

Title 26. Taxation

Chapter VI. Arkansas Public Service Commission

Subchapter A. Generally

Part 230. Market Valuation Rules for Telephone Companies

Codification Notes. This part as promulgated prior to codification into the Code of Arkansas Rules provided as follows:

"Revised: July 27, 2009"

Subpart 1. Generally

26 CAR § 230-101. Introduction.

(a) Pursuant to Arkansas Code § 26-26-1601 et seq., the property owned and/or controlled by a telephone company in Arkansas is to be assessed for ad valorem tax purposes by the Tax Division of the Arkansas Public Service Commission.

(b)(1) The division will value the taxable property actually used in the business of transmitting telephonic messages for hire, within, into, from, or through this state.

(2) The value determined by the division shall include tangible and intangible property, it being the purpose to include in the valuation every element that adds value to the property.

(3) Value shall be determined upon what a clear fee simple title to the utilities' interest in the property would sell for under conditions that govern the sale of property of that character.

(c) The division will estimate the value of a telephone company's property in accordance with the unit rule.

(d)(1) In appraising telephone company property, the division will use, if applicable, three (3) approaches to value:

- (A) Cost;
- (B) Stock and debt; and
- (C) Income capitalization.

(2) The division may also consider other information as evidence of value that will enable it to determine the fair market value of the property of telephone companies.

(e)(1) In utilizing the approaches to value, comparables are required.

(2) The standard for determining comparability is not perfect comparability, but rather reasonable similarity.

(3) It is based upon as objective and comparable data as possible, but experience and judgment must be used in drawing conclusions from the data.

(4) The comparables used should be sufficient in number as to be representative of that industry.

(5) When determining comparability, the appraiser may analyze:

(A) Industry classes;

(B) Risk;

(C) Growth;

(D) Profitability;

(E) Size and physical characteristics; and

(F) Other characteristics.

Authority. Arkansas Code § 26-24-107.

Codification Notes. This section was promulgated as Section I of the Market Valuation Rules for Telephone Companies prior to codification into the Code of Arkansas Rules.

26 CAR § 30-102. Methods used in determining market value — Cost approach.

(a)(1) The cost approach estimates market value by calculating original cost less depreciation of the property.

(2) Reconstruction cost new less depreciation, replacement cost less depreciation, or reproduction cost less depreciation of the property may also be considered if such amounts can be reasonably determined.

(b) The cost estimate shall include:

- (1) Telephone plant in service;
- (2) Construction work in progress;
- (3) Plant held for future use; and
- (4) Material and supplies.

(c) The Tax Division of the Arkansas Public Service Commission may consider adjustments for functional and economic obsolescence if such amounts can be reasonably determined.

(d) The division may consider and adjust construction work in progress for the replacement of existing plant.

Authority. Arkansas Code § 26-24-107.

Codification Notes. This section was promulgated as part of Section II of the Market Valuation Rules for Telephone Companies prior to codification into the Code of Arkansas Rules.

26 CAR § 230-103. Methods used in determining market value — Stock and debt approach.

(a)(1) The stock and debt estimate of market value is calculated by summing the market value of all stock and long-term debt securities.

(2) Accumulated deferred federal income taxes and investment tax credits shall not be included in this approach as a separate item.

(b) Market value shall be calculated as follows:

- (1) **Market value of traded stock.**

(A)(i) The market price may be derived from monthly prices from the period of September through December of the year immediately preceding the assessment date.

(ii) Consideration may also be given to prices derived from the same time period in the three (3) years immediately preceding the assessment date.

(B) A premium or discount to the stock may be considered above or below the current market price where evidence warrants;

(2) Market value of nontraded stock.

(A)(i) In the absence of direct market data, the market value of stock shall be determined by way of a proxy.

(ii) Where a parent-subsidary company relationship exists and the subsidiary company does not have traded stock, the parent company's stock may act as the appropriate proxy provided the parent is in the same risk class.

(iii) A parent proxy may not be appropriate if the parent company is engaged in diversified business activities different from the subsidiary.

(B) The estimate of value of the nontraded stock shall be via consideration of:

(i)(a) The percentage relationship of the market to book equity ratio of the parent (proxy) company as applied to the subsidiary book equity.

(b) Consideration may also be given to ratios derived from the same time period in the three (3) years immediately preceding the assessment date;

(ii)(a) The price-earnings multiple of the parent or proxy companies multiplied by the net income of the subsidiary, after adjustment for abnormalities.

(b) The price-earnings multiple of the parent or proxy companies may be derived from monthly multiples from the period of September through December of the year immediately preceding the assessment date, with consideration given to multiples derived from the same time period in the three (3) years immediately preceding the assessment date, or the price-earnings multiple may be derived using current prices and future earnings estimates made by security analysts.

(c) When employing this technique, comparability is required.

(d) In determining comparability, primary emphasis should be placed on each of the following items:

- (1) Industry classes;
- (2) Risk;
- (3) Growth;
- (4) Profitability;
- (5) Size and physical characteristics; and
- (6) Other characteristics;

(iii) The values/ratios of the subsidiary components in relation to the parent as published by analysts in financial publications generally available to the public; and

(iv) The total subsidiary to total parent ratio of:

- (a) Gross plant;
- (b) Net plant;
- (c) Gross revenue; and
- (d) Net operating income.

(C) For parent-subsidary companies or other companies not meeting the above requirement, other risk-equivalent companies having traded stock may be used to estimate the market value of nontraded stock;

(3) Market value of long-term debt and preferred stock.

(A) **Traded.** When a telephone company's long-term debt and preferred stock are traded, the market price of each debt and preferred issue shall be derived from monthly prices from the period of September through December of the year immediately preceding the assessment date.

(B) Nontraded.

(i) In the absence of direct market data, the market value of debt and preferred stock may be estimated by way of a recognized financial rating such as the required current market rate or the yield to maturity of similarly rated debt securities of similar maturities.

(ii) United States Treasury bonds shall be the proxy for all federally financed debt; and

(4) Nonoperating and nontaxable property.

(A) Any nonoperating property or nontaxable property included within the unit value shall be deducted.

(B) Nonoperating property that can be identified may be deducted directly by the use of a direct adjustment mechanism, which excludes those funding sources from the stock and debt indicator that are not directly related to the actual property subject to valuation.

(C) The estimate of the value of the remaining nonoperating property shall be via consideration of the total remaining nonoperating property to total property ratios of two (2) or more of the following:

- (i) Gross plant;
- (ii) Depreciated plant;
- (iii) Gross revenue; and
- (iv) Net operating income.

Authority. Arkansas Code § 26-24-107.

Codification Notes. This section was promulgated as part of Section II of the Market Valuation Rules for Telephone Companies prior to codification into the Code of Arkansas Rules.

26 CAR § 230-104. Methods used in determining market value — Income capitalization approach.

- (a) The income approach to estimate market value is based upon two (2) factors:
- (1) The income stream; and
 - (2) The capitalization rate, yield or direct.

(b) Determination of the income stream — Yield capitalization method.

(1) The future income stream to be capitalized is that income expected to flow from the property at the assessment date.

(2)(A)(i) The estimate of each company's net operating income stream may be based on a historical analysis of one to five (1 – 5) years preceding the assessment date via consideration of:

(a) Averages;

(b) Weighted averages;

(c) Net operating income adjusted for increases in net plant investment;

(d) A least squares analysis of net operating income; and

(e) Income level attained in the year immediately preceding the assessment date.

(ii) Historical income should be adjusted to remove the effects of extraordinary income or expenses that will not be incurred in subsequent years.

(B)(i) The income to be projected may include construction work in progress.

(ii)(a) The income stream attributable to construction work in progress shall be determined by multiplying the amount subject to inclusion by a performance ratio.

(b) The performance ratio is to be the capitalization rate determined in subsection (c) of this section discounted by twenty percent (20%).

(iii) The income to be projected on additions made during the prior year in the determination of the future income stream shall be included at fifty percent (50%) of the booked amount.

(iv) The income stream attributable to additions shall be determined by multiplying the amount subject to inclusion by the performance ratio.

(3)(A) Forecasted future income streams, with the inclusion of a terminal, reversion, or proceeds upon sale amount, may be considered if such amounts can be reasonably determined.

(B) These income forecasts would encompass income to be realized on construction work in progress and additions made during the year.

(c) Determination of the capitalization rate — Yield capitalization method.

(1)(A) The Tax Division of the Arkansas Public Service Commission shall compute the overall capitalization rate by the band of investment method.

(B) This method assigns a cost to each component of the capital structure and weights that cost by the amount each component contributes to the total capital structure.

(2) In estimating the yield capitalization rate, comparability should be determined by placing primary emphasis on risk.

(3) The equity and debt costs are to be estimated in the following manner:

(A) Common equity rate — Traded securities.

(i)(a) The estimate of the common equity rate shall be derived by the use of the Discounted Cash Flow (DCF) Model.

(b) Consideration may also be given to the Capital Asset Pricing Model (CAPM) and estimates made by independent analysts.

(ii)(a) The DCF Model assumes the value of an investment is the present value of the future benefits of ownership.

(b) In the case of an investment in common stock, the value is the present value of future dividends plus expected growth.

(c) This model may be expressed by the formula:

$$R = D_1 / P_0 + g$$

Where:

R = Required rate of return.

D₁ = Expected dividend at end of Year 1.

Po = The current stock price, derived from monthly prices from the period of September through December of the year immediately preceding the assessment year.

g = The expected future growth. The "g" factor in the DCF formula shall be derived from long-term projections made by stock analysts in the major capital markets. Sources to be used for analysts' forecasts shall include The Value Line Investment Survey and other recognized financial sources.

(iii)(a) The CAPM is based on the assumption that the cost of equity can be estimated by adding a risk premium to a risk-free rate of return.

(b) According to the CAPM, the cost of equity can be stated as the risk-free rate plus a market risk premium that is adjusted by beta to reflect a particular security's risk.

(c) The CAPM may be expressed as follows:

$$R = R_f + (K_m - R_f) * b$$

Where:

R_f = Risk-free rate, measured by the rate of return on long-term United States Treasury bonds.

K_m = Required return on the market.

b = Beta, a measure of a stock's volatility relative to the market as a whole, sources for which shall include The Value Line Investment Survey and other recognized

financial sources.

(iv)(a) Analysts' estimates of common equity rates may be considered.

(b) All calculations shall be adjusted for any abnormalities over the historical period reviewed and any other relevant information from stock analysts.

(c) The above methods shall be based on data derived from the parent company, provided the parent is in the same risk class and is not engaged in diversified business activities different from the subsidiary, or companies of comparable risk;

(B) Long-term debt and preferred stock.

(i) The rates for long-term debt and preferred stock shall be the market cost of long-term debt and preferred stock and the current cost of any other outstanding debt.

(ii) The market rate of debt shall be determined based upon the current yield to maturity for long-term debt of comparable risk.

(iii) The market rate for preferred shall be determined by the amount of preferred dividend requirement divided by the current market value of preferred; and

(C) Deferred income tax and investment tax credits.

(i)(a) Deferred income taxes and investment tax credits will be treated as cost-free debt in the determination of the overall capitalization rate.

(b) The proxy for market value of these items is thirty-five percent (35%) of the book value on the company's balance sheet.

(ii) Deferred income taxes and investment tax credits will not be considered in the capital structure as cost-free debt when forecasted future income streams take these into account as separate items.

(d) Income capitalization — Direct capitalization method.

(1) Direct capitalization may be considered in conjunction with the above outlined income capitalization method or methods.

(2) Determination of income stream — Direct capitalization method.

(A) The income stream to be capitalized is that income expected to flow over the appropriate time period from the property at the assessment date.

(B)(i) The estimate of each company's net operating income stream may be based on a historical analysis of one to five (1 – 5) years preceding the assessment date via consideration of:

(a) Averages;

(b) Weighted averages;

(c) A least squares analysis of net operating income; and

(d) Income level attained in the year immediately preceding the assessment date.

(ii) Historical income should be adjusted to remove the effects of extraordinary income or expenses that will not be incurred in subsequent years.

(iii) These income forecasts would encompass income to be realized on construction work in progress and additions made during the year in a manner consistent with the development of the direct capitalization rate.

(e) Determination of the capitalization rate — Direct capitalization method.

(1)(A) The division shall compute the overall capitalization rate by the band of investment method.

(B) This method assigns a rate to each component of the capital structure and weights that rate by the amount each component contributes to the total capital structure.

(2) When determining comparability in direct capitalization, primary emphasis should be placed on each of the following items:

(A) Industry classes;

(B) Risk;

(C) Growth;

(D) Profitability;

(E) Size and physical characteristics; and

(F) Other characteristics.

(3) The equity and debt rates are to be estimated in the following manner:

(A) Common equity rate — Traded securities.

(i)(a) The estimate of the common equity rate may be derived by the use of the Earnings-Price Model.

(b) The Earnings-Price Model expresses the relationship between net income and price.

(c) It is derived by an analysis of earnings-price ratios from the stock market or other financial sources.

(d) The earnings-price ratio, the inverse of the price-earnings multiple, may be derived from monthly ratios from the period of September through December of the year immediately preceding the assessment date, with consideration given to ratios derived from the same time period in the three (3) years immediately preceding the assessment date, or the earnings-price ratio may be derived using future earnings estimates made by security analysts and current prices.

(ii) The above method shall be based on data derived from the parent company, provided the parent is comparable and is not engaged in diversified business activities different from the subsidiary, or from comparable companies; and

(B) Long-term debt and preferred stock.

(i) The market rate of debt shall be determined by the amount of annual interest actually paid divided by the current market value of debt.

(ii) The market rate of preferred shall be determined by the amount of annual dividends actually paid divided by the current market value of preferred.

(f) Income streams and capitalization rates determined for use in direct capitalization should be derived from the same time period for both the subject and comparable companies.

Authority. Arkansas Code § 26-24-107.

Codification Notes. This section was promulgated as part of Section II of the Market Valuation Rules for Telephone Companies prior to codification into the Code of Arkansas Rules.

26 CAR § 230-105. Overall capitalization rates.

(a) The overall capitalization rate in yield capitalization is a weighted average of the product of the firm’s individual costs of capital and its market value proportion in the capital structure.

(b) The overall capitalization rate in direct capitalization is a weighted average of the product of the firm’s direct capitalization rate for each type of security and its market value proportion in the capital structure.

Authority. Arkansas Code § 26-24-107.

Codification Notes. This section was promulgated as Section III of the Market Valuation Rules for Telephone Companies prior to codification into the Code of Arkansas Rules.

26 CAR § 230-106. Correlation of value — Weighting percentages.

(a)(1) The actual weighting percentages for each approach for the first three (3) years of implementation of this part shall be as follows:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Cost	20%	30%	40%
Stock and Debt	30%	20%	10%
Income Capitalization	50%	50%	50%

(2) The weighting percentages specified for Year 3 shall be used for each year after the third year of implementation of this part.

(b) For telephone companies in which there is available neither a market price nor appropriate surrogate to develop a reliable stock and debt approach or income capitalization approach, the cost approach alone may be used.

(c)(1) In instances in which the property is new, the cost approach alone may be used for the first assessment year.

(2) Thereafter, either subsections (a) or (b) of this section shall apply.

Authority. Arkansas Code § 26-24-107.

Codification Notes. This section was promulgated as Section IV of the Market Valuation Rules for Telephone Companies prior to codification into the Code of Arkansas Rules.

26 CAR § 230-107. Administrative Adjustment.

(a)(1) During the first three (3) years of implementation of this part, an Administrative Adjustment shall be utilized by the Tax Division of the Arkansas Public Service Commission in order to arrive at the Final System Value.

(2) The Final System Value for each year after the third year of implementation of this part will be the Correlated Value determined in 26 CAR § 230-106.

(b)(1) The Administrative Adjustment figure shall be derived by utilizing last year's Final System Value and adjusting this by the total net amount of change in total telephone plant, which would include construction work in progress, from the year immediately preceding the assessment date.

(2)(A) For the first year of implementation of this part, the Final System Value component shall be last year's Correlated Value.

(B) For each year thereafter, last year's Final System Value shall be that value that results from the weighting as described below of the Correlated Value and the Administrative Adjustment.

(c) Weighting percentages to arrive at final system value.

(1) The Correlated Value from 26 CAR § 230-106 shall be weighted seventy-five percent (75%) and the Administrative Adjustment figure shall be weighted twenty-five percent (25%).

(2) For telephone companies in which there is available neither a market price nor appropriate surrogate to develop a reliable stock and debt approach or income capitalization approach, the Correlated Value from 26 CAR § 230-106 and the Administrative Adjustment figure shall be weighted as follows:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Correlated Value	25%	50%	75%
Administrative Adjustment	75%	50%	25%

(3) In instances in which the property is new and the cost approach alone is used as specified in 26 CAR § 230-106 for the first assessment year, the Administrative Adjustment shall be used and weighted with the Correlated Value determined in 26 CAR § 230-106 in the second assessment year and each year thereafter as specified in either subdivision (c)(1) or (c)(2) of this section.

Authority. Arkansas Code § 26-24-107.

Codification Notes. This section was promulgated as Section V of the Market Valuation Rules for Telephone Companies prior to codification into the Code of Arkansas Rules.

26 CAR § 230-108. Allocation.

A state allocation estimate should be derived by consideration of the Arkansas-to-system ratios of:

- (1) Gross plant;
- (2) Net plant;

- (3) Gross revenues; and
- (4) Net operating income.

Authority. Arkansas Code § 26-24-107.

Codification Notes. This section was promulgated as Section VI of the Market Valuation Rules for Telephone Companies prior to codification into the Code of Arkansas Rules.

26 CAR § 230-109. Adjustment to correlation value — Leased property.

(a) After the correlated value has been computed, an adjustment will be made for the value of leased property.

(b) Criteria for the valuing of leased property to be included in this adjustment are as follows:

(1) The categories of leased property are limited to real estate, transportation, and equipment used in the transmission of telephonic messages;

(2) No lease is to be reported if capitalized and included in the cost approach;

(3) The state allocation of total system leased property to be included in the valuation shall be the leased property located in Arkansas;

(4)(A) All the aforementioned leased property will be reported to the Tax Division of the Arkansas Public Service Commission.

(B) The companies shall specify when reporting their leased real property if the terms of the lease require the taxes to be paid by the lessor.

(C) If, under terms of the lease, the lessor is required to pay the taxes, the leased property will not be assessed by the division.

(D) All other leased property will be assessed by the division; and

(5)(A) The companies shall include in their division reports the market value of the property as determined by the county assessor of the county in which the property is located, if it has been assessed locally.

(B) Their estimate of market value will be used by the division to value the property.

(C) If this information is not available, the value will be determined on a depreciated book basis.

Authority. Arkansas Code § 26-24-107.

Codification Notes. This section was promulgated as Section VII of the Market Valuation Rules for Telephone Companies prior to codification into the Code of Arkansas Rules.

26 CAR § 230-110. Information filing requirement.

(a) Information and data necessary and relevant to implementation of this part is to be filed in accordance with Arkansas Code § 26-26-1601 et seq. as a portion of the company's Annual Report to the Tax Division of the Arkansas Public Service Commission.

(b)(1)(A) The information to be furnished in the division's Annual Report form should be in accordance with generally accepted accounting principles.

(B) Should regulatory accounting information be available, it should be furnished as well.

(2) It is particularly important that the information contained in the Annual Report be from an audited source that can be verified, if necessary, within the whole of a company's overall organizational structure.

(3) Should any of the information be omitted, the division has the discretion to estimate by whatever means it deems reasonable the information necessary to determine an overall assessment.

Authority. Arkansas Code § 26-24-107.

Codification Notes. This section was promulgated as Section VIII of the Market Valuation Rules for Telephone Companies prior to codification into the Code of Arkansas Rules.