

SUPREME COURT OF ARIZONA

SAN DIEGO GAS & ELECTRIC
COMPANY, a California corporation,

Plaintiff/Appellee,

vs.

ARIZONA DEPARTMENT OF
REVENUE, an agency of the State of
Arizona; MARICOPA COUNTY, and
YUMA COUNTY, each of which is a
political subdivision of the State of
Arizona,

Defendants/Appellants.

No. CV-23-0283-PR

Case No. 1 CA-TX 21-0008

Arizona Tax Court
No. TX 2019-001758

PLAINTIFF/APPELLEE'S RESPONSE TO PETITION FOR REVIEW

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INTRODUCTION

Pursuant to Rule 23, ARCAP, Plaintiff/Appellee, San Diego Gas & Electric Company (“SDG&E”) files its Response to defendants’ Petition for Review (“Petition”).¹ The Petition should be denied because it disregards Arizona law and it ignores and/or misstates the facts.

The Opinion upheld the Tax Court’s correct ruling about the meaning of the statutory term “accumulated provision for depreciation” in A.R.S. §42-14154(B)(2). As both lower courts stated, this term is defined by the uniform system of accounts (“USoA”) adopted by the Federal Energy Regulatory Commission (“FERC”). The Opinion held correctly that those definitions are binding on defendant, Arizona Department of Revenue (“ADOR”) in determining the full cash value of electric transmission property, pursuant to A.R.S. §42-14154(F). (Opinion, ¶¶19-21)

In particular, FERC has ruled the accumulated provision for depreciation must include an accrual for the cost of removal (“COR”) of a utility’s assets. *See*, FERC Order No. 631, page 16, ¶¶33-39. In relevant part, that Order states: “[R]emoval costs that are not asset retirement obligations are included as a component of the depreciation expense and recorded in accumulated depreciation.” *Id.* at ¶36. The law on this point is clear, and the Opinion is correct in its holding.

¹ The Petition was filed on November 29, 2023, but SDG&E did not receive a copy until December 4th. On December 1st, SDG&E timely filed a Cross-Petition for Review of unrelated issues decided incorrectly in the same Opinion.

In spite of this undisputed FERC requirement, ADOR asks this Court to grant review and reverse the Court of Appeals' Opinion upholding the method prescribed by the Legislature to value SDG&E's property. ADOR ignored SDG&E's reported accumulated provision for depreciation, thereby increasing its 2020 full cash value.² The Opinion correctly held ADOR's valuation is excessive under the statute.

Nonetheless, in a desperate attempt to overturn both lower courts, ADOR misrepresents the facts and seeks to prejudice this Court against SDG&E by exaggerating the effect of these rulings. Ultimately, ADOR's entire argument is tied to its unsupported assertion that Section 42-14154 produces a negative number.³

ADOR's PETITION DISREGARDS ARIZONA LAW

The Tax Court (and court of appeals) correctly resolved the main question presented by this statutory tax appeal. Both courts interpreted the plain language of the valuation statute in accordance with the directive in A.R.S. §42-14154(F) that "all terms used in the statute should be *interpreted and applied* in accordance with the [FERC's] uniform system of accounts ("USoA")." (Emphasis added). This is consistent with *Arizona Dept. of Revenue v. Salt River Project Agricultural*

² During discovery, ADOR sought to adjust SDG&E's full cash value to reflect the portion attributable to COR, but that issue was never adjudicated by the Tax Court.

³ The record conclusively establishes that SDG&E's tax year 2020 full cash value under A.R.S. §42-14154 is a *positive* number, as the Tax Court ruled below. The Opinion mistakenly ignored this undisputed fact based solely on ADOR's misrepresentations. SDG&E filed a Cross-Petition to reinstate the correct valuation.

Improvement and Power District, 212 Ariz. 35, 39, ¶19 (Ct. App. 2006), where the court held: “Although A.R.S. §42-14154 does not define the term ‘actual cost,’ the statute provides us with interpretive guidance because it does state: ‘**All terms and applications of terms shall be interpreted according to the federal energy regulatory commission uniform system of accounts for electric and gas utilities in effect on January 1, 1989.**’ A.R.S. §42-14154(F); *see also*, A.A.C. R14-2-212(G)(2). This is a broad directive, because it extends to both defining and applying statutory phrases. **Moreover, the statute does not state that the FERC USoA is to be used only to resolve statutory ambiguities; rather, the use of the word ‘shall’ in the electric utility valuation statute ‘indicates that the legislature intended the statutory method of’ valuation ‘to be mandatory.’** *Ariz. Dep’t of Revenue v. Trico Elec. Coop., Inc.*, 151 Ariz. 544, 547 (1986). **Thus, the statute requires that all of its terms and applications be interpreted in accordance with the FERC accounting rules.**” (Emphasis added).⁴

⁴ If this quote from *Salt River* is not clear enough about the deference to be accorded what Section 42-14154(F) mandates, footnote 6 explains: “[T]he valuation statute previously provided as follows: ‘All terms and applications of terms shall be interpreted **as nearly as possible, under the circumstances**, as contained in the federal energy regulatory commission reports for electric and gas utilities in effect on January 1, 1979.’ A.R.S. §42-124.01(I) (as amended by 1980 Ariz. Sess. Laws, ch. 8, §43) (emphasis added). In 1989, the legislature amended the recodified provision by striking the qualifying language ‘as nearly as possible, under the circumstances’ and replacing the reference to the FERC reports with the unqualified language. *See* A.R.S. §42-144(I) (as amended by 1989 Ariz. Sess. Laws, ch. 132, §10).” *Id.* at 39, ¶19, fn. 6. In 1999, the statute was re-numbered without change.

The “accumulated provision for depreciation” referenced in A.R.S. §42-14154(B)(2)(a) is also the title of Account 108 in USoA, and FERC’s specification as to what must be reported in that account includes COR – *and it always has*. Until this case, ADOR never had any problem using the numbers derived from this definition during the 40-plus years since this statute was enacted. Moreover, even after choosing to ignore the statute in valuing SDG&E in tax year 2020, ADOR continued to apply it the same way it always had for other Arizona taxpayers – except SDG&E – in tax years 2021 and 2022.⁵

ADOR’s PETITION MISSTATES THE FACTS

ADOR’s Petition misstates the facts. First, at the top of page 3 ADOR states: “[SDG&E’s] reported accumulated depreciation exceeds the plant’s cost because in addition to the property’s actual accumulated straight-line depreciation, the company included \$21,092,257.55 *set aside in a separate reserve account* to pay for the plant’s removal at the end of its economic life (“COR Reserve”). (Emphasis added). This statement is factually incorrect. COR is not “set aside in a separate reserve account” as ADOR asserts. Rather, COR is included in FERC Account 108 as part

⁵ SDG&E filed timely valuation appeals for both tax years which remain stayed pending resolution of this case. Starting in tax year 2023, ADOR changed its application of Section 42-14154 for other utility taxpayers who also report their accumulated depreciation – including COR – as FERC mandates. ADOR made this change only *after* the Tax Court ruled its interpretation was incorrect. As a result, other taxpayers have also now filed appeals challenging ADOR’s valuations.

of the “accumulated provision for depreciation.” By its nature, “depreciation” (including COR) is a non-cash charge that is “accrued” according to generally-accepted accounting procedures such as FERC’s USoA.⁶

As explained above, SDG&E (and all utilities) are required to report COR in this manner because they are regulated monopolies. This treatment reduces the “rate base” (or net book value) which the utility is allowed to earn a return on, so it does not produce an economic benefit to the utilities. Presumably, FERC mandates this form of reporting in order to ensure that both the benefit and burden of these expenses is paid by current ratepayers. If not, current ratepayers would receive a windfall vis-à-vis future ratepayers when the removal costs are actually incurred.

Second, ADOR’s presentation of the full cash value calculation on page 4 of its Petition is contrary to the worksheet it actually used to determine the full cash values of SDG&E in every other tax year, including 2020. A copy of that worksheet was attached to the Answering Brief in this case and it is reproduced here as Appendix A. (IR-8, Ex. A) Every number in Appendix A – an ADOR form – was taken from the property tax return filed under oath by James Asay, Director of

⁶ ADOR repeatedly asserts the “COR Reserve” represents “monies.” (Petition, 3-14) This is both inaccurate and misleading. These are merely accruals on financial statements. As noted, depreciation (including COR) is a non-cash expense. ADOR also asserts only “a minority” of other companies owning transmission property report as SDG&E does, but the record contradicts this. *See*, AB at 35-36.

Corporate Tax for SDG&E’s parent, Sempra Energy. In *every* tax year (including 2020), ADOR used the numbers reported by SDG&E to value its property located in Arizona. Those numbers were all derived from SDG&E’s audited Annual Report to FERC (known as the Form 1), and they *always* included COR as part of the accumulated provision for depreciation that must be deducted by ADOR under A.R.S. §42-14154(B)(2)(a). The accumulated provision for depreciation is merely an accumulation of the total depreciation expense recorded for plant in service. Thus, ADOR’s oft-repeated assertion about a “negative number” is simply false.⁷

Indeed, ADOR’s claim of a “negative number” in its calculation of the full cash value was created by altering the sequence of its calculations. The *only* way there is a negative number here is if the construction work in progress (“CWIP”) is valued entirely separate from the calculation of the total full cash value under Section 42-14154. But that is *not* how the valuation statute reads. *See*, Table below.

⁷ Here are the actual facts reported by SDG&E for tax year 2020 (as of 12/31/18):

Original Plant in Service Cost	53,035,587	
Minus: Accumulated Provision for Depreciation	<u>(51,992,185)</u>	
Equals: Net Book Value of Plant in Service (sub. B)		1,043,402
Plus: CWIP at 50% (sub. C); M&S (sub. D); EPF (sub. E)		<u>3,648,474</u>
Equals: Full Cash Value of Subsections B, C, D & E		4,691,876
Then: Exclude Land Rights, etc. (sub. G8)		
Original Cost of Land Rights	4,218,191	
Minus: Accumulated Depreciation on Land Rights	<u>(545,788)</u>	
Equals: Net Book Value of Land Rights		<u>3,672,403</u>
FINAL FULL CASH VALUE (net of Subsection G8)		1,019,473

This Table illustrates how full cash value is calculated using the statutory method.

Third, on page 7 of its Petition, ADOR asserts the Opinion creates an “absurd” result: “The notion that [SDG&E’s] plant in service as of January 1, 2019, had a statutory value of -\$2,629,001—and will have a growing negative taxable value for the remainder of its useful life—is absurd on its face and violates every applicable provision of A.R.S. § 42-14154.” Leaving aside the fact there is zero evidence to support ADOR’s claim of any “negative” value, SDG&E never made such a claim in this case – nor could it based on the statutory valuation method.⁸

Ironically, footnote 9 of ADOR’s Petition hypothesizes a truly absurd result. It states: “Per the Opinion, [SDG&E] should presumably be entitled to \$6.787 billion in accumulated depreciation because it reported \$6.787 billion in ‘accumulated depreciation’ on its FERC Form 1.” There are two problems with this statement: (1) SDG&E has *never* reported such a number for its *Arizona* property; and (2) all the referenced numbers come from a FERC-audited report. The referenced numbers are for SDG&E’s reported accumulated depreciation for its *entire system* located (primarily) in California. The Arizona tax return depreciation represents a small fraction of the referenced amount (less than .8%). ADOR’s rhetoric is a prejudicial attempt to influence this Court by referencing a meaningless larger number.

⁸ When the CWIP amounts reported in 2019 for the 2020 tax year were placed into service at 100% of their cost in tax year 2021 (as the statute requires), the alleged “negative number” disappears altogether from ADOR’s contrived calculation. This is because once CWIP is placed into service it becomes “plant in service” at double the value it had as CWIP, pursuant to A.R.S. §42-14154(C).

Finally, on page 17, ADOR’s argument heading asserts: “The Opinion’s \$0 Value for Plant in Service Violates the Exemptions Clause.” The Opinion did not consider this issue because it was raised by ADOR for the first time on appeal. (Opinion, ¶23, n.3). However, even if it was timely raised, the short answer to this argument is it ignores Arizona law. In *Maricopa County v. Fox Riverside Theatre Corp.*, 57 Ariz. 407 (1941), a case involving property that was not taxed due to its location on government-owned land, this Court stated: “[T]here are many classes of taxation which the state may provide for but does not.” *Id.* at 413.

Stated differently, ADOR conflates a valuation statute which the Legislature prescribed for valuing utility property in a particular manner (including COR) with an exemption from taxes. These are *not* the same thing. *See, Maricopa County v. Trustees of Arizona Lodge*, 52 Ariz. 329 (1938) (involving taxation of intangible assets, and quoted extensively in *Fox Riverside* as support); *Airport Properties v. Maricopa County*, 195 Ariz. 89, ¶58 (Ct. App. 1999) (involving non-taxed possessory interests and quoting from *Fox Riverside* as support).

In summary, ADOR’s “exemption” argument is legally baseless. As this Court noted in *Trustees Lodge*, “For over twenty-six years [in 1938], no effort has been made to tax intangible property. * * * [W]e think, because it has been recognized for so many years as settled law, it is better that the legislature change it than that we disturb vested rights . . .” *Trustees Lodge*, 52 Ariz. at 340-43.

CALCULATING “FULL CASH VALUE” UNDER A.R.S. §42-14154

According to the first sentence of A.R.S. §42-11001(6), “Full cash value means the value determined as prescribed by statute.” The statutory method prescribed for utility property in Section 42-14154 is a cost approach. As such, it adds-together the components that comprise the entirety of the taxable utility property. The statute starts with the “original plant in service cost.” A.R.S. §42-14154(B)(1). From this, the related “accumulated provision for depreciation” is then deducted. A.R.S. §42-14154(B)(2)(a).⁹ (Opinion, ¶10)

The resulting subtotal from subsection B is then added to “construction work in progress” (CWIP) at 50% of cost, as prescribed by subsection C.¹⁰ To this amount, the value of taxable materials and supplies (M&S) is added per subsection D.¹¹ Next, an adjustment to reported net costs is required by subsection E for “environmental protection facilities” (EPF), reducing such costs by 50%.¹²

⁹ This is also known as “net book value.” It approximates the “rate base” on which a regulated utility is allowed to earn a return. The depreciation adjustment was the main focus of the litigation in Tax Court. The principal question was whether COR is included. Both courts held it is under FERC’s Order No. 631 and USoA.

¹⁰ A utility’s “rate base” (or net book value) is not increased by new construction until it is placed into service. As such, CWIP is valued at 50% of cost because it has some value even though a utility is not yet permitted to earn a return on it.

¹¹ Because SDG&E does not maintain an inventory of materials and supplies in Arizona, it did not report such property in its 2020 tax return.

¹² Due to the nature of electric transmission property, SDG&E did not own or report such property in Arizona, so this adjustment was not implicated.

Finally, any net value attributable to land rights must be excluded per A.R.S. §42-14154(G)(8).¹³ The resulting calculation is shown in footnote 7. Because “Plant does not include land rights” – per §42-14154(G)(8) – the value of land rights should not be part of the “plant in service” value. Yet, rather than *exclude* land rights from the total full cash value (as the statute directs), ADOR subtracted the value of land rights from the net plant subtotal *before* adding-in SDG&E’s CWIP. That is the *only* reason there is a negative number anywhere in ADOR’s calculation of the total full cash value under Section 42-14154. (Opinion, ¶3)

However, as the Table in footnote 7 shows, this argument is contrived. The only way to derive a negative number is to manipulate the *sequence* as to when the adjustment for “land rights” is made.¹⁴ This exclusion is mandated by the Legislature in A.R.S. §42-14154(G)(8). Hence, it is no different than the deduction for the “accumulated provision for depreciation” in Section 42-14154(B)(2)(a). Moreover, there are entirely legitimate reasons for excluding land rights and the other categories of property listed in subsection G(8) from the total full cash value of the taxable

¹³ Curiously, ADOR’s quote from subsection G(8) is incomplete. (Petition, n.1) It continues: “*Plant, does not include land rights . . .*” Rather than *exclude* land rights altogether, ADOR first includes them (in violation of the statute) and then subtracts them from the value of plant *before* adding SDG&E’s CWIP.

¹⁴ In contrast, “contributions in aid of construction,” another category of excluded assets in §42-14154(B)(3), never appears in the calculation. The statute never specifies how (or when) “exclusions” are to be made.

property.¹⁵

In summary, the valuation statute prescribed by the Legislature is binding on ADOR and Arizona’s courts. In *Arizona Department of Revenue v. Trico Electric Cooperative*, 151 Ariz. 544 (1986), this Court held this is the Legislature’s prerogative under Article 9, §11 of the Constitution. Therefore, this Court must defer to that decision under the separation of powers doctrine. If ADOR wants a different result, it should ask the Legislature to amend the statute. (Opinion, ¶18)

ADOR’s REMAINING ARGUMENTS ARE BASELESS

As outlined herein, the Opinion resolved correctly the question of whether the deduction for depreciation prescribed by Section 42-14154(B)(2)(a) includes COR. There is no dispute FERC defines this deduction as including COR. This statute applies to *all* utility property in Arizona. Because such property is also subject to regulation by FERC, the Legislature included subsection F to aid in interpreting the statutory terms. Indeed, for over 40 years – until this case – there was never any question about whether COR was part of the “accumulated provision for depreciation” referenced in Section 42-14154.

¹⁵ As noted, subsection G(8) defines “plant” broadly, but that definition is followed immediately by *exclusions* for land rights and other assets. Accordingly, they should be excluded *after* the taxable value is computed, which includes CWIP. Presumably, land rights were excluded because they are part of the value of fee-owned land, so taxing these again constitutes prohibited double-taxation. A.R.S. §42-11003. As for the others, inventories of materials and supplies are exempt (Art. 9, §13(1)), and licensed vehicles pay a vehicle license tax in lieu of property taxes (Art. 9, §11).

The statutory valuation method is based on the cost approach because all regulated monopolies are only allowed to earn what the regulator determines to be a “fair and reasonable return” on the utility’s “rate base.” Generally speaking, this is the utility’s net investment in plant and rates are set based on this amount, to limit what a regulated utility is allowed to earn.

ADOR seeks to ignore the Legislature’s chosen methodology by focusing on the word “related” in reference to depreciation, claiming it is not defined. As a general proposition, words in any statute are construed according to their ordinary meaning. A.R.S. §1-213. Here, the word “related” is an adjective that modifies the descriptive-noun “accumulated provision for depreciation.” That term has a defined meaning in FERC’s USoA—which includes COR. At its essence, the word “related” means “connected.” *American Heritage Dictionary* (2019). USoA’s Account 108 (Accumulated Provision for Depreciation) is *related* (or connected) to Account 101 (Original Plant in Service Cost), because USoA specifies Account 108 be deducted from Account 101 to calculate the net investment in plant. Thus, according to FERC these two defined accounts *are* “related” to each other.

Nonetheless, without any support ADOR asserts “related” only applies to *part* of the “accumulated provision for depreciation” in Account 108; namely, what it calls “life depreciation.” Of course, this contradicts FERC’s interpretation, which is binding under A.R.S. §42-14154(F). Consequently, ADOR’s entire argument

hinges-on re-defining “accumulated provision for depreciation” to exclude COR. From this flawed premise ADOR quotes Mr. Asay’s testimony on page 14 of its Petition, claiming he supports its position. Unfortunately, ADOR ignores completely what Mr. Asay actually said, as his testimony undeniably used FERC’s terms and their corresponding definitions, which include COR.¹⁶

On page 16, ADOR criticizes the Opinion harshly, calling it “schizophrenic.” This criticism is directed at the “negative value” issue ADOR raised below. SDG&E agrees this part of the Opinion is incorrect – because there is no negative value. *See*, Cross-Petition. However, the Opinion’s construction of the statute as including COR in the accumulated provision for depreciation is undeniably correct.

Finally, in its Conclusion, ADOR asks this Court to increase SDG&E’s 2020 full cash value to \$22,111,000, but there is no lawful way to do what it has asked.¹⁷

REQUEST FOR ATTORNEY’S FEES

Pursuant to Rule 21, ARCAP, SDG&E requests an award of its fees.

¹⁶ On page 15, ADOR raises another new argument based on A.R.S. §42-14154(B)(2)(b). This part of the statute is inapplicable here, but it also uses the term “accumulated depreciation” so it does not contradict the interpretation made by both lower courts regarding the inclusion of COR.

¹⁷ This value is derived by adding the two numbers in ADOR’s Conclusion together. There are two problems with this: (1) the value of SDG&E’s CWIP is *part* of the *total* full cash value calculated under Section 42-14154, not a separate number; and (2) this total exceeds ADOR’s 2020 value which is what SDG&E appealed. (IR-1)

CONCLUSION

For the foregoing reasons, as well as those set-forth in its Answering Brief and in the Tax Court record, SDG&E requests ADOR's Petition be denied.

RESPECTFULLY SUBMITTED this 3rd day of January, 2024.

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Arizona Department of Revenue - Centrally Valued Property
 Electric Transmission and Distribution Property
 Tax Year 2020

San Diego Gas & Electric Company

CVP ID #: **54-675**

FULL CASH VALUE CALCULATIONS

Plant in Service - Class 54	Original Cost	Accumulated Depreciation	Net Book Value
Plant in Service (excluding CIAC)	53,035,587	51,992,185	1,043,402
Less: Environmental Protection Facilities	0	0	0
Fee Land	0	N/A	0
Land Rights	4,218,191	545,788	3,672,403
Licensed Transportation Equipment	0	0	0
Net Plant in Service	48,817,396	51,446,397	-2,629,001
Add: Fee Land	0	N/A	0
Materials and Supplies	0	N/A	0
PIS Non-Capitalized Leased Operating Property	0	0	0
Less: Government Ordered Restricted Use Property	0	0	0
Taxable Plant in Service	48,817,396	51,446,397	-2,629,001
T & D Full Cash Value Rate			1.0
Arizona Full Cash Value Plant in Service			-2,629,001
Environmental Protection Facilities - Class 64			
Total Environmental Protection Facilities	0	0	0
Add: EPF Non-Capitalized Leased Operating Property	0	0	0
Taxable Environmental Protection Facilities	0	0	0
EPF Full Cash Value Rate			0.5
Arizona Full Cash Value Environmental Protection Facilities			0
Construction Work in Progress - Class 65			
Total Construction Work in Progress			7,296,949
Less: CWIP Fee Land			0
CWIP Land Rights			0
CWIP Licensed Transportation Equipment			0
Net Construction Work in Progress			7,296,949
Add: CWIP Fee Land			0
CWIP Non-Capitalized Leased Operating Property			0
Taxable Construction Work in Progress			7,296,949
CWIP Full Cash Value Rate			0.5
Arizona Full Cash Value Construction Work in Progress			3,648,475
Arizona Full Cash Value All Property			1,019,474