BEFORE THE STATE TAX APPEAL BOARD
OF THE STATE OF MONTANA

THOMPSON RIVER CO-GEN LLC, Appellant, -vs- THE DEPARTMENT OF REVENUE OF THE STATE OF MONTANA, Respondent	) DOCKET NO.: PT-2005-14)))))))) FACTUAL BACKGROUND, CONCLUSIONS OF LAW, ORDER and OPPORTUNITY FOR JUDICIAL REVIEW

The above-entitled appeal was heard on November 29 and 30, 2006, in Helena, Montana, in accordance with an order of the State Tax Appeal Board of the State of Montana (Board). The notice of the hearing was duly given as required by law. Thompson River Co-Gen, LLC (TRC), represented by David W. Woodgerd, attorney, presented testimony in favor of the appeal. The Department of Revenue (DOR), represented by Keith Jones, tax counsel, and Gary Peterson, industrial appraiser, presented testimony in opposition to the appeal. Testimony was presented and exhibits were received.

The Board allowed the record to remain open for a period of time for the purpose of allowing post-hearing briefing and proposed findings of fact and conclusions of law from both parties.

STATEMENT OF ISSUE

The issues before this Board are the appropriate market value and proper classification of Thompson River Co-Gen LLC, an electrical energy generating facility in Sanders County.

FACTUAL BACKGROUND

1. Due, proper, and sufficient notice was given of this matter, and of the time and place of the hearing. All parties were afforded opportunity to present evidence, oral and documentary.
2. The Board has jurisdiction over the issues. (Section 15-2-301, MCA).
3. The subject property, owned by Thompson River Co-Gen LLC (TRC), is a 10 megawatt cogeneration facility in Sanders County described as follows:

   > An electrical generating facility located in Section 13, Township 21 North, Range 29 West, County of Sanders, near the City of Thompson Falls, Montana, geocode 35-3091-13-1-01-01-4000. (Appeal form).

4. The Department, through industrial appraiser Gary Peterson, initially provided a valuation of the subject property to TRC for tax year 2005. TRC filed an AB-26 form requesting an informal review by the DOR. The DOR conducted an informal review and adjusted the valuation of the subject property. (Appeal Form; Ex. G).

5. On or about September 26, 2005, the DOR issued its revised assessment to TRC, reflecting a value of $18,939,422 and a tax due of $1,126,215. (Exhibit F).

6. The taxpayer appealed to the Sanders County Tax Appeal Board on October 17, 2005, requesting a value of $1,075,658 for the land and $10,624,621 for the improvements and citing the following reasons for appeal:

> The current appraisal does not reflect costs incurred by the original contractor that the taxpayer was forced to pay in violation of their original construction agreement. Current costs to construct like facilities have not been considered. (Appeal form).

7. The County Board held a hearing on April 27, 2006. In its April 27, 2006 decision, it denied the taxpayer's appeal, stating:

> Based on Dept. of Revenue presentation, we feel their valuation is valid as of 1/1/05. Appellant did not present adequate data to support their cost. (Appeal form).

8. TRC appealed that decision to this Board on May 4, 2006. TRC argues that the property is incorrectly valued and is also misclassified. TRC argues that the plant's real property and equipment should be classified as class 4 (Section 15-6-134, MCA) and class 8 (Section 15-6-138,

MCA), respectively and not as class 13 (15-6-156, MCA), as determined by the Department.

9. TRC was formed in 2000 for the purpose of constructing a power plant near Thompson Falls, Montana. Construction of the power plant began in December of 2002. (Testimony of Barry Bates [Member of TRC LLC].

10. Key components of the power plant were purchased as used machinery and equipment from RJ Reynolds in North Carolina, dismantled, shipped to the site in Sanders County, Montana, and installed. (Testimony of Barry Bates and Exhibit 6 [Bodington Analysis]).

11. The original budget to construct the power plant was approximately $9.8 million (Testimony of Barry Bates).

12. Several problems arose during the dismantling of the used components and subsequent construction of the power plant. These problems caused significant cost overruns. TRC believes that it paid too much for the plant. (Testimony of Barry Bates).

13. The power plant first produced electric power in the end of December, 2004, as a result of a test run which lasted for a very short period of time and produced very little power. (Testimony of Barry Bates).

14. Air emissions exceeded allowable levels during the 2004 test operations. (Testimony of Barry Bates).
15. After the December 2004 test run, the power plant did not operate again until January 12, 2005. (Exhibit 1). It only operated on 12 out of 31 days in January 2005, (Exhibit 1) or 4.26 percent of capacity. (Exhibit 2).
16. The plant continued to operate sporadically throughout 2005, routinely producing energy at less than 20 percent of capacity (Exhibit 2). Air emissions also exceeded allowable levels during the 2005 test operations. Ultimately, the plant was fully shut down in October 2005. (Testimony of Barry Bates and Exhibit 2).
17. The plant has not operated since that time and is not currently operating. (Testimony of Barry Bates).
18. Testimony indicated that the plant cannot operate in compliance with state air quality laws without significant modifications to certain equipment or the purchase of new equipment. (Testimony of Barry Bates).
19. Budget proposals submitted to TRC indicated two potential system upgrades to reduce emission levels. (Ex. 6, p. 14.)
20. The capital cost to install a functional emission system utilizing much of TRC's existing equipment was estimated at $1.5 million. A second proposal to install a new system

was estimated to cost approximately $3.5 million. Ex. 6, p.14. Installation of these modifications and receiving an amended air permit are anticipated to bring the plant into emission compliance. Ex. 6, p.14.

21. Jeff Bodington of Bodington and Company presented testimony concerning the sales prospects and market value of the subject power plant. Mr. Bodington has been employed as a consultant on the valuation of electrical power generating facilities since 1978. In 1990, he started his own firm, Bodington and Company, a boutique investment and consulting firm, that provides assistance in buying, selling, financing, restructuring, and appraising electric power plants. In 2004, TRC contracted with Bodington and Company to sell the TRC property. (Testimony of Barry Bates and Jeff Bodington).
22. Mr. Bodington made dozens of contacts with potential buyers in order to attempt to market the TRC power plant. (Exhibit 5 and Testimony of Jeff Bodington).
23. As part of its marketing efforts, Bodington and Company prepared a financial model which predicted financial expectations for the subject power plant.
24. Mr. Bodington also utilized a “scorecard” to track the sales activities of TRC. The 2004 Scorecard (Confidential

Marketing Status Report) indicates that 20 companies signed Confidentiality Agreements in order to obtain information concerning the TRC power plant. (Testimony of Jeff Bodington).

25. Four conditional bids were received in 2004. Two required TRC to be debt free and two would assume TRC debt. The offer prices were provided to the Board as confidential information. TRC did not accept any bid. (Test. Bodington.)

26. As of January 1, 2005, the Department determined the appraised value of TRC at $18,939,422 based on the cost approach to valuation. (Exhibit E).

27. On September 30, 2005, the DOR completed its final review and determined that the appraised value of the subject property was $18,939,422, which was calculated as follows:

Electrical Generation Real Property	$ 1,992,500
Electrical Generation Mach. and Equip.	$16,608,585
Furniture and Fixtures	$ 51,027
Supplies and Materials	$ 287,310
Total	$18,939,422

(Exhibit F.)

28. Because TRC leases its land, the real property is comprised of real property improvements such as buildings. (Test. Peterson).
29. In its appraisal, the DOR classified TRC's property as Class 13 property pursuant to § 15-1-156 MCA. (Exhibit G)
30. Gary Peterson, an industrial appraiser with the DOR, testified that he considered the three standard approaches to value in determining a final value for TRC. (Test. Peterson).
31. Mr. Peterson considered the market approach valuation unreliable due to a lack of comparable market data. (Test. Peterson).
32. Mr. Peterson also chose not to use the income approach because TRC could not and would not provide him with enough reliable income information to calculate a value based on the income method. The plant had not been producing power prior to the lien date so reliable income figures did not exist. (Test. Peterson).
33. Mr. Peterson testified that the cost approach is most reliable for valuing new or proposed construction when the improvements represent the highest and best use of the land and the land value is well supported. Further, the cost approach can effectively be used to develop an opinion of

market value or value in use of special-use properties and properties that are not frequently exchanged on the market, such as small electrical generation facilities. (Test. Peterson).

34. Mr. Peterson testified that the DOR received TRC's 2005 Property Reporting Form, signed by Laurence L. Doute and dated March 21, 2005. DOR also received TRC's Balance Sheet as of December 31, 2004. (Exhibits A and B, respectively). Mr. Peterson responded with a Rebuilt Balance Sheet, which requested more information. TRC provided the information requested (Exhibit C).

35. Using the requested information and DOR's Computer Assisted Mass Appraisal System (CAMAS), Mr. Peterson prepared a Business Equipment Valuation Summary of Value Report dated April 25, 2005. (Exhibit D).

36. The majority of the equipment TRC purchased was at least 10 years old. The Department maintains that the cost approach used to value TRC's property reflects the age of the equipment because the value is based on the price TRC paid for the equipment. (Peterson testimony; Exhibit D).

37. Based on the cost approach, Mr. Peterson prepared a Summary of Appraisal Data: Structures, Improvements and Land, to report the value of TRC's improvements to the real property

(Exhibit E). The final valuation given to TRC was $1,992,500 for industrial real property and $16,608,585 for machinery and equipment. (Exhibit G)

38. Upon appealing the property tax appraisal, TRC contracted with Bodington and Company to perform an analysis of the fair market value of the subject plant for purposes of a property tax appeal. (Exhibit 6).

39. Bodington's valuation report included market values for two different valuation dates: January 1, 2005, and January 1, 2006, which are the assessment dates for the respective years. Bodington concluded that the fair market value as of January 1, 2005, was $5,200,000. (Exhibit 6). (The value assigned for 2006 was not relevant to this appeal.)

40. Bodington and Company considered three standard approaches to value and weighted each as follows: cost approach – 10 percent; market approach – 20 percent; income approach – 70 percent. Mr. Bodington considers the cost approach to be the least appropriate valuation method for the subject plant because it did not take changing market conditions into consideration and, further, did not produce sound estimates of functional and economic obsolescence. (Ex. 6, Test. Bodington).

41. Bodington and Company used two methods to calculate the cost approach: original cost less depreciation and replacement cost new less depreciation. These two methods resulted in values of $10,350,000 and $9,934,000 respectively. (Exhibit 6, p. 42).

42. Mr. Bodington indicated that the income approach to value produces the most reliable indicator of market value for this type of property because, for investors who buy and sell electric power plants, return on their investment (in the form of an income stream) is the primary motivator. (Testimony of Jeff Bodington).

43. Bodington and Company used their marketing model to calculate the value of TRC's property through the income approach. (Exhibit 6, p. 25). Initially, the Bodington financial model used to market the plant for sales purposes employed a "place holder" discount rate with the expectation that potential buyers would substitute their own discount rates. For purposes of the tax appraisal (Exhibit 6), Bodington and Company utilized the same financial model and additionally calculated a discount rate to replace the "place holder" rate used in the model for marketing purposes. (Exhibit 6, p. 25 and 26).

44. To calculate a market based approach to valuation, Bodington and Company used the sales information in Exhibit 6 at page 24 to estimate a value. The estimated value was $8,400,000. (Exhibit 6, p. 24; 42).
45. Bodington and Company applied a weight to the values from each approach and determined a value of $5,528,000 for the subject plant at the assessment date of January 1, 2005. (Exhibit 6, p. 42).
46. The $5.5 million value was significantly lower than any of the conditional offers.
47. The DOR argues that Mr. Bodington possesses no licensing or other credential in appraisal and cannot therefore be considered an expert in appraisal. Further, his "appraisal" was not conducted in accordance with USPAP (Uniform Standards of Professional Appraisal Practice) and, because Mr. Bodington's compensation is dependent upon the sale amount itself, the Department argues that his determination of market value is suspect. (Peterson test.)
48. Mr. Peterson testified that Mr. Bodington does not understand, nor did he correctly apply, depreciation, functional and economic obsolescence.
49. Mr. Peterson testified that Mr. Bodington, in his market approach, did not apply any adjustments for comparability.

Further, there were no truly comparable sales to use in valuing the subject plant.

50. Regarding Mr. Bodington's income approach, Mr. Peterson testified that Mr. Bodington did not include sufficient data to support his income approach values and his income forecasts were originally developed for marketing, not tax appeal purposes.

BOARD DISCUSSION

All taxable property must be assessed at 100% of its market value except as otherwise provided. Section 15-8-111(1), MCA. The Supreme Court has held that the Department may use construction cost as one approximation of value. The Court further notes that "evidence of construction costs alone, without consideration of any market factors, does not satisfy the requirement of §15-8-111(1), MCA, that the assessed value equal market value. *DeVoe v. Department of Revenue State of Montana*, 263 Mont. 100, 116, 866 P.2d 228 (1993).

At issue in this matter is whether the cost approach accurately captured all relevant data for purposes of valuing the plant. As of the lien date, there was no relevant operating history from which to calculate an income approach valuation. In addition, there were no comparable sales for purposes of a market based approach to valuation.

Though the cost approach method used by the Department of Revenue supplies the most accurate and relevant data in this case, we find that the DOR failed to adequately calculate some level of adjustment for the fact that the plant was not operational prior to or on the lien date in question.

Prior to the lien date, the one and only time the plant operated was for a test run at the end of December, 2004. Thus, there is little, if any data, to show that the plant was fully operational at the time of the lien date.

The operations of the plant after the lien date confirm this. The Board notes, however, that such data cannot be used to value the plant as the information was not known or knowable on the lien date.

Information known at the time of the lien date demonstrated that the plant was able to function at a minimal level as shown by the test data. In fact, Mr. Bates testified that the plant was expected to be up and running in the first quarter of 2005. (Bates test.). A conditional air quality permit, valid for 180 days, required the plant to meet air quality standards by May 22, 2005. (Bates test.). Thus, it was clear that TRC anticipated being fully functional in the first quarter of 2005 and the valuation of the plant should reflect that value as of the lien date.

There were however, other indications that the value of the plant did not reach the value of the cost-based analysis. Market data relating to offers on the property prior to the lien date do provide some information on the market for this type of plant.

Pursuant to the confidential material provided to the Board, four bids were sent to TRC. All of these bids were rejected. The bids were all below the DOR value but above Mr. Bodington's tax value. The reasoning behind these offers, which TRC considered too low, included a necessary higher contract price for purchase of energy, the plant was too small to be economically viable, too much uncertainty on economic value without income history, and too small and troubled to be worth the investment. (Ex. 5. Confidential). This evidence is relevant in this matter, especially in light of the Supreme Court's directive that "evidence of construction cost alone, without consideration of any market factors, does not satisfy the requirement of §15-8-111(1), MCA, that the assessed value equal market value." **DeVoe v. Department of Revenue**, 263 Mont. 100, 116, 866 P.2d 228(1993).

Clearly, the offers demonstrate that there is some "risk factor" to purchasing a non-operational plant that the cost approach does not address in this matter.

"When applicable, the cost approach reflects market thinking because market participants relate value to cost. Buyers tend to judge the value of an existing structure not only by considering the prices and rents of similar buildings, but also by comparing the cost to create a new building in optimal physical condition with optimal functional utility. Moreover, buyers adjust the prices they are willing to pay by estimating the costs to bring an existing structure up to the physical condition and functional utility they desire." The Appraisal of Real Estate, 11th Ed., 335.

In this instance, there is also evidence that the Department failed to consider the functional obsolescence that prevented the plant from being fully operational as of the lien date. The deficiency, a defective emissions system, prevented the system from working within the required air emission requirements. This is a curable expense and evidence of the expense was submitted to the Board. See Ex. 6. In addition, the low offers and comments relating to those offers confirms that the emissions deficiency affected the value of TRC.

TRC's presentation of valuation also fails to provide an adequate valuation of the subject property. The Department has continuously opposed Mr. Bodington's testimony relating to the valuation of TRC. While we understand that the Bodington

analysis is not an appraisal, and not subject to USPAP standards, Mr. Bodington's testimony is not without some merit.

By statute, both the County Tax Appeal Boards and this Board may consider "the actual selling price of the property, independent appraisals of the property, and other relevant information presented by the taxpayer as evidence of market value of the property." Section 15-7-102(6), MCA. Consideration of Mr. Bodington's testimony and evidence is permitted as relevant information. *See DOR v. American Timber and Glacier Gold*, DV 05-394(B); Montana 11th Judicial District Court.

We do note, however, that Bodington & Company's evaluation lacked substantial income history, the forecast calculations were highly speculative and in addition those figures were originally developed for marketing purposes. There is little doubt that Mr. Bodington has great expertise in his field of valuing and marketing electric utility plants and we have little doubt as to his knowledge of the industry. The issue, however, is that his valuation methodology is too speculative in nature to assist this Board in valuing the property for tax purposes on the date of the appraisal.

In addition, his valuation of the company, at $5,200,000 is significantly lower than the 2004 offers made to TRC. Mr.

Bodington himself testified that he believed the offers made were too low, and TRC declined those offers. There was no material change to TRC between the time of the offers and the subsequent lien date which would explain the significant difference in valuation.

The Board agrees that inadequate information on which to base the market and income approaches leaves the Department with only the cost approach to value this property. We also find that the Department failed to adequately calculate some level of functional obsolescence based on the failure of the plant to be operational as of the lien date. The significantly low sales offers submitted to TRC in comparison to the assessed value demonstrate the existence of some level of functional obsolescence. The sale offers are, however, market data that would have been unavailable to the Department at the time of valuation and are an example of the appropriateness of the appeal process.

In calculating an appropriate value in this matter, we find that the electrical generation real property is properly valued at $1,992,500. Reviewing the value of $16,608,585 for TRC machinery and equipment and comparing it to the sales offers, which are significantly lower than the cost valuation,

indicates to the Board that an adjustment for the emission system's functional obsolescence is appropriate.

Based on the evidence, the Board finds that the emission system would require a minimum cost of $1.5 million to bring the plant to functional emission requirements. Thus, an adjustment of $1.5 million to the Department's value for the machinery and equipment is appropriate.

The Department's value of $16,608,585, with the functional obsolescence adjustment, is hereby modified to $15,108,585. The value of the electrical generation real property remains at $1,992,500 for a total value of $17,101,085.

Classification Issue

The Department classified the TRC property as class 13 property pursuant to §15-6-156, MCA. TRC argues that its property is properly classified as class 4 and class 8 property. TRC bears the burden of proving that the DOR classification is incorrect. *Farmer's Union Central Exchange v. DOR*, 272 Mont. 471, 477, 901 P.2d 561, 564 (1995).

Electrical generation facilities are generally classified as Class 13 property. Section 15-6-156, MCA, states in its entirety:

> 15-6-156. Class thirteen property -- description -- taxable percentage. (1) Except as provided in subsections (2)(a) through (2)(g), class thirteen property includes:

(a) electrical generation facilities, except wind generation facilities classified under 15-6-157, of a centrally assessed electric power company;
(b) electrical generation facilities, except wind generation facilities classified under 15-6-157, owned or operated by an exempt wholesale generator or an entity certified as an exempt wholesale generator pursuant to section 32 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79z-5a;
(c) noncentrally assessed electrical generation facilities, except wind generation facilities classified under 15-6-157, owned or operated by any electrical energy producer; and
(d) allocations of centrally assessed telecommunications services companies.

(2) Class thirteen property does not include:

(a) property owned by cooperative rural electric cooperative associations classified under 15-6-135;

(b) property owned by cooperative rural electric cooperative associations classified under 15-6-137 or 15-6-157;

(c) allocations of electric power company property under 15-6-141;

(d) electrical generation facilities included in another class of property;

(e) property owned by cooperative rural telephone associations and classified under 15-6-135;

(f) property owned by organizations providing telecommunications services and classified under 15-6-135; and

(g) generation facilities that are exempt under 15-6-225.

(3) (a) For the purposes of this section, "electrical generation facilities" means any combination of a physically connected generator or generators, associated prime movers, and other associated property, including appurtenant land and improvements and personal property, that are normally operated together to produce electric power. The term includes but is not limited to generating facilities that produce electricity from coal-fired steam turbines, oil or gas turbines, or turbine generators that are driven by falling water.

(b) The term does not include electrical generation facilities used for noncommercial purposes or exclusively for agricultural purposes.

(c) The term also does not include a qualifying small power production facility, as that term is defined in 16 U.S.C. 796(17), that is owned and operated by a person not primarily engaged in the generation or sale of electricity other than electric power from a small power production facility and classified under 15-6-134 and 15-6-138.

(4) Class thirteen property is taxed at 6% of its market value.

The statute allows for certain exceptions to that definition including electric generation facilities that are included in another class of property; that are exempt as small electrical generation equipment pursuant to §15-6-225, MCA; or

that are a qualifying small power production facility as defined by 16 U.S.C. 796(17).

TRC acknowledges that it is not a small power production facility as defined by 16 U.S.C. 796(17). (TRC Reply Legal Brief, p. 8.) TRC instead argues that it is an entity certified as an exempt wholesale generator pursuant to section 32 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79z-5a. TRC makes this claim by asserting that all cogeneration facilities are exempt from the Public Utility Holding Company Act and references 18 C.F.R. §§ 292.601-292.602. (TRC Reply Legal Brief, p. 8.)

In reviewing the relevant federal statutes, the Board notes that Congress repealed the Public Utility Holding Company Act of 1935 (PUHCA) after the January 1, 2005, lien date relevant in this appeal and instituted the Public Utility Holding Company Act of 2005. Thus, the Board finds the 1935 Act pertinent to the January 1, 2005, lien date in question.

The federal definition of exempt wholesale generators states in part that "no person shall be deemed to be an exempt wholesale generator under this section unless such person has applied to the Federal Energy Regulatory Commission for a determination under this paragraph." 15 U.S.C.S. §79z-5a (2004).

In support of its argument that TRC is an exempt wholesale generator, TRC references an application as Exhibit 1 to the TRC Legal Memorandum Supporting Proposed Findings of Fact and Conclusions of Law and Order. The Board notes however, that the document supplied to the Board is dated August 12, 2005; eight months after the lien date in question. In addition, the document is titled "Completed Form 556 for Obtaining Self-Certification of Qualifying Facility Status under PURPA." The document does not reference PUHCA, Public Utility Holding Company Act, FERC Order 667, exempt wholesale generator, or other relevant reference. No material has been submitted to this Board to demonstrate that TRC is an exempt wholesale generator. Thus, the Board cannot agree with TRC's statement that it is an entity certified as an exempt wholesale generator pursuant to section 32 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79z-5a and thus, exempt from classification under §15-6-156, MCA.

TRC also notes that the benefits of being a qualified facility are substantial and beneficial and that the code encourages the development of both cogeneration and renewable energy facilities. TRC argues that because the tax code is silent as to whether TRC is expressly taxed in class 13, the benefit of the doubt should be granted to the taxpayer and TRC

should be taxed as an equal with federally recognized qualifying facilities. (Exhibit 1, County Tax Appeal Board). Again, we cannot agree. This is not a situation where the interpretation of a statute is susceptible to differing constructions such as the cases cited by the taxpayer. Section 15-6-156(1)(c)classifies TRC as class 13 property. TRC has failed to overcome its burden to show that the Department’s classification is incorrect.

ORDER

Market Value & Classification Issue
Issue

The Board finds the TRC plant value is $17,101,085, and that the TRC plant was properly classified as class 13 property.

Dated this 4th day of May, 2007.

BY ORDER OF THE
STATE TAX APPEAL BOARD

(S E A L)

/s/_____
KAREN E. POWELL, Chairwoman

/s/_____
SUE BARTLETT, Member

/s/_____
DOUGLAS A.KAERCHER, Member

NOTICE: You are entitled to judicial review of this Order in accordance with Section 15-2-303(2), MCA. Judicial review may be obtained by filing a petition in district court within 60 days following the service of this Order.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this 4th day of May, 2007, the foregoing Order of the Board was served on the parties hereto by depositing a copy thereof in the U.S. Mails, postage prepaid, addressed to the parties as follows:

David W. Woodgerd
BITTERROOT TAX CONSULTING, PLLC
113 Log Cabin Lane
Stevensville, Montana 59870

Michael J. Uda
DONEY, CROWLEY, BLOOMQUIST, PAYNE, UDA P.C.
P.O. Box 1185
Helena, Montana 59624

Keith Jones
Tax Counsel
Office of Legal Affairs
Department of Revenue
Mitchell Building
Helena, MT 59620

_____
DONNA EUBANK
Paralegal