ARIZONA SUPREME COURT

MESQUITE POWER, LLC, a limited liability company, Plaintiff-Appellant, v. ARIZONA DEPARTMENT OF REVENUE, an agency of the State of Arizona; COUNTY OF MARICOPA, a political subdivision of the State of Arizona, Defendants-Appellees.	No. CV-23-0016-PR Court of Appeals No. 1 CA-TX 22-0002 Arizona Tax Court No. TX2018-000928

DEFENDANTS' RESPONSE TO PETITION FOR REVIEW

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INTRODUCTION

Defendants the Arizona Department of Revenue ("Department") and Maricopa County (collectively "Defendants") oppose Mesquite Power LLC ("Mesquite")'s Petition for Review ("Petition"). The legal issue is simply whether an appraiser should consider the revenues that an electric generation plant receives through a market-rate bilateral contract to reserve and sell power and the lower risk that results from the contract when valuing the plant. In other words, should the appraiser value the plant as it actually is—a reliable, efficient plant that sells its power through a long-term contract—or should it pretend that the plant struggles to operate without a contract in place and value it as such?

The court of appeals correctly held that because Mesquite's appraisal pretended that the plant did not sell electricity through a bilateral contract and instead valued the plant under the income approach without considering the revenues and reduced risk that a market-rate bilateral contract provided, it was incompetent to overcome the statutory presumption that the Department's valuation was correct. *Mesquite Power, LLC v. Ariz. Dep't of Revenue*, No. 1 CA-TX 22-0002, 2022 WL 17814186 (Dec. 20, 2022) (the "Opinion") ¶ 51. The Opinion is correct and does not alter Arizona property tax law. There is no reason for this Court to grant review.

MATERIAL FACTS

Sempra U.S. Gas & Power ("Sempra") built an electric generation power plant, Mesquite Block 2, located in Arlington, Arizona (the "Plant"). (Electronic Index of the Record ["IR"] 1; IR 124 at 6.) The Plant was one of the most efficient and reliable combined cycle plants operating in the Desert Southwest market. (IR 124 at 6.) Mesquite's current owner, Southwest Generation ("SWG" or "Southwest Gen"), stated that "inefficient gas, as well as coal and nuclear units, cannot compete" with the Plant. (IR 130 at 8.) In addition to being a superior-quality facility, the Plant is located in Maricopa County, which was experiencing above-average growth around the January 1, 2018, valuation date (the "Valuation Date"). (IR 89 at 17-18.)

The Plant sold electricity through an Amended and Restated Power Purchase Agreement dated September 15, 2017 (the "PPA"). (IR 93.) The PPA provided for fixed payments to Mesquite for capacity reservation and for the Plant's operation and maintenance ("O&M") expenses as well as for smaller monthly energy charges for the energy that the buyers actually used. (*Id.* at 17-18.) The PPA reserved 271 megawatts in contracted capacity through May 1, 2021, after which it increased to 475 megawatts. (IR 93 at 2, 11.) The Plant had a net operating capacity of 625 megawatts. (IR 65 at 2, ¶ 2.)

ArcLight Capital Partners, LLC ("ArcLight") purchased Sempra's 100% interest in Mesquite in 2015 for $369,000,000. (IR 89 at 106.) ArcLight then spent $27,600,000 in capital improvements on a major overhaul of the Plant in 2016. (IR 124 at 7; IR 161, 165:25-166:9.) Less than one month before the Valuation Date, ArcLight offered its 100% ownership interest in Mesquite for sale. (IR 145 at 6.) Potential buyers were instructed to submit a first-round bid that valued Mesquite as of December 31, 2017—just one day before the Valuation Date. (IR 127 at 2.)

Based on its analysis, SWG submitted a $518,000,000 first-round bid for Mesquite. (IR 148 at "Purchase Price," Bates No. 11696.) Southwest Gen submitted a second-round bid that increased its offer to a base price of $542,900,000. (IR 122 at "Purchase Price," Bates No. 11830.) The final sale price was $555,598,000. (IR 65 at 4, ¶ 14.)

The Department valued the Plant at $196,870,000 for tax year 2019 based on the statutory formula. (*Id.* at 2.) Mesquite seeks to reduce the value to $105,000,000. (Petition at 4.)

REASONS WHY THE COURT SHOULD DENY REVIEW

I. The Opinion Is Not Contrary to the Statutory Valuation Formula that Considers Intangible Costs When Valuing Tangible Personal Property.

Mesquite argues that A.R.S. § 42-14156 prohibits an appraiser from considering the presence of a contract and all of the revenues that the Plant will receive through it when valuing the Plant. (Petition at 8.) Mesquite is wrong.

First, the applicable valuation statute uses a cost formula to determine value. A.R.S. § 42-14156. The statute defines the personal property's cost to include "the invoice cost of the personal property, *the cost of transporting* the property to the facility site and *the cost of labor to install* the property." A.R.S. § 42-14156(A)(6)(b) (emphasis added). Transportation and installation costs are intangible costs. *See In re Appeal of ANR Pipeline Co.*, 79 P.3d 751, 761, ¶ 35 (Kan. 2003) (noting that the issue was whether intangible installation costs should be removed from the valuation). The Legislature, however, chose to include these intangible costs in the valuation formula and thus recognized the need to consider intangible items to determine the tangible personal property's true value.

Second, the statute does not state that when valuing the taxable tangible property under a standard income approach to valuation, the Department must ignore revenues that the property is expected to receive through a long-term, market-rate contract. Mesquite argues that an appraisal cannot consider such

revenues because property tax is an *in rem* obligation and the tax lien applies only to the Plant. (Petition at 8-9.) Mesquite confuses tax collection with property valuation and taxation even though the issues are unrelated. For example, an Arizona court has found that the fact that some collection procedures could transgress Indian rights if carried out against a possessory interest on reservation land does not mean that the tax on that possessory interest is invalid. *Pimalco, Inc. v. Maricopa County,* 188 Ariz. 550, 557 (App. 1997).

Mesquite argues that contracts are intangibles and that an appraiser cannot consider income received through an intangible. (Petition at 10-11.) All revenues that the Plant receives come from a contract of some sort, whether written or oral, short-term or long-term. Even energy sales on the spot market involve a meeting of the minds with respect to quantity and price—in other words, a contract. It is impossible to ignore all revenues that the Plant receives through a contract.

Mesquite's position would mean that an appraiser cannot consider lease income when valuing commercial property because a lease is a contract. Low-income-housing tax credit properties, however, are valued using their actual contract rents. *Maricopa County v. Viola*, 251 Ariz. 276, 277, ¶ 1 (App. 2021). There is no reason why the Assessor may consider contract rental income in valuing an apartment complex but cannot consider the PPA in valuing the Plant. In both situations, the tax lien would attach to the taxable property and not to the

contracts. The Opinion correctly found that Mesquite's position actually contradicts A.R.S. § 42-14156. (Opinion ¶ 34.)

II. The Opinion Properly Held that a Competent Appraisal Must Consider the Plant's Current Operations When Valuing It, Which Means Valuing the Plant with a Power Purchase Agreement in Place.

The income approach values property based on the present worth of anticipated future cash flows. (IR 162, 81:1-12.) The appraiser's cash flow must include all income that the Plant is expected to generate. As Mesquite's appraiser, Mark Simzyk ("Simzyk"), testified at trial, when entities buy a power plant, they are buying the cash flow from the plant, which includes the projected income from a separate power purchase agreement. (IR 163, 132:19-22.)

Mesquite argues that under *Maricopa County v. Trustees of Arizona Lodge No. 2*, 52 Ariz. 329 (1938), intangible assets are not subject to taxation absent legislative authorization. (Petition at 2.) Defendants taxed the Plant, not Mesquite's intangible assets. (IR 65 at 3, ¶¶ 4-5.) Mesquite refuses to accept that the Opinion resolved the issue of how to properly value tangible personal property, not the issue of whether to tax intangible assets. (Opinion ¶ 2.)

The Opinion is consistent with decades of case law from other jurisdictions holding that the appraiser needs to consider intangible property when determining the tangible property's true value. *See, e.g., Mich. Wis. Pipe Line Co. v. Iowa State Bd. of Tax Rev.*, 368 N.W.2d 187, 193 (Iowa 1985) (finding that a state may look

to intangible property to determine tangible property's market value); *RT Commc'ns, Inc. v. State Bd. of Equalization*, 11 P.3d 915, 925 (Wyo. 2000) (finding that although intangible property was exempt from taxation, it should be considered to properly reflect the tangible property's true value); *ANR Pipeline*, 79 P.3d at 770 (upholding the decision to tax the enhanced value that the intangible property imparted to the tangible property).

Two California power plant cases are directly on point. *Freeport-McMoran Resource Partners v. County of Lake*, 16 Cal. Rptr. 2d 428, 434-35 (App. 1993) and *Watson Cogeneration Co. v. County of Los Angeles*, 120 Cal. Rptr. 2d 421, 427 (App. 2002). The courts in those cases specifically held that a power plant's cash flow under the income approach included the plant's income from long-term contracts, even though California law did not tax intangible assets. These cases have never been overruled, but California changed its law to expressly provide that intangible assets shall not be reflected in the taxable property's value. Cal. Rev. & Tax. Code § 110(d)(1). Arizona has no similar statutory provision.

Mesquite argues that the PPA cannot "enhance" the Plant's value if it does not have an independent value.[1] (Petition at 10-11.) This assertion overlooks the

[1] Mesquite claims that Defendants' expert conceded that the PPA did not add value to the Plant. (Petition at 11.) Mr. Barreca testified that all income that the Plant generates, including the reservation or the capacity payments, was part of its income. (IR 163, 194:9-14.) Based on the information provided to him, he did not

synergy that comes from having both a plant and a contract to sell electricity together. As the Utah Supreme Court concluded, the "fair market value requirements recognize some element of value that is not attributable to either intangibles or simple cost and that this enhanced value is taxable." *Beaver County v. WilTel, Inc.*, 995 P.2d 602, 611, ¶ 40 (Utah 2000), *superseded by statute on other grounds as stated in T-Mobile USA, Inc. v. Utah State Tax Comm'n*, 254 P.3d 752, 758 (Utah 2011). In other words, the court recognized that the whole can be worth more than the sum of the parts.

Simzyk, Mesquite's appraiser, stated that he expected the Plant to have a power purchase agreement or some other bilateral contract in place. His appraisal stated as follows:

> The majority of the electrical generation plants in the region of the Subject Assets either a) are owned by a utility; b) are contracted to a utility; or c) are contracted through another third party. As such, it is fair to assume that few, if any, power plants would be operating without the specific status of one of the three aforementioned scenarios.

(IR 89 at 67.) The Opinion correctly stated that even if the PPA did not exist, a new sales agreement could be negotiated with the current PPA purchasers or other willing electricity purchasers. Opinion ¶ 21. Therefore, the appraiser must include

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view the PPA as having any value separate from the Plant. (IR 164, 123:19-124:12, 167:17-168:12.)

amounts in the cash-flow analysis that a merchant power plant in Arizona would receive through a market-rate bilateral contract.

Despite Mesquite's assertions (Petition at 12 n.10), the record contains no evidence concerning market rates for Arizona bilateral contracts. Simzyk testified that he never compared the PPA's terms to bilateral contracts at other plants. (IR 162, 237:15-24.) The record contains no evidence of any other power plant's bilateral contract or the market rate for energy sales, capacity payments, and O&M reimbursements under a market-rate Arizona bilateral contract. The witnesses at trial compared the PPA and bilateral contracts in general to amounts that a power plant would receive just selling power on the spot market—not to amounts that it would receive under a market-rate bilateral contract. (IR 162, 15:15-16:13.) That testimony did not establish a market price for energy sales under a bilateral contract.

The record evidence demonstrated that the parties to the PPA negotiated an amendment that changed the PPA's term, reserved capacity amounts, and pricing just before the Valuation Date. (IR 93.) Simzyk testified that Mesquite and its energy buyers viewed the PPA as representing the market for such contracts as of September 15, 2017. (IR 162, 238:10-25.)

Mesquite does not want to value the property with a market-rate power purchase agreement in place. Rather, it insists that an appraiser must value the

Plant as if all of its power was sold through spot sales on the energy market, ignoring the income stream that plants receive from buyers who want to reserve electricity and the reduced risk from having a contract such as the PPA in place. (Petition at 9.) That is the position that the Opinion correctly rejected. Opinion ¶ 25.

The Opinion acknowledged that there are some contracts that may have a value that is separate from the tangible personal property. (Opinion ¶ 23.) There was no record evidence as to whether the PPA had a separate appraised value on the Valuation Date. Mesquite tries to treat a purchase price allocation as valuation evidence by an "expert." (Petition at 12 n.10.) Arizona Rule of Civil Procedure 26(b)(4)(f) provides that "each side is presumptively entitled to call only one retained or specially employed expert to testify on an issue." Mesquite identified Simzyk as its expert, and it cannot use another so-called expert report to overcome the presumption of correctness. Moreover, the purchase price allocation was prepared using accounting Fair Value standards rather than appraisal Fair Market Value standards. (IR 110 at MESQUITE(928)00003.) Therefore it is not competent appraisal evidence.

Mesquite compares the PPA to a McDonald's franchise agreement. (Petition at 13.) It first raised this argument in a motion for reconsideration to the court of appeals. It did not present any information about how franchise agreements, which

are an expense to the property owner, are valued or how they relate to any tangible property's value. The only legal citation that Mesquite offers is *Roehm v. Orange County*, 196 P.2d 550 (Cal. 1948), which it claims stands for the proposition that an intangible asset's value will be taxed to the owner under the state's income tax, not to its property tax. (Petition at 13 n.12.) The *Roehm* court actually stated that although a liquor license is nontaxable intangible property, "assessing authorities may take into consideration earnings derived therefrom" to value the taxable property. 196 P.2d at 554. The *Roehm* decision is actually contrary to Mesquite's position. As it did below, Mesquite fails to cite any case law to support its assertion that an appraiser should ignore a plant's revenues and reduced risks from having a market-rate bilateral contract in place when valuing tangible personal property under an income approach.

Finally, Mesquite suggests that the Opinion violates the Arizona Constitution's Uniformity Clause. (Petition at 13-14.) This argument is based on Mesquite's incorrect assertion that *In re America West Airlines, Inc.*, 179 Ariz. 528 (1994), concerned "valuing" two identical airplanes differently. This court actually held that the statute was unconstitutional because it applied different *tax rates* to identical property, and the Court did not address valuation at all. *Id.* at 535. Moreover, Mesquite did not raise this issue at trial and merely speculates that the Opinion may lead to different valuations without identifying any record

evidence of another power plant with the same equipment that the Department valued differently and therefore fails to establish a Uniformity Clause violation. *See Magellan S. Mountain Ltd. P'ship v. Maricopa County*, 192 Ariz. 499, 504, ¶ 23 (App. 1998) (stating that a Uniformity Clause violation requires proof beyond a reasonable doubt).

The Opinion correctly held that Mesquite's appraiser used hypothetical cash flows that ignored income that the Plant would likely receive and that his approach was legally inappropriate. Opinion ¶ 39. The cash-flow defect, along with an improper calculation of the weighted average cost of capital with the PPA in place (*id.* ¶¶ 40-48), rendered the appraisal incompetent to rebut the statutory presumption of correctness. *Id.* ¶ 51.

III. Mesquite Misstates the Applicable Standard of Review.

The Petition is essentially premised on Mesquite's belief that appellate courts must accept all the tax court's conclusions. (Petition at 14-15.) Appellate courts are not bound by the trial court's determination concerning mixed questions of law and fact. *In re Est. of Musgrove*, 144 Ariz. 168, 170 (App. 1985). Appellate courts must set aside findings of fact that are clearly erroneous. *In re Triggs Est.*, 3 Ariz. App. 385, 388 (1966). A finding is clearly erroneous when the reviewing court is "left with the definite and firm conviction that a mistake has been committed." *Deck v. Hammer*, 7 Ariz. App. 466, 471 (1968).

Contrary to Mesquite's assertion (Petition at 15), appellate courts do not give special deference to the Arizona Tax Court. They instead review tax court decisions and overturn them when appropriate. In *Eurofresh, Inc. v. Graham County,* 218 Ariz. 382, 393, ¶ 50 (App. 2008), the court rejected the tax court's obsolescence finding and directed the tax court to reinstate the county assessor's value. It rejected the taxpayer's argument that the court had to accept the appraiser's testimony that he followed standard appraisal methods in calculating obsolescence. *Id.* at 392, ¶ 45. This Court has also reviewed and reversed a trial court decision concerning a property's value, finding that an appraisal that the trial court accepted as more persuasive was "so fraught with infirmities as to be totally useless as a means by which a lawful valuation can be made." *Pima County v. Cyprus-Pima Mining Co.*, 119 Ariz. 111, 115 (1978).

The Opinion correctly found that Mesquite's appraisal was incompetent (Opinion ¶ 51), which was a mixed question of law and fact. *Eurofresh* at 386, ¶ 23. Simzyk's legal error in ignoring the Plant's market-rate contract revenues rendered his appraisal's opinions impossible to accept for many reasons, including these:

- Simzyk projected earnings before interest, tax, depreciation, and amortization ("EBITDA") for the *whole plant* that was less than what SWG had projected for just the plant's *uncontracted portion*.

(*Compare* IR 89 at 163, *with* IR 126 at 15.) For example, for 2022, Simzyk projected $6,518,000 in EBITDA for the entire Plant and SWG projected $12,295,000 in EBITDA for just the Plant's uncontracted capacity. (*Id.*) Southwest Gen expected that the Plant would generate about 590 megawatts of its 625 megawatts capacity. (IR 161, 50:18-51:11.) When the PPA increased to 475 megawatts in 2021, it left only 100-110 megawatts of uncontracted capacity.

- Simzyk used an 18.2% cost of equity for his income model. (IR 89 at 75.) This far exceeded the 9.6% return on its equity investment that SWG had projected. (IR 130 at 13.) In other words, Simzyk opined that an investor would require almost double what the actual equity investor in Mesquite expected to receive.
- Simzyk gave the most weight in his market approach to a 2016 Gila River Block 4 sale to Salt River Project ("SRP") for $100,000,000. (IR 89 at 59-61.) The prices for Arizona plants were decreasing in 2015 and 2016 and were at their lowest point when that sale occurred. (IR 161, 136:20-138:9.) Simzyk gave no weight to SRP's subsequent purchase of Blocks 1 and 2 at the same Gila River facility for $330,000,000 that was announced in October 2017 and was expected

to close in early 2018.[2] (IR 89 at 60-61.) Even though the blocks in the 2016 and 2017 sales were identical and the buyer was identical, the sales price for the 2017 sale increased by $65,000,000 per block. (*Id.*) Moreover, Simzyk admitted that the $330,000,000 sales price for Blocks 1 and 2, adjusted for size, indicated a $214,171,000 value for Mesquite's Plant. (IR 89 at 106; IR 163, 136:13-23.) This exceeds the Department's $196,870,000 valuation. (IR 62 at 2.)

- Simzyk reduced the 2017 Gila River total sale price for Blocks 1 and 2 by 50% because SRP entered into a separate agreement with Tucson Electric Power ("TEP") for 100% of Block 2's capacity. (IR 163, 130:10-15.) Thus, according to Simzyk, the block that SRP kept for its own use was worth $165,000,000, but the identical block that it contracted to TEP had no value. Simzyk admitted at trial that under his method, if a purchase agreement reserved the plant's entire capacity, then the physical plant, i.e., the tangible personal property, would have no value. (*Id.* at 127:19-128:5.)
- After ArcLight purchased its interest in Mesquite in 2015, it spent $27,600,000 on capital improvements in 2016. (IR 124 at 7; IR 161,

[2] Mesquite cites only the 2016 sale to this Court. (Petition at 13 n.11.) It fails to acknowledge the higher-priced 2017 sale, or the fact that the Gila River blocks were only 550 megawatts compared to the Plant's 625 megawatts. (IR 89 at 59-60.)

165:25-166:9.) Yet Simzyk's valuation increased the Property's value only by less than $10,000,000 from January 1, 2016 (tax year 2017), to the Valuation Date. (IR 86 at 10 n.8.)

CONCLUSION

For the foregoing reasons, Defendants request that this Court deny Mesquite's Petition for Review.

Respectfully submitted this 15th day of February, 2023.

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