ARIZONA SUPREME COURT
ORAL ARGUMENT CASE SUMMARY

MESQUITE POWER, LLC v. ARIZONA DEP'T OF REVENUE
CV-23-0016-PR
254 Ariz. 355, 523 P.3d 960 (App. 2022)

PARTIES:

Petitioner:	Mesquite Power, LLC
Respondents:	Arizona Department of Revenue ("ADOR") and County of Maricopa ("County")
Amicus Curiae:	Arizona Tax Research Association, Arizona Competitive Power Alliance, Griffith Energy, LLC, and Western States Association of Tax Representatives

FACTS:

This case involves a tax dispute regarding ADOR's valuation of Mesquite's power plant (the "Plant") for the 2019 tax year. ADOR determined the Plant's full cash value to be $196,870,000, using the statutory formula set forth in A.R.S. § 42-14156 for valuation of electric generation facilities. The County then assessed property taxes against the Plant for the 2019 tax year based on ADOR's valuation. Mesquite appealed that determination to the tax court, arguing that the statutory value of the Plant exceeds the market value in violation of A.R.S. § 42-11001(6). After a bench trial, the tax court concluded that, under the income approach to valuation, the full cash value of the Plant for the 2019 tax year should be reduced to $105,000,000.

ADOR appealed, arguing that the tax court erred by discounting the impact of a power purchase agreement ("PPA") on the Plant's value. The PPA at issue is an agreement between Mesquite and Southwest Public Power Resources Group ("SPPR"). Under the PPA, Mesquite guarantees SPPR access to a specified amount of electrical capacity in return for SPPR's payment of a specified amount. SPPR's payments are fixed whether or not SPPR draws upon any guaranteed electrical capacity. The PPA does not require that Mesquite provide electricity to SPPR from the Plant. If it chooses, Mesquite may purchase power on the open market to cover the capacity guarantee to SPPR. The PPA and the Plant are severable, and the PPA can be transferred separately from the ownership of Mesquite's tangible personal property. However, any such severance would require approval by SPPR.

The Court of Appeals vacated the tax court's judgment and remanded for the tax court to impose ADOR's statutory valuation. Rejecting the notion that the PPA has independent value, the court found that the PPA must be considered in determining the Plant's value because it contributes to the Plant's cash flows and current usage. The court noted that although the PPA is severable from the Plant, it is not easily disentangled from the Plant and therefore cannot be ignored in an income approach to valuation.

The court also found that Mesquite's expert testimony was incompetent to rebut the statutory presumption that ADOR's valuation was correct because Mesquite's income-based model did not calculate cash flows for the Plant. The court found such a model improper because it envisions the Plant operating in a way that is not its current usage as required by A.R.S. § 42-11054(C)(1).

ISSUES:

(1) When the value of an electric generation facility is calculated using the income approach to valuation, does A.R.S. § 42-14156 permit the consideration of cash flows from a power purchase agreement that is severable from the facility but reserves a portion of the facility's generating capacity in exchange for annual payments?

(2) When the value of an electric generation facility is calculated using the income approach to valuation, does the "current usage" requirement of A.R.S. § 42-11054(C)(1) require consideration of a power purchase agreement that is severable from the facility but reserves a portion of the facility's generating capacity for in exchange for annual payments?

RELEVANT STATUTES:

<u>A.R.S. § 42-14156 states as follows:</u>

A. The valuation of electric generation facilities referred to in § 42-14151, subsection A, paragraph 4 shall be determined as follows:

1. The value of land used in operating the facility shall be the cost to the current owner as of December 31 of the preceding calendar year.

2. The valuation of real property improvements used in operating the facility is the cost multiplied by valuation factors prescribed by tables adopted by the department.

3. The valuation of personal property used in operating the facility is the cost multiplied by the valuation factors as prescribed by tables adopted by the department, adjusted as follows:

(a) For the first year of assessment, the department shall use thirty-five per cent of the scheduled depreciated value.

(b) For the second year of assessment, the department shall use fifty-one per cent of the scheduled depreciated value.

(c) For the third year of assessment, the department shall use sixty-seven per cent of the scheduled depreciated value.

(d) For the fourth year of assessment, the department shall use eighty-three per cent of the scheduled depreciated value.

(e) For the fifth and subsequent years of assessment, the department shall use the scheduled depreciated value as prescribed in the department's guidelines.

4. In addition to the computation prescribed in paragraphs 2 and 3 of this subsection, the taxpayer may submit documentation showing the need for, and the department shall consider, an additional adjustment to recognize obsolescence using standard appraisal methods and techniques.

5. The valuation prescribed in paragraph 2 of this subsection shall not reduce the valuation below ten per cent of the cost of the real property improvements. The valuation prescribed in paragraph 3 of this subsection shall not reduce the valuation below ten per cent of the cost of the personal property.

6. The following apply in determining cost for the purposes of this subsection:

(a) "Cost" means the cost of constructing the property or acquiring the property in an arm's length transaction.

(b) The cost of personal property is 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, plus any transaction privilege or use taxes paid.

(c) The cost of leased property is the lessor's cost of the property, except that in the case of a lease financing transaction, the cost is the actual cost of construction based on the invoice cost similar to any other type of financing.

(d) In the case of a facility that is acquired from another taxpayer:

. . . .

7. The department shall not value personal property construction work in progress until the property is first placed in commercial service. . . .

. . . .

B. For the purposes of this section:

1. "Electric generation facility" means all land, buildings and personal property that is situated in this state and that is used or useful for the generation of electric power.

2. "Personal property" means all tangible property except for land and real property improvements as defined in this section. Personal property includes foundations or supports for the machinery or apparatus for which they are provided, including water cooling towers.

3. "Real property improvements" means buildings, including administration buildings, maintenance warehouses and guard shacks, water retention ponds, sewage treatment ponds, reservoirs, sidewalks, drives, curbs, parking lots, tunnels, duct banks, canals, fencing and landscaping.

<u>A.R.S. § 42-11054 states, in pertinent part, as follows:</u>

C. In applying prescribed standard appraisal methods and techniques:

1. Current usage shall be included in the formula for reaching a determination of full cash value.