

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

Court of Appeals
Case No. 1 CA-TX 21-0008

Arizona Tax Court
No. TX 2019-001758

PLAINTIFF/APPELLEE'S SUPPEMENTAL BRIEF

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INTRODUCTION

Pursuant to this Court’s Order dated March 6, 2024, Plaintiff/Appellee, San Diego Gas & Electric Company (SDG&E) files its Supplemental Brief on the issue requested by the Court; namely, whether the court of appeals incorrectly held that accumulated depreciation calculated as prescribed by A.R.S. § 42-14154 cannot reduce the full cash value of a plant in service to a negative number or offset the value of unrelated property? As outlined below, the answer is: Yes.¹

LEGAL ARGUMENT

I. SDG&E’s 2020 Full Cash Value Under Section 42-14154 is Correct.

The tax court’s Judgment in this case set the “full cash value” of SDG&E’s Arizona property at \$1,019,473. That value is correct. It was determined after applying A.R.S. § 42-14154 to the undisputed facts in the record below. Under A.R.S. § 42-11001(6), “Full cash value means the value determined as prescribed by statute.” Section 42-14154 is the method prescribed by the Legislature to determine the full cash value of utility property, including the electric transmission

¹ This question posits two alternative assumptions about the court of appeals’ holding, neither of which is accurate. First, there is no “negative number” implicated by including the cost of removal as part of the “accumulated provision for depreciation” used to compute *part* of SDG&E’s total full cash value under Section 42-14154(B). The net plant in service portion of SDG&E’s total full cash value is still a positive number after this deduction is made. Second, SDG&E’s construction work in process (“CWIP”) is *not* “unrelated” to its taxable property. It is part of the taxable property under Section 42-14154(C). Thus, it is directly related to the full cash value of SDG&E’s *total* taxable “electric transmission property” in Arizona.

facilities owned by SDG&E in Arizona. This method is based on a cost approach which requires ADOR to combine the various components that make-up a utility's taxable property in order to determine the total full cash value.

The tax court entered Judgment regarding the full cash value as required by A.R.S. § 42-16213(A). The court of appeals held (correctly) that the future cost of removal ("COR") is part of what the FERC defines as the "accumulated provision for depreciation" referenced in Section 42-14154(B). Notwithstanding this part of its holding, the court of appeals vacated the tax court's Judgment based on its mistaken belief that the full cash value was determined using a negative number. That argument was first made by ADOR on appeal. This part of the Opinion is incorrect because the total full cash value under Section 42-14154 also includes the value of SDG&E's CWIP, which is fully reflected in the tax court's Judgment.

The plant in service cost is the starting point in determining the full cash value. A.R.S. § 42-14154(B)(1). It is reduced by the "related accumulated provision for depreciation." A.R.S. § 42-14154(B)(2)(a).² (Opinion, ¶10) To this number are added the CWIP from subsection C, materials and supplies from subsection D, and what are called "environmental protection facilities" ("EPF") from subsection E.

² This number is known as net book value. It approximates the rate base on which a regulated utility is allowed to earn a return. The inclusion of COR in the depreciation adjustment is mandated by FERC. Given this Court's Order denying ADOR's Petition for Review of that part of the Opinion, that is no longer in dispute.

Lastly, the net value of any land rights (and other items) must be “excluded” from the taxable value. A.R.S. § 42-14154(G)(8). The statutory calculation required by all the subsections of Section 42-14154 is summarized in the following Table: ³

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

In its calculations, ADOR chose to deduct the value of land rights from the net plant in service subtotal, and it also failed to add the value of CWIP into the total. Only by doing this can the 2020 full cash value be a negative number. The court of appeals mistakenly assumed ADOR’s calculations were correct. (Opinion, ¶13)

The Table above shows this assumption is false. Even when COR is included as part of the reported depreciation, the total accumulated depreciation is still less than the plant in service cost. Hence, the only ways to derive a negative number are to (1) manipulate the sequence of adjustments during the calculation, or (2) exclude some of the other property listed in Section 42-14154 (*i.e.*, the CWIP). What is clear is that every one of these adjustments was specified by the Legislature.

³ All these numbers came directly from SDG&E’s 2020 tax return. As required by law, it was timely-filed with ADOR under oath. (IR-8, Asay Declaration, Ex. A)

II. Section 42-14154 Must Be Construed as Written and Not by Inference.

This Court first confronted the predecessor version of A.R.S. § 42-14154 in *Ariz. Dept. of Revenue v. Trico Electric Coop., Inc.*, 151 Ariz. 544, 546 (1986). Although the statute has since been re-numbered – and the definition of “full cash value” has been refined – the essence of this Court’s holding in *Trico* was that the Legislature has broad authority under Article 9, § 11 of the Constitution to specify how property in Arizona is valued and taxed. This is consistent with longstanding Arizona law. *See, e.g., State of Arizona v. Martin*, 59 Ariz. 438, 444 (1942) (“The Legislature has plenary power over the subject of taxation ...”). Therefore, if the Legislature wants to reduce or offset values, it has the absolute right to do so.⁴

In contrast with these established principles, the holding in paragraph 21 of the Opinion completely ignores the Legislature’s exclusive prerogative to decide how utility property should be valued in Arizona. That power includes the power to specify how the terms of that statute should be interpreted. A.R.S. § 42-14154(F). Ironically, the court of appeals deferred to this part of the valuation statute when it

⁴ Besides land rights, the Legislature chose to exclude various assets from the full cash value determined under Section 42-14154, including contributions in aid of construction (“CIAC”) A.R.S. § 42-14154(B)(3), as well as inventories and licensed vehicles. A.R.S. § 42-14154(G)(8). It also prescribed a reduction for 50% of costs for environmental protection facilities (“EPF”). A.R.S. § 42-14154(E). Going the other way, the Legislature included a provision to add value for 50% of the cost of CWIP that would not otherwise be part of taxable utility plant because, by definition, it has not yet been placed into service. A.R.S. § 42-14154(C). And, it specified an addition for taxable materials and supplies (“M&S”). A.R.S. § 42-14154(D).

held (correctly) that COR was part of the “accumulated provision for depreciation” within the meaning of A.R.S. § 42-14154(B)(2)(a). (Opinion, ¶11) The Legislature’s decision to exclude land rights and other assets in calculating the full cash value of utility property under A.R.S. § 42-14154(G)(8) is entitled to no less deference.

Against this backdrop, the court’s statement in paragraph 21 of the Opinion that: “Nothing in the plain language of A.R.S. § 42-14154 ... expressly provides for or precludes a negative full cash valuation of a plant in service,” demonstrates its error in deciding what the Legislature meant. The court inferred the Legislature would not have enacted a statute where a negative number for one component of the total full cash value could be used to offset other positive component values to arrive at a final full cash value, but this ignores the plain language of the statute.⁵

The court of appeals made this inference based on a mistaken premise; namely, that SDG&E’s full cash value would otherwise be a negative number. As set forth above, that inference is incorrect because CWIP is part of the total full cash value under Section 42-14154, and it more than offsets any negative numbers in the calculation. But even if that assumption was true, this part of the Opinion shows why it should be reversed—this is a legislative and not a judicial function.

⁵ By definition, reducing the plant in service cost for “depreciation” implicates a “negative” number that reduces cost based on the age of the asset. In addition, CWIP and EPF are valued at only 50%, so half is subtracted from the reported amounts. ADOR also calculates the exclusion of land rights (and other assets) by subtraction.

III. By Definition, CWIP is Part of the Taxable Property in A.R.S. § 42-14154.

Section 42-14154(A) states: “The valuation of all electric transmission ... property that is subject to valuation for tax purposes shall be determined in the manner prescribed by this section . . .” (Emphasis added). In SDG&E’s case, it owns ONLY electric transmission property in Arizona. Thus, all of its Arizona plant in service is “electric transmission property,” as is all of its CWIP.⁶ Since all of SDG&E’s Arizona property is “electric transmission property,” all of it is subject to valuation under Section 42-14154; therefore, by definition, all of SDG&E’s Arizona property – both its plant in service and its CWIP – is “related.”

Because utility property is subject to financial regulation, its ability to earn a given return is tied directly to its net investment in plant and equipment (or “rate base”). That is why utility property is usually valued for tax purposes by reference to its net book value. When new property is under construction it does not become part of the rate base until it is placed into service. The predecessor to Section 42-14154 was adopted when the Palo Verde Nuclear Generating Station was being built. The utility owners spent billions of dollars over many years to build it, but the property tax valuation did not reflect any of these amounts. The valuation statute was enacted to rectify this by adding a provision to value CWIP at 50% of those costs, based on the assumption that such construction had some market value.

⁶ SDG&E does not own or report EPF, CIAC, M&S or licensed vehicles in Arizona.

In SDG&E’s case, the CWIP in its tax year 2020 full cash value became part of its plant in service cost in 2021 at 100% of the reported costs. Thus, SDG&E’s CWIP is directly-related to the value of the rest of its “electric transmission property” in Arizona. For administrative purposes, ADOR values CWIP separately from the plant in service (pursuant to subsection C), but it is still included in the *total* full cash value of SDG&E’s electric transmission property under Section 42-14154. ADOR’s attempt to characterize SDG&E’s CWIP as something different from the rest of its property in this case is both disingenuous and inaccurate. According to the plain language of Section 42-14154, SDG&E’s CWIP is part of its taxable property. A.R.S. § 42-14154(C). As such, off-setting the value of CWIP against any other part of the value determined under A.R.S. § 42-14154 is entirely appropriate.

Indeed, to do otherwise would conflict directly with this Court’s prior precedents. In *Transamerica Development Co. v. County of Maricopa*, 107 Ariz. 396, 399 (1971), this Court held that “property valuation must be considered one subject, not to be broken into separate components . . .” This Court stated:

[I]f the total valuation represents the full cash value of the property, it is immaterial for purposes of appeal that one part is overvalued and the other is undervalued. *It is the total value that is the concern of the ... court.*

Id. (emphasis added). Although the issue in that case was a taxpayer seeking to limit its tax appeal to the value of its improvements only (and not the land underlying those improvements), the same principle applies. *See, Appeal of Rieck Ice Cream*

Co., 209 A.2d 383, 387 (Pa. 1965) (“The thing from which the property owner appeals and, therefore, the concern before the court is the total assessment of the property as a unit. The itemization of an assessment required of an assessor separately for the land and for the building is but an intermediate step in the ascertainment of the taxable value of the property as a whole”). *Id.* ADOR’s practice of itemizing CWIP separately from the plant in service is exactly the same.

As such, it should not matter that some of the numbers that make-up the total full cash value of SDG&E’s property may be higher or lower (or even negative). What matters is that the value of the *entire* taxable property is included in the total full cash value under A.R.S. § 42-14154. That is the full cash value derived by applying the method prescribed by the Legislature to all of SDG&E’s taxable property, and that is also the full cash value determined by the tax court’s Judgment. Whether or not the Legislature intended to use a negative number to determine the full cash value of utility property under Section 42-14154, that is not what happened in this case.⁷ Even more importantly, however, it is not the province of Arizona’s courts to second-guess the wisdom of such a legislative judgment.

⁷ As alluded to above, implicit in the valuation formula prescribed by Section 42-14154, are both positive and negative numbers used to calculate the total full cash value of utility property. Given the Legislature’s adoption of FERC’s accounting rules by reference in A.R.S. § 42-14154(F), it may very well have intended that negative numbers be considered because that is how FERC’s uniform system of accounts (and all other accounting conventions) work. (Opinion, ¶13)

IV. Section 42-14154 Prescribes a Unitary Method That Includes CWIP.

Defendants have argued that Section 42-14154 provides for a separate determination as to the full cash value of CWIP from plant in service. This argument ignores the plain language of the valuation statute as a whole. Moreover, as already discussed herein, the property that is subject to valuation under Section 42-14154 includes several components that are all summed to arrive at a total full cash value. One of these components is the value of CWIP, pursuant to A.R.S. § 42-14154(C).

In addition, because utility assets like the electric transmission lines at issue here often cross county lines, the total full cash value must be allocated between different taxing jurisdictions. This is a common practice for all so-called “unitary” properties, which includes railroads, pipelines, telecommunications assets, airlines and utilities. Notably, the Legislature has not prescribed any single method for such allocations of the total full cash value. Instead, it is left to ADOR’s discretion, with the only constitutional constraint on such methods being that they are reasonable.⁸

In summary, there is nothing in the structure of Section 42-14154 that prevents ADOR from applying it to SDG&E’s property in this case. As this Court already

⁸ Indeed, this is an issue that has been the focus of valuation involving interstate assets in the federal courts for over 100 years. *See, Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194 (1897) (holding the “unit” principle can be used to value such assets as railroads and express companies without violating the constitution). ADOR also allocates the full cash values it determines across multiple counties for railroads, pipelines, telecommunications companies and electric utilities, and it does so using a variety of different methodologies, so it can do so in this case as well.

held in *Transamerica*, the full cash value at issue in any appeal is the value of the property “as a unit,” and ***not*** the individual components of value that go into it. *Transamerica*, 107 Ariz. at 399 (quoting from *Rieck Ice Cream*).

CONCLUSION

For the foregoing reasons, SDG&E respectfully requests that this Court reverse the court of appeals’ Opinion to the extent it purports to vacate the Arizona tax court’s correct ruling below, and reinstate its Judgment establishing the full cash value of SDG&E’s Arizona property for tax year 2020 at \$1,019,473.

The Opinion’s holding that COR is part of the “accumulated provision for depreciation” deducted from the “original plant in service cost,” pursuant to A.R.S. § 42-14154(B), is correct and should be affirmed. However, to the extent its holding implies that SDG&E’s CWIP is not part of the total full cash value under Section 42-14154, it should be reversed. Finally, the court of appeals’ holding regarding the effect of “negative numbers” in calculating the full cash value of utility property under Section 42-14154 should be stricken altogether from the Opinion.

SDG&E also respectfully requests an additional award of its attorneys’ fees incurred in this Court, and that the portion of its appellate fees not awarded by the court of appeals be reconsidered in light of this Court’s final decision before the issuance of the Mandate in this case.

RESPECTFULLY SUBMITTED this 25th day of March, 2024.

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