included on the taxpayer's books and records, less annual allowances. In particular, new pipelines, such as the one in the present case, are straightforward to value, as the cost to build the pipeline is known and is recent.

In the present case, the Department applied the statutory valuation methodology to establish the value of the petitioner's pipeline.

Rebuttable Presumption of Validity of the Statutory Method

In order to deviate from the statutory methodology, the petitioner must prove that the cost-based method does not reflect the true value of the property.

The Supreme Court of Ohio interpreted R.C. 5727.11 in *Texas E. Transm. Corp. v. Tracy, supra*:

> R.C. 5727.11 does not preclude the use of a unit-appraisal method and, where true value is being contested, there need not be a finding of special or unusual circumstances . . . [T]he words 'special and unusual circumstances' do not appear in R.C. 5727.11 and are not a prerequisite for using an alternate valuation method where appellees are contesting true value rather than depreciation rates. If the statutory method does not yield true value, then another method of valuation may be used, whether or not there are special or unusual circumstances. Although a statute may provide a prima facie estimate or presumption of value, where rigid application of the statute would be inappropriate, the presumption of value must yield to other competent evidence reflecting true value. *Monsanto Co. v. Lindley*, 56 Ohio St.2d 59, 61, 10 Ohio Op.3d 113, 381 N.E.2d 939 (1978); *W.L. Harper Co. v. Peck*, 161 Ohio St. 300, 53 Ohio Op. 178, 118 N.E.2d 643 (1954). *Id.* at 85-86

Three justices dissented in *Texas E. Transm. Corp. v. Tracy* and would have ruled the BTA's deviation from the statutory valuation method to be unnecessary, unlawful, and unreasonable. Even so, both the majority and dissenting opinions acknowledged that it remains the taxpayer's burden to demonstrate that application of the statutory cost-based formula does not result in true value. *Texas E. Transm. Corp. v. Tracy*, *Id.* at p. 87 (Cook, J., dissenting) citing *Snider v. Limbach*, 44 Ohio St.3d 200, 542 N.E.2d 647 (1989). Furthermore, both the statute and the majority in *Texas E. Transm. Corp. v. Tracy*, *supra* are silent as to when the Commissioner needs to apply an alternate methodology for determining valuation, except in circumstances where the application of the cost of the property will not result in true value. A review of how the Court has decided other cases where a taxpayer seeks a deviation from a statutorily-prescribed method of valuation is helpful in this regard.

In the context of the former tangible personal property tax, Ohio courts have looked at how the property or equipment was used when compared to its intended use or how other taxpayers used similar or identical property.[9] For example, in *Sun Chem. Corp. v. Limbach,* BTA No. 86-A-157, 1989 WL 82611

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[9] *See also Phoenix Dye Works v. Limbach*, BTA No. 83-E-299, 1985 WL 23004 (July 16, 1985) (equipment used under conditions not intended by its original purchase); *Spang & Co., Ferroslag Div. v. Limbach*, BTA No. 86-D-71, 1989 WL 107396 (Aug. 25, 1989) (equipment used under conditions not intended by the original specifications); *The Reynolds & Reynolds Co. v. Limbach*, BTA No. 85-C-219, 1988 WL 162060 (Mar. 25, 1988) (technological and functional obsolescence requires alternate valuation); *Dayton Walther Corp. v. Limbach*, BTA No. 88-J-190, 1992 WL 141599 (Aug. 25, 1990) (foundry equipment was run 24-hours per day, for six or seven day per weeks, and was exposed to corrosive wet sand, extreme weight due to the products, excessive vibrations, high operating speeds, and extreme heat); *Philips Electronics N. Am. Corp., v. Tracy*, BTA No. 93-K-825, 1996 WL 368488 (June 28, 1996) (equipment was used in a manner not intended by its original purchase); *Defiance Precision Products Inc. v. Tracy*, BTA No. 95-T-564, 1998 WL

(Apr. 21, 1989), the Ohio Board of Tax Appeals ("BTA") found that a taxpayer requesting an alternative valuation must establish either that: (1) the personal property under valuation be subject to external factors negatively impacting its value; or (2) the taxpayer used the equipment in an abnormal manner as compared to the industry, causing the taxpayer's equipment to diminish in value more rapidly.

In *Terraza 8, L.L.C. v. Franklin Cty. Bd. of Revision*, 150 Ohio St.3d 527, 2017-Ohio-4415, 83 N.E.3d 916, the Ohio Supreme Court held that a party challenging the presumptive value of real property for ad valorem tax purposes has the burden to submit rebuttal evidence showing that the presumptive value did not reflect the property's true value. In addition, in *Columbus City Schools Bd. of Edn. v. Franklin Cty. Bd. of Revision*, 146 Ohio St.3d 470, 2016-Ohio-757, 58 N.E.3d 1126, the Court held "the mere fact that an expert has opined a different value should not be deemed sufficient to undermine the validity of the sale price as the property value." Most recently, in *Columbus City Schools Bd. of Edn. v. Franklin Cty. Bd. of Revision*, Slip Opinion No. 2020-Ohio-353, the Court reaffirmed that an appraisal could not be used to rebut the presumed value of property (sale price) when the appraiser failed to state why the presumed value was not indicative of value but merely offered an alternative opinion of value. Therein, the Court held:

> Because Weiler did not account for the fact that the entity transfer involved a transfer of the real estate for consideration, he failed to explain why that datum should be accorded no weight in valuing the property This permitted the BTA to regard Weiler's appraisal as failing to refute the $35,250,000 sale price as the value of the property. See *Columbus City Schs. Bd. of Educ. v. Franklin Cnty. Bd. of Revision*, 146 Ohio St. 3d 470, 2016-Ohio-757, 58 N.E.3d 1126, ¶ 29-30 (reliance on appraisal affirmed when appraiser explained why he did not rely on the sale price), superseded by statute on other grounds, as stated in *Westerville City Schs. Bd. of Educ. v. Franklin Cty. Bd. of Revision*, 154 Ohio St. 3d 308, 2018-Ohio-3855, 114 N.E.3d 162, ¶ 13.

Accordingly, appraisal evidence must be evaluated, but the appraisal must show something specific about the property or the sale that proves that the sale price does not reflect true value. Merely offering an alternative opinion of value is not sufficient.

This same analysis applies to the valuation of public utility property. In order to deviate from the presumed value determined by the statutory methodology, the property owner must prove that the cost-based method does not reflect the true value of the property. This requires more than simply providing an alternative opinion of value. Rather, in order to rebut the presumptive value, the property owner must show something specific about this property that renders the statutory methodology unreliable.

The Court recognized in *Texas E. Transm. Corp. v. Tracy, supra,* that the statutory valuation method, itself, is prima facie evidence of true value. Absent evidence that shows otherwise, the Tax Commissioner has no basis for applying a different valuation method. The burden is not on the Tax Commissioner to establish the accuracy of the statutory valuation method; that method is the one chosen by the General Assembly to establish true value. Unless the Commissioner has information showing that the statutory method does not reflect true value, the statutory method applies. In this case, the

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156482 (Apr. 3, 1998) (equipment was operated at twice the normal speed for three eight-hour shifts per day for up to six or seven days per week).

Commissioner did not have any such evidence or information that would warrant his deviation from the statutory method, and the petitioner did not provide evidence as to why the statutory method should not be used.

THE STATUTORY COST METHOD IS AN ACCURATE & APPROPRIATE MEASURE OF THE TRUE VALUE OF NEXUS' PUBLIC UTILITY PERSONAL PROPERTY

R.C. 5727.11(A) requires that the Tax Commissioner make a finding that the statutory valuation method does not reflect true value before "he may use another method of valuation." The petitioner has not submitted evidence establishing how the statutory valuation method as applied to its property resulted in an error that rendered the cost-based determination of true value inaccurate. In addition, the Commissioner has found no other basis or need to deviate from the statutory valuation method because it accurately and appropriately reflects the true value of the petitioner's property as required by R.C. 5727.11. The personal property at issue is newly constructed, so the costs are known, current, and are accurate. There is no statutory reduction for unforeseen cost, and the petitioner has not presented evidence or authority sufficient to support the reductions it seeks. The statutory method requires all capitalized cost to be reported for tax purposes, not just the ones that were forecasted. For these reasons, the Tax Commissioner concludes the prescribed cost-based method accurately and appropriately establishes the true value of the personal property.

In attempting to refute the accuracy and appropriateness of the statutory cost-based valuation, the petitioner relies heavily on its Appraisal and alternative valuation methodology. However, the fact that the petitioner's Appraisal produces a different calculation of true value is not, by itself, evidence that the statutory method is inappropriate or inaccurate. The petitioner's Appraisal is simply an opinion of true value; not evidence of any fundamental or inherent deficiency in the statutory valuation method that prevents it from determining true value. The petitioner has not demonstrated that the application of the statutory method results in an inaccurate or inappropriate measure of true value of its newly constructed personal property or that its Appraisal is a more accurate and appropriate measure of true value.

Based on all the information and evidence currently available, the Tax Commissioner finds that the statutorily prescribed cost-based valuation method accurately and appropriately represents the true value of the personal property at issue in this case and therefore must be applied.

Here, the petitioner asserts that an additional approximately $400 million in excess cost related to regulatory delays and excess construction costs, and asserts that this amount should be deducted from its capitalized costs for purposes of taxation. The petitioner, however, has not prepared an impairment study or booked a reduction on the long-lived assets that it claims have no ability to make a return on investment. Pursuant to the BTA's holding in *Ohio Bell Tel. Co. v. Wilkins*, BTA No. 2005-K-202, (Aug. 4, 2006), discussed herein, consideration must also be given to the fact that the petitioner did not record the reduction it seeks for tax purposes on its books. As such, the petitioner is asking the Department to ignore the value its property holds on its own financial records and make an adjustment to the value of its property based on a value that it has not recorded for financial accounting purposes. The fact that the petitioner did not record these values in its financial statements tends to show that the petitioner, itself, does not believe the Appraisal to be an accurate capture of true value as to incorporate the Appraisal value into its financial statements. This is of particular importance as such recording of impairment by U.S.-based companies is required by the Financial Accounting Standards Board ("FASB"), as explained herein. It is also well settled that a company is bound by its books and records. *Rickenbacker Holding Corp. v. Tracy*, BTA No. 91-Z-709, 1993 WL 122514 (Apr. 12, 1993).

THE APPLICATION OF AN ALTERNATIVE VALUATION METHODOLOGY

R.C. 5727.11 provides that the Tax Commissioner may apply an alternate methodology to value a taxpayer's personal property only in cases where the statutory methodology will not result in the true value of that property. If the evidence presented demonstrates that the statutory cost-based valuation methodology does not result in an accurate and appropriate measure of true value, the next question for the Commissioner to consider is what alternative value should be attached to the personal property. Since the petitioner has asked the Commissioner to review its proposed alternative valuation methods, the Commissioner shall analyze each one separately.

Unit Appraisals

The Appraisal states that "(g)enerally, when appraising the operating properties of a natural gas pipeline company the unit appraisal concept is applied."[10] As a result, in both of its alternative valuation calculations, the Appraisal applies concepts and approaches common to a unit appraisal. The Ohio Supreme Court has stated that "(i)n a unit appraisal, a professional appraiser determines the 'unit' to be appraised (such as the public utility's operating properties), estimates the market value of that unit, and allocates an appropriate portion of the unit to the taxing jurisdiction." *Ohio Bell Tel. Co. v. Levin*, 124 Ohio St.3d 211, 2009-Ohio-6189, 921 N.E.2d 212, ¶ 9 (2009). Prior to the Ohio General Assembly amending R.C. 5727.11 in 1989, Ohio taxed public utility personal property under "unit" valuation, but, under the amended statute, the prima facie approach became one which determined the value of property by "using cost as capitalized on the public utility's books and records less composite annual allowances as prescribed by the commissioner." *WCI Steel, Inc. v. Testa*, 129 Ohio St.3d 256, 2011-Ohio-3280, 951 N.E.2d 421, ¶ 46 (2011).

Nevertheless, subsequent to the amendment of R.C. 5727.11, courts and tribunals in Ohio have reached different conclusions as to whether and when it is appropriate to value property under a unit appraisal. See, *Ohio Bell Tel.*, *supra*, (Ohio Supreme Court rejected the use of a unit appraisal); *WCI Steel, Inc.*, *supra*, (Ohio Supreme Court remanded the BTA for consideration of a unit appraisal); *Texas E. Transm.*, *supra*, (in a split decision, the Court's majority found that the BTA's decision to allow a pipeline to use an alternate valuation methodology was not unlawful or unreasonable). Even so, it is worth noting that the Court has identified a "fundamental dissimilarity" between the statutory cost-based approach valuation provided for under R.C. 5727.11 and the unit appraisal approach "because a unit appraisal is an 'appraisal of an integrated property as a whole, without reference to the value of its component parts.'" *WCI Steel, Inc.*, *supra*, at ¶ 45 (2011) (internal citations omitted).

Notably, the BTA examined a "unit appraisal" method to valuation in *Trunkline Gas Co. v. Tracy*, BTA No. 93-P-593, 1995 WL 389812 (June 30, 1995), which is similar to the income-deficiency approach used by the petitioner in this matter. *Trunkline Gas Co. v. Tracy* involved a national pipeline company that requested to deviate from the statutory valuation method provided under R.C. 5727.11(A), and instead sought to use an appraisal prepared by Tegarden & Associates, the same firm that prepared the

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[10] *Tegarden & Associates, Inc. Appraisal of the Operating Properties of Nexus Gas Transmission, LLC as of January 1, 2019* at 16.

appraisal report submitted in this case. The BTA had concerns about the disconnect and dissonance between the well-documented and well-founded statutory cost-approach and the flawed estimates and approaches involved in the alternative valuations on which the petitioner rests its request. The BTA denied the use of an appraisal relying upon a unit appraisal methodology to alternatively value a new pipeline stating that:

> As to the unit appraisal prepared by Tegarden and Associates, we are troubled by the lack of any explanation as to why tangible personal property acquired for a reported $45,165,287 only one year earlier in 1990 would only have a value of half that much only one short year later, in 1991. (St – 13.) The Tegarden appraisal shows a purported true value of $22,752,000. *See* St – 13, 241. Without an adequate explanation for this discrepancy, we do not believe Appellant has sustained its burden of overcoming the presumption of validity that has attached to the Tax Commissioner's finding. *Aluminum Co. of Am. v. Kosydar*, 54 Ohio St.2d 477, 481, 377 N.E.2d 785 (1978). Nor has Appellant established its right to the relief requested. *See Belgrade Gardens, Inc. v. Kosydar*, 38 Ohio St.2d 135, 311 N.E.2d 1 (1974); *Ohio Fast Freight, Inc. v. Porterfield*, 29 Ohio St.2d 69, 278 N.E.2d 361 (1972); *Midwest Transfer Co. v. Porterfield*, 13 Ohio St.2d 138, 235 N.E.2d 511 (1968); *Natl. Tube Co. v. Glander*, 157 Ohio St. 407, 105 N.E.26 648 (1952). Examining the evidence in its entirety, Appellant has not proved that the Tax Commissioner's use of the statutory formula does not reflect true value of this tangible personal property. *See CC Leasing Corp. v. Limbach*, 23 Ohio St.3d 204, 492 N.E.2d 421 (1986); *Aluminum Co. of Am. v. Kosydar*, supra.

The discussion of unit appraisals is key because there are numerous similarities between the appraisal in *Trunkline Gas Co. v Tracy* and the petitioner's Appraisal. Not only were both appraisals involving valuation approaches common to the income-deficiency method produced by Tegarden & Associates, but in both cases, the taxpayer seeking to deviate from the statutory method failed to rebut the presumption that the cost formula contained in R.C. 5727.11 accurately reflected true value. In the petitioner's Appraisal, Tegarden & Associates provides two methods of valuation, both of which apply concepts from the unit appraisal approach.

First Proposed Alternative Calculation of True Value: A Cost Approach Based on Income-Deficiency

The first alternative approach the petitioner seeks to use is a variation of cost-based methodology sometimes referred to as an "income-deficiency" approach or "income shortfall" approach. An examination of the following authority regarding valuation and appraisal methodologies reveals that valuation assumptions and estimates used in the petitioner's request to use an income-deficiency approach would produce an inaccurate measure of true value in this case.

In light of the weight the petitioner places on this Appraisal, the Tax Commissioner has examined the estimates, methods, and valuations contained within it. Under the cost approach portion of the Appraisal, the property is valued at $1,178,500,000, and under the income approach the property is valued at $1,182,200,000.

How the Petitioner's Appraisal Cost Approach Reaches its Alternative Valuation of $1,178,500,000

This cost approach is laid out in the following calculation from the Appraisal:

NEXUS Gas Transmission, LLC
Cost Approach - January 1, 2019

Utility Plant (101 - 106, 114)		$ 2,481,597,585
Construction Work in Progress (107)		14,499,094
Total Utility Plant		$ 2,496,096,679
Less Accum. Provision for Book Depr., Amort., & Depl.		8,571,954
Net Utility Plant		$ 2,487,524,725
Add: System Balancing Gas		950,118
Total Net Utility Plant		$ 2,488,474,843
Add: Materials & Supplies		0
Net Assets (Actual at BOY 2019)		$ 2,488,474,843
Net Assets (Projected at EOY 2019)		2,500,767,010
Expected Average Net Assets in service		$ 2,494,620,927
Expected Level Equivalent Income *		177,088,570
Achieved Rate of Return =		7.10%
Overall Cap Rate (R_O) ** =		14.99%
Net Assets (Actual at BOY 2019)		$ 2,488,474,843
Achieved ROR as % of Required Return	47.36%	
External Obsolescence =	52.64%	1,309,933,157
Cost Approach after External Obsolescence =		$1,178,541,686
	Rounded =	**$1,178,500,000**

First, the Appraisal arrives at a valuation under a "cost-approach" by starting with Utility Plant plus Construction Work in Progress to yield "Total Utility Plant" as of January 1, 2019 of $2,496,096,679. From this amount, booked accumulated depreciation, amortization, and depletion are subtracted to yield "net utility plant" cost of $2,487,524,725. Then, "system balancing gas" is added in to yield "Total Net Utility Plant" of $2,488,474,843, which is averaged with "projected net assets" as of end of year 2019 of $2,500,767,010 to yield "Expected Average Net Assets in service" of $2,494,620,927.

The Appraisal then applies assumptions applicable to an income-deficiency approach to the calculation factoring in an overall capitalization rate or "rate of required return" of 14.99% to estimate the value of the pipeline. The Appraisal computes a "level equivalent cash flow" for the pipeline and divides this level cash flow by average net plant during 2019 to yield the "rate of return on operating assets". This computation yields a "rate of return on operating assets" of 7.10%. Then, the Appraisal compares this 7.10% "rate of return on operating assets" with the overall capitalization rate chosen of 14.99%. The Appraisal describes its capitalization approach as follows:

> A prospective purchaser of the operating natural gas pipeline property of NEXUS Gas Transmission, LLC would require a market rate of return. If the level equivalent cash flow is divided by the average net plant during 2019, the rate of return on the operating assets can be calculated. The indicated rate of return on the average plant during 2019

> was expected to be 7.10%. If this 7.10% rate of return is compared with the investor required overall capitalization rate of 14.99%, the expected rate of return is 7.89% below the investor required rate of return (14.99% - 7.10 = 7.89%). This 7.89% deficiency in rate of return equates to a 52.64% external obsolescence (7.89% / 14.99% = 52.64%).

As described above, the Appraisal takes this "level equivalent income" amount of $177,088,570 and divides it by "Expected Average Net Assets in service" of $2,494,620,927 to arrive at NEXUS' "Achieved Rate of Return" of 7.10%. As explained above, this 7.10% rate of return is compared with the investor required overall capitalization rate of 14.99%, and this 7.89% deficiency in rate of return equates to a 52.64% external obsolescence.

The Appraisal takes this computed "external obsolescence" of 52.64% and multiplies it by the beginning of year 2019 net assets of $2,488,474,843 to yield "external obsolescence" cost of $1,309,933,157. Then, the Appraisal takes beginning of year 2019 net assets of $2,488,474,843 and subtracts "external obsolescence" cost of $1,309,933,157 to yield "cost approach value after external obsolescence" of $1,178,541,686. The Appraisal rounds "cost approach value after external obsolescence" to $1,178,500,000.

Other States Have Rejected the Cost Approach Based on Income-Deficiency

Alaska, Louisiana, Montana and Oregon have rejected utilizing the income-deficiency method to value public utility property. Specifically, *BP Pipelines (Alaska) Inc., et al. v. State of Alaska Dept. of Revenue, State Assessment Review Bd., and N. Slope Borough*, Alaska No. 3AN-06-08446 CL, 2011 WL 10604082 (Dec. 30, 2011), also dealt with an appraisal in which the cost and value was based upon the "income-deficiency" method. In that matter, the Alaska Department of Revenue ("Alaska DOR") rejected the use of the "income-deficiency" approach for a matter involving the valuation of the Trans-Alaska Pipeline System ("TAPS") for ad valorem tax purposes. The Alaskan court wrote "[o]ther appraisers persuasively testified that the effect of applying an income shortfall method is to eliminate the independent value of the cost approach by altering it to an income approach." Further, the court stated "[t]his Court finds, as it did in the 2006 matter, that such a method should not be applied to determine the economic obsolescence of TAPS." Furthermore, the court explained that a number of western states have denied the use of the "income-deficiency" method, noting that the Western States Association of Tax Administrators ("WSATA") has rejected the "income-deficiency" method. Specifically, the Superior Court stated:

> The * * * WSATA Appraisal Handbook rejects the income-deficiency method:
>
> A few appraisers attempt to measure obsolescence by comparing a company's actual earnings with the theoretical earnings that should have been achieved by the company with the assets on hand if they were earning a fair return on cost. This method is an improper variation of a method often used for individual properties, where it can be demonstrated that the subject property is not technologically capable of producing as much operating income (cash flow) as new replacement property. When used to compare earnings with theoretical company earnings, the method simply forces the cost approach to agree with the capitalized earnings approach.

> The WSATA Appraisal Handbook has wide acceptance by the approximately 35 states that do unit valuation and has undergone a comprehensive peer review process.

As such, the Superior Court of Alaska has rejected the "income-deficiency" approach method.

Likewise, in *In re Appeal of ANR Pipeline Co., Mona Kelly as Cameron Parish Tax Assessor v. ANR Pipeline Co., et al.*, 73 So.3d 398 (La.App.2011), the Court of Appeals of Louisiana denied the use of an appraisal using the "income-deficiency" approach and refused to allow a reduction from that appraisal for "economic obsolescence" of the pipeline's property. Also, in *Southwest Airlines Co. v. Arizona Dept. of Revenue*, Arz.App. No. 1 CA-TX 11-0007, 2012 WL 3041179 (July 26, 2012) (Memorandum Decision),[11] the Court of Appeals of Arizona found that the "income-deficiency" approach failed to accurately measure the obsolescence of assets.

The Montana Tax Appeal Board also rejected an appraisal prepared by Tegarden utilizing the "income shortfall" approach in a matter involving the valuation of a large electric generation company. *PacifiCorp v. State of Montana, Dept. of Revenue*, Docket Nos. CT-2006-05 and CT-2007-7. The appraisal used by *PacifiCorp* is very similar to the one at issue in the case at hand, and this case is instructive. The Montana Department of Revenue consulted a number of appraisal experts to review and evaluate the proposed appraisal. Montana's Tax Appeal Board ultimately rejected PacifiCorp's proposed use of the "income shortfall approach" used in that appraisal. This decision involved weighing evidence from multiple Ph.D.s and appraisers for both sides regarding the accuracy, acceptability, and applicability of the income shortfall methodology used in the privately-prepared appraisal. In this opinion, Dr. James Ifflander, who has a Ph.D. in finance, is a Chartered Financial Analyst, and was "certified as an expert in the areas of corporate finance, valuation and valuation methodologies", reviewed the appraisal. The Tax Appeal Board noted:

> In Dr. Ifflander's opinion, Mr. Tegarden's income shortfall method is not a valid or accepted method of measuring obsolescence. In addition to the inherent circularity of this method, Dr. Ifflander noted that Mr. Tegarden improperly attempts to compare a rate of return on booked accounting assets when in actuality it is calculated on the rate base. This creates a mismatch. Moreover, Mr. Tegarden's comparison, Dr. Ifflander notes, is in no way a measure of obsolescence.
>
> Dr. Ifflander also stated that Houlihan Lokey Howard & Zukin (Houlihan & Lokey), the investment bankers hired by MEHC [parent company of PacifiCorp] for valuing the purchase of PacifiCorp, did not use the income shortfall approach, nor did they find any additional external obsolescence above normal depreciation.
>
> * * *
>
> Based on Dr. Ifflander's independent analysis, he did not find evidence of additional economic obsolescence that was not already accounted for in the Department's OCLD [original cost less depreciation] approach.

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[11] Pursuant to Ariz. Sup. Ct. R. 111(c), memorandum decisions of Arizona state courts are not precedential and, [as] such, a decision may be cited only: (1) for persuasive value; and (2) if the citation indicates [that the] decision is a memorandum decision.

The Montana Tax Appeal Board also weighed testimony of Brent Eyre, an Accredited Senior Appraiser with the American Society of Appraisers (ASA), who testified in support of the Montana Department of Revenue's valuation. The decision noted:

> Mr. Eyre criticized Mr. Tegarden's income shortfall calculations for a number of reasons. Mr. Eyre explained that Mr. Tegarden's income shortfall methodology is not found in the traditional appraisal texts and that it is not the same capitalization of income loss method as outlined in *The Appraisal of Real Estate*, and has been rejected in other jurisdictions.
>
> * * *
>
> Mr. Eyre also detailed the inherent circularity in Mr. Tegarden's income shortfall methodology which converts the cost approach to an income approach, rather than considering them as two diverse ways of valuing the company.
>
> * * *
>
> Mr. Eyre noted that the cost indicator of value should stand on its own in the valuation process, separate from income indicators, as one of many methods of calculating value. It is an important value indicator as it calculates the total investment in plant made by the company. Comparing a historical stream of income that is calculated as a return on rate base to the historical cost less depreciation is, in essence, a mismatch. EP 46. Dr. Ifflander also noted that the calculation "effectively converts his cost approach to an income approach leaving but one indicator of value." Ifflander, Stipulated Exh. 53, p. PC-Dor 003463.

Additionally, the Montana Tax Appeal Board considered expert testimony from Dr. John W. Wilson who criticized the privately-prepared appraisal's economic obsolescence deductions:

> Dr. John W. Wilson testified in favor of the Department. He received his Ph.D. in Economics and has testified in numerous regulatory proceedings across the United States during the course of his career. Stipulated Exh. 50. Dr. Wilson is an expert on public utility company issues, particularly as it relates to rate regulation. Stipulated Exh. 50. Dr. Wilson was certified as an expert in the field of economics and public utility regulatory issues. Tr. P. 732, ll. 9-24.
>
> Dr. Wilson criticized Mr. Tegarden's economic obsolescence deductions. Dr. Wilson explained that this is not a true measure of obsolescence, but rather, the mathematical difference between Mr. Tegarden's "understated" projected earnings and his overstated "required" earnings. Stipulated Exh. 51, pp. 4-5; Tr. P.737,l. 6, through p.172,l. 8.
>
> Dr. Wilson also stated that economic obsolescence, like physical and functional obsolescence, is "regularly reflected in depreciation accrual rates, which are approved by regulatory authorities, and they would be recoverable from ratepayers, they would be reflected in the company's rates. So the idea that there is unrecouped obsolescence is invalid." Tr. P.736. ll. 3-12.
>
> * * *
>
> Finally, Dr. Wilson testified that if there really was economic obsolescence, PacifiCorp would include it in its rate base and recover it from the ratepayers, so there is no unrecovered loss. EP 50.

The Montana Tax Appeal Board concluded its review of the privately-prepared appraisal's obsolescence deductions by noting:

> Thus, we find no empirical evidence demonstrating that economic or external obsolescence impaired the value of PacifiCorp for tax year 2006 and 2007. We find that the company does not suffer from economic obsolescence. Thus, we cannot find Mr. Tegarden's value of PacifiCorp to be market value. Further, we find Mr. Tegarden's appraisal less credible than other evidence presented to this Board. Additionally, the Court of Appeals of Louisiana, in *In re Appeal of ANR Pipeline Co., Mona Kelly as Cameron Parish Tax Assessor v. ANR Pipeline Co., et al.*, 73 So.3d 398 (La.App.2011), denied the use of an appraisal submitted by a representative using the "income-deficiency" approach and refused to allow a reduction for "economic obsolescence" of the pipeline's property.

The Supreme Court of Montana reviewed and upheld the decision of Montana Tax Appeal Board, which rejected the use of the "income-deficiency" approach in an appraisal. *PacifiCorp v. State of Montana, Dept. of Revenue*, 360 Mont. 259 (Mont.2011). Like the Montana Tax Appeal Board, the Supreme Court of Montana found numerous inaccuracies in the use of the "income-deficiency" method of valuation.

In *United Tel. Co. v. Department of Revenue* (1989), 307 Ore. 428; 770 P.2d 43, the Oregon Supreme Court examined the income shortfall approach to preparing cost approach valuations. The Oregon Supreme Court weighed testimony of Dr. John R. Davis, III, and provided a clear explanation of why the income shortfall approach to cost is, in reality, an income approach:

> * * * the mathematical logic of Dr. Davis' approach essentially converts the cost approach to an income approach. Where the income and the rate are given, Dr. Davis' method will always result in a value exactly the same as the income approach because it shoves the cost out the back door. Algebraically, the method cancels all cost in excess of the value indicated by the income approach as obsolescence.
>
> In theory, each approach [to valuation] views the concept of value from a different perspective, with the intent of considering all facts and perspectives relevant in the result in the marketplace. Adjusting one approach to make it rely on the result in the same indication of value as another approach effectively eliminates a relevant perspective from consideration. *Pacific Power & Light Co. v. Dept. of Rev.*, 7 OTR 203, 217 (1977).

As explained above, the petitioner's cost approach to value, as prepared under the income-deficiency methodology, converted the cost approach into an income approach. In *United Tel. Co. v. Department of Revenue*, *supra*, the Oregon Supreme Court explained that the income-shortfall approach to cost valuation essentially converts the cost approach into an income approach. Thus, the petitioner has not submitted a real cost approach to valuation.

Further, there is considerable case law holding that using an "income-deficiency" approach to valuation is flawed because it converts the "cost-approach" into an "income-based" valuation. In *Delta Air Lines, Inc. v. Dept. of Revenue, State of Oregon*, 328 Or. 596 (Or.1999), the Oregon Supreme Court explained that the "income-deficiency" approach to cost would convert a "cost-approach" method into an "income-approach" valuation to such a great extent that the "income-deficiency" method would measure income rather than the cost of the assets. In *In re Appeal of ANR Pipeline Co., supra*, the Court of Appeals of

Louisiana denied the use of an appraisal submitted by a representative using the "income-deficiency" approach and refused to allow a reduction for "economic obsolescence" of the pipeline's property.

Again, in *Southwest Airlines Co. v. Arizona Dept. of Revenue*, *supra*, the Court of Appeals of Arizona rejected the use of the "income-deficiency" approach to determine property value. The Arizona court found that the "income-deficiency" approach failed to accurately measure the obsolescence of assets because the stock market value of its assets was listed above book value while the appraisal ignored market values in order to obtain a valuation far below book value for tax purposes.

Although the Commissioner has already determined that the statutory method of valuation is appropriate and accurate in this case, the Commissioner rejects the petitioner's first alternative valuation methodology for the reasons laid out herein.

The Petitioner's Appraisal Converts a Cost Approach to an Income Approach

In effect, the Appraisal's cost approach to value, as prepared under the income-shortfall methodology, has effectively converted a cost approach into an income approach. In *United Tel. Co. v. Department of Revenue*, *supra*, the Oregon Supreme Court explained that the income-shortfall approach to cost valuation essentially converts the cost approach into an income approach. In *Delta Air Lines, supra,* the Oregon Supreme Court again explained that the "income-deficiency" approach to cost would convert a "cost-approach" method into an "income-approach" valuation to such a great extent that the "income-deficiency" method would measure income rather than the cost of the assets.

In *In re Appeal of ANR Pipeline Co.*, *supra*, the Court of Appeals of Louisiana denied the use of an appraisal submitted by a representative using the "income-deficiency" approach and refused to allow a reduction for "economic obsolescence" of the pipeline's property. In *BP Pipelines, et al.*, *supra*, the Superior Court of Alaska rejected the use of the "income-deficiency" approach for a matter involving the valuation of the TAPS for ad valorem tax purposes. The Alaskan court wrote "[o]ther appraisers persuasively testified that the effect of applying an income shortfall method is to eliminate the independent value of the cost approach by altering it to an income approach." Further, the court stated, "[t]his Court finds, as it did in the 2006 matter, that such a method should not be applied to determine the economic obsolescence of TAPS." The Court in *BP Pipelines, et al.*, *supra*, explained that a number of western states have denied the use of the "income-deficiency" method noting that WSATA has rejected the "income-deficiency" method. In *PacifiCorp v. State of Montana, Dept. of Revenue*, *supra*, the Supreme Court of Montana also rejected the use of the "income-deficiency" approach in an appraisal.

As explained herein, WSATA has rejected the income-shortfall approach. Thus, the petitioner is asking that the Tax Commissioner accept a method of valuation which WSATA, an organization which includes most states in the western USA, including Texas and the states west of Texas, has rejected as being inaccurate, flawed, and circular. It is just as inaccurate, flawed and circular in Ohio. By relying exclusively on an income approach, the petitioner has no way to test the reasonableness of its estimate of value against other, independent valuation methods. Any errors in assumptions, methodology, data interpretation and gathering, or appraisal judgment that the petitioner makes under the income approach are magnified. By using a "back-door" income approach as its "cost approach," the petitioner's "cost approach valuation" is truly misnamed. In fact, it is simply an income valuation study masquerading as a cost approach. Moreover, it is a significant deviation from the straightforward valuation that is achieved through the statutory cost method.

As noted above, in *BP Pipelines, et al., supra*, the Superior Court of Alaska held that the income shortfall approach would not be accepted to determine economic obsolescence. Similarly, in *In re Appeal of ANR Pipeline Co., supra*, the Court of Appeals of Louisiana denied the use of an appraisal using the "income-deficiency" approach and refused to allow a reduction from that appraisal for "economic obsolescence" of the pipeline's property. Again, in *Southwest Airlines Co. v. Arizona Dept. of Revenue*, the Court of Appeals of Arizona found that the "income-deficiency" approach failed to accurately measure the obsolescence of assets. Similarly, the Tegarden Appraisal in this case takes a large obsolescence reduction but fails to address or assuage the valid concerns many courts have had with such a reduction. Moreover, the petitioner has not demonstrated that the Tax Commissioner, by allowing such a large obsolescence reduction, would arrive at a more accurate reflection of the true value of its public utility's taxable property.

External Obsolescence & Anticipated Rates of Return

The petitioner's "cost-approach" valuation seeks a reduction in "true value" for "external obsolescence". This "cost-approach" valuation bases its obsolescence adjustments on estimated income capabilities of the property because the petitioner's predicted rate of return of 7.10% is less than the Appraisal's required rate of return of 14.99%. As such, the petitioner has effectively turned its "cost-approach" valuations into "income-approach" or "income-deficiency" valuations by making these reductions based on the income capabilities of its assets.

There are numerous rough estimates in the computation of the Appraisal's external obsolescence percentage. First, in computing the "level equivalent income", the Appraisal estimates revenue, taxable income, various expenses, capital expenditures, and after-tax cash flow for a 48-year period, for every year out to 2066. As the "level equivalent income" is based on estimates projected so far into the future, both the reliability and accuracy of the estimates become tenuous. The Tegarden Appraisal's computation of "external obsolescence" yielded an obsolescence percentage of 52.64%. The computations done by the appraiser to compute external obsolescence confirm that the external obsolescence percentage is merely a rough estimate.

Notably, in *The Duriron Co., Inc., v. Limbach*, BTA No. 89-M-446, 1992 WL 275695 (Sept. 25, 1992), the Board of Tax Appeals held that a reduction in the value of inventory due to obsolescence can only be granted to the extent the taxpayer is able to substantiate the obsolescence. In the case at hand, the Appraisal's computation of external obsolescence, which used a very high "required" capitalization rate of 14.99% against which to compare NEXUS' rate of return, shows that the petitioner is – at best – making rough estimates of obsolescence. The Montana Department of Revenue determined from an extensive review of natural gas pipelines that 8.9% is the capitalization rate that is an accurate and appropriate rate to be used by gas pipelines.[12] Likewise, Mercer Capital, a valuation and advisory firm, has determined that a 10% capitalization rate is an accurate and appropriate rate for oil and gas companies.[13] The Washington State Department of Revenue ("DOR") performed a "Cost of Capital Study" for the Pipeline Industry for 2019 and determined that the appropriate capitalization rate for the "Pipeline Industry" for 2019 was 8.48%.[14] Further, the Washington State DOR used an allocation of 55% to equity and 45% to debt in computing the cost of capital for the "Pipeline Industry". Thus, the

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[12] Montana Department of Revenue, *2019 Capitalization Rate Study - Gas Pipelines*, Completed: April 22, 2019.

[13] *WACCs [weighted average cost of capital] for E&P Companies*. Prepared by Mercer Capital on August 2, 2016. Mercer Capital is an employee-owned business and financial advisory firm founded in 1982.

[14] Washington State Department of Revenue, *Cost of Capital Study Pipeline Industry*, 2019 Assessment Year.

Appraisal uses a much higher capitalization rate than the above-mentioned scholarly capitalization rate studies. Using a much higher capitalization rate of 14.99% leads to a much lower valuation in the Tegarden Appraisal.

Flotation Costs

The Appraisal includes a flotation cost adjustment used in the income-deficiency cost approach. Flotation costs are the costs to issue debt and equity financing. Courts have previously not allowed the addition of flotation costs to the costs of debt and equity capital because it relates to a potential cost of doing business rather than an actual cost of acquiring capital. *Reed v. Robilio* (W.D.Tenn.1967), 273 F.Supp. 954. The Appraisal states that a flotation rate of 0.35% was used in computing the cost of capital used in the Appraisal. The flotation cost used by the Appraisal increased the capitalization rate by being added to the capitalization rate, which further reduced the value obtained within the Appraisal for the pipeline assets. Relatedly, in *PacifiCorp v. State of Montana, Dept. of Revenue*, *supra*, two Ph.D. expert witnesses testified that flotation costs should not be added to the cost of capital, and that the flotation costs are inappropriate because they are not a part of the opportunity cost of capital. The Montana Tax Appeal Board wrote:

> Dr. Bernardo testified that the flotation costs should not be added to the cost of capital.
>
> Dr. Ifflander testified that the flotation costs are inappropriate because they are not a part of the opportunity cost of capital, which is the rate used in a yield capitalization calculation. He also stated that they are usually trivial costs and that Mr. Tegarden's rates were calculated incorrectly and "overstated to a significant degree."

Even assuming that the flotation cost adjustment used was permissible, the petitioner's flotation costs were not based upon facts and circumstances pertinent to the petitioner, but instead on industry averages developed from third party materials which were not submitted for review.

SECOND PROPOSED ALTERNATIVE CALCULATION OF TRUE VALUE: AN INCOME APPROACH BASED ON AFTER-TAX CASH FLOW AMOUNTS FROM 2019 THROUGH 2066

The second approach with which the petitioner seeks to alternatively value its public utility property is an income approach based upon projected after-tax cash flow amounts from 2019 through 2066. The primary basis for the petitioner's income approach is the Tegarden Appraisal.

The Tegarden Appraisal computes a projected free cash flow for 48 years, from 2019 through 2066. It computes an estimated after-tax cash flow for each year, then applies a present value factor for each year to convert each year's after-tax cash flow to a "present value cash flow" amount. The sum of these "present value cash flow" amounts for years 2019 through 2066 totals $1,181,494,499. The Appraisal multiplies that number by the capitalization rate of 14.988523% to yield a "level equivalent income" amount of $177,088,570.

How the Petitioner's Appraisal Income Approach Reaches its Alternative Valuation of $1,182,200,000

The petitioner arrives at an "income-approach" discounted cash flow method of valuation by taking an estimated after-tax cash flow for each year from 2019 through year 2066. This after-tax cash flow estimate for each year is multiplied by a present value factor to obtain "present value cash flow" for each year from 2019 through 2066. The cash flow estimate covers a 48-year period from 2019 through 2066. The Appraisal acknowledges that "(b)ecause the [NEXUS] is new (it began operations in October 2018) there is no historical information to make projections of net operating income over the past few years."[15] Therefore, Tegarden & Associates "rely on projections from [NEXUS] documents which are believed to be appropriate and appear to take into consideration all of the surrounding circumstances affecting [NEXUS]." The Appraisal does not identify or project what specific factors or market trends may impact the petitioner's cash flows thirty or forty years out, but rather focuses on circumstances primarily related to issues which had already occurred or are likely only to impact the petitioner's near-term cash flows, such as regulatory and construction delays and initial subscription rates.[16]

Based on these assumptions, the Appraisal adds the present value of the 48 years of cash flow together to obtain total free cash flows at present value of $1,181,494,499. Then, the Appraisal takes the 49th year's projected level net operating income of $82,462,762 and divides it by the Appraisal's capitalization rate of 14.97% to obtain what it calls "the terminal value of the Company" of $550,853,450. The terminal value is then discounted by the present value factor for 48 years at a 14.97% rate, which results in a present value of $680,736. Then, the present value of the free cash flows of $1,181,494,499 is added to the present value of the terminal value of $680,736 to get a total value from the income approach of $1,182,175,235. The Appraisal then rounds the income approach amount to $1,182,200,000. The estimates and calculations the petitioner uses for its income approach are laid out in the following figure from the Appraisal:

[15] *Tegarden & Associates, Inc. Appraisal of the Operating Properties of Nexus Gas Transmission, LLC as of January 1, 2019* at 55.

[16] *Id.* The Appraisal states that "The Company has obtained some new contracts with certain shippers and may be able to take advantage of its connections with other pipeline and shale gas supplies. However, due to FERC caused delays in the completion of the NEXUS pipeline, two other pipelines - Rover and TransCanada's Columbia came on line and captured shippers that were potentially due to ship on NEXUS which caused subscribed volumes to drop and unsubscribed volumes and price to be exceedingly low. As a result, a large portion of the pipeline's capacity is unsubscribed, i.e., not long-term contracted volumes, making it more risky than it would be if fully subscribed. The unsubscribed volumes are subject to short-term agreements at current market rates, which are substantially lower than NEXUS' current long-term firm contracts."

NEXUS Gas Transmission, LLC **Income Approach (DCF model)** **2019 - 2066**	**Present Value of Cash Flows:**			**Discount Rate =**	**14.97%**
	0.5	1.5	2.5	3.5	4.5
	2019	**2020**	**2021**	**2022**	**2023**
Total Revenue	272,960,912	279,587,081	291,817,375	293,909,141	302,277,442
Total Operating Expenses	59,429,767	89,651,768	110,824,935	111,194,880	111,598,938
Property Tax Expense					
Depreciation Expense - (Fed. Inc. Tax)	146,032,224	120,126,658	108,181,928	97,368,985	87,670,621
Taxable Income	67,498,921	69,808,655	72,810,512	85,345,275	103,007,883
Income Tax at 21.948%	14,814,663	15,321,604	15,980,451	18,731,581	22,608,170
Taxable Income less Income Taxes	52,684,258	54,487,051	56,830,061	66,613,694	80,399,712
Add back Depr. Expense - (Fed Inc. Tax)	146,032,224	120,126,658	108,181,928	97,368,985	87,670,621
Less Capital Expenditures	56,525,974	0	0	63,339	2,609,546
After-Tax Cash Flow	142,190,508	174,613,710	165,011,989	163,919,341	165,460,787
Present Value Factor	0.932626	0.811191	0.705568	0.613697	0.533789
Present Value Cash Flow	132,610,630	141,645,096	116,427,124	100,596,840	88,321,146
Sum of Present Value of Free Cash Flows =			**1,181,494,499**		
Terminal Value:					
Proj. Level NOI (Year 49 forward)		82,462,762			
Discount Rate (for NOI)		14.97%			
Terminal Value		550,853,450			
Present Value of Terminal Value =			**680,736**		
Total Present Value by Income Approach =			**1,182,175,235**		
		(Rounded)	**1,182,200,000**		

*Note - This budget projection does not include an estimate for property tax expense.

Effective Property Tax Rate =	6.18%					
Tax affected Effective Property Tax Rat	4.82%					
	2018	**2,019**	**2,020**	**2,021**	**2,022**	**2,023**
Net Investment at end of year	2,488,474,843	2,500,767,010	2,455,746,551	2,410,726,091	2,365,768,794	2,323,349,559

Discount Rates

There are numerous issues with the Appraisal's income approach valuation. First, the Appraisal discounts the cash flows using the overstated discount rate of 14.97%. It should be noted that the Appraisal used a 14.99% rate in its cost approach computations but a 14.97% rate in its income approach computations. At the administrative hearing, Mr. Tegarden stated that this slight difference occurred due to the results of the computations. The use of such a high discount rate lowers the present value of the cash flows and reduces the valuation obtained under the cash flow method used.

As explained herein, Mercer Capital, a valuation and advisory firm, explained that companies in the oil and gas industry typically use a 10% discount rate to evaluate oil and gas capital projects. The Montana Department of Revenue determined the appropriate rate should be 8.9%. The Washington State Department of Revenue performed a "Cost of Capital Study" for the Pipeline Industry for 2019 and determined that the appropriate capitalization rate for the "Pipeline Industry" for 2019 was 8.48%. Thus, using this unrealistically high 14.97% rate in its income approach, the Tegarden Appraisal greatly underestimates the value of the NEXUS pipeline in its income approach.

Further, the overall discount rate used by Tegarden of 14.99% is comprised of an after-tax discount rate of 10.15% plus what the Appraisal labels "the effective property tax rate of 4.82%". The Appraisal determined this "effective property tax rate" as follows: 6.18% effective property tax rate times 1 minus income tax rate.[17] If the Tegarden Appraisal had used its after-tax discount rate of 10.15% and not added a property tax rate to it, the petitioner would have used a discount rate of 10.15%, which is close to the discount rates set by Montana, Washington State and Mercer Capital.

To show the great extent to which using a very high discount rate reduces the value of a stream of cash flows, the following example is instructive. Company A has determined that it will receive an after-tax cash flow of $140,000,000 each year for a period of 48 years. For a discount rate of 8.48% (Washington State DOR discount rate), the present value of 48 annual payments of $140,000,000 is $1,617,757,946.29. Using a discount rate of 14.97% (Tegarden Appraisal discount rate), the present value of 48 annual payments of $140,000,000 is $934,048,031.19. In this example, using the overly high discount rate of 14.97% instead of the Washington State DOR discount rate of 8.48% reduces the present value of this 48-year stream of Company A's payments by almost $700 million. Although the Appraisal's income approach is computationally correct in the way it computes net present value, the use of an overly large discount rate leads to an unrealistically low net present value of the annual cash flows.

Cash Flow Forecasts

In addition to the inflated discount and obsolescence rates, the income approach used in the Appraisal relies on some other unconventional estimates. To estimate the after-tax cash flow for each year from 2019 through 2066, the Appraisal starts with an estimate of total revenue for each of these 48 years: $272,960,912 for 2019, increasing to $311,594,111 for years 2024 through 2032, then decreasing down to $224,371,627 in 2038, then down to $206,141,824 in 2043, then to $192,266,005 in 2048, to $179,562,296 in 2053, to $168,730,545 in 2058, ending at revenue of $159,037,857 in 2066. NEXUS' revenue is primarily comprised of fees to transport natural gas owned by others through its pipeline.

The petitioner has not adequately explained why its estimates for pipeline transportation fees will steadily decrease over this 48-year period. It is difficult to envision or accurately project a scenario in which pipeline transportation fees and volume of gas shipped would decrease steadily over such a long period. There is generally a two to five percent annual rate of inflation in the USA over time,[18] and most companies, even mature companies that are not growing, have their revenues increase with the rate of inflation. The assumption of decreasing revenues over time for NEXUS is not supported by historical data but, as part of the income approach, it significantly reduces the resulting property value estimate in the Appraisal.

In the Appraisal's discounted cash flow income approach, the Appraisal must estimate total operating expenses, depreciation expense, income tax expense, and capital expenditures for each year in the 48-year period from 2019 through 2066. The Appraisal has Total Operating Expenses first rising, then falling, then trending upward for most years in the 48-year period. In the Appraisal, depreciation expense is subtracted out to determine Taxable Income, but then later added back in as a noncash expense to compute After-Tax Cash Flow. Therefore, depreciation expense does not affect the After-Tax Cash Flow meaningfully. Regarding After-Tax Cash Flow, for 2020 the Appraisal yields $174,613,710, for 2026

[17] *Tegarden & Associates, Inc. Appraisal of the Operating Properties of Nexus Gas Transmission, LLC as of January 1, 2019* at 48.

[18] Board of Governors of the Federal Reserve. Minutes of the Federal Open Market Committee, September 17-18, 2019 https://www.federalreserve.gov/monetarypolicy/fomcminutes20190918ep.htm#:~:text=The%20medians%20of%20projections%20for,and%202022%20were%202.0%20percent.&text=For%202022%2C%20all%20participants%20projected,between%201.8%20and%202.2%20percent. (accessed July 2, 2020); Federal Reserve Bank of Cleveland. Inflation Expectations. https://www.clevelandfed.org/our-research/indicators-and-data/inflation-expectations.aspx (accessed July 2, 2020).

$173,358,898, for 2031 $170,019,181, for 2041 $146,386,711, for 2051 $115,854,896, for 2061 $98,231,602, and for 2066 $85,218,665. Thus, the Appraisal has After-Tax Cash Flow continually decreasing for the 48-year period. During the hearing, Mr. Tegarden stated that the petitioner gave him the estimated amounts for this 48-year period for Total Revenues, Total Operating Expenses and After-Tax Cash Flow.

Regarding After-Tax Cash Flow, the Appraisal again arrives at an illogical result by going against the financial workings of a typical pipeline company in projecting decreasing cash flow over a long period of time. Pipeline companies normally do not own the oil and gas products being shipped in the pipeline, but rather make their revenue by charging fees or tariffs to ship other companies' oil and gas. The Appraisal's pessimistic view of total revenue projections for the 48-year period for NEXUS conflicts with actual revenue growth of total revenues for pipeline companies for which data is available. For example, the Value Line Investment Survey one-page report for Energy Transfer, LP, a large pipeline company that operates within the USA, shows revenues increased from $6.6 billion in 2010 to $57 billion in 2020. For Enbridge, Inc., one of the owners of the NEXUS pipeline and, itself, a major pipeline company in North America, the Value Line Investments one-page report shows revenues increased from $15.1 billion in 2010 to $51.5 billion in 2020. Recent Value Line Investment Survey materials reflect increases in both revenues and cash flow over time for the following publicly traded pipeline companies: T C Energy Corp. (formerly known as TransCanada), Plains All American Pipeline, L.P., Oneok, Inc., Enterprise Product Partners, L.P., Williams Companies, Inc., and Kinder Morgan, Inc. The Value Line Investment Survey materials show that all these pipeline companies recorded growth in both revenues and cash flow over a similar period of years.[19]

This data shows that revenues and cash flows for the pipeline companies will decrease occasionally from one year to the next if oil and gas prices drop or if the United States enters a recession, and that revenue and cash flows may not grow quickly, due to the pipeline transportation business being a stable, mature industry. However, a review of ten years of data shows that all the pipeline companies mentioned herein have shown significant growth. Thus, the Appraisal's projections of NEXUS' total revenues and cash flow decreasing over the period from 2019 through 2066 appears to be questionable and overly pessimistic. The Appraisal, in projecting decreasing revenues and cash flow over time for its income approach to valuation when industry data shows the exact opposite is occurring within the industry is a distortion of historic industry trends and is dissonant with the rest of the pipeline industry. Again, the income approach in the NEXUS Appraisal is based upon projections of revenue and cash flow that are incorrect, as well as using a 14.97% discount rate that is much too high, and therefore the income approach in the Appraisal cannot be considered.

Further, the petitioner is using a very limited number of months of actual financial data for its income and cost approach valuation analysis – so limited that it cannot be considered stabilized. As the NEXUS natural gas pipeline was placed in service in October 2018, only one quarter of operating data and income data is available for tax year 2019, as tax year 2019 has a tax lien date for year ending December 31, 2018. Such a small sample of data, three months of operations, is inadequate to set the value of such a major asset. Pipelines take some time to get running at full capacity after their start up, to work out issues and to determine how the pipeline will receive and hand off natural gas with intersecting pipelines, and evaluating NEXUS on its first three months of operation is not a representative period to evaluate the operation of the pipeline.

[19] Value Line Inc., Value Line Investment reports published on February 28, 2020. Available at www.valueline.com (accessed July 2, 2020).

The court in *BP Pipelines (Alaska) Inc., supra*, explained that valuing a pipeline strictly on the value of the tariff income it generates is an incorrect method to value a pipeline because the producers of the oil and gas products and the owners of gas processing plants, which have their product shipped in the pipeline, would place a much higher value on the pipeline than merely the "tariff income" that the pipeline generates. The Alaskan court in *BP Pipelines* explained that pipelines are built to monetize the oil and gas reserves in the collection region of the pipeline and to unlock the value of those oil and gas reserves to market for sale. Although the gas producers and natural gas processing plant owners using the NEXUS pipeline do not own the pipeline, for these gas producers and processors relying on NEXUS to transport their natural gas to market for sale, the NEXUS pipeline has a value much greater than its tariff income generates, as the pipeline enables these producers and processors to have access to the energy end users to which they will sell their product. Valuing a pipeline merely on the tariff income it generates ignores the great economic value that the pipeline creates for the producers and processors by enabling oil and gas products to be transported to and sold in the marketplace. See *BP Pipelines (Alaska) Inc.,* pp. 197-208.

Similarly, as explained in Enbridge Inc.'s 2019 annual report to shareholders, the NEXUS pipeline has strategic importance to Enbridge, Inc., as it is a supplier of natural gas for Enbridge's utility franchise in Ontario, Canada. Enbridge has a business in Ontario supplying natural gas to individual customers and the NEXUS pipeline is a key and valuable asset to Enbridge as it provides gas supplies that enable Enbridge to carry on its utility business in Ontario. In the "Letters to Shareholders" section of Enbridge, Inc.'s 2019 annual report, the company writes: "We successfully brought $7 billion of projects into service, including two highly strategic natural gas pipeline projects: the NEXUS pipeline, which connects growing production in the Marcellus and Utica basins to key markets in the upper U.S. Midwest and serves our utility franchise in Ontario."[20]

The above-quoted language shows that the NEXUS pipeline is a valuable component of Enbridge's utility operation in Ontario and for this reason has much more value for 50% owner Enbridge than merely a revenue generator from fees for shipping gas. Likewise, the other 50% owner of NEXUS, DTE Energy, owns a natural gas utility in Michigan that serves natural gas to 1.3 million customers. For DTE Energy, the NEXUS pipeline not only supplies gas to its natural gas utility operation in Michigan, but also supplies DTE Energy with much of the natural gas needed to operate its own utility business. DTE Energy is primarily an electric and natural gas utility in Michigan, and DTE Energy undoubtedly took an ownership position in NEXUS in part to secure a long-term supply of natural gas for its Michigan gas utility business. The Tegarden Appraisal ignores the great economic value that the NEXUS pipeline creates for its two owners, Enbridge and DTE Energy, by providing a steady supply of natural gas for the two owners' gas utility businesses. In summary, just as the Alaska BP Pipeline was of much more value to its owners as a way for its owners, oil and gas producers, to get their oil and gas produced in Alaska to market in the lower 48 states, for Enbridge and DTE Energy, the NEXUS pipeline system has a great value in securing a stable supply of natural gas for both Enbridge's and DTE Energy's gas utility businesses in their operating regions of Ontario, Canada and Michigan, respectively.

"Cost Overruns"

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[20] Enbridge Inc. 2018 Annual Report, page 1. Retrieved from https://www.enbridge.com/~/media/Enb/Documents/Investor%20Relations/2019/ENB-AR-2019-English.pdf (accessed on July 2, 2020).

Aside from the positions taken in the appraisal, the petitioner contends that cost overruns that occurred in building the NEXUS pipeline resulted in unpredictable and unanticipated costs. The petitioner states that it originally projected that it would cost approximately $2.2 billion to build the NEXUS pipeline, but it ultimately spent about $2.6 billion on the project. According to the petitioner, this approximately $381 million budget difference in an additional cost was due to significant overruns that occurred during construction as well as $180 million of cost from scope reductions. More specifically, the petitioner asserts that the overall cost increased by $381 million due to the following factors: (a) beginning in February 2017 there were vacancies on the five-member FERC that prevented the agency from reaching a quorum, making it unable to make binding decisions; (b) the existence of other pipeline projects in Ohio created a higher cost environment for the construction; (c) opposition to the project resulted in reroutes adding additional mileage to the project; and (d) additional meter stations were added for the pipeline route.

The petitioner describes the impact of the cost overrun relating to FERC approval as follows:

> The inability of the FERC to provide NEXUS with a Certificate of Public Convenience and Necessity as well as construction and transportation certificates from February-August 2017 ultimately led to a total 11-month delay in the project. The 11-month delay resulted in cost overruns due to cost pressures created by contractor and execution extensions, union premiums, material storage and preservation, and carrying costs.

It must be noted that the petitioner recorded on its books as assets what it contends are "cost overruns". The petitioner could have chosen to expense many of its "cost overruns" or it could have later written off these "cost overruns" if it believed these costs were not valid assets on its books. However, the petitioner decided that these costs are assets to be recorded on its books. Thus, the petitioner is arguing that its books are incorrect in recording the costs at issue as assets, and that the Commissioner should ignore its books in determining how to treat these costs.

The petitioner's data shows that what it considers to be "cost overruns" are actual costs to construct the pipeline that exceeded its budgeted costs to construct the pipeline. The petitioner is contending that its budgeted costs to construct the pipeline are the best determinant of true value, and any cost above budgeted cost is a "cost overrun" that should not be included in determining the true value of the pipeline. Such a stance mistakenly makes budgeted costs a controlling factor for determining true value. The reality is that a budget is just an estimate of the cost of construction, and costs above budget are not necessarily a sign of overspending on construction, but may be an indicator of an overly ambitious budget in which all phases of construction occur under perfect planning and perfect conditions. R.C. 5727.11(A) sets the starting point for determining the true value of taxable property as the cost of that property on the company's books and records, less composite annual allowances. The petitioner is disregarding R.C. 5727.11(A) in attempting to set the value starting with its budgeted costs.

Many of the cost overruns were due to various delays, construction problems, and other issues. The petitioner also explained at the hearing how the lack of a quorum in FERC board members caused a six to eight-month delay in the pipeline construction being approved. In a colossal project such as constructing a major pipeline, construction delays and regulatory approval processes should be anticipated. Moreover, the petitioner has not accurately demonstrated what, if any, costs may have been a direct result of the FERC delay. The budget did not adequately plan for regulatory delays and construction costs over budget. More importantly, the petitioner's estimates regarding what additional costs may have arisen from the FERC delay are not verifiable. Rather, they are merely estimates that cannot accurately and appropriately be accounted for.

Regarding its purported cost overruns, the petitioner has failed to substantiate its contention that the costs warrant a reduction in the true value of its property. Therefore, the petitioner's contentions are not well-taken.

Weighted Average Cost of Capital

Page 50 of the Appraisal shows that the Appraisal weighted 63% to equity and 37% to debt in computing its weighted average cost of capital. As equity has a much higher cost than debt, the Appraisal, by using 63% for equity rather than 55% for equity as used by the Washington State DOR cost of capital study, or the 55% for equity used by the Montana Department of Revenue in its study, pushes the overall cost of capital much higher. On page 55 of the Appraisal, the "Summary of Capital Structure Data" chart shows that the Appraisal throws in a weighting for "S&P 500 companies with BBB-rated debt". The other data used in the chart are weightings for Pipeline MLP's, Interstate Natural Gas Pipelines, and Natural Gas Pipeline Screened Comparables. Pipeline MLP's, Interstate Natural Gas Pipelines, and Natural Gas Pipeline Screened Comparables have a much higher debt component and a lower equity component than "S&P 500 companies with BBB-rated debt". By including "S&P 500 companies with BBB-rated debt" in the capital structure computation, the Appraisal is skewing the capital structure more heavily toward equity, thus raising the capitalization rate. Also, it must be noted that "S&P 500 companies with BBB-rated debt" is a very broad group of companies from many industries and is inappropriate to include in the computation of capital structure for a natural gas pipeline.

In April 2019, the Montana DOR released its "2019 Capitalization Rate Study – Gas Pipelines", which was completed on April 22, 2019.[21] In this study, the Montana DOR did an extensive review of what is an appropriate capitalization rate for a natural gas pipeline and determined that the weighted average cost of capital for natural gas pipelines is 8.9%. Montana used a 55% equity weighting and a 45% debt weighting in its computations and arrived at the weightings after stock and debt weightings of a group of pipelines. It arrived at equity cost of capital and debt cost of capital likewise through a study of pipeline companies.

In addition, the Appraisal's external obsolescence percentage is based upon an overstated capitalization rate of 14.99%. The Appraisal uses a discount rate of 14.99% as a yardstick against which to measure what the Appraisal computed as NEXUS' "Achieved Rate of Return" of 7.10%. The 7.10% achieved rate of return is 47.36% of the 14.99% discount rate yardstick, which results in a 52.64% external obsolescence rate for purposes of the Appraisal. However, the 14.99% cost of capital used by Tegarden & Associates is an unrealistically high rate. Again, for comparison purposes, Mercer Capital, a valuation and advisory firm that, on average, performs 500 business valuations per year, explained that companies in the oil and gas industry typically use a ten percent discount rate/capitalization rate to evaluate oil and gas capital projects.[22] If a 10% discount rate had been used in the Appraisal, the external obsolescence would have been a much smaller percentage than 52.64%, even under the flawed Appraisal methodology.

Book Value, Impairments, and Write-Downs

[21] Montana Department of Revenue, *2019 Capitalization Rate Study - Gas Pipelines*, supra.

[22] Mercer Capital, Energy Valuation Insights Blog, Retrieved from https://MercerCapital.com/energyvaluationinsights (last accessed July 2, 2020)

As explained above, pursuant to R.C. 5727.11, the true value of the taxable property of a public utility taxpayer is to be determined by using the capitalized cost of the assets on the taxpayer's books, less composite annual allowances as permitted by the Tax Commissioner. In *Ohio Bell Tel. Co. v. Wilkins*, *supra*, the BTA held that the fact that a taxpayer does not book an impairment write-down used to reduce the value of its property is due some consideration but this fact alone is not enough for the Board to completely disregard the appraisal. Thus, the BTA still considered Ohio Bell's appraisal but gave consideration to the fact that Ohio Bell did not book any impairment write-downs based upon the appraised values. The petitioner is asking the Department to ignore its books and to ignore the cost-based method of valuation in R.C. 5727.11, which requires public utility taxpayers to determine taxable value based upon capitalized cost on the petitioner's books.

In this case, the petitioner did not complete an impairment study of its long-lived assets to be held and used and it did not "book" the reduction in property value for what the petitioner labels "cost overruns" and for which it seeks a reduction herein. Pursuant to the FASB, an entity shall review its long-lived assets held and used for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The FASB has indicated that the following is a non-exhaustive list of circumstances which would require an entity to prepare an impairment study: (1) a significant decrease in the market value of an asset; (2) an accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset; or (3) a significant adverse change in legal factors or in the business climate that could affect the value of an asset or an adverse action or assessment by a regulator. Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 144*, *Accounting for the Impairment or Disposal of Long-Lived Assets* (2001) at 144-7.[23]

An impairment loss shall be recognized when and if the carrying amount of a long-lived asset is not recoverable and exceeds its fair value. *Id.* at 144-15. The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. *Id.* at 144-7. An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value. *Id.* The fair market value of an asset is the amount at which the asset could be bought or sold in a *current* transaction between willing parties. *Id.* at 144-32. (Emphasis added.) The FASB standards note that quoted market prices in active markets are the best evidence of fair market value and shall be used as the basis for the measurement, if available. It is also well settled in Ohio law that the best method of determining value is the actual purchase or sale of property on the open market between a willing buyer and a willing seller. *See Grabler Mfg. Co. v. Kosydar*, 43 Ohio St.2d 75, 330 N.E.2d 924 (1975); *Tele-Media Co. of Addil v. Lindley*, 70 Ohio St.2d 284, 436 N.E.2d 1362 (1982); *Conalco, Inc. v. Monroe Cty. Bd. of Revision*, 50 Ohio St.2d 129, 363 N.E.2d 722 (1977).

Under the national accounting standards set by the FASB, an entity shall review its long-lived assets held and used for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In the instant case, the petitioner argues that NEXUS' pipeline assets are impaired and should be valued at a much lower amount. However, it appears that the petitioner does not see any impairment of the pipeline assets, as the petitioner has not computed an

[23] Available at:
https://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175823288266&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=332866&blobheadervalue1=filename%3Daop_fas144.pdf&blobcol=urldata&blobtable=MungoBlobs (accessed July 2, 2020).

impairment amount and taken such a write down on its books for financial reporting purposes. The petitioner is arguing for an impairment and reduction that it did not find to exist when/if it reviewed these assets for impairment.

If the petitioner truly believes that its pipeline is overvalued, it can engage its financial accounting experts to conduct an impairment study and adjust its books and records accordingly, assuming that is the outcome of the analysis. That would provide the Tax Commissioner a factual, professionally-verified basis upon which a reduction in value could be considered. The Commissioner will not reduce the valuation based on the mere allegations of the petitioner.

THE PETITIONER'S OTHER CONTENTIONS & REQUESTS FOR EXEMPTIONS

In its "Second Amended Petition for Reassessment" and in its hearing outline, the petitioner raised additional contentions. These contentions are addressed below.

Reliance on Real Property Authority

The petitioner argues that Ohio Adm.Code 5703-25-07(D)(2) allows the addition of the property tax rate to the discount rate used in the income approach. However, that chapter of the administrative code applies specifically to the appraisal of real property, not public utility personal property, and is therefore neither applicable to nor directly transferable or translatable to Ohio public utility property tax matters. It must be noted that there is no equivalent rule or provision expressly allowing taxpayers to use an income approach for public utility property tax purposes. Rather, as discussed herein, taxpayers must demonstrate that the statutorily-prescribed cost approach to valuation does not reflect true value. Further, it should be noted that the discount rates used by other states and Mercer Capital, as discussed above, do not include a factor for property taxes.

Engineering Costs

The petitioner contends that engineering drawings costs are included in the assessed value, and that this cost must be removed from the assessment. This contention is denied. The petitioner has provided a copy of an email message from Fluor Corporation stating that there are engineering drawings costs of $54,755,255.68 for NEXUS, and allocates approximately 84%, or $46,081,093.61 of that cost, to Ohio. In order for the Commissioner to exclude qualifying amounts, the petitioner is required to provide sufficient evidence that the underlying costs were included in the assessment originally. Although generally engineering drawings costs are excludable amounts, the petitioner has not submitted probative information or documentation to prove that the claimed amount of engineering drawings costs is included in the assessed costs. Further, the petitioner has not shown that this estimate of engineering drawings costs is accurate and has not submitted detail sufficient to verify the accuracy of these costs.

Pollution Control Costs

The petitioner contends that an additional $100 million of cost should be removed from the assessment to account for other pollution control costs included in the assessment. This contention is denied. First, it must be noted that the Department allowed the petitioner to deduct $27,739,891 of costs denoted as "pollution control – exemption sought" as filed on its Schedule D in its 2019 annual report. This $27,739,891 of costs allowed relates to exempt facility applications that the petitioner applied for with the Department. However, the petitioner indicated at the hearing that the $100 million of additional exemption sought is for additional estimated costs for which it has not yet filed applications. Because the petitioner has not documented these costs of $100 million in any manner, a rough estimate of additional pollution control equipment costs cannot be accepted.

Intangible Costs

The petitioner contends that $2,999,873 of intangible costs, including licensing fees, legal fees, environmental costs, quality assurance and quality control costs, inspection costs, software costs, and other costs should be removed from the assessed costs. This contention is denied. The petitioner asked for this amount to be exempted on Schedule E of its 2019 annual report and the Department accepted this exemption. Thus, the Department has already granted this exemption.

Real Property Costs

In Schedule E of the 2019 annual report, the petitioner sought exemption for $227,359,262 in real property costs broken down as: $199,344,889 for rights of way costs, $15,646,679 for land and land rights costs, and $12,367,694 for real property improvements. The Department allowed these costs of $227,359,262 to be exempted pursuant to Schedule E of the 2019 annual report. The petitioner now contends that *additional* real property costs were purportedly included in the assessment erroneously, specifically relating to $211 million in land, land rights, and rights of way, which the petitioner raised during the hearing. This contention is denied. The petitioner has not submitted information and documentation to prove that additional costs of $211 million, for which it sought exemption for the first time during the hearing, should be exempted from taxation.

Construction for Work-in-Progress Costs

The petitioner requests the Department allow for a reduction for costs relating to construction work-in-progress. However, according to the 2019 annual report, the Department allowed an exemption for allowance for funds used during construction of $183,182,915 and allowed exemption for construction work-in-progress costs of $14,499,094. As such, any additional exemption is denied.

SUMMARY

The Tegarden Appraisal cannot be accepted as a measure of true value for the following reasons:

1. The Appraisal's cost approach uses an income-shortfall methodology that has many flaws. This approach has been rejected by many courts and by WSATA due to those flaws, and the Commissioner agrees with the analyses provided by other tax authorities. These flaws are compelling and present in the petitioner's alternate valuation.

2. The Appraisal's cost approach computes external obsolescence using too high of a yardstick for "Required Return" of 14.99%, yielding an external obsolescence of 52.64% that is unrealistically high.

3. The Appraisal's cost approach uses a methodology that converts the "cost-approach" into an "income-approach" valuation to such a great extent that the proposed "income-deficiency" method would measure income rather than the cost of the assets. See *Delta Air Lines, Inc. v. Dept. of Revenue, State of Oregon, supra.*

4. The discount rate and capitalization rates used by the Tegarden Appraisal of 14.97% and 14.99% are unrealistically high when compared to capitalization rates computed by scholarly capitalization rate studies done by the Montana DOR, the Washington State DOR, Mercer Capital, and other studies of natural gas pipeline cost of capital.

5. As the discount rate used in the Tegarden Appraisal's income approach is overstated at a rate of 14.97%, this unrealistically understates the value of the petitioner's business in the Appraisal's income approach and grossly understates the net present value of the petitioner's estimated after-tax cash flows for the 48-year period.

6. The total revenue and after-tax cash flow amounts in the 48-year period used in the Tegarden Appraisal's income approach are unusually pessimistic forecasts of the pipeline's future and cannot be considered a valid measure of the petitioner's true value. The Appraisal does not forecast any increase in pipeline revenues over the 48-year period, when reviews of many publicly-traded pipeline companies shows some growth in transportation fees over a period of years.

7. The total revenue and after-tax cash flow amounts used in the 48-year period from the Tegarden Appraisal's income approach are wild guesses, at best, and cannot be relied on as a measure of value. It is difficult to accurately forecast revenues and cash flows 48 years into the future.

8. Pursuant to the FASB, an entity shall review its long-lived assets held and used for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. However, it appears that the petitioner does not see any impairment of the pipeline assets, as the petitioner has not computed an impairment amount and taken such a write-down on its books. The petitioner is arguing for an impairment and reduction for tax purposes only, as it did not find such an impairment to exist when it reviewed these assets for impairment for financial reporting purposes.

9. For Enbridge, Inc. and DTE Energy, each fifty percent owners of the NEXUS pipeline, the NEXUS pipeline system has a great value in securing a stable supply of natural gas for both Enbridge's and DTE Energy's gas utility businesses in their operating regions of Ontario, Canada and Detroit, Michigan, respectively. The Tegarden Appraisal fails to consider this great value of the pipeline as a stable source of gas supply for these two owners' gas distribution businesses. See *BP Pipelines (Alaska) Inc., supra*, which explains that valuing a pipeline strictly on the value of the tariff income it generates is an incorrect method to value a pipeline, because the producers of the oil and gas products and the owners of gas processing plants that have their product shipped in the pipeline would place a much higher value on the pipeline than merely the "tariff income" that the pipeline generates.

10. In *Trunkline Gas*, *supra*, the BTA found that a pipeline was properly valued pursuant to its acquisition cost one year earlier, rather than valued by an appraisal submitted by the company. Similar to *Trunkline Gas*, the NEXUS pipeline went into operation in October 2018, only three months before tax year 2019's listing date of December 31, 2018, and the acquisition cost of NEXUS as of the in-service date of October 2018 is a better measure of NEXUS' value than the Tegarden Appraisal.

11. In *PacifiCorp v. State of Montana, Dept. of Revenue*, *supra*, Dr. James Ifflander was "certified as an expert in the areas of corporate finance, valuation and valuation methodologies" and determined that for a similar Tegarden Appraisal that Mr. Tegarden's income shortfall method is not a valid or accepted method of measuring obsolescence.

12. In *PacifiCorp v. State of Montana, Dept. of Revenue*, *supra*, Brent Eyre, an Accredited Senior Appraiser with the American Society of Appraisers (ASA), detailed the inherent circularity in Mr. Tegarden's income shortfall methodology, which converts the cost approach to an income approach, rather than considering them as two diverse ways of valuing the company.

13. In *PacifiCorp v. State of Montana, Dept. of Revenue*, *supra*, Brent Eyre explained that Mr. Tegarden's income shortfall methodology is not found in the traditional appraisal texts and that it is not the same capitalization of income loss method as outlined in *The Appraisal of Real Estate*, and has been rejected in other jurisdictions.

14. In *PacifiCorp v. State of Montana, Dept. of Revenue*, *supra*, regarding a similar Tegarden appraisal, Dr. John Wilson criticized Mr. Tegarden's economic obsolescence deductions. Dr. Wilson explained that this is not a true measure of obsolescence, but rather, the mathematical difference between Mr. Tegarden's "understated" projected earnings and his overstated "required" earnings.

15. In computing its weighted average cost of capital, the Tegarden Appraisal improperly increases its capitalization and discount rates by adding a flotation cost. In *PacifiCorp v. State of Montana, Dept. of Revenue*, *supra*, Dr. Antonio Bernardo testified that the flotation costs should not be added to the cost of capital. Dr. James Ifflander testified that the flotation costs are inappropriate because they are not a part of the opportunity cost of capital, which is the rate used in a yield capitalization calculation.

CONCLUSION

By its terms, R.C. 5727.11(A) expressly requires use of the capitalized cost of taxable property, as shown on the taxpayer's books, as the basis of the property's true value calculation, unless the Tax Commissioner finds that it does not reflect true value. In providing for the use of booked cost less annual allowances to determine the true value of public utility property, the General Assembly has statutorily prescribed the prima facie method for the Tax Commissioner to value public utility property, i.e., the true value of a pipeline is the cost of the pipeline as included on the taxpayer's books and records, less annual allowances. In particular, new pipelines, such as the one in the present case are straightforward to value, as the cost to build the pipeline is known. Moreover, there is no need to deviate from the statutory method absent probative evidence showing that the statutory method would result in an inaccurate or inappropriate measurement of true value. In this matter, the statutory valuation method prescribed in R.C. 5727.11 results in an accurate and appropriate measure of the true value of the petitioner's public utility property. The petitioner submitted two alternative valuation computations, but, for the reasons laid out above, they are unreliable and unrealistic opinions of true value. Such estimates of value are not sufficient to make a reduction in the property's true value that is below the value carried on the petitioner's books. For these reasons, the Tax Commissioner must affirm the assessment.

Accordingly, the assessment is affirmed.

THIS IS THE TAX COMMISSIONER'S FINAL DETERMINATION WITH REGARD TO THIS MATTER. UPON EXPIRATION OF THE SIXTY-DAY APPEAL PERIOD PRESCRIBED BY R.C. 5717.02, THIS MATTER WILL BE CONCLUDED AND NOTICE WILL BE SENT PURSUANT TO R.C. 5727.47 TO THE APPROPRIATE COUNTY AUDITORS, WHO SHALL PROCEED IN ACCORDANCE WITH R.C. 5727.471.

I CERTIFY THAT THIS IS A TRUE AND ACCURATE COPY OF THE ENTRY RECORDED IN THE TAX COMMISSIONER'S JOURNAL

Jeffrey A. McClain

JEFFREY A. MCCLAIN
TAX COMMISSIONER

/s/ Jeffrey A. McClain

Jeffrey A. McClain
Tax Commissioner