BEFORE THE STATE TAX APPEAL BOARD

OF THE STATE OF MONTANA

BIG SKY TRANSPORTATION CO., Appellant, -vs- THE DEPARTMENT OF REVENUE OF THE STATE OF MONTANA, Respondent.	DOCKET NO.: MT 1996-3 FINDINGS OF FACT, CONCLUSIONS OF LAW, ORDER and OPPORTUNITY FOR JUDICIAL REVIEW

The above-entitled appeal was heard on the 22nd day of April, 1997, in the City of Billings, Montana, in accordance with the order of the State Tax Appeal Board of the State of Montana (the Board). The notice of the hearing was given as required by law. The taxpayer was represented by agent Brian Connealy and Big Sky Airlines' Executive Vice President and Division Manager Craig Denney, Big Sky Airlines' Director of Accounting Karie Kane, and Ron Elkin of Business Properties presented testimony in support of the appeal. The Department of Revenue (DOR) was represented by Tax Counsel Brendan Beatty and Tax Counsel Pat Dringman and Bureau Chief Eugene Walborn, and appraisers Darragh Walker and Vern Fogle presented testimony in opposition to the appeal. Testimony was presented, exhibits were received, and the Board then took the appeal under advisement; and the Board having fully considered the testimony, exhibits, and all things and matters presented to it by all parties, finds and concludes as follows:

STATEMENT OF THE ISSUE

BIG SKY TRANSPORTATION CO. is requesting a modification of the capitalization rate, which is part of the formula used to determine the company’s 1996 allocated value.

FINDINGS OF FACT

1. Due, proper, and sufficient notice was given of this matter and of the time and place of the hearing. All parties were afforded the opportunity to present evidence, oral and documentary.

2. The taxpayer, doing business as Big Sky Airlines, is a regional air carrier and provides scheduled passenger, freight, express package, and charter services. The Company is the successor to another corporation of the same name, incorporated in the State of Montana in 1978, and commenced flying operations in September 1978.

3. Big Sky Airlines serves nine Montana locations. The hub is located in Billings, and seven of the eight routes are subsidized under an Essential Air Services (EAS) contract with the federal government.

4. The DOR determined the 1996 ad valorem valuation

of Big Sky Transportation Co. to be $2,256,838, a value derived by combining 80% of the cost approach to value with 20% of the income approach. The income value was computed by averaging income for three prior years, adding an operating lease adjustment, and then applying a capitalization rate of 9% to the adjusted income figure.

TAXPAYER'S CONTENTIONS

The taxpayer is requesting that the DOR change the capitalization rate from 9% to 15%, thereby reducing the valuation of Big Sky Transportation Co.

Mr. Connealy testified that the DOR's 9% airline capitalization rate is an inappropriate rate to apply to determine Big Sky's value. He stated the DOR's airline capitalization percentage is developed using financial data, primarily secured from Value Line and Standard and Poor publications, for twelve airline companies. Mr. Connealy pointed out that these twelve companies are not comparable to and have little in common with Big Sky Airlines which is a small, regional carrier. Each of the twelve is larger in terms of seat capacity and area served. Many are international, all have superior investment grades, higher financial fitness ratings, and larger operating margins. (TP Ex 4, 8, 10)

Mr. Connealy pointed out that the reliance on the revenue produced from the Essential Air Services (EAS) contract further impacts the financial stability of Big Sky’s operation; and it is a higher risk investment which, in turn, influences its value. In an October, 1996 report, Dun & Bradstreet cited that reliance on EAS contract funding raised concern about the company’s financial well being. (TP Ex 6)

EAS subsidies represented 69%, 70%, and 61% of company revenues for fiscal years 1995, 1994, and 1993, respectively.(TP Ex 11) Mr. Denney testified that providers of essential air services sign one or two year contracts to provide service in isolated, remote locations. A profit margin, while built into the negotiated contract rate, is still dependent upon the provider company’s containment of costs and expenses and is dependent, as well, on annual funding by congress.

Mr. Denney added that EAS subsidies are competitive and, even after contracts are negotiated, are not guaranteed. Contracts can and have been modified. Mr. Denney testified that, after securing a signed agreement, a funding reduction by congress in November, 1995 reduced the subsidy to Big Sky by a half million dollars. Mr. Denney further testified that, if not for the EAS contract funding, there would be doubt about the Company’s ability to continue as a going concern. (TP Ex 13)

Mr. Connealy testified that, of the twelve airlines used by the DOR to establish an airline industry capitalization rate, none had subsidized revenues. Big Sky’s EAS subsidy, on the other hand, represented an average of 66.67% of revenues over a three year period. He stated the subsidy represented an increased risk factor.

Mr. Connealy testified he developed an “Adjusted Capitalization Rate” of 15% by taking 67% (the percentage of Big Sky’s annual subsidized revenue) of the DOR’s 9% airline industry capitalization rate and adding the result, 6% (referred to as the “Capitalization Rate Equivalency Factor”), to the DOR’s 9% figure. He stated that the additional 6% acknowledges the higher risk inherent in Big Sky’s operation when compared to the twelve airline companies used to develop the DOR’s rate.(TB Ex 14) Mr. Connealy acknowledged he was not familiar with any recognized or unrecognized authority using the same method of capitalization rate adjustment, but that it was developed through discussions with Mr. Elkin.

Mr. Elkin stated “a capitalization rate is simply a measurement of risk," and that, the higher the risk associated with the producer of the income stream, the higher the capitalization rate. He acknowledged that the adjustment to 15% from the DOR's 9% rate is arbitrary, but went on to say that one must accept the important premise that it is incomparable and unfair to use the same rate to capitalize the subsidized income of Big Sky Airlines as is used to capitalize the income of international and domestic carriers identified in Exhibit 4 and from which the DOR's rate was established.

The total allocated value of Big Sky Transport Co. requested, substituting a 15% capitalization rate for the DOR's 9% rate, is $2,079,662.(TP Ex 15)

DEPARTMENT OF REVENUE'S CONTENTIONS

At the outset, Mr. Beatty stated that the DOR "utilized acceptable means by which to arrive at the appropriate capitalization rate for Big Sky Airlines."

Mr. Walborn provided an explanation of the process utilized by the DOR to value centrally assessed properties which are appraised annually. He stated that airlines are centrally assessed and Big Sky Airlines is included in Class 12 as a scheduled airline.

Mr. Walborn testified that the appraisal requires the taxpayer to submit an annual return which includes the financial statements and property records needed to conduct an appraisal. This information then is used to develop the three traditional approaches to value: market, income, and cost. These indicators of value then are correlated into a unit value and allocated to reflect the portion of the business conducted in Montana. Mr. Walborn added that sometimes fewer than three indicators of value are developed when not enough data is available.

Mr. Walborn stated that the market indicator, usually developed through a stock and debt correlation, was not used for Big Sky. He testified that, although it was calculated, the reorganization of Big Sky and lack of active trading of the common stock might place into question the reliability of the market indicator of value, and so it was not used.

Mr. Walborn testified that the 80% cost/20% income calculation of value (DOR Ex A) represents the DOR’s appraisal judgment of the contribution of each indicator to the appraised value. The cost and income indicators were relatively close in value.

Ms. Walker testified that the calculation of the income approach to value utilized data submitted by Big Sky

Airlines in the State of Montana 1996 Annual Report it was required to file.(DOR Ex B) She stated that the DOR annually produces an airline industry capitalization rate using publicly available data for airline companies. To calculate an income indicator of value, she testified that typically she might use two years to average income, but in the case of Big Sky she averaged income for three years. This was an “attempt to more normalize” income in view of Big Sky’s declining income which showed a significant decline in FY 1995.

Insofar as the 80% cost/20% income conclusion of value, she stated that the weight given to the cost indicator was a more reliable indication of value for Big Sky Airlines for a variety of reasons. She believed she could substantiate the cost indicator using other approaches and, given Big Sky’s previous financial situation, believed giving weight to the cost approach would more accurately reflect value. She further testified she calculated the value for Big Sky utilizing both the sales comparison approach (DOR Ex C) and the stock and debt approach (DOR Ex D) to validate her cost indicator.

Mr. Fogle testified he had been involved in the development of capitalization rates throughout the ten years he has been working with centrally assessed properties for the

DOR. He stated: “A capitalization rate is a percent which is used in conjunction with some measure of income to produce an income indicator of value.” He further testified that in unitary appraisal there are two general categories of capitalization used for developing income indicators: yield capitalization and direct capitalization. The former uses a yield rate to discount a stream of future cash flows; and the latter uses a capitalization rate to directly convert a current measure of income into an income indicator of value. Both techniques are generally accepted methodologies and are commonly used in unitary appraisal. Montana uses the direct capitalization method.

Mr. Fogle testified that a direct capitalization rate is not considered equivalent to a return on investment. It is a relationship that is observed in the market and used to convert directly a net operating income figure into an income indicator of value. He stated that capitalization rates are arrived at in a generally uniform manner; and Montana’s direct capitalization rates (DOR Ex E) are developed from publicly available financial information on publicly-traded companies published in Value Line Investment Survey, Standard & Poor’s Bond Guides, and Standard & Poor’s Stock Guides.

According to Mr. Fogle, any capitalization rate, yield or direct, will be a band of investment or weighted rate. He stated that the DOR considered two sources of financing for the airline industry (common stock and debt) to develop a typical, average industry capital structure based on market value of common stock and market value of debt. For the airlines (DOR Ex F), it was about 44% common stock and 56% debt.

Mr. Fogle explained that the price/earnings (P/E) ratio is used for equity in direct capitalization and, for all of the companies in the data set, several different measures of the P/E ratio were analyzed, the resultant ratio being 8.9%. Mr. Fogle stated it is a similar concept when looking at the rate for debt: simply one year's earnings for the bond divided by the average price for the bond. Then the two rates (common stock and debt) are weighted according to the typical market structure for the industry and a direct capitalization rate is calculated. In this case, the calculated rate is 8.81%, rounded up to the nearest quarter percentage, or 9%.

In choosing comparables to develop an industry capitalization rate, Mr. Fogle testified that the one thing necessary is that the companies be publicly traded and information be publicly available. Further, he stated there is no one selection factor that is the best, although one of the most consistently mentioned was the line of business or industry class. There are other factors that should be considered, he said: for example, risk, operating characteristics, size or physical characteristics, profitability, and growth. He testified that the method utilized by the DOR in selecting comparables is a recognized means and, for substantiation, submitted four documents from authoritative texts (DOR Ex G and H) explaining the selection of comparables.

Mr. Fogle testified that, in his opinion, the capitalization rate developed by the DOR for the airline industry and applied to Big Sky Airlines is appropriate. While he conceded there is a size difference between Big Sky and the comparables used, other characteristics are “reasonable similar though not perfect” and “comparable though not identical.” This is acceptable terminology as proffered by the National Conference on Unit Valuation Standards.(DOR Ex H).

To further underscore the acceptability of the comparables, Mr. Fogle noted that the first three digits of the Standard Industrial Code (SIC) of Big Sky and the comparables are identical, citing page 96 of the second document in the DOR's Exhibit G: "The results suggest that industry membership or a combination of risk and earnings growth are effective criteria for selecting comparable firms. .... The accuracy of selecting comparable firms by industry improves as the number of SIC digits used in matching firms increases, up to the third digit."

A company-specific capitalization rate for Big Sky Airlines was developed (DOR Ex K) although not utilized. Mr. Fogle pointed out, the capitalization rate applied had to come from the market, but the company-specific rate was offered for comparative purposes. The calculated company-specific rate was 5.97%.

Mr. Fogle testified that Big Sky Airlines' alternative method of deriving a capitalization rate (TP Ex 14) utilized an invalid approach because it has no theoretical basis. Additionally, if pursuing this approach, separate adjustments would have to be made to the debt rate and to the equity rate before blending. Mr. Fogle contended that Big Sky's adjustment is based on the assumption that risk increases because of the EAS subsidy. In fact, he stated, the subsidy reduces the variability of the income stream and, therefore, reduces the risk. He stated, if there was an adjustment to be made and if this method could be justified, the adjustment of the capitalization rate should be downward rather than upward. He concluded that the EAS subsidy is not very risky. Big Sky has been receiving it for years and there is no indication it will end immediately. (DOR Ex L & M)

DISCUSSION

The issue before this Board is whether there exists evidence to warrant an increase in the capitalization rate applied to the income of Big Sky Transportation Co. which would, in turn, lower the income indicator of value and, thus, reduce the 1996 ad valorem valuation. The taxpayer is requesting the capitalization rate be changed from 9% to 15%.

The Board disagrees with the taxpayer's development of an overall capitalization rate of 15%. There are various methods used to arrive at a capitalization rate, i.e. market transactions, mortgage market, bond market, stock market, etc. The taxpayer, however, failed to provide support through testimony or documented evidence that the method used by the taxpayer to arrive at a overall capitalization rate of 15% is an accepted method in the appraisal industry. It has not been proven to the Board that the additional 6% the taxpayer has added to the DOR’s capitalization rate of 9% is associated with higher risk because of reliance on an EAS subsidy.

From the evidence and testimony presented, it is the opinion of this Board that the taxpayer, BIG SKY TRANSPORTATION CO., has failed to meet the burden that the value as determined by the DOR is in error. It is also the opinion of this Board that the DOR has provided evidence and testimony that the subject property has been treated in accordance with governing statutes and applicable administrative rules.

CONCLUSIONS OF LAW

1. The State Tax Appeal Board has jurisdiction over this matter. §15-2-302 MCA

2. Properties centrally assessed. The department of revenue shall centrally assess each year:

(3) all property of scheduled airlines. §15-23-101

3. “Airline” means a company engaged in scheduled air commerce. ARM 42.22.101 (1)

4. “Unit method of valuation” is a method for determining the market value of a centrally assessed company. 42.22.101 (21)

5. The unit method of valuation will be used to appraise centrally assessed companies whenever appropriate.

When applying this method, the department will use commonly accepted methods and techniques of appraisal to determine market value. The application of the unit method may include a cost indicator, capitalized income indicator, and a market indicator of value when sufficient information is available. ARM 42.22.111 (1)

6. The income indicator may be determined by consideration of one or more of the following methods depending on the department's analysis of the future earning capacity of the company:

(a) capitalization of the company's historic income or average of historic incomes;

(b) capitalization of a projected level of income;

(c) discounted cash flow analysis;

(d) other accepted method.

(2) The capitalization rate utilized will be determined by the band of investment theory or other accepted methodology. ARM 42.22.114

7. It is true, as a general rule, that the appraisal of the Department of Revenue is presumed to be correct and the taxpayer must overcome this presumption. The Department of Revenue, however, should bear a certain burden of providing

documented evidence to support its assessed value. Western Airlines, Inc. v. Catherine J. Michunovich, et al, 149 Mont. 347.428 P.2d 3.(1967).

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ORDER

IT IS THEREFORE ORDERED by the State Tax Appeal Board of the State of Montana that the 1996 ad valorem valuation of BIG SKY TRANSPORTATION CO., is $2,256,838 as determined by the Department of Revenue.

Dated this 19th of June, 1997.

BY ORDER OF THE
STATE TAX APPEAL BOARD

/s/__________________________
PATRICK E. McKELVEY, Chairman

(S E A L)

/s/__________________________
GREGORY A. THORNQUIST, Member

/s/_____________________
LINDA L. VAUGHEY, 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.