

OHIO BOARD OF TAX APPEALS

Rover Pipeline, LLC,)	CASE NO. 2020-1540
)	
)	
Appellant,)	
vs.)	DECISION AND ORDER
)	
Patricia Harris, Tax Commissioner,)	
)	
)	
)	
Appellee.)	

APPEARANCES:

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Entered, Thursday, March 7, 2024

Mr. Harbarger and Ms. Clements concur.¹

INTRODUCTION

Rover Pipeline LLC (“Rover”) owns and operates a 713-mile-long natural gas pipeline from the Marcellus and Utica shale basins across Ohio to Defiance County, where the pipeline turns due north into Michigan. For the tax year 2019, the Tax Commissioner valued the pipeline using the costs capitalized method found in R.C. 5727.11(A), often called the

¹ Ms. Allison took no part in the consideration or decision of this appeal.

“statutory method.” Rover appealed to this Board, and the parties have presented the Board with a substantial record, including hundreds of pages of testimony and tens of thousands of pages of exhibits. The Commissioner’s primary expert valued the pipeline as a unit at \$5.67 billion. Rover’s primary expert valued the pipeline as a unit at \$3.317 billion.

Based on the totality of the facts, we are persuaded that Rover’s opinion of value cannot be correct. Rover’s pipeline was operationally brand new on the tax lien date, and actual construction costs are always a significant indicator of value for new property. Rover’s opinion of value is close to 50% below its actual costs. We are unpersuaded that a pipeline in its infancy became so obsolete so fast.

Rover’s value is also inconsistent with the partial sale of the pipeline through an entity transfer (the “Blackstone transaction”) that occurred approximately eighteen months before the tax lien date. With any property—new or old—a recent and arm’s-length sale is a strong indicator of value. Rover’s value is substantially below the imputed value of the sale negotiated by two exceptionally sophisticated market participants.

We further find a lack of support for several key choices made by Rover’s appraiser in developing his opinion of value. For starters, *Rover* dictated to the appraiser some key figures to be used in the appraisal. Rover directed its appraiser to change his methodology for valuing exempt property, and it told the appraiser how to quantify functional obsolescence. These were not mundane or legal determinations. Rover made *appraisal* decisions that significantly impacted the appraiser’s opinion of value. We conclude that what began as an independent fee appraisal devolved into a group project. We also find a lack of support for the figures themselves.

Additionally, the Commissioner's experts credibly showed other appraisal choices made the appraisal less probative. For example, we agree with the Commissioner's experts that Rover's appraiser improperly included certain premiums in his cost of equity. Rover's appraiser also blended his approaches by using data from his income approach to quantify economic obsolescence in his cost approach. That made his cost approach less probative as an independent measure of value. The benefit of having independent approaches is the ability to compare independent approaches. The appraiser's method, by design, makes the income approach a load-bearing pillar of the cost approach. While we agree with Rover that the method is not a mirror image of the income shortfall method, we must acknowledge the obvious: the cost approach loses some probative value when it ceases to be independent.

None of this is to say that Rover has not articulated persuasive arguments undermining the Commissioner's appraisal. There are shortcomings. Nonetheless, on the whole, we find the Commissioner's appraisal to be the best evidence of value. For the reasons that follow, we reverse and remand to the Commissioner to assess the pipeline consistent with her expert's appraisal.

BACKGROUND AND PROCEDURAL HISTORY

Because relatively little Ohio case law exists regarding the valuation of pipelines, we begin by summarizing the history and nature of the public utility personal property tax before turning to Rover's corporate structure. We then discuss the process of building the pipeline, where we draw from the statutory transcript and the record of this Board's hearing.

From there, we summarize the appraisals. These appraisers often use slightly different terms to reference the same or similar concepts. For example, Rover's expert classified one of

his cost of equity adjustments as a “property-specific risk premium,” but the Commissioner’s experts argued this was actually (or functionally) a “company-specific” or “firm-specific” risk premium. Also, the experts sometimes use the same terms in very different ways.

Any confusion is compounded by the fact that the appraisers use some concepts, such as “going concern” and “direct capitalization,” in a manner different from how we typically use them in our decisions. In the sections summarizing the appraisals, we take the appraisers at their word. We recite the terms as the appraisers recited them in defining their concepts and methods. Lastly, we provide our analysis.

The Public Utility Personal Property Tax

Ohio’s public utility personal property tax was created in the early 20th century. The ad valorem tax has evolved over the decades, but the tax still applies to pipeline companies transporting natural gas in this state. R.C. 5727.01(D)(5). More specifically, a pipeline company is a company that engages “in the business of transporting natural gas, oil, or coal or its derivatives through pipes or tubing, either wholly or partially within this state[].” *Id.*; see also *Columbia Gas Transmission Corp. v. Levin*, 117 Ohio St.3d 122, 2008-Ohio-511, 882 N.E.2d 400 (differentiating a pipeline company that transports natural gas from a “natural gas company”); *Cobra Pipeline Co., LTD v. Testa*, BTA Nos. 2016-260, et al., 2017 Ohio Tax LEXIS 2978 (Dec. 13, 2017).

Today, Ohio has a centralized valuation process headed by the Tax Commissioner. See generally Ohio Department of Taxation, *Property Tax-Public Utility Property*, https://tax.ohio.gov/static/communications/publications/property_tax_public_utility_property.pdf (accessed Aug. 18, 2023). Taxpayers subject to the tax must file annual reports, which

must include information necessary for the Commissioner to assess the tax according to the property's true value. R.C. 5727.08; R.C. 5727.10 (providing the Commissioner "shall be guided by the information contained in the report filed by the public utility and such other evidence and rules as will enable" the Commissioner to determine true value). The Commissioner must review the utility's annual report no later than the first Monday in October, find value, and issue a preliminary assessment. R.C. 5727.23. Pipeline property is assessed at 88% of true value. R.C. 5727.111(D). The preliminary assessments are certified to the county auditors, who must add the taxable values to the tax list. The utility may file a petition for reassessment according to R.C. 5727.47, and objections must be raised, e.g., objections to true value, objections to apportionment, and objections to taxable value percentages. The Commissioner's final determination is appealable under R.C. 5717.02, and appellants must comply with the requirements of that statute. *See Ohio Bell Tel. Co. v. Levin*, 124 Ohio St.3d 211, 2009-Ohio-6189, 921 N.E.2d 212 (taxpayer could not raise new unit valuation theory because the theory was not preserved). Later appeals may be taken pursuant to R.C. 5717.04. *See, e.g., Ohio Bell*; *see also WCI Steel, Inc. v. Testa*, 129 Ohio St.3d 256, 2011-Ohio-3280, 951 N.E.2d 421.

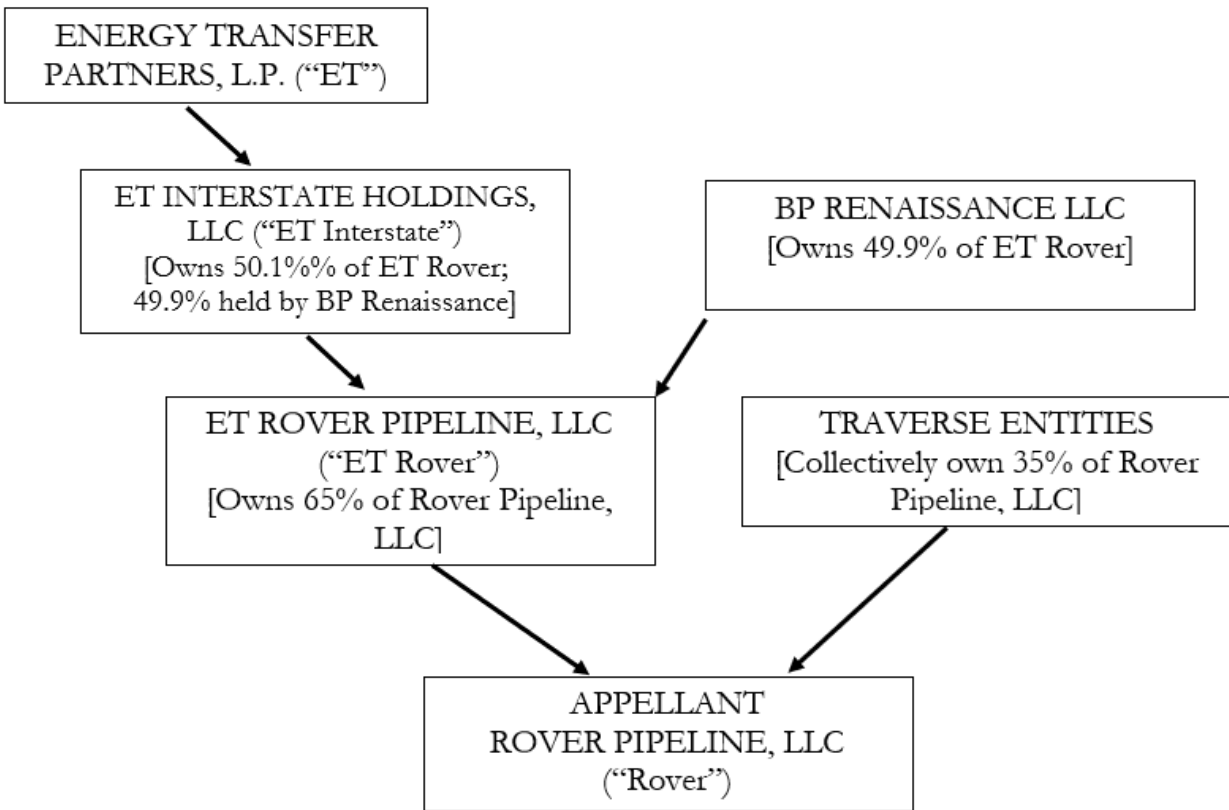
A reader of the Commissioner's final determination will see the Commissioner is an ardent defender of the statutory method, a cost-based method defined as the "costs as capitalized on the public utility's books and records less composite annual allowances." R.C. 5727.11(B); *Snider v. Limbach*, 44 Ohio St.3d 200, 201, 542 N.E.2d 647 (1989), citing *W.L. Harper Co. v. Peck*, 161 Ohio St. 300, 118 N.E.2d 643 (1954) (acknowledging the statutory formula may be used because "it is impractical for the" Commissioner to "personally value all

personal property in Ohio”). However, the Commissioner is not bound by the statutory method and may employ an alternative method if she determines the statutory method is unreliable.

The Ohio Supreme Court addressed that situation in *Texas Eastern Transmission Corporation v. Tracy*, 78 Ohio St. 3d 83, 676 N.E.2d 523 (1996). There, the Court affirmed the purpose of the statute was to find “true value” and that a different method could be used to reach that goal. *Id.* at 86, citing *R.H. Macy Co., Inc. v. Schneider*, 176 Ohio St. 94, 197 N.E.2d 807 (1964). Notably, the *Texas Eastern* Court found a taxpayer could prevail in a valuation challenge before this Board using a different method of valuation, e.g., a unit valuation. See *WCI Steel, Inc. v. Testa*, 129 Ohio St.3d 256, 2011-Ohio-3280, 951 N.E.2d 421, ¶ 46 (discussing the history and general differences between the unit valuation method and the statutory method). The unit valuation method has been considered reliable in numerous jurisdictions.

Rover Pipeline LLC and Associated Companies

Rover is the owner of the pipeline and the taxpayer. However, in order to comprehend the facts of this case, one must understand the structure of Rover’s parent companies. The general ownership structure is displayed below.



At the top of the structure is Rover’s corporate great-grandparent, ET, which is a master limited partnership that trades on the New York Stock Exchange and owns one of the largest and most diversified portfolios of energy assets in the United States. ET’s assets include tens of thousands of miles of pipeline carrying natural gas and natural gas liquids. ET owns 100% of ET Interstate, which in turn owns 50.1% of ET Rover. As discussed further below, the remaining portion of ET Rover is owned by Blackstone. And finally, ET Rover owns 65% of Rover. The remaining 35% of Rover is owned by entities the parties called “Traverse.”

The ultimate question in this case is the value of Rover’s public utility personal property, the determination of which turns on the testimony and written appraisals provided by experts on both sides of the dispute. Those appraisals contain sophisticated economic and financial analyses but rest on a foundation of granular and nuanced facts that must be

understood to effectively assess and analyze the valuation opinions offered by the parties' appraisers. Accordingly, we now undertake a detailed review of the evidence and then move on to the appraisals.

Building the Pipeline

The northeastern portion of Ohio, along with the areas near the northern panhandle of West Virginia and the western portion of Pennsylvania, lies over an underground abundance of natural gas, with those gas basins capable of producing billions of cubic feet of natural gas per day. H.R. at 93; Ex. 27. Those underground gas-producing areas are known as the Marcellus and Utica basins. H.R. at 27.

Before the pipeline was constructed, it was common knowledge within the natural gas and energy industries that the basins contained prolific amounts of natural gas. The producers of the natural gas (those that removed it from the basins) indicated that because the region was "under-piped," the gas remained "bottlenecked" underground. The limited pipeline capacity in the area effectively kept immense volumes of gas and its value stuck underground and away from markets that were otherwise willing to pay for it.

But such a large pipeline project is not lightly undertaken or without due regard for profit. The construction of an interstate natural gas pipeline covering hundreds of miles is a massive planning, financial, and logistical enterprise. The permitting and installation of interstate gas pipelines are controlled mainly by a comprehensive regulatory regimen administered by the Federal Energy Regulatory Commission ("FERC"). The failure to comply with FERC's requirements can bring the installation of a pipeline to a halt. Even so, substantial proceeds can await the intrepid builder.

Throughout the development and construction of an interstate natural gas pipeline, each of those ongoing functions, financing, logistics, and regulatory compliance, including environmental compliance, proceed simultaneously. The coordination required to manage the numerous moving parts necessary to develop and install such a large pipeline successfully is typically undertaken in various stages or steps, which we now examine.

The Road Show

Installing a natural gas pipeline needs to make financial sense. In early 2013, ET began to consider whether the construction of the Rover pipeline could be a financially viable endeavor. H.R. at 37. After exploring pricing in the natural gas marketplace—particularly in the Marcellus and Utica basins—ET determined that an economic opportunity existed to transport gas from the basin to other markets. H.R. at 35-36.

ET needed to determine if gas producers, called shippers, were interested in using such a pipeline. ET courted shippers during “road shows” presentations to potential shippers to gauge their interest in using the proposed pipeline. H.R. at 38. Those presentations depicted a possible pipeline route that would run from the producing area, where the gas would enter the pipeline, and then head northwesterly across Ohio to the vicinity of Defiance in northwestern Ohio, where the pipeline would turn north into Michigan. H.R. at 554. ET touted the benefits to the gas producers of such a pipeline, which included “direct access to active [gas] trading centers,” “access to multiple markets,” and “low execution risk” because ET had “experience in bringing projects in on-time and under budget.” Ex. 23. In March 2014, ET advised potential shippers that Phase I of the pipeline would be completed by the first quarter of 2017 and that the pipeline would be in full service by the third quarter of 2017. H.R. at 44. ET aimed

to obtain a critical mass of shippers contractually committed to using the pipeline before beginning construction to limit risk. H.R. at 41.

The ultimate route chosen for a gas pipeline was developed through an iterative process. In the pre-construction planning phase, while the pipeline's planners knew of the pipeline's general route, they could not communicate its specific path until contracts with shippers were secured. That is because the specific route may change according to the needs of the shippers. Once a shipper commits to using the pipeline, the planners can determine the precise path for the pipeline to get closest to that wellfield. Thus, the final route taken by the pipeline factors in the location of the gas fields that will be feeding the pipeline. Based on those considerations, ET claims it estimated that the pipeline would cost approximately \$4.2 billion. H.R. at 48-51.

ET used a financial model to calculate a projected rate of return on its proposed investment. If the financial model showed a low rate of return, ET's board was unlikely to risk the large capital required to move forward with the project. H.R. at 54-55. The model considered a number of interdependent variables, each of which could impact whether the project was financially viable. Ex. 22; H.R. at 53-54.

ET had to secure transportation agreements for large volumes of gas from price-sensitive shippers willing to transport it through the pipeline at agreed-upon prices. ET met those goals with success. ET eventually secured "precedent agreements" with several shippers at prices that ET projected would make the project financially feasible. In its application filing with FERC, Rover noted that "absent the contractual commitments under the precedent agreements, the Rover Pipeline could not go forward. Rover recognized early in the planning

stages that a project of this scale would only proceed if the project could attract relatively large, long-term commitments.” Ex. 13 at 20. The precedent agreements followed standard industry practice, addressed many variables, and were subject to contingencies, including FERC’s issuance of a permit for the pipeline. In general, however, the agreements granted shippers the right to transport a maximum daily quantity of gas through the pipeline at a specified price per “dekatherm,” or a unit of energy used to measure the heating value of a specific volume of natural gas. For example, in the case of shipper Antero Resources Corporation, it agreed to pay 49.2 cents per dekatherm to transport its gas through the pipeline. Ex. 3; H.R. at 85.

ET’s precedent agreements were for an initial 15-year term, with some agreements subject to a shipper’s option to extend the agreement for up to 20 years. H.R. at 79. If all contingencies were met, then the parties would be bound by a “Firm Transportation Services Agreement” attached to the precedent agreement that locked in the agreed-upon pricing for the length of the initial term and any extensions. In addition, some of ET’s agreements contained a most favored nations clause, where a shipper’s rate would be reduced to match a lower rate subsequently negotiated with another shipper. H.R. at 87.

The Precedent Agreements and FERC

Aside from providing a financial basis for the construction of the pipeline, the precedent agreements serve a second regulatory-related purpose. The federal government heavily regulates the installation and construction of natural gas pipelines, and any entity seeking to develop and install an interstate natural gas pipeline must receive approval from FERC. H.R. at 22. FERC’s authority over the construction and installation of interstate natural gas pipelines is governed by the federal Natural Gas Act and 15 U.S.C. 717f (7). H.R. at 196.

That section provides that the applicant must show that the “operation, construction, extension, or acquisition” of the pipeline “is or will be required by the present or future public convenience and necessity.” 15 U.S.C. 717f(7)(e). Applicants seeking to build and operate a natural gas pipeline must formally obtain authorization from FERC through the issuance of a Certificate of Public Convenience and Necessity. 15 U.S.C. 717f (c)(1)(A); H.R. at 201-202.

In obtaining FERC’s approval, the precedent agreements serve the important purpose of showing FERC that the market needs the proposed service. H.R. at 198. As stated by the United States Court of Appeals for the D.C. Circuit, “[a] common method for applicants to demonstrate a public benefit is by showing demand for the project with precedent agreements, long-term contracts with shippers who would use the pipeline to transport natural gas.” *City of Oberlin v. FERC*, 39 F.4th 719, 722 (D.C. Cir. 2022). FERC is not “ordinarily required ‘to assess a project’s benefits by looking beyond the market need reflected by the applicant’s existing contracts with shippers.’” *Del. Riverkeeper Network v. FERC*, 45 F.4th 104, 114 (D.C. Cir. 2022), quoting *Minisink Residents for Env’t Pres. & Safety v. FERC*, 762 F.3d 97, 111 n.10 (D.C. Cir. 2014); H.R. at 198 (ET executive explaining that an applicant must show market demand and public need). The Code of Federal Regulations governing applications for natural gas pipelines mandates that applications include, among other things, a “copy of each contract, letter of intent, or other agreement for sale or transportation of natural gas proposed by the application.” 18 C.F.R. 157.14(a)(12)(v). Thus, the precedent agreements and firm transportation contracts play a critical part in obtaining FERC’s certificate authorizing the pipeline. Again, Rover met with success in obtaining several signed precedent agreements. According to its FERC application, “Rover initially executed eight precedent agreements that

included pre-arranged conforming bids. These initial eight executed precedent agreements were for terms of 15 or 20 years, and substantially subscribed the proposed pipeline capacity.” Ex. 13 at 16. Rover described those precedent agreements as “the product of extensive negotiations with producer-shippers in a highly competitive environment.” Ex. 13 at 17.

Approval by the Board

Starting on June 26, 2014, ET engaged in a 30-day “open season,” a process where the developer further publicizes that it is contemplating the construction of a pipeline and seeks inquiries and additional contractual commitments from shippers who might be interested in obtaining capacity to ship gas on the to-be-constructed pipeline. H.R. at 81-82. Multiple shippers indicated they were interested, and ET determined that a pipeline on the larger end of its projected size range capable of handling 3.25 bcf per day was warranted. H.R. at 82. With that knowledge and executed precedent agreements in hand, ET’s board approved the expenditure for the construction of the pipeline. H.R. at 61-62.

Submission of the Application to FERC

ET Rover filed a statement of intent with FERC, advising it of the company’s intention to apply for a certificate to construct and operate the pipeline and requesting that FERC issue a notice approving the use of the FERC’s pre-filing review process for the project. In the pre-filing process, the applicant interacts with the FERC staff and identifies and addresses, among other things, environmental issues that may be encountered during the pipeline’s construction. 18 C.F.R. 157.21; H.R. at 199-200. FERC’s staff approved Rover’s use of FERC’s pre-filing process. Ex. 28, H.R. at 212-213.

On October 30, 2014, ET issued a press release announcing that it had obtained “binding shipper agreements on its Rover natural gas pipeline project to connect Marcellus and Utica shale supplies to markets in the Midwest, Great Lakes and Gulf Coast regions of the United States and Canada. As a result of the additional agreements, the pipeline is fully subscribed through 15 and 20 year fee-based contracts to transport 3.25 billion cubic feet per day [] of capacity.” Ex. 27; H.R. at 93.

On February 20, 2015, Rover submitted its certificate application. The filing was a voluminous four-volume submission. As required by law, it contained detailed information about the construction and operation of the proposed pipeline, including its proposed path, its customer pricing, impacts on affected landowners, impacts on existing pipelines, environmental impacts, and the benefits to be realized from its construction. The application described the pipeline as follows:

The Rover Pipeline will consist of approximately 711 miles of 24-inch, 30-inch, 36-inch, and 42-inch pipelines in West Virginia, Pennsylvania, Ohio, and Michigan, with associated surface facilities that include compressor stations, metering and regulating stations, and other ancillary facilities * * *. The Project’s proposed pipelines consist of ten Supply Laterals and three Mainlines (Mainlines A and B, and the Market Segment). Generally, the Supply Laterals will deliver gas from receipt points in the Marcellus and Utica shale supply areas in West Virginia, Pennsylvania, and Ohio to delivery points along Mainlines A and B, which will run parallel (for most of their length) from Harrison County, Ohio to the Midwest Hub in Defiance County, Ohio. The Market Segment will run from the Midwest Hub north to the interconnection with Vector [Pipeline system (“Vector”)] in Livingston County, Michigan * * *.

Specifically, the Supply Laterals will consist of approximately 237 miles of 24-inch, 30- inch, 36-inch and 42-inch pipelines, and will receive processed natural gas at the tailgate from various processing plants, or from interconnects with other pipeline systems. These processed natural gas supplies will be pressurized at supply compressor stations, which will move the gas into Mainlines A and B at the Mainline Compressor Station 1 in Carroll County, Ohio.

Mainlines A and B will include approximately 374 miles of dual 42-inch diameter pipelines to be installed in the same right-of-way approximately 20 feet apart. They will commence at the tailgate of Mainline Compressor Station 1, where the gas stream in Mainlines A and B will be pressurized up to a Maximum Operating Pressure of 1,440 pounds per square inch gauge, and the total capacity will be up to 3.25 Bcf/day to the Midwest Hub. From Mainline Compressor Station 1, the gas will be moved to Mainline Compressor Station 2 in Wayne County, Ohio, then onward to Mainline Compressor Station 3 in Crawford County, Ohio, and then to the Midwest Hub. At the Midwest Hub, Rover will have delivery facilities at interconnects with Panhandle and ANR. The Panhandle and ANR metering facilities will consist of metering, regulating, and other components capable of delivering up to 1.1Bcf/day and 1.7 Bcf/day, respectively. Exiting the Midwest Hub, the Rover Pipeline will downsize to a single 42-inch diameter, approximately 100-mile pipeline with a total capacity of 1.3 Bcf/day, designated as the Market Segment. The Market Segment will commence at the Midwest Hub, extend north into Livingston County, Michigan, and terminate at the interconnection with Vector. The Market Segment will include construction of a delivery meter station and interconnect with Vector.

Ex. 13 at 10-11.

Rover advised FERC through its application of the importance of opening the pipeline “at the earliest date possible.” Ex. 13 at 6. To facilitate such an opening, Rover advised FERC that it intended to open the pipeline in two phases. In Phase I, Rover sought to “commence service on a portion of the Supply Laterals (the Seneca, Clarington, and Cadiz Laterals) and the entirety of Mainlines A and B to the Midwest Hub by December 2016.” Phase II of the pipeline, connecting with the Vector in Livingston County, Michigan, was scheduled to be completed and placed in service by June 2017. Ex. 13 at 6.

FERC’s Regulatory Authority

FERC’s regulatory authority over the licensing and construction of new gas pipelines is significant. FERC’s broad and ongoing oversight over the effects of new pipeline

construction on the environment is particularly important. FERC, like other federal agencies, is bound by the National Environmental Policy Act or “NEPA.” NEPA “is a procedural statute intended to ensure federal agencies consider the environmental impacts of their actions in the decision-making process.” 40 CFR 1500.1. FERC’s certificate process incorporates the review of proposed projects under NEPA. It must consider environmental consequences at every stage of the process. *Sierra Club v. FERC*, 68 F.4th 630, 636 (D.C. Cir 2023); *North Carolina v. Virginia Beach*, 951 F.2d 596 (4th Cir. 1991). In addition, a pipeline project must comply with other federal, state, and local regulations. *Id.* at 637. In implementing environmental mandates, FERC requires certificate applicants to comply with a host of regulations. For example, FERC requires certificate applicants to provide an environmental report with any application that proposes the construction of a natural gas pipeline.

On February 2, 2017, FERC issued a certificate to Rover. Appendix B to that Certificate was entitled “Environmental Conditions” and contained eleven pages of environment-related requirements that Rover was required to meet before, during, and after the pipeline’s construction. After that, Rover was expected to file an implementation plan explaining how the pipeline would proceed for FERC’s review. H.R. at 203-204. Rover was aware that violations of the terms contained in the certificate and/or the implementation plan could compel FERC to impose additional inspections and conditions on the construction, which can slow down or suspend the construction process. H.R. at 303-304, 377. FERC eventually issued the authorization.

The Construction Contracts and Contractors

Rover's main construction contractors were Precision Pipeline, LLC ("Precision"), who completed a majority of the work on the pipeline, and U.S. Pipeline, Inc. ("USP"), who did a smaller portion of the work on the southern reaches of the pipeline and laterals. H.R. at 286. Rover entered a "Master Construction Agreement" with Precision on November 28, 2016, and a similar Master Construction Agreement with USP on January 3, 2017. The Precision contract called for construction on sections of the pipeline, known as "spreads," as follows: Spreads A, B, C, D, 7, 8; the Majorsville Lateral; the CGT Lateral; the Sherwood Lateral, the Berne Lateral; and the Seneca Lateral. Ex. 42. The USP contract called for construction on Spread 1, the Clarrington Lateral, and the Cadiz Lateral. Ex. 43.

Although covering different pipeline segments, both contracts contained many similarities. For example, each contract had a detailed scope of work which set out, among other things, specific dates for that contractor on which construction on each of the spreads and laterals was to be commenced and on which that segment of the pipeline was to be in-service and finally completed. In addition, for each contractor, each date was followed with the words "with time being of the essence at all times." In the Precision contract, that phrase is found in excess of 80 times.

Both contracts also contained incentives for the contractors to finish ahead of schedule as well as penalties if they finished late. The same "target price incentive" provision appears in Section 10 of both contracts. Under that section, Rover and the contractors, under their respective contracts, "shall share in the risk of exceeding" a "target price estimate." The contractors were to be compensated with a "target price incentive" for the timely completion of the work for an amount less than the target price estimate. For early completion in

accordance with the requirements of the contract where the actual costs incurred are less than the target price, the contractor is to receive a “sum equal to 20% of the difference between the actual [t]arget [p]rice cost and the estimated [t]arget [p]rice cost.” If, however, the actual costs exceeded the estimated target price, Rover would reduce the compensation the contractor would otherwise receive by compensating the contractors with 80% of the direct and actual target price related to the overage amount.

The Construction Process

In March 2017, Rover commenced construction. H.R. at 297. Rover used a number of different “crews,” each specializing in a different construction-related function. As each crew finished its work on one section of the pipeline, it moved forward to perform that same work on the next section of the pipeline until it was performed along the entire length of the pipeline’s path. But before work began in specified areas, agents for the company secured easement rights along the pipeline’s path, with specific descriptions of the boundaries of those easements. H.R. at 758.

At this Board’s hearing, Steven Futch, Vice President of Engineering and Construction for ET, testified about sequencing the tasks involved in the pipeline construction process and how work progresses along the length of the pipeline’s path. Futch well-articulated the process, and we reproduce portions of this testimony below.

The basic premise is that the pipeline construction crews will start on one end and move continuously from one end to the other.

There are approximately a dozen crews that you can break the work into and it moves like an assembly line. Each crew does its own piece of work, but the crews move instead of being stationary with the assembly line coming past.

H.R. at 247-248. He then described the different types of crews that work on the pipeline and their tasks, including those that mark the boundaries of the pipeline easement.

So one of the first crews they will send out will be your clearing crews and your fencing crews. Those crews will go out and they will establish the limits of the workspace [easement]. There will be a survey crew ahead of them. They'll put the stakes in the ground and say this is where we can work, guys. This is the edge of the right-of-way here. This is the edge of the right-of-way here. This is the center line of the ditch. This is the area we're clearing.

They will come to features that are along that linear path. A feature might be a fence. It's important that when later the construction crews come through they're able to progress in a linear fashion. They're going to have to adjust every single fence that they come to, which means they all set H-bracing and rebuild the fence on a temporary basis across the right-of-way in a perpendicular fashion so that it can be opened and the equipment and people can move through it.

Then you will have an environmental crew that will come through and set the erosion and sedimentation-control fencing, structures, anything that is required for compliance from an environmental permit perspective.

H.R. at 248-249.

He then testified about the dirt grading needed to establish a workable surface prior to pipeline installation.

Then you will have your grade crews come in. Your grade crews will establish a level working surface, a safe working surface, for your equipment and for your personnel that are to come. That involves a large amount of soil movement. The first thing they'll do is they'll strip the topsoil and they will segregate that and move it to the edge. And then they will make a flat surface which means you will have a large pile of dirt on one side of the right-of-way or the other.

H.R. at 249.

Once the grading is completed, separate stretches of pipe are transported to their pre-installation locations along the easement.

So after the grade crew comes through, they will come through with 18-wheeler flatbed stringing trucks, tractor-trailers, and they will string the pipe is what they

call it. They take the pipe off the trailer and they set it on cribs all the way up and down the right-of-way.

Then an engineering and bending crew will come through and they will survey the topography and the direction changes of the pipe and they will apply the bends to certain pieces of pipe along the way so that when it is ultimately welded up and lowered into the ditch it fits the hills and it fits the valleys and it turns left and it turns right and it crosses the roadways perpendicular.

After the bending crew comes through, and depending on how the contractor has its workforce set up, you will then have either the welding, the production welding, or the ditching crew come through.

H.R. at 249-250. After the pipe was bent into the appropriate configuration for placement in the pipeline ditch, a crew started to assemble the separate pieces of metal pipe into a continuous pipeline.

The production welding crew will take the pieces of pipe and they will make all of what we call the production welds. So this is -- traditionally for this size of pipe and this thickness of pipe it's going to be mechanized welding which is a quality control and quality assurance approach to make sure that we have good mechanical welding. It limits human error, it limits rework, and it is much quicker.

So they'll come through and they'll weld up all the pieces of pipe except for the locations where they can't. And examples of locations where they can't is where, when, later, the pipe is lowered into the ditch, there could be another pipeline crossing the right-of-way. We can't lower the pipe over that. We have to put it under. So we have to leave a section out. They can't weld it across the roads. They can't weld it across the railroad tracks. They can't weld it across the rivers. They have to leave some sections out. The crew that comes later will take care of that.

H.R. at 250-251.

Once the separate pieces of pipe have been welded together, the outside surface of the pipeline is treated to protect against corrosion, and the pipeline ditch is prepared for the pipeline's installation.

After the welding is done, there's a coating crew that comes through and they will coat for purposes of protecting against corrosion, long-term corrosion on the pipe, those surfaces that were subject to the welding process which will be denuded and bare. They'll strip it down to bare metal and they'll put a two-part epoxy on it and they just go from one weld to the next.

And after that is finished, traditionally you will have the pipeline contractor come in if they haven't already dug the ditch. Sometimes they ditch ahead of the welding. Then they'll ditch. They'll dig a huge ditch that will fit this 42-inch pipeline. And it is a really big ditch. 25 feet across, 15 feet deep.

After that soil is out, they come through and they throw sandbags in at the bottom so we can cradle the pipe when it's lowered in.

H.R. at 251-252. Once that work is completed, the pipe is ready to be lowered into the ditch.

And then the lowering-in crew will come along and pick it up with sidebooms and gently just kind of pick the whole pipe up and start laying it into the ditch. There will be a series of eight to ten sidebooms. One is holding the pipe up in the back and the one at the very front will actually be cradling it down into the ditch. They just kind of pick it up like a big straw and just tube it in.

After that crew is finished, they'll have a padding and backfill crew come through. That is simply to put the dirt back on top of the pipe. There's a padding operation.

If you can imagine going through some of the training we go through, we see a lot of rock in the subsoil and you don't want to drop a rock from 20 feet on top of a brand new pipe. So we run it through screeners and padding machines that separate out the larger rocks * * *.

H.R. at 252. Unusual circumstances that require special handling are sometimes encountered.

I mentioned earlier that there's some places where we leave some sections out. So from there, our tie-in crews come in. It's a crew that comes in and they will go to each location where there is not a piece of pipe tied in and they will take these pieces and they will move it in and put it into position.

One of the examples that I gave is where we cross another pipeline. We can't go over it. We must go under it. Well, this crew will come in and they'll prepare

the worksite, the bell hole that we call it, so that it is accessible for people to actually get down inside of it.

And they will take equipment and they will lower this piece of pipe down underneath that foreign pipeline crossing and they will line up either end of the pipe with a pipe that was set to the side. And they will make very careful measurements and they will make very precise cuts, they'll bring it back up on top, re-bevel it, and then they'll lower it back in, get the final fit up on this plumbing job and start making their welds.

Each one of those 42-inch welds takes 8 hours to complete. Each one. So every time we cross a stream, a parish -- I'm sorry-a county -- I'm from Louisiana -- a county road, a state highway, an interstate, we cross a river, anything where we have a change in direction from north to east to west on the pipeline, what we call a PI, a survey point of intersection, is going to require tie-ins. So it's a big effort.

H.R. at 253-254. These specialized situations are not amenable to mechanized welding, and welders often need to climb into confined underground locations to complete the welds.

[T]hose welds are made manually. You can't get the mechanized welding equipment down into the bell hole, down into the ditch, to make these welds. It has to be done by hand.

So these are welders and helpers who actually get into the bell hole. They will oftentimes, after they get a dry, clean, safe working surface, they'll put pallets in the bottom with plywood on top of it and maybe some mattress material. They actually have to lie on their back and weld over their head to get to the bottom of the pipe. And it's a weld that has to be made on both sides at the same time, so you have multiple welders down in the ditch working.

The alignment tolerance on these welds, each end of the pipe has to be about that far from where they're tying into. It's a very close tolerance * * * I would need to review the weld procedure, but I can tell you that the maximum tolerance per industry standard for internal misalignment of the pipe, the inner wall of the pipe, is 94 thousandths of an inch. That's how tight they have to get it. It has to match or it won't pass the x-ray test that comes later.

Each one of these welds, whether production or tie-in, has to be x-rayed. We x-ray 100 percent of our welds to make sure that we've got something we can count on.

H.R. at 254-255. A field inspection is required before the welds are finally approved.

It's reviewed in the field. It's accepted or rejected. And then it goes to an auditor who looks at every one of them again to make sure the call in the field was correct. And then when it gets to Houston, we have another auditor that spot checks it to make sure that the auditor didn't miss anything. So there are three layers of management by exception for this process. It's very important.

Q. What would happen if a weld wasn't up to standard?

A. We would have to cut it out, and we would have to bring another piece of pipe in, and we would have to make two more welds.

H.R. at 255-256.

Environmental Monitoring and Inspection

In its certificate application, Rover advised FERC as follows:

To ensure that construction activities are conducted in compliance with all applicable requirements, including any conditions imposed by the Commission, Rover has agreed to fund a third-party environmental compliance monitoring program that will be directed by the Commission staff. The overall objectives of the compliance monitoring program are to: (1) assess environmental compliance during the construction process to achieve a high level of compliance throughout the process; (2) assist the Commission staff in screening and processing requests for any variances; and (3) create and maintain a database of daily reports documenting compliance. Final details regarding staffing and implementation of the compliance monitoring program will be developed in consultation with Commission staff prior to the commencement of construction and as part of Rover's Initial Implementation Plan documenting compliance with required mitigation measures.

Ex. 29 at 40. In the world of pipeline construction, there is a distinction between environmental monitors and environmental inspectors, although the terms might sound like they mean the same thing. While monitors and inspectors interact with one another and are involved in related environmental work, they have different authority and report to different principals. Thomas Gunter, an employee of Groundwater & Environmental Services, Inc. ("GESI"), a third-party environmental inspection company hired by Rover for the pipeline

project, was the chief inspector on the Rover pipeline. H.R. at 731. He explained the duties of an inspector.

Well, they do a lot of things. The environmental inspector is responsible to go out to the project site, the construction area, monitor all of the aspects of the environmental permit requirements, erosion control, make sure that the erosion control measures, silt fences, filter socks, straw bales, those things are in place, that they have been installed correctly by the contractor, and that they are functioning appropriately.

If those things need maintenance, the inspector goes to the foremen of a particular crew and informs them, and the maintenance is done.

The inspector then has to come back and check to make sure that the maintenance was done correctly, and properly.

We also watch for making sure that the contractor stays within the permitted limits of the project and doesn't get outside.

We watch for any kinds of impacts outside the permitting corridor. That may be erosion that runs outside, goes around, or defeats the environmental controls.

We also look for endangered threatened species. If there are cultural sites that are known, those are usually barricaded off so the contractor can't enter them. We make sure that those barricades are up.

We also make sure that there's signage for wetlands, water bodies, endangered species, whatever the project requires under the permit conditions.

H.R. at 731-733. Gunter explained that he supervised around 60 inspectors on behalf of Rover.

H.R. at 733. Throughout the construction, those environmental inspectors reported to FERC's project manager regarding environmental conditions. H.R. at 204. While GESI provided the inspectors on behalf of Rover, the project's environmental monitor, a company called Cardno, reported to FERC. H.R. at 368-369, 755-756. The monitor ensured all the above conditions are met and relays information to federal and state regulators. The monitors "check" the work of the inspectors. H.R. at 735.

As noted earlier by Futch, the area in which Rover conducted its construction and installation, called the “construction corridor,” was approximately 400 feet wide. The area covered the actual area for laying the pipe and the additional workspace needed for equipment, dirt storage, and other construction-related functions. H.R. at 737-738. Given the width and length of that corridor, some “variances” were made. Some of those variances were minor and sometimes included situations where, for example, a piece of equipment was placed outside of the construction corridor, causing damage or disruption to the area outside the corridor. H.R. at 738. These smaller disruptions are categorized as “Level 1” and were typically addressed and corrected in the field with relatively minor disruptions to the construction. H.R. at 738-739. Level 2 variances had a more considerable impact, for example, where less than a cubic yard of sediment entered a stream or wetland. Rover’s inspector would document those variances and notify Cardno. If Cardno’s project manager approved the mitigation measures proposed by the inspector, then the remediation work would move forward as proposed. H.R. at 740-741. Finally, Level 3 variances typically had the largest impacts outside the construction corridor and can require technical specialists to examine the damage in the field. Level 3 variances were placed on FERC’s “docket” and were reviewed by FERC’s staff, who would decide whether the pipeline sponsor was allowed to go outside of the construction corridor to remediate or mitigate the problem. H.R. at 741-743.

Delays in Construction Caused by Weather

Rover reported construction delays from weather, e.g., from rain. As part of its FERC certificate, Rover was required to place rain gauges along the pipeline’s path. ET’s Futch testified that rainfall was higher than usual during the construction period compared with

historical rain data collected by Ohio's Department of Natural Resources. H.R. at 280-281; Ex. 55. Rover reported that rain increased costs because it can inhibit some of the tasks associated with pipeline construction, including welding. H.R. at 276-278, 284. Rover also reported that rain makes digging and placing heavy equipment more difficult.

Delays in Construction Caused by Environmental Violations

Rover's crews continued to work through the rain until the Tuscarawas River peaked on the horizon. *See generally State ex rel Yost v. Rover Pipeline LLC*, 167 Ohio St.3d 223, 2022-Ohio-766, 191 N.E.3d 421. There, Rover utilized a method of drilling called horizontal directional drilling to move the pipe under the river. The drilling method is used when certain natural or manmade features are not amenable to more typical trenching techniques that allow for the pipeline's pathway to be trenched from the surface downward and the pipe lowered into the trench. In horizontal directional drilling, the pipeline's pathway is bored underground, and the pipe is inserted into that underground pathway. ET's Buffy Thomason explained the method:

[A] method of constructing a pipeline across the resource, typically a major river or an interstate highway where the pipeline is literally bent underneath that resource. So it [the drill] goes in through a pilot hole on one side, a couple hundred feet from the resource, it travels down, it varies how deep, but to whatever distance it's been designed to underneath that resource, and then it curves -- keeps the same curve, basically, and comes up just as far on the other side of the resource, and it's intended to avoid impacts to whatever resource you're drilling under.

H.R. at 354-355. The horizontal directional drilling is usually twenty to thirty feet below the specific resource.

Beginning around March 18, 2017, Rover's contractor, Precision, utilized the method at the river but encountered difficulties with subsurface and geologic features. H.R. at 300-

301, 374. Then, someone made a choice to resurrect an older and illegal method of drilling using diesel-laced drilling fluid. H.R. at 300-301. The fuel created an inadvertent return and was soon discovered in nearby waters and wetlands. As required, Rover notified state and federal regulators, and FERC put the pipeline in timeout. Geotechnical engineers were consulted, and in a letter dated May 10, 2017, FERC wrote to Rover as follows:

On April 13, 2017, Rover alerted the Ohio Environmental Protection Agency and FERC's Compliance Monitor that it had located an inadvertent return of drilling fluid while completing the [horizontal directional drilling] of the Tuscarawas River (approximate milepost 42 of Mainlines A and B, Stark County, Ohio). Two days later, on April 15, 2017, Rover alerted Commission staff of the release. The [horizontal directional drilling] release resulted in the deposition of approximately 2 million gallons of bentonite-based drilling fluid into wetland W1M-ST180, a state-designated category 3 wetland. The release covered an area of approximately 6.5 acres, coating wetland soils and vegetation with bentonite clay and bore-hole cuttings.

Ex. 61 at 1-2. FERC's staff reviewed drilling logs and other information regarding the inadvertent return and expressed "serious concerns" about the extent of the inadvertent return, which it said was "several orders of magnitude greater than other documented [horizontal directional drilling] inadvertent returns for this project" as well as "the lack of clarity regarding the underlying reasons for its occurrence, and the possibility of future problems." Ex. 61 at 2. It appeared FERC was quite skeptical of Rover's story. FERC selected J.D. Hair and Associates as its third-party geotechnical advisor. H.R. at 376.

The Ohio EPA also inspected the inadvertent return at the river and, on July 11, 2017, sent Rover findings and orders from the Director of the Ohio EPA regarding environmental violations at the river and other pipeline locations. As to the inadvertent return at the river, the Director found that it arose through horizontal directional drilling on April 13, 2017, and that as a result of that release, "drilling fluids accumulated within an area estimated to be 6.5

acres in size.” Ex. 54 at 4. The Director noted that additional returns continued at the site and that cleanup was “ongoing and incomplete.” Ex. 54 at 4. Of significance, the Director found that the Ohio EPA conducted multiple samplings on different days and confirmed the presence of “diesel range organics” and petroleum hydrocarbons. Ex. 54 at 4. The Director noted that “spent drilling fluids containing refined oil-based substances, including diesel fuel, or any other commercially produced additives” were considered “industrial waste” under Ohio law and needed to be disposed of at a solid waste landfill. Ex. 54 at 4.

The Director found that Rover violated several environmental provisions of the Ohio Revised Code, including (1) discharging pollutants from the drilling site and other locations into state waters and wetlands without proper authorization, in violation of R.C. 6111.04 and 6111.07 and Ohio Adm.Code 3745-33-02(A), 3745-38-02(A), and 3745-32-02(B); and (2) improperly disposing of “spent drilling mud containing diesel fuel residuals,” which is categorized as industrial waste, in violation of R.C. 6111.45. Ex. 54 at 10-11. The Director ordered Rover to implement and conduct an extensive groundwater monitoring program, including the installation of monitoring wells, at the site and to submit all monitoring analysis results to Ohio EPA for review. Ex. 54 at 14-17. All told, orders from FERC and the Ohio EPA led to approximately four or five months of delays. H.R. at 377.

As the construction progressed, FERC began authorizing certain portions of the pipeline to commence service. In general, with some exceptions, FERC’s authorizations moved from east to west along the pipeline’s route. On August 31, 2017, FERC granted authorization to Rover to commence service of “Phase 1A,” which was along “Rover’s Cadiz Lateral, Mainline A, Supply Connector A,” the Panhandle-Rover Interconnect, and several

meter stations. On December 15, 2017, FERC authorized service along the Berne, Seneca, and Clarrington Laterals in eastern Ohio, as well as several meter and compressor stations. On February 21, 2018, it authorized service for Mainline Compressor Station 2 in Wayne County, Ohio. On April 25, 2018, it authorized service for Mainline Compressor Station 3, west of Compressor Station 2, in Crawford County, Ohio, as well as the portion of Mainline B between Compressor Stations 2 and 3. On May 1, 2018, FERC authorized service on the “Market Segment” of the Rover pipeline, that portion of the pipeline still further west of Compressor Station 3 that ran from Defiance, Ohio, north into Michigan, where it connected with the Vector Pipeline. Ex. 66. On May 31, 2018, FERC authorized full service on Mainline B and the Supply Connector pipeline segment.

On August 23, 2018, the Majorsville Lateral in eastern Ohio and its compressor and meter stations were approved. Service on a second lateral, the Burgettstown lateral, and its compressor station in eastern Ohio were also authorized. On November 1, 2018, FERC authorized the Sherwood and CGT Laterals and their associated compressor and meter stations. Those laterals connected the transmission lines to the gas-producing area in the northern panhandle of West Virginia and the western portion of Pennsylvania. Ex. 66.

The Final Construction Costs

As initially planned, ET claimed it projected the fully operational pipeline to cost approximately \$4.2 billion and to be fully in service by November 2017. Neither of those goals was met. After the pipeline was in service, ET wrote the Ohio Department of Taxation on June 11, 2019, and advised it that total plant costs had climbed to \$6,301,485,440.

The Blackstone Transaction

ET decided it needed a partner at some point before or during construction. At least four entities expressed interest in the pipeline. One of those prospective purchasers who ultimately purchased the equity offered by ET was BCP Renaissance L.L.C., a Delaware limited liability company owned by the well-known investment firm Blackstone. Ex. 48; Ex. C at 8-9.

ET and Blackstone eventually agreed to a sale of equity interest in ET Rover, which held a 65% equity interest in Rover, while Traverse owned the remaining 35%. The parties presented the Board with a contribution agreement dated July 30, 2027, between ET International, ET Rover, and Blackstone. Ex. 48; H.R. at 184. While portions of the record conflict, the record on the whole suggests the sole asset of Rover was the pipeline and the contracts and property directly related to the use of the pipeline. Ex. M; Ex. C at 10. The transaction was structured so that Blackstone, in exchange for an approximately \$1.5 billion payment, purchased a 49.9% interest in ET Rover. Multiplying the 65% ownership interest of ET Rover in appellant Rover by the 49.9% interest in ET Rover being purchased by Blackstone gave Blackstone an indirect interest of 32.435% in appellant Rover. With that purchase, Blackstone was entitled to 32.4% (rounded) of the cash flows of the pipeline. H.R. at 161, 1071. Blackstone's contribution amount was set at a specified amount regardless of ongoing construction costs exceeded budget. H.R. at 154-156, 177. Due to delays and the time value of money, Blackstone's contribution was eventually reduced by \$60 million. H.R. at 149. ET retained operational control.

Annual Report, Statutory Method, and Administrative Proceedings

Rover was eventually obligated to pay 2019 Ohio public utility property taxes. As discussed above, the Commissioner has primary responsibility to value pipeline companies. She has prescribed a Pipeline (Natural Gas) annual report form (form U-PL) that elicits information reported by the public utility in its filings with federal and state regulators.

The form requires the taxpayer to list the value of its property inside and outside Ohio based on its balance sheet. It must then compile a list of each FERC account with Ohio property. Plant assets (long-term fixed assets) are further grouped based on class life and vintage year (the calendar year in which the taxable property was first capable of being used by the taxpayer). Each plant group had a class life of 15, 25, or 30 years. For each plant group, the book cost is entered by vintage year, as is the cost for property that the taxpayer claims is exempt or excluded from the taxable value for that vintage year. For each class life for each group, the taxpayer applies a “percent good” factor (the complement to depreciation) to the net cost (after exemptions are deducted) to reach the true value. Just as depreciation increases as property ages, the “percent good” decreases by vintage year as the group ages. Exemptions may be for real property, licensed motor vehicles, capitalized interest, or “other.” When a taxpayer seeks exemption as “other exempt property,” it must provide the account number, account name, exempt amount, and a description of the exempt property. The taxpayer must also complete a County and Taxing District Recap that the Commissioner uses to apportion the total value among the various taxing districts in the state. The recap reported the net cost of all taxable property as of both the prior and current tax lien date for each taxing district and included a total for each county. The Commissioner then uses the information reported for her assessment and apportionment among taxing districts.

Here, Rover’s report was expansive, but a few numbers stand out. Rover’s report indicated its balance sheet reflected a \$6,513,439,890 total ending balance for all property inside and outside Ohio. The bulk of Rover’s Ohio assets were reported as transmission plant, though it also reported plant materials, supplies, and a small amount of general plant. Rover reported that its total Ohio transmission plant balance was \$4,866,593,435 (\$1,658,797,530 from 2017 and \$3,207,795,905 from 2018), of which it claimed \$2,104,344,172 was exempt property. In addition to real property and capitalized interest, Rover sought an “other exemption” for \$1,341,174,078. Rover described the exempt property as follows:

\$267,176,671	Weather Delay
\$228,879,137	Tusc Incident & HDD Replan Delays
\$93,732,411	Increased Regulatory Post Tusc
\$319,748,301	Slips
(\$5,038,562)	G&A Inc Net of Contingency
\$322,198,358	Contractor Costs Assoc with Delays
(\$5,929,672)	Budgeted Adj for Reduction in Meas Budget
\$60,000,000	Acceleration Costs-Seneca
\$60,407,435	Subcontractor Fall Through Cost
\$8,602,698	Construction Work in Progress

After applying the “percent good” for each year and adding the other assets, Rover calculated the total true value of the property at \$2,700,739,775 (\$2,376,651,000 taxable value). Rover submitted correspondence that further described the requested exemptions. It asserted that

various unforeseen events resulted in delays and additional expenses that did not contribute to the value of the pipeline.

Ultimately, the Commissioner found Rover's arguments wanting. In the Commissioner's final determination, she emphasized that there is a strong presumption in favor of the statutory method and that the burden on the taxpayer to prove the statutory method did not lead to a reliable indication of value. In her view, the Commissioner wrote, it was insufficient to present evidence of a different value without proving the statutory method led to an arbitrary value. The Commissioner also rejected Rover's requests for further exemptions. For example, the Commissioner rejected Rover's regulatory and weather delays arguments. She found that many of the issues associated with the delays were caused by Rover when Rover and its contractors failed to comply with state and federal regulations. She rejected the argument that Rover was entitled to exemptions in excess of its budgeted costs because the Commissioner found Rover under-budgeted. Rover appealed the Commissioner's final determination to this Board.

Reilly

Credentials and Qualifications

We now turn to the appraisal evidence presented at this Board's hearing. This Board qualified Rover's expert, Robert Reilly, as an expert in several areas, including (1) the market valuation of real and personal property; (2) unit principle valuation of properties; (3) the valuing utility property and utility pipelines in particular; (4) GAAP treatment of asset valuation and the fair value impairment of assets under GAAP; and (5) the valuation of a business. H.R. at 527-529. Reilly testified that he had conducted thousands of appraisals and

published articles in professional journals. Reilly also gives professional presentations and teaches. H.R. at 535.

Reilly prepared two appraisal reports: an original appraisal report dated October 29, 2021, in which he asserted a pipeline value for the taxable Ohio portion of the pipeline of \$2.28 billion, and an amended appraisal report dated June 29, 2022, in which he asserted a pipeline value for the taxable Ohio portion of the pipeline of \$1.792 billion. Ex. 44 (original); Ex. 45 (amended). According to Reilly, he amended the original report because Rover instructed him to modify specific obsolescence figures based on cost overruns and because Rover directed Reilly to value exempt property consistent with a specific figure. H.R. at 524, 562. Throughout this proceeding, the Commissioner maintained that Rover's instructions were improper, partly because Rover instructed Reilly to change his appraisal after this Board granted a medical continuance of the hearing at Rover's request. Had the continuance not been granted, the Commissioner argued, Reilly would not have had time to amend his appraisal based on instructions from Rover.

We now return to the specific changes. Reilly specifically stated that the changes impacted his entire report and opinion of value. Reilly originally calculated cost overruns based on documents from Rover's management, including budget documents. In his original report, Reilly's cost overruns were primarily attributed to weather and "rivers overflowing." H.R. at 566. The new data for the amended report, Reilly stated, now included excess costs, which Rover provided based on an analysis from Veritas Consulting ("Veritas"). Reilly did not review the actual financial details in support of the new cost overrun amount, nor did he review any information from Veritas. H.R. at 563. Reilly argued his decision to accept the figures did not

run against generally accepted appraisal standards because he stated he could utilize a client's instruction to accept any certain number provided he disclosed the directive in his report. H.R. at 563.

In his amended report, Reilly also used an amount that differed from his original report regarding exempt property. That new amount, \$770 million, was given to him by Rover. H.R. at 693. In his original report, Reilly estimated the value of exempt property using general appraisal techniques, but in his amended report, he used a figure utilized by Rover when the case was before the Commissioner during the administrative proceedings. In other words, Reilly used the higher figure based on the exempt property's book value but not the pipeline's higher book value. Because Reilly ultimately utilized the updated numbers in his amended report, we will utilize the value conclusion of his amended report as his ultimate value conclusion.

General Overview of Reilly's Methodology

Reilly performed a "unit principle appraisal" or "unit appraisal" of Rover's "total unit of operating property," which he called "the total unit." In the amended report, he explained that the total unit "represents the total bundle of Rover utility plant operating property consisting of real estate and tangible personal property." The total unit also represents "the Rover total utility plant property category." Ex. 45 at 1. Because the total unit included property outside of Ohio, Reilly allocated a proportionate share to Ohio.

He testified that a unit appraisal was appropriate for an interstate pipeline because the "property is physically[,] functionally[,] and economically integrated." H.R. at 547-548. The appraisal method was appropriate for Rover, Reilly found, because if it was physically cut off

at a county or state border, it would cease functioning as a fully integrated pipeline, and the pipeline is an integrated unit. In both reports, he utilized the cost and income approaches. Within each of those approaches, he employed two valuation methods, thus providing him with a total of four methods. At the conclusion of his appraisal, he applied different weights to each of those four numbers and reconciled them to reach a final true value of the taxable subject property.

In his amended report, Reilly stated he was “looking at the value of pipe in the ground and the compressor stations above the ground.” He attested he was not looking at ownership structure or securities. H.R. at 588. Reilly stressed he valued the property as a “total bundle” or “total assemblage.” He contrasted the unit valuation approach with what he called a “summation principle appraisal,” in which each piece of property is valued separately and then added together to arrive at a total value of the entire portfolio of properties. H.R. at 547.

His amended report mirrored his testimony on this point. Ex. 45 at 1. Reilly also stated he was attempting to value the property at its true value in money. H.R. at 580. Reilly concluded that the highest and best use of the subject property was its current state as a pipeline in use. H.R. at 582, 623-624; Ex. 45 at 11.

Reilly generally reviewed the three traditional approaches to value and how they apply to the valuation of public utility personal property. H.R. at 578. He rejected the use of the sales comparison approach to value the pipeline “because [he] could not identify sales of sufficiently comparable property to the subject property, as of the appraisal date” and because “meaningful pricing multiples were not available as of the appraisal date.” Ex. 45 at 46. Accordingly, he utilized only the cost and income approaches to value. H.R. at 622-623.

Reilly also identified the pipeline as a “special purpose property.” He testified that he considered special purpose property useful for “basically one purpose.” He testified the concept would apply to other properties, such as churches, cemeteries, and bridges. Reilly considered an interstate gas pipeline a “textbook example” of special purpose property. H.R. at 711. Reilly emphasized that most weight should be given to the cost approach given the age of the property. But because the pipeline is also an income-producing property, and because he believed he had sufficient data to perform two different income approach methods, he also utilized that valuation method. H.R. at 624-625.

Reilly’s Cost Approach

Reilly testified that he initially considered three appraisal methods under the cost approach: (1) the reproduction cost of the property new less depreciation; (2) the replacement cost new less depreciation (“RCNLD”); and (3) the historical cost new less depreciation (“HCLD”). Ex. 45 at 34; H.R. at 620. Reproduction cost is the total cost of acquiring or constructing an exact duplicate of the subject property, while replacement cost represents the total cost of acquiring or constructing a property that has the same functionality as the subject. Ex. 45 at 32. In his amended report, Reilly defined historical cost as:

The cost of an asset not adjusted for inflation since the date of purchase, as opposed to the current replacement or reproduction cost. Usually the basis for depreciation in accounting which has a requirement that all information on financial statements be presented in terms of the item’s original cost to the entity. Also called original cost.

Ex. 45 at 33. In his cost approach analysis, Reilly applied the RCNLD and HCLD methods but did not use reproduction cost as a separate method. H.R. at 628.

Of importance, Reilly stressed his opinion that each cost approach method requires consideration of depreciation, and Reilly indicated that depreciation of the subject property must be factored into the ultimate value conclusion. He claimed these considerations were supported by appraisal literature, specifically the American Society of Appraisers, *Valuing Machinery and Equipment: The Fundamentals of Appraising Machinery and Technical Assets*, (4th Ed. 2020) (“*VM&E*”) and The Appraisal Institute, *The Appraisal of Real Estate* (15th Ed. 2020)², in support of that proposition. Reilly also quoted *The Appraisal of Real Estate*, which stated that depreciation is the difference between the contributory value of an improvement and its cost at the time of appraisal.

Reilly testified that under generally accepted appraisal standards, there are three types of depreciation traditionally recognized by appraisers: physical deterioration, functional obsolescence, and economic obsolescence. H.R. at 607; Ex. 45 at 34. Reilly again relied on *VM&E*, which provides that physical depreciation is:

Loss in value or usefulness of a property due to the using up or expiration of its useful life caused by wear and tear, deterioration, exposure to various elements, physical stresses, and similar factors.

Ex. 45 at 35. Physical deterioration, Reilly indicated, is typically estimated by considering the age and life of the property. Ex. 45 at 35.

Regarding the second component of depreciation (functional obsolescence) in his amended report, Reilly again quoted from *VM&E*, which states that functional obsolescence is:

² Unless otherwise noted, all references to the *Appraisal of Real Estate* hereinafter relate to The Appraisal Institute, *The Appraisal of Real Estate* (15th Ed.2020).

[T]he loss in value or usefulness of a property caused by inefficiencies or inadequacies of the property itself, when compared to a more efficient or less costly replacement property that is available with new technology. Symptoms suggesting the presence of functional obsolescence are excess operating (i.e. manufacturing) cost, excess construction (excess capital cost), overcapacity, inadequacy, lack of utility, or similar conditions.

(Emphasis deleted.) Ex. 45 at 35. At the hearing, Reilly testified that functional obsolescence includes excess capital costs and excess operating costs. By excess capital costs, Reilly meant costs associated with circumstances where the “owner/operator spent more than they needed to spend to build that property.” H.R. at 597-598. By contrast, Reilly classified excess operating costs as those costs the owner/operator spends more than is necessary to operate the property. H.R. at 597-598. In Rover’s case, Reilly stated neither he nor Rover management identified any excess operating costs; however, Reilly indicated Rover had determined there were excess capital costs. As noted above, Reilly used figures presented by Rover on excess capital costs as his method for determining functional obsolescence in his RCNLD and HCLD analyses. Ex. 45 at 35.

Finally, Reilly discussed his third consideration, which was economic obsolescence. In his amended report, Reilly again quoted from the *VM&E*, which defines economic obsolescence as follows:

Economic obsolescence (sometimes called external obsolescence) has been previously defined as the loss in value or usefulness of a property caused by factors external to the asset. These factors include an increased cost of raw materials, labor, or utilities (without an offsetting increase in product price); reduced demand for the product, increased competition; environmental or other regulations; or similar factors.

(Emphasis deleted.) Ex. 45 at 36. According to Reilly, economic obsolescence is “something outside of the pipeline due to economic conditions” that may be measured by an analysis of

industry returns, an analysis of the earnings capabilities of the entire business in which the subject property is used, analyses of the rate of return of that business or industry as a whole, and analyses of income projections for the subject property at the time of its acquisition as opposed to its actual income performance. Reilly utilized economic obsolescence, as well as functional obsolescence, in his RCNLD and HCLD analyses. Ex. 45 at 36.

Reilly testified that he considered identifying economic obsolescence “easy,” and he gave examples of economic obsolescence.

Economic obsolescence basically is the property operated so that the owner/operator, whoever that is -- does the owner/operator earn its cost of capital, okay? So if your cost of capital is 10 percent, are you earning a 10 percent or greater return on investment? If you are, there's no economic obsolescence, okay? If you aren't, if your cost of capital is 10 percent, but you're earning 8 percent or 6 4 percent or 4 percent, there's economic obsolescence. You're actually not earning your cost of capital, you're earning a return on investment lower than what you would need to pay just to finance the investment itself, okay? And when I looked at the financial statements here I could see very quickly that the Rover Pipeline was earning a return on investment that was inadequate compared to a market derived cost of capital for this pipeline.

H.R. at 598-599. According to Reilly, the long-term, fixed-rate contracts between Rover and its shippers contributed to what he perceived as economic obsolescence. He testified he determined that economic obsolescence was present because he believed profitability was lower than expected. H.R. at 656.

Reilly's Cost Approach: How it Differs from the Statutory Method

Before reviewing the steps taken by Reilly in each method of his cost approach analysis, it is worth noting that in challenging the Commissioner's valuation, Reilly differed from the statutory method, which is itself a type of cost approach. Using Reilly's words, the Commissioner used the statutory valuation method that looks at historical costs as recorded

on the company's books and records, less an allowed depreciation percentage based upon a table that has annual depreciation rates. While that methodology is, in fact, a historical cost method, Reilly argued the statutory method would be generally reliable in 95% of cases, but Reilly stated he found it unreliable when used to value Rover's pipeline. H.R. at 614-615. For example, Reilly was adamant that the depreciation tables used by the Commissioner would not account for functional and economic obsolescence. H.R. at 617. Reilly indicated his method was superior to the statutory method because he included adjustments for functional and economic obsolescence. H.R. at 613-614.

Reilly's Cost Approach: The RCNLD Method

As mentioned above, Reilly conducted only an RCNLD and HCLD method valuation under the cost approach. He rejected a separate reproduction cost analysis because he believed it would have been duplicative.³ As shown below, however, he did use reproduction cost new in connection with his RCNLD analysis.

In the amended report, Reilly described the sequence of steps he used in reaching a value under the RCNLD method as follows:

First: He estimated the reproduction cost new of the total unit.

Second: He considered and made adjustments for the functional obsolescence component related to the excess capital costs that were applicable to the total unit reproduction cost new, and then subtracted that functional obsolescence amount from the reproduction cost new in order to estimate a replacement cost new of the total unit.

Third: He estimated the appropriate amount of physical depreciation for the total unit and multiplied the percentage that was not physically depreciated

³ As Reilly testified, "So if I used a separate reproduction cost new less depreciation method, which I could have, it would have been kind of a duplication of my -- of my replacement cost new less depreciation method, only because in this case the pipeline is brand new. So reproduction cost and then reproduction cost less obsolescence to get your replacement cost would wind up in about the same place." H.R. at 628.

times the replacement cost new to determine the amount of the RCNLD before (1) the functional obsolescence component related to excess operating costs and (2) economic obsolescence.

Fourth: He adjusted the functional obsolescence related to excess operating costs and economic obsolescence.

Fifth: He concluded the RCNLD of the total unit.

See Ex. 45 at 45-46.

Reilly also testified about the steps he took to implement the above sequence. He started with the reproduction cost, which he believed was very close to the historical cost because of the young age of the pipeline. He then “applied an inflationary index factor to the historical cost new as of 12-31-18, so that would include all the historical excess construction costs, but stated in 12-31-18 dollars.” H.R. at 630-633. In his amended report, he stated that:

Based on instruction from legal counsel, we understand the excess capital costs (that is, construction cost overruns) totaled approximately \$1.359 billion. We adjusted the amount of excess capital costs as functional obsolescence from the RPCN of the Total Utility plant.

It was Reilly’s understanding that the excess cost data he was given came from Veritas, which was approximately \$1,358,811,000, as the actual amount of functional obsolescence.

He next addressed the physical deterioration of the pipeline. Because the subject was less than one year old, he identified the subject property as one year of age and used thirty years as the total lifespan for the pipeline. Consequently, he concluded to a physical depreciation amount of approximately 4%. H.R. at 631, 640. He then subtracted physical depreciation to get to RCNLD. Again, he determined no functional obsolescence based on excess operating costs. H.R. at 640.

Having been previously given the amount of functional obsolescence to use in his calculations, he next turned to the amount of economic obsolescence to use. To determine economic obsolescence, Reilly used his method called the capitalization of income loss method (“CILM”). According to Reilly, the CILM looks at the “return on investment that you want versus the return on investment that you have.” H.R. at 647. To determine the amount of economic obsolescence to use in his calculations, he first determined an actual return on investment for the pipeline by dividing the actual income generated by the pipeline by his prior replacement cost to arrive at a percentage. He then compared that actual return on investment to a market-derived cost of capital. H.R. at 647. Reilly believed Rover’s actual return on investment was 35% less than the return for his market-selected control group. H.R. at 631, 640. That percentage differed from the 22% measure in his original report. Ex. 44 at 74.

Having determined economic obsolescence, he then subtracted the economic obsolescence from the RCNLD amount (after the functional obsolescence was subtracted but before the economic obsolescence was subtracted) to reach an indicated value under this approach at \$3,206,000,000. H.R. at 630-631; Ex. 45 at 69. The chart below shows his calculations to reach that \$3.206 billion amount, but that amount is before he subtracts out the exempt property.

**EXHIBIT 6
ROVER PIPELINE LLC
OHIO TAXABLE PROPERTY
COST APPROACH
REPLACEMENT COST NEW LESS DEPRECIATION METHOD
VALUE SUMMARY
AS OF DECEMBER 31, 2018**

<u>RCNLD of the Total Unit:</u>	\$000	
Reproduction Cost New of the Total Unit Utility Plant	6,533,627	[a]
Minus: Functional Obsolescence Component Related to Utility Plant Excess Capital Costs	<u>(1,358,811)</u>	[b]
Equals: Replacement Cost New	5,174,816	
Times: Physical Depreciation Percent Good (i.e., less PD)	<u>95.6%</u>	[c]
Equals: RCNLD (before FO component related to excess operating costs and EO)	4,948,024	
Minus: Functional Obsolescence Component Related to Excess Operating Costs	<u>-</u>	[d]
Equals: RCNLD of the Total Unit after FO but before EO	4,948,024	
Minus: Economic Obsolescence Measurement (based on RCNLD before EO)	35% <u>(1,742,150)</u>	[e]
Equals: RCNLD of the Total Unit Utility Plant (Indicated Total Unit value, rounded)	<u>3,206,000</u>	

Definitions are presented in Schedule A.

[a] As presented in Exhibit 7.

[b] Rover Pipeline LLC incurred excess capital costs during the construction of the Rover pipeline. Based on instruction from legal counsel, we understand the excess capital costs (that is, construction cost overruns) totaled approximately \$1.359 billion. We adjusted the amount of excess capital costs as functional obsolescence from the RPCN of the Total Unit utility plant.

[c] Equals the weighted physical depreciation percent good for total utility plant (on a historical cost basis) and is based on the data presented in Exhibit 7.

[d] After consideration of the Rover functional obsolescence component related to excess capital costs, we concluded that there is no additional functional obsolescence component related to excess operating costs.

[e] Our RCNLD economic obsolescence analysis is summarized in Exhibit 8.

Sources: Exhibits 7 and 8; Rover FERC Form No. 2; the Rover Annual Report to the Ohio Tax Commissioner; and Willamette Management Associates calculations.

To distinguish the above approach from the income approach, Reilly stated that even though he used income data in connection with the above RCNLD method (to help determine the pipeline's return on investment), the approach is independent of the income approach. H.R. at 649.

Reilly's Cost Approach: The HCLD Method

In his amended report, Reilly described the sequence of steps he followed in reaching a value under the HCLD method of the cost approach as follows:

First: He calculated the historical cost of the total unit.

Second: He subtracted the amount of accumulated depreciation related to the Total Unit in order to estimate the HCLD of the total unit before functional and economic obsolescence.

Third: He considered adjustments for the functional obsolescence component related to (1) excess capital costs and (2) excess operating costs for the total unit in order to estimate the HCLD of the total unit after functional obsolescence but before economic obsolescence.

Fourth: He considered adjustments for EO.

Fifth: He concluded the HCLD for the total unit.

See Ex. 45. at 51.

Reilly testified that his starting point (the historical cost of the total unit) was derived from Rover's books and records without any adjustment. From that number, he subtracted the accumulated depreciation, also derived from Rover's financial statements. That subtraction provided Reilly with the historical cost less depreciation before his obsolescence calculations. H.R. at 664.

Reilly proceeded to address the amount needed to account for functional obsolescence. Again, Reilly did not identify any excess operating costs. His calculations brought him to an amount representing "historical costs less depreciation after functional obsolescence of zero, but before economic obsolescence." H.R. at 664. That number was \$6,205,726,000. Ex. 45 at 72 (Ex. 9).

He next calculated economic obsolescence and used his CILM economic measurement method, as discussed above, to "conclude economic obsolescence of 48 percent." Multiplying \$6,205,726,000 by 48% produced an economic obsolescence amount of \$2,978,748,000 (which was much higher than the economic obsolescence figure in the RCNLD) that Reilly then subtracted from the cost amount to determine an indicated value of \$3,227,000,000. In the footnote, he indicated that economic obsolescence captures functional obsolescence.

The chart below shows his calculations to reach the \$3.227 billion amount of his method.

**EXHIBIT 9
ROVER PIPELINE LLC
OHIO TAXABLE PROPERTY
COST APPROACH
HISTORICAL COST LESS DEPRECIATION METHOD
VALUE SUMMARY
AS OF DECEMBER 31, 2018**

<u>HCLD of the Total Unit:</u>	\$000	
HC of the Total Unit Utility Plant	6,310,855	[a]
Minus: Accumulated Depreciation	(105,129)	[a]
Equals: HCLD of the Total Unit before FO and EO	6,205,726	
Minus: Functional Obsolescence Component Related to Excess Capital Costs	-	[b]
Minus: Functional Obsolescence Component Related to Excess Operating Costs	-	[b]
Equals: HCLD of the Total Unit after FO but before EO	6,205,726	
Minus: Economic Obsolescence Measurement (based on HCLD)	48% (2,978,748)	[c]
 Equals: HCLD of the Total Unit Utility Plant (indicated Total Unit value, rounded)	 3,227,000	

Definitions are presented in Schedule A.

[a] As presented in Exhibit 1.

[b] We consider the economic obsolescence measurement for the HCLD method to include the functional obsolescence component that is related to the excess capital costs (that is, the construction cost overruns). We conclude that there is no additional functional obsolescence component related to excess operating costs.

[c] Our HCLD economic obsolescence analysis is summarized in Exhibit 10.

Sources: Exhibits 1 and 10; Rover FERC Form No. 2; the Rover Annual Report to the Ohio Tax Commissioner; and Willamette Management Associates calculations.

Reilly's Income Approach: Yield Capitalization

Reilly used two income approach methods to value the pipeline: the yield capitalization approach and the direct capitalization method. Reilly explained the difference between the two. According to Reilly, direct capitalization takes one period of expected future income and divides that by a direct capitalization rate. He also stated that “[t]he direct capitalization rate is the yield capitalization rate minus the expected growth rate in that measure of income.” H.R. at 668. Regarding yield capitalization, Reilly testified a projection of income is used and then discounted to present value consistent with a yield capitalization rate. H.R. at 668.

As such, both approaches require an initial determination of income to be capitalized. Reilly indicated that the direct capitalization method relies on estimated income “and a risk-adjusted direct capitalization rate.” Ex. 45 at 54. However, because there are different measures of “income” that could potentially be capitalized, one of those income measures needed to be selected. Reilly chose normalized net cash flow as the appropriate measure of income to be capitalized under the discounted cash flow and explained that normalized net cash flow is an after-tax income measure. Reilly believed it provided an income return for all property (tangible and intangible). He measured normalized net cash flow over the next 12 calendar month period and set forth the formula that he used:

$$\begin{aligned} & \text{Normalized Net Utility Operating Income} \\ & \text{(plus) + Depreciation and Amortization Expense} \\ & \text{(minus) - Maintenance Capital Expenses} \\ & \text{-/+ Increase (Decrease) in Working Capital Requirements} \\ & = \text{Normalized [Net Cash Flow]} \end{aligned}$$

Ex. 45 at 54.

Each of the steps in the above formula required its own separate determination or calculation. In explaining the formula, Reilly said that the first step is to determine a representative net operating income for the property. While Reilly considered using historical income data for the pipeline for 2017 and 2018 to determine NOI, he rejected that idea because he stated the pipeline was not operating at full capacity during either of those years. Instead, Reilly selected the representative NOI based on Rover’s 2019 earnings before interest and taxes (“EBIT”), which was \$447.7 million, an amount supplied to Reilly by Rover.

Reilly then adjusted the EBIT to account for income taxes. He used “a normalized effective corporate tax rate of 25.7 percent” as the appropriate rate.⁴ Based on that rate, he deducted normalized income taxes to reach a “representative net utility operating income” of \$332.47 million. Reilly then incorporated that figure into the formula above.

Reilly’s next step in the above formula was to determine depreciation and amortization expenses so that they could be added to the net operating income. Reilly said that Rover uses “the composite method, at straight-line [depreciation] rates, based on the FERC-mandated useful lives” of Rover’s assets to calculate normalized depreciation expense. Ex. 45 at 55. Reilly determined that the historical depreciation expense did not represent long-term depreciation expense. Reilly “considered the three-year average projected depreciation and amortization expense” used in connection with its yield capitalization calculation “to represent a long-term normalized level of depreciation and amortization expense.” Ex. 45 at 55. That amount, \$164,195,000, was added to the net operating income. Ex. 45 at 74.

The next step in the above formula was to determine maintenance capital expenditures to subtract them from net operating income. Based on Rover’s three-year projected average maintenance capital expenditures, Reilly determined that the long-term normalized estimate of maintenance capital expenses was \$13,924,000, which was subtracted from NOI. Ex. 45 at 55, 74-75.

⁴ In the amended report, Reilly said “We tax affected the representative normalized EBIT based on the consideration of (1) the federal corporation income tax rate of 21 percent, (2) the effective Michigan, Pennsylvania, and West Virginia state corporation income tax rates, and (3) the Ohio public utility excise tax. Further, we considered Rover’s estimated effective state income tax rate (composite) of 6 percent, as presented in the Rover certificate application to the FERC.” Ex. 45 at 55.

The final step in determining net cash flows in the above formula was to determine additions to net working capital. In the amended report, Reilly stated that, based on his analysis, he concluded the unit “would not require an additional investment in working capital accounts in order to generate future [net cash flow].” Ex. 45 at 55. Based on all the above calculations, Reilly determined that normalized net cash flow was \$482,745,000.

Having determined the applicable amount of income to use during the relevant period, Reilly next determined the “risk-adjusted direct capitalization rate” to apply to that income. Reilly testified that in order to get to a direct capitalization rate he needed to ascertain a yield capitalization rate and subtract long-term growth rates to arrive at a direct capitalization rate. H.R. at 672; Ex. 45 at 55.

Reilly explained the meaning of the “yield capitalization rate” in his amended report. He stated:

The yield capitalization rate represents the weighted average of the cost of each of the components in the Rover capital structure (i.e. debt capital and equity capital). [The weighted average cost of capital is referred to as “WACC.”] These capital costs, expressed as required rates of return, are weighted according to our analysis of the capital structure (on a true value basis) for the guideline publicly traded companies (“GPTCs”).

Ex. 45 at 114. As discussed above, a portion of the pipeline was funded with the sale of equity to Blackstone, while the balance was funded with debt. Accordingly, Reilly needed to address both the cost of equity capital in the marketplace as well as the cost of debt to arrive at a WACC.

In his testimony, Reilly first addressed the cost of equity capital and stated that to determine that rate, he needed to “estimate a required return on equity capital, what an equity investor would want [in order] to invest in the Rover Pipeline.” H.R. at 673. To determine that

rate, Reilly testified that he used three of the six or seven generally accepted methods to determine the cost of equity capital and discussed those three financial models. The models he used to determine the cost of equity capital were (1) the Modified Capital Asset Pricing Model (ex post equity risk premium) (“MCAPM-EX”); (2) the Modified Capital Asset Pricing Model (supply side equity risk premium) (“MCAPM-SS”); and (3) the Build-Up Model (“BUM”). Each of the three methods uses a formula to determine the cost of equity, and each produced a different indicated cost of equity capital. Ex. 45 at 76.

Each of the three models Reilly used to determine the cost of equity factored in what Reilly called “risk premiums.” In determining those risk premiums, he considered four categories of risk: (1) a risk-free return; (2) a general equity risk premium; (3) a risk premium for the particular industry in which the pipeline operated; and (4) a property-specific risk premium. Reilly testified that each risk layer has its own “risk quantum.” H.R. at 678-679. He factored in each of the four layers of risk in each of his three models. In each model, as each of the four layers of risk was added on, a typical investor would require a higher rate of return to correspond to the increased risk.

The risk-free rate used by Reilly in each of his models was 2.9%, based on 20-year U.S. Treasury bonds. Again, in each of his models, he added to that 2.9% risk-free rate of return additional risk premiums (increases in rates of return) for each of the other layers of risk. For each model, the sum total of the four risk premiums produced the “indicated cost of equity capital” under that model. Ex. 45 at 76.

But while each of the models utilized a mathematical calculation or formula to determine its indicated cost of equity capital Reilly needed risk premium data to populate the

formula. For that, he utilized data from Duff & Phelps, now part of a company called Kroll. H.R. at 675. As set forth in the amended report, Duff & Phelps's "Cost of Capital Navigator" shows that "the historical equity risk premium on the S&P 500 Composite Stock Index above the risk-free rate for the period 1926 to 2018 was 6.91 percent." But, according to Reilly, the overall equity risk premium is typically adjusted by an industry beta. The beta measures systematic risk relative to the overall equity market. Reilly also consulted data for seven guideline companies operating natural gas transmission pipelines.

Reilly stated that he estimated Rover's beta based on selected guideline publicly traded companies in the natural gas pipeline industry. Taken together, Reilly indicated those betas represented an "industry beta" that suggested Rover's beta should be 0.9. Reilly also argued there were differences, and he believed more adjustments were made to account for size. Ex. 45 at 116. Accordingly, Reilly made adjustments for risks related to both the size of the Rover project and for further risks related to the Rover project specifically. Regarding the added risk related to Rover's smaller size, Reilly found D&P's Cost of Capital Navigator provided data for (1) the total equity risk premium returns for all public companies (6.91%) and (2) the equity risk premium returns realized by smaller companies like Rover. Reilly classified Rover in the "low cap" decile of companies, which means Rover had an arithmetic mean annual return of 1.58% above the overall equity risk premium as shown in the S&P 500. After considering additional market data and Rover's operations, revenue, earnings, and the indicated true value of the total unit, Reilly estimated a size equity risk premium of 1.6%. Ex. 45 at 116.

Reilly then considered a property-specific equity risk premium for Rover. In doing that, Reilly considered the differences between the subject property and the underlying theoretical

assumptions that supported his CAPM formula, the same formula upon which his MCAPM models are based. Regarding the pipeline’s property-specific risks, Reilly testified that he believed the adjustment necessary to account for geography, supply/demand, existing contracts, and lack of diversification, among other considerations. H.R. at 676-677; Ex. 45 at 115-116. Accordingly, Reilly assigned a property-specific equity risk premium of 4%. Ex. 45 at 117.

Returning to his CAPM models, Reilly utilized a 1.6% size equity risk premium and his 4.0% property-specific risk premium to reach their respective costs of equity. In his first two models (the MCAPM-EX and the MCAPM-SS), Reilly multiplied the general equity risk premium⁵ by the 0.9 industry beta. Under the MCAPM-EX model, he performed the following calculation to reach his indicated cost of equity capital in that model.

Risk Free Return	=	2.9%
(plus) + General Equity Risk Premium (times) x 0.9 Industry Beta	=	6.2%
(plus) + Size Equity Risk Premium	=	1.6%
(plus) + Property Specific Risk Premium	=	<u>4.0%</u>
(equals) = INDICATED COST OF EQUITY CAPITAL	=	14.7%

⁵ It should be noted that the general equity risk premium differed in the MCAPM-EX and the MCAPM-SS models. For the MCAPM-EX model, the general equity risk premium was 6.9% (which was then multiplied by the industry beta of 0.9 to produce a 6.2% industry-adjusted general equity risk premium). For the MCAPM – SS model the general equity risk premium was 6.2% (which was then multiplied by the industry beta of 0.9 to produce a 5.5% industry-adjusted general equity risk premium).

His MCAPM-SS model used the same percentages as the MCAPM-EX model, except for the general equity risk premium, which started at 6.1% before being multiplied by the 0.9 industry beta to reach an indicated cost of equity capital of 14.0%. Ex. 45 at 117-118.

The third model, the BUM, is a “model that similarly incorporates the various risk factor components of the cost of equity capital including (1) a risk-free rate of return, (2) an equity risk premium, (3) an industry risk premium, (4) a size-related equity risk premium, and (5) a property-specific risk premium.” Ex. 45 at 118. The primary difference between the BUM and MCAPMs is that instead of the 0.9 industry beta, the BUM “includes a risk component related to the relevant industry,” which was 2.1% in the case of companies operating in Standard Industrial Code 4922. Thus, Reilly’s BUM calculation was as follows:

Risk Free Return	=	2.9%
+ General Equity Risk Premium	=	6.9%
+ Industry Equity Risk Premium	=	2.1%
+ Size Equity Risk Premium	=	1.6%
+ Property Specific Risk Premium	=	<u>4.0%</u>
= INDICATED COST OF EQUITY CAPITAL	=	17.4%

Finally, Reilly averaged the results of all three models to reach an overall cost of equity for Rover of 15.4%. Reilly summarized the calculations in the following chart:

EXHIBIT 12a
ROVER PIPELINE LLC
OHIO TAXABLE PROPERTY
YIELD CAPITALIZATION RATE AND DIRECT CAPITALIZATION RATE
AS OF DECEMBER 31, 2018

Cost of Equity Capital:		
Model #1: Modified Capital Asset Pricing Model (ex post equity risk premium)		Source
Risk-Free Rate of Return	2.9%	20-year U.S. Treasury bond, Federal Reserve Statistical Release, as of December 31, 2018
General Equity Risk Premium	6.9%	Duff & Phelps, Cost of Capital Navigator: U.S. Cost of Capital Module as of December 31, 2018
Multiplied by: Industry Beta	<u>0.90</u>	As presented in Exhibit 13
Industry-Adjusted General Equity Risk Premium	6.2%	
Size Equity Risk Premium	1.6%	Duff & Phelps, Cost of Capital Navigator as of December 31, 2018 [a]
Property-Specific Equity Risk Premium	<u>4.0%</u>	Willamette Management Associates functional analysis [b]
Indicated Cost of Equity Capital	<u>14.7%</u>	
Model #2: Modified Capital Asset Pricing Model (supply side equity risk premium)		Source
Risk-Free Rate of Return	2.9%	20-year U.S. Treasury bond, Federal Reserve Statistical Release, as of December 31, 2018
General Equity Risk Premium	6.1%	Duff & Phelps, Cost of Capital Navigator: U.S. Cost of Capital Module as of December 31, 2018
Multiplied by: Industry Beta	<u>0.90</u>	As presented in Exhibit 13
Industry-Adjusted General Equity Risk Premium	5.5%	
Size Equity Risk Premium	1.6%	Duff & Phelps, Cost of Capital Navigator as of December 31, 2018 [a]
Property-Specific Equity Risk Premium	<u>4.0%</u>	Willamette Management Associates functional analysis [b]
Indicated Cost of Equity Capital	<u>14.0%</u>	
Model #3: Build-Up Model		Source
Risk-Free Rate of Return	2.9%	20-year U.S. Treasury bond, Federal Reserve Statistical Release, as of December 31, 2018
General Equity Risk Premium	6.9%	Duff & Phelps, Cost of Capital Navigator: U.S. Cost of Capital Module as of December 31, 2018
Industry Equity Risk Premium	2.1%	Duff & Phelps, Cost of Capital Navigator: U.S. Cost of Capital Module as of December 31, 2018 (SIC code 4922)
Size Equity Risk Premium	1.6%	Duff & Phelps, Cost of Capital Navigator as of December 31, 2018 [a]
Property-Specific Equity Risk Premium	<u>4.0%</u>	Willamette Management Associates functional analysis [b]
Indicated Cost of Equity Capital	<u>17.4%</u>	
Selected Cost of Equity Capital	<u>15.4%</u>	Average of Models #1 – #3 Indicated Cost of Equity Capital

Definitions are presented in Schedule A.
Footnotes and sources are presented in Exhibit 12b.

To determine cost of debt, he referred to D&P’s Cost of Capital Navigator, which purportedly showed that for businesses operating in Rover’s industry code, the industry median before-tax cost of debt capital was 5.4%. Reilly then estimated the after-tax cost of this debt capital by “tax-affecting” it at an estimated income tax rate of 25.7%, which he determined was the normalized effective income tax rate. That produced an estimated after-tax cost of 4.0% for debt capital as of December 31, 2018.

Reilly's final hurdle in determining a yield capitalization rate was to determine the debt/equity mix to be applied to Rover. There was a substantial difference between Reilly's cost of equity determination at 15.4% and his cost of debt determination at 4.0%. To do that, Reilly reviewed the capital structures (the debt-to-equity ratio) of the selected guideline companies as well as those of companies operating in the industry and estimated a capital structure consisting of 40% debt and 60% equity. H.R. at 682; Ex. 45 at 119. He then multiplied the equity capital rate of 15.4% by 60% (15.4×0.6) to get a weighted cost of equity capital of 9.2%. He then multiplied the debt capital rate of 4.0% by 40% (4.0×0.4) to get a weighted cost of debt capital at 1.6%. Adding 9.2% to 1.6%, he arrived at a yield capitalization rate of 10.8%.

Reilly then addressed taxes, including property taxes, federal income taxes, and state income taxes. He estimated a combined federal and state effective tax rate of 25.7%. In the amended report, he stated:

As described earlier in this report, we removed property tax expense from the historical financial operations of Rover and the projected financial operations of Rover.

To include the effect of property taxes on the value of the Total Unit, taxable property, and subject property, we included a blended property tax rate of 5.71 percent in our yield capitalization analysis.

Ex. 45 at 119. Reilly applied the effective tax rate to the 5.71% blended property tax rate⁶ to determine that the tax-affected property tax rate adjustment was 4.2%. In a final step, Reilly added the sum of the weighted cost of equity capital and the weighted cost of debt capital to

⁶ Reilly said that the 5.71% blended property tax rate "considers each taxing district that the Rover personal property is located in." H.R. at 684; Ex. 45 at 119.

the property tax adjustment to reach a yield capitalization rate of 15.1%. Utilizing present value factors for his capitalization rates, Reilly calculated an indicated value under the yield capitalization approach at \$3,851,000,000.

Reilly's Income Approach: Direct Capitalization

Reilly next determined the direct capitalization rate. In determining the expected long-term net cash flows, Reilly assumed the total unit represented tangible and intangible property. He also assumed FERC would limit Rover's rates, and he assumed that Rover was unlikely to be able to increase future profits because of its long-term contracts. Ex. 45 at 120.

Based on those factors, Reilly determined that "a long-term growth rate comparable to the producer price index of approximately" 2% was appropriate. Ex. 45 at 55, 120. That percent was subtracted from the 15.1 yield capitalization rate to produce a direct capitalization rate of 13.1%. Next, Reilly used the direct capitalization rate to calculate an annuity factor of 7.440, which he used to multiply the net cash flows in order to value the full unit. Based on that, Reilly determined that the total unit value under the direct capitalization approach was \$3,591,000,000.

Reconciliation

As shown above, Reilly had reached two indicated values under the cost approach and two under the income approach. He reached an indicated value of \$3.206 billion under the RCNLD method and \$3.227 billion under the HCLD method. He came to an indicated value of \$3.591 billion under the direct capitalization method and \$3.851 billion under the yield capitalization method. Reilly gave 80% weight to the cost approach methods and 20% weight to the income approach methods. He stated he did so because of the age of the pipeline and

because the property was special use. Each method was given 50% with each given approach. H.R. at 694-695. Mathematically, he gave 40% of the weight to the RCNLD method and 40% of the weight to the HCLD method. He gave 10% of the weight to the direct capitalization method and 10% to the yield capitalization method. Simply, he multiplied the RCNLD value of \$3.206 billion by 0.4, the HCLD value of \$3.227 billion by 0.4, the direct capitalization value of \$3.591 billion by 0.1, and the yield capitalization value of \$3.851 billion by .1. He then added together the products of that multiplication to reach a total reconciled value of \$3.317 billion.

Allocation and Deduction of Exempt Property

Because portions of the pipeline were located in states other than Ohio, Reilly next needed to determine what portion of that total unit was located in this state. In determining that, Reilly testified he “looked at the total cost, meaning the gross cost, of the plant in service in Ohio, as reported on the Ohio reporting form” and reported to FERC. He then calculated the percentage cost in Ohio compared to the percentage cost everywhere. He eventually found the percentage cost in Ohio was 77.252%. That percentage, multiplied by a total unit value of \$3.591 billion, produced a property value in Ohio of \$2.562 billion (rounded).

For his final step, Reilly deducted the value of the Ohio exempt property from the \$2.562 total value of the property in Ohio.

*** I was instructed to use \$770 million as the value of the exempt property in Ohio *** and what I’m trying to do again is get to the value of the taxable property in Ohio, so if I have the value of the total property in Ohio, and I have an indication of the value of the exempt property in Ohio *** then I simply have to subtract the value of the exempt property and the value of the total property to get to the value of the taxable property in Ohio.

H.R. at 697. In doing that subtraction, Reilly determined that the total value of taxable property in this state was \$1,792,000,000.

Eyre

Credentials and Qualifications

In support of her proposed valuation, the Commissioner offered the testimony of Brent Eyre, who, like Reilly, was a highly experienced and credentialed appraiser. Presently a fee-appraiser and consultant, Eyre was most recently an assistant director of property taxes for the Utah State Tax Commission. He spent approximately 28 years there, the last 14 of which were spent as the assistant director of its property tax division. In that capacity, his primary responsibility was to oversee the annual assessment of “centrally assessed properties,” including all public utilities and pipelines in the State of Utah. He testified that he had appraised close to 50 individual pipelines, some of them multiple times. H.R. at 792-794. He has designations from the American Society of Appraisers in machinery and technical specialties, including utilities. Eyre also has a designation in the area of appraisal review. Eyre testified that he had been a certified general licensed appraiser for approximately 35 years and was licensed in multiple states. H.R. at 793. He had also been the chairman of the Western States Association of Tax Administrators (“WSATA”) education committee and was responsible for its appraisal school. Eyre teaches appraisal practice and has presented on unitary valuations approximately 200 times in 20 states. H.R. at 794-795. Eyre has presented expert testimony before approximately 27 courts and tribunals. As a consultant, Eyre provides services for government agencies, revenue departments, and private investors.

At this Board’s hearing, Eyre was qualified as an expert in three areas: (1) the market value of personal property, (2) unit principle valuations of properties, and (3) valuing utility properties, including pipelines. H.R. at 796. Eyre prepared three documents in connection

with the valuation of the pipeline. The first was his appraisal report dated December 31, 2021, in which he valued the pipeline as of December 31, 2018. Ex. J; H.R. at 868. The second document, dated March 4, 2022, was Eyre's review appraisal of Reilly's original report. Ex. K.; H.R. at 870. The third document was Eyre's amended appraisal review, created due to Reilly's decision to amend his report at Rover's direction. As discussed below, it is no surprise that there were several important areas of disagreement between Reilly and Eyre in their valuations, but there were also some points on which they did agree.

General Overview of Eyre's Methodology

In his appraisal, Eyre used both cost and income approaches but, like Reilly, did not use the comparable sales approach. H.R. at 816. His appraisal was noticeably less complicated than Reilly's appraisal. His analysis followed a sequence similar to the one followed by Reilly, with Eyre first determining the total value of the entire unit both in and out of Ohio, then allocating a portion of that total value to Ohio, and finally deducting exempt property from the Ohio portion of the subject's value.

Like Reilly, Eyre determined that the appropriate way to value the property was as an integrated unit, as opposed to valuing its components separately. In his appraisal, Eyre wrote that a "[u]nit appraisal means valuing an integrated group of operating assets functioning as an economic unit as 'one thing' without reference to the independent value of the component parts." Ex. J; H.R. at 798-799. In support of that definition, Eyre cited the *WSATA Appraisal Handbook – Unit Valuation of Centrally Assessed Properties*, (2009), at 1-8. Ex. J. 9, fn. 3.

In that regard, Eyre testified that the subject's highest and best use of this "integrated group of assets" was in continued operation as a functioning and active natural gas pipeline.

Ex. J at 9. By operating as a unit, Eyre argued the assets achieved their highest and best use. Eyre sometimes referenced the term “going concern” but emphasized it did not mean he valued the entity Rover Pipeline, LLC. He stated that

‘Going concern’ as used here is not synonymous with enterprise value. Enterprise value is a broader term which encompasses the value of a corporate entity including all of its tangible and intangible assets; it is a valuation of the present owner’s total business in contrast to the exchange valuation of tangible assets as a going concern.

Ex. J at 9, fn. 4. Eyre, like Reilly, determined that the pipeline was special purpose property. H.R. at 802.

Before continuing to our summarization of Eyre’s approaches, we address his use of the WSATA handbook because of its impact on Eyre’s approaches and because the parties have used this case to engage in an intellectual proxy war over the handbook. Eyre posited the handbook had become a broadly accepted manual after it was originally developed in the early 1970s. Eyre testified the handbook originated when thirteen states considered evidence from numerous sources and distilled those sources to a manual listing best practices for valuing unitary properties. H.R. at 818-819. Eyre personally prepared an initial draft of the 2009 rewrite. Comments were solicited from interested academics, attorneys, and appraiser associations, and public hearings were held. Eyre characterized it as a “fairly extensive review process” and said the handbook was recognized as “the most authoritative appraisal treatise for unitary appraisals of these types of properties for property or ad valorem tax purposes.” H.R. at 820-821; Ex. J at 18. Eyre testified nearly all other significant appraisal manuals focused more on real property or the valuation of personal property such as machinery. Eyre explained

that not all of the methods and assumptions for valuing those properties apply to unit valuations of utility property, which is why the handbook was created and is useful in this case.

Eyre's Cost Approach

Eyre testified the HCLD approach was the only generally accepted cost approach method to appraise pipelines like Rover. He stressed the approach was widely seen as the most reliable approach for regulated utility property when he stated, “[t]he standard cost approach that assessment jurisdictions across the country that perform unit appraisal for properties such as the Rover Pipeline would be historical costs less depreciation.” H.R. at 816; Ex. J at 17. Eyre rejected the use of the RCNLD method as inappropriate and speculative, especially for regulated companies. Eyre unpacked his position further in his report. There, he wrote that one of the significant problems with using the reproduction or replacement cost methods was because “it is difficult to estimate the indirect costs and value enhancement [entrepreneurial profit] that would be appropriate for a natural gas pipeline” like the subject. Ex. J at 18. In addition, he testified that the large expense and personnel required to do “a quality replacement cost new estimate of cost is quite extensive,” and that because the income approach is a “primary indicator of value * * * the effort to do a competent replacement cost new would certainly not be money well spent or necessarily accurate. H.R. at 816-817.

In his report, Eyre stated that the cost approach should stand on its own as an independent measure of value without further adjustment. Eyre, in explaining the reasoning behind his HCLD method, quoted from the WSATA handbook:

HCLD cost indicators are generally not adjusted further to account for appreciation or depreciation. A deduction from HCLD for obsolescence is just as inconsistent as adding value to HCLD because some of the utility’s property has increased in value since it was acquired, or because the utility’s earnings are

extraordinarily high for some reason (e.g. lax regulatory oversight). The practice of not adjusting HCLD for perceived obsolescence does not mean that obsolescence has not been considered and measured, since as noted previously, regulatory depreciation should, in theory, reflect all forms of obsolescence. The degree to which regulatory depreciation reflects accurate estimates of market depreciation for a particular property is taken into account when reconciling the value indicators.

Ex. J at 18. Eyre stressed he did not ignore functional and economic obsolescence. Instead, he focused on the cost approach as an independent measure because any additional obsolescence is captured (if it exists) in the income approach. H.R. at 818; Ex. J at 18. Otherwise, Eyre indicated, the two approaches would collapse and render essentially the same result, and the cost approach would no longer be a reliable check on the income approach.

Eyre then testified about the steps he took to calculate his HCLD value determination of \$6,225,973,073, as reflected in the following chart:

Rover Pipeline, LLC - State of Ohio - 2019 Assessment		Exhibit 1
Historical Cost Less Depreciation Indicator of Value		
Utility Plant in Service		\$ 6,301,485,440
Less: Accumulated Depreciation & Amortization		<u>\$ (105,128,694)</u>
Net Utility Plant in Service		\$ 6,196,356,746
Construction Work in Progress		\$ 9,369,084
Plant Materials and Supplies		\$ 20,877,707
Gas Owed to System Gas		<u>\$ (630,464)</u>
Historical Cost Less Depreciation Indicator of Value		\$ 6,225,973,073
Source: FERC Form 2 for 12/31/2018		

Ex. J. at 19. As shown in the exhibit, his information source was the FERC Form 2 for December 31, 2018, which includes information Rover actually reported to federal regulators.

He explained that he first calculated the value of the utility plant in service in the amount of \$6,301,485,440, which he also took from Rover's public financial statements. H.R. at 822. He deducted \$105,128,694 from that amount as the accumulated book depreciation and amortization. He then made adjustments for "construction work in progress," "plant materials and supplies," and then "gas owed to system gas," which he testified was a capitalized gas account. Based on the above calculations, he reached an indicated total unit HCLD valuation of \$6,225,973,073.

To test the reliability of his HCLD valuation, Eyre also engaged in a market analysis of guideline companies operating in the natural gas pipeline industry. His first task was to select from the range of all possible companies whose characteristics were most similar to Rover. Eyre indicated he examined all companies in the oil and gas transmission industry segment from the Value Line Investment Survey. Ex. J at 27. In selecting his guideline companies, Eyre stated he relied on appraisal literature that stated: "chosen comparables should be 'reasonably similar,' after an analysis of industry class, risk, growth, profitability, and size or physical characteristics." Ex. J at 27. Utilizing that standard and the above criteria, he selected six guideline companies, two of which overlapped with the guideline companies selected by Reilly. The two companies were The Williams Companies, Inc. and Kinder Morgan, Inc. Eyre explained that he looked at the market-to-book ratios of the guideline companies in comparing them to Rover. For the guideline companies, Eyre explained his process as follows:

And what I do here, as I analyze the equity and debt securities of these publicly traded companies -- so they have publicly traded equity, publicly traded debt, and I determine their ratio of the market value of their equity to the book value of their equity, and the market value of their debt to the book value of their debt, and then you can see the average market-to-book ratio for their equity is 1.48. So in other words, anything above 1 would indicate that the market

perceives the market value of their equity to be greater than the book value of their equity. And then also I did the same analysis to their debt securities; took the book value of their debt securities, compared it to -- all these companies will report within their Form 10-Ks what the market value of their debt is, and so you can determine their market-to-book ratio of their debt, and the market-to-book ratio -- go down a little bit further -- was just above 1; 1.01.

H.R. at 823-824; Ex. J at 19-20. Eyre specifically determined the average market-to-book ratio for guideline company equity was 1.48 and 1.01 for debt. H.R. at 823-824; Ex. J at 20. Eyre indicated he also reviewed the capital structure for each guideline company to determine its debt-to-equity mix. Those calculations showed that their average capital structure was 54% equity and 46% debt. H.R. at 824; Ex. J at 20.

To determine the average market-to-book for the guideline companies, he then multiplied the average equity market-to-book of 1.48 by 54% (the average percentage of equity for the guideline companies) to reach an average equity market-to-book of .80%. He performed a similar calculation for the debt of the guideline companies, multiplying the average debt market-to-book of 1.01 by 46% (the average percentage of debt for the guideline companies) to reach an average debt market-to-book of 0.47%. He then added the average equity market-to-book to the average debt market-to-book to determine the overall market-to-book ratio of 1.27. H.R. at 824; Ex. J at 19-20.

That 1.27 market-to-book ratio, according to Eyre, shows that “the market is perceiving that the market value of the debt and equity securities of the industry should be greater than the book value of the industry.” H.R. at 824. In other words, Eyre believed his assumptions were correct and confirmed the HCLD approach should be reduced no further because a “market-to-book ratio of greater than ‘1’ would be an indication of no obsolescence.” Ex. J at 19; H.R. at 824-825.

Eyre's Income Approach

Moving to his income approach, Eyre clarified his understanding of the approach when he stated that the approach is premised on the idea that “the income that a property is expected to produce is converted into a value estimate through the capitalization process.” Ex. J at 21. According to Eyre, the goal was to “determine the present worth of all anticipated future benefits.” H.R. at 836. His report stated that the income approach is grounded “on the assumption that investors will buy and sell property based on the income it is expected to yield.” Ex. J at 21. The process used to convert future income to present value is known as yield capitalization. Ex. J at 21; H.R. at 836-837.

Like Reilly, Eyre testified that two different capitalization methods exist: direct capitalization and yield capitalization. A single year’s stabilized and normalized income is converted to value using a capitalization rate in the direct capitalization method. The capitalization rate, he testified, is based upon the relationship between income and value that was observed in the market. H.R. at 837; Ex. J at 22.

In the yield capitalization method, Eyre explained that an appraiser uses a discounting procedure to convert future income cash flows to present value based on a required level of return or rate of return. According to Eyre, he did this by estimating an appropriate WACC, which he considered a discount rate to discount those cash flows to present value. H.R. at 837. The most sophisticated form of yield capitalization, Eyre said, is discounted cash flow (“DCF”), which is the form Eyre used in his appraisal of the subject pipeline. Ex. J at 22; H.R. at 837.

Eyre's Income Approach: The DCF Model

A critical initial step in the DCF method is to determine the amount of cash flows from future income over a specified period. As explained by Eyre,

A DCF model requires an appraiser to make estimates of net cash flows for an explicit period of time. The explicit forecast period must be long enough so that the company has reached a steady state by the end of the period. At the end of the explicit forecast period, the appraiser uses a simplified formulaic approach to determine the value of the property for the remaining life of the property. The value of the property at the end of the explicit forecast period is known as the terminal value or the continuing value.

Ex. J at 23. Eyre listed the steps he took to determine “net cash flow to discount” as follows:

Total Revenues

- (minus) - Operating Expenses
- (minus) - Depreciation & Amortization
- (minus) - General & Administrative Expenses
- (minus) - Taxes Other Than Income Tax [e.g., property taxes]

Equals Taxable Income

- (minus) - Income Taxes (@ 21% marginal rate)

Equals Net Operating Income

- (plus) + Depreciation & Amortization
- (minus) - Maintenance Capital Expenditures

Equals Net Cash Flow to Discount

Ex. J at 24, Exhibit 3 (shown below). Eyre populated the above formula with actual amounts, and he identified relevant assumptions he made in his calculations. Ex. J at 24.

Rover Pipeline, LLC - State of Ohio - 2019 Assessment				Exhibit 3
Discounted Cash Flow Valuation of Operating Property (000)				Terminal
	2019	2020	2021	Cash Flow
	(Forecast)	(Forecast)	(Forecast)	
Total Revenues	\$ 794,048	\$ 811,631	\$ 820,050	
- Operating Exp.	\$ (165,104)	\$ (165,783)	\$ (166,296)	
- Deprec. & Amort.	\$ (162,656)	\$ (164,865)	\$ (165,064)	
- Gen. & Adm. Exp.	\$ (18,572)	\$ (19,126)	\$ (19,983)	
- Taxes Oth. Th. Inc.	\$ (187,365)	\$ (192,972)	\$ (198,886)	
Taxable Income	\$ 260,351	\$ 268,885	\$ 269,821	
- Inc. Tax (21%)	\$ (54,674)	\$ (56,466)	\$ (56,662)	
Net Oper. Inc.	\$ 205,677	\$ 212,419	\$ 213,159	\$ 216,612
+ Deprec. & Amort.	\$ 162,656	\$ 164,865	\$ 165,064	\$ 167,738
- Maint. Capex	\$ (17,236)	\$ (9,596)	\$ (9,336)	\$ (12,056)
Net Cash Flow	\$ 351,097	\$ 367,688	\$ 368,887	\$ 372,294
P.V. Factor (8.61%)	0.9595	0.8835	0.8134	
DCF Value	\$ 336,893	\$ 324,844	\$ 300,067	
	Terminal Value (assuming 1.62% terminal inflationary growth rate)			\$ 5,326,092
	P.V. factor (8.61%)			0.7805
	Discounted Terminal Value			\$ 4,157,183
TOTAL DCF VALUE	\$5,118,988			
Assumptions: (1) Revenues, Oper. Exp., and Deprec. - used Rover's Long Range Plan for Fall 2018.				
(2) Maint. Capex from Rover's Long Range Plan for Fall 2019.				
(3) Terminal Value = Terminal NCF divided by Discount Rate minus 1.62% inflation rate.				
(4) Terminal NCF determined; NOI = 2021 NOI x 1.0162; Deprec. = 2021 Deprec x 1.0162; Maint. Capex in the terminal period assumed to be the ave. of 2019 - 2021 forecast.				
(5) Discount rate will be 8.61%.				

As shown above, Eyre used Rover's forecasted revenues for 2019-2021. The numbers for those projected revenues came from Rover's long-range plan for the fall of 2018. Ex. J at 24-25; H.R. at 838. Having determined the amount of taxable income, Eyre then applied a marginal income tax rate of 21%, which produced an amount for net operating income that Eyre described as "the accounting income stream that's available to equity holders and debt holders." H.R. at 838.

In his DCF model, Eyre's next step was determining net cash flow. He explained how that calculation was made.

And now we have got to convert that net operating income to a cash flow. So you add back any noncash expenses, and depreciation is a noncash expense. You didn't have any cash out flow when you incurred the depreciation charge. And then you -- so you add that back, and then you subtract out any costs that are associated with maintaining the pipeline in this case, they are called maintenance capital expenditures, that this would be the cost to replace compressors, meters, valves, those types of things as you go forward. Then you get -- that gets you a net cash flow * * *.

H.R. at 838-839.

Eyre explained some of the terminology he used. He testified that "terminal value," as used in the exhibit, is "[t]he value of the property at the end of the explicit forecast period" and is also sometimes known as continuing value. Ex. J at 23; H.R. at 839. Eyre added an inflation factor to his terminal cash flow based on an analysis of the inflation charges for the last ten years, which averaged 1.62%. H.R. at 840. He increased the prior year's income by 1.62% and then added back depreciation, which he also increased by the same inflationary amount, 1.62%. He further explained that the "maintenance capital expenditures" in the terminal period were the average of the three forecasted years. H.R. at 840.

After determining net cash flow, the next step in Eyre's DCF calculation was to apply the correct discount rate to the net cash flow. According to Eyre, "the correct discount rate to use in a DCF valuation is the" WACC. Ex. J at 26. According to Eyre, "the WACC is a company's after-tax cost of raising funds." Ex. K at 13.

Like Reilly, Eyre explained that the WACC is comprised of both equity and debt rate components. Eyre's report states that his "estimate of WACC" was "developed by weighing the equity discount rate and debt discount rate by the typical capital structure [percentage of debt vs. percentage of equity] in the natural pipeline industry." Ex. J at 26; H.R. at 837. The typical capital structure, he wrote, "should be representative of the typical structure of an

industry group, not that of the present owner.” Ex. J at 28. To determine the typical equity-to-debt ratio, Eyre again returned to his guideline companies. He reviewed the equity-to-debt percentages of the guideline companies and then averaged them together to reach an average capital structure for the guideline oil/gas transportation companies of 54% debt to 46% equity. Ex. J at 29 (Exhibit 4); H.R. at 824.

Eyre’s Income Approach: The Cost of Equity - The CAPM Formula

Eyre’s next task in his DCF model was to determine the WACC. Accordingly, the WACC’s two components (again, the cost of equity and the cost of debt) each needed to be determined. He started with equity.

To determine the “equity discount rate or cost of equity,” Eyre used three different estimates: (1) the CAPM Model – Ex Post (“CAPM-EX”); (2) the CAPM Model – Ibbotson Supply Side (“CAPM-SS”); and (3) the Dividend Growth Model (“DGM”). Ex. J at 30, 35. Eyre explained that because equity investments have a higher risk than other “risk-free” investments – which, presumably, any investor could easily obtain – the CAPM is developed by selecting a risk-free rate that accounts for certain risks with a subject investment. In other words, that math (risk-free + additional risk premium) presumes that there is a need to pay a higher rate of return to encourage a reasonable investor to invest beyond a risk-free investment. He set out the CAPM model’s basic formula as follows:

$$K_e = R_f + (R_m - R_f)\beta$$

Eyre explained that in the above formula, “ K_e is the cost of equity, R_f is the risk-free rate (typically government securities), $R_m - R_f$ is the market risk premium or the premium

demanded by equity holders over and above a risk-free rate, and β is the beta factor.” Ex. J at 30.

As to the first element of the formula, the risk-free rate, Eyre determined the rate in a manner similar to Reilly, using the return on 20-year U.S. Treasury bonds. Ex. J at 32; H.R. at 847. While Reilly used a rate of 2.9% for the bond’s yield rate as of December 31, 2018, Eyre used a slightly different rate and determined that “the yield on the long-term government bonds was estimated to be 2.87% at or around December 31, 2018.” Ex. J at 33. Having determined the risk-free rate, Eyre next needed to determine the market rate and the beta to complete the above CAPM formula.

Eyre’s Income Approach: The Cost of Equity - The C-EX Method

The first model, the CAPM-EX, “is where market risk premium is determined by taking historical averages of the differences between the return of equities and various risk-free securities.” Ex. J at 31. Eyre obtained his data, in part, from the “SBBI” or “Stocks, Bonds, Bills, and Inflation” data published by the CFA Institute Research Foundation as an annual yearbook. Eyre derived the market risk premium data available from 1926 to the present. H.R. at 850. In reading the SBBI, an investor can “calculate average returns of the equity market and compare them to average returns on so-called risk-free securities * * *.” Ex. J at 31. Eyre incorporated the data into his CAPM-EX, and he stated he “used the arithmetic average of the premium of equities over long-term government bonds for the entire 93-year historical period that is provided by the SBBI Yearbook.” Based on the data, under the CAPM-EX, the market risk premium was 6.91%. Ex. J at 32.

Eyre’s Income Approach: The Cost of Equity - The CAPM-SS Method

Eyre next discussed the CAPM-SS, his second CAPM, to determine the equity risk premium. Whereas the CAPM-EX was based on historical, backward-looking data, the CAPM-SS model was more forward-looking. Known as the “supply side model,” Eyre testified that the data on which the model is based includes only “the return on the equities that results from the payment of dividends.” The CAPM-SS model, he testified, eliminates “any cost depreciation, or depreciation resulting in the market’s perception of the future – or of the cost appreciation expectations of the – of that stock.” H.R. at 850-851. Eyre said that according to the SBBI, under the CAPM-SS:

[L]ong-term expected equity returns can be forecasted by the use of supply side models. The supply of stock market returns is generated by the productivity of the corporations in the real economy. Investors should not expect a much higher or lower return than that produced by the companies in the real economy. Thus, over the long run, equity returns should be close to the long-run supply estimate.

Ex. J at 34.

The CAPM-SS model produced a different risk premium than the CAPM-EX model. According to Eyre, the data showed a “forward-looking market risk premium to be lower than their straight long-term historical estimate [the CAPM-EX model].” Accordingly, Eyre estimated the market risk premium using the CAPM-SS model to be 6.14% as of December 31, 2018. Ex. J at 34.

Eyre’s Income Approach: The Cost of Equity - The DGM Method

Eyre’s third model to determine the equity risk premium was the DGM, which he said is sometimes known as the discounted cash flow model. Ex. J at 35. Eyre testified that the DGM “is measured by taking the dividend yields” for guidelines companies and adding those to an estimate of sustainable growth. H.R. at 852; Ex. J at 35. The formula for determining

DGM is $K_e = D / P + g$. In the formula, K_e is the cost of equity, and D is the calculation of dividends per share estimated to be received in the next year. Also, P is a share price on the appraisal date, and g is the estimate of sustainable growth. Ex. J at 35. While share price and dividends per share can be readily obtained from available data, the determination of sustainable growth is less definitive.

Eyre discussed some of the issues that arise in determining sustainable growth. Issues can arise because past dividend growth has tracked earnings growth; however, Eyre indicated that in more recent years, some companies have cut or eliminated dividends. This, according to Eyre, has resulted in “large differences between earnings growth estimates and dividend growth estimates.” Ex. J at 36. To address the differences, Eyre said that a consensus has developed “based on substantial academic literature,” which is that “the most common solution is to use analyst forecasts of earnings growth as a proxy for the growth rate in dividends.” Ex. J at 36.

But, Eyre noted, using analysts’ forecasts raises another question in determining the rate of sustainable growth. He needed to determine the years to review. Forecasts by analysts usually fall within the three to five-year time frame. But with unitary appraisals, like for the pipeline, the discount rate projects in perpetuity. Ex. J at 36. So, Eyre needed to reconcile shorter-term growth projections to determine a discount rate.

To address that problem, according to Eyre, “many experts advocate a multistage approach in calculating estimated sustainable growth[.]” Eyre testified that the multistage growth model is widely accepted, and he testified that Rover even uses a multistage growth

model in its FERC filings, although Rover uses a two-stage, not a three-stage model. H.R. at 858.

Eyre explained the components of his multistage approach. He used forecasts for the first five years and then applied a “linear convergence of the analysis forecast to the long-run economic growth forecast for the next 15 years.” Ex. J at 37. He applied the growth rate into perpetuity. Eyre applied the three-stage approach for each of his guideline companies to determine each company’s “g” and used “the 3-5 year Value Line analyst forecast for the first five years, a 15-year linear convergence to the long-run economic growth estimate of 3.90% and then the 3.90% into perpetuity.” Ex. J at 37. Eyre used the Congressional Budget Office’s long-range estimate.

Based on that data, his three-stage growth rate for the guideline companies ranged from a low of 4.24% to a high of 14.57%, with two companies having no meaningful figure. Ex. J at 29-35. Eyre concluded that for the natural gas pipeline industry, the typical dividend yield should be 7.90%, and the sustainable growth rate should be 11.00%, as determined from the three-stage growth analysis. Ex. J at 37. Eyre plugged those figures into his formula and arrived at an 18.90% cost of equity under the DGM.

Eyre’s Income Approach: The Cost of Equity - Determining the Industry Beta

Having determined the market equity risk premium under each of his three methods, the final piece in completing the CAPM formula needed to calculate the WACC was the industry beta. Eyre had to decide how the risk premium of the oil and gas transmission company compared to the general market. The oil and gas transmission industry is not the general investment market; it is a subset of that market. To address the difference in risk

between the general market and the subset market in which the pipeline operates, Eyre, like Reilly, developed a beta factor. Eyre explained that the higher the beta, the more risky the investment. A beta of “1” represented the average risk of the market. Ex. J at 30. He testified that “if your subject property is in an industry that has an equal risk to the market as a whole, a beta will be 1. If it has less risk than the market as a whole then your beta will be less than 1.” H.R. at 851-852. By contrast, a larger beta suggests the market perceived more risk. H.R. at 851-852. In his report, Eyre stated that

It is important to note here that beta should measure only the business risk associated with the property. Business risk is sometimes known as systematic risk or the risk you cannot diversify away. Property specific or nonsystematic risk should not be accounted for in the cost of equity, but rather should be accounted for in the forecast of expected cash flows.

Ex. J at 31. In support of that proposition, Eyre cited Brealey, Myers, & Marcus, *Fundamentals of Corporate Finance*, 310-311 (4th Ed.2004), which says that property-specific risks should be addressed in cash-flow forecasts.

Expected cash-flow forecasts should already reflect the probabilities of *all* (italics in original) possible outcomes, good and bad. If cash-flow forecasts are prepared properly, the discount rate should reflect only the market risk of the project. It should not have to be fudged to offset errors or biases in the cash-flow forecast.

Ex. J at 31.

As shown in the basic CAPM formula above, the beta is multiplied by the number that results when the risk-free rate is subtracted from the general market risk rate. Eyre used Value Line’s estimates of beta for his guideline companies, which ranged between 1.00 and 1.95 as shown below.

	Value Line
<u>Company</u>	<u>Beta</u>
Enbridge, Inc.	1.00
Kinder Morgan, Inc	1.45
ONEOK, Inc.	1.55
Pembina Pipeline	1.10
TransCanada	1.10
Williams Cos.	1.95
Average	1.36
Average H-L	1.48
Median	1.28

Ex. J at 29. Based on the above, Eyre determined that the beta for the oil and gas transmission industry was 1.32, between his average and median figures.

Eyre's Income Approach: The Cost of Equity - Determining the Cost of Equity

Having determined the industry beta, Eyre returned to the CAPM formula for each of his three methods and, for each method, determined the risk premium as follows:

Cost of Equity	
<u>CAPM Model - Ex Post (Natural Gas Pipeline)</u>	
Risk Free Rate + (Market Risk Premium)*Beta	
2.87% + (6.91%)(1.32) =	11.99%
<u>CAPM Model - Ibbotson Supply Side (Natural Gas Pipeline)</u>	
Risk Free Rate + (Market Risk Premium)Beta	
2.87% + (6.14%)(1.32) =	10.97%
<u>Dividend Growth Model: (Natural Gas Pipeline)</u>	
Dividend Yield + Growth	
7.90% + 11.00% =	18.90%
Selected Cost of Equity	12.50%

Eyre's final step in determining the cost of equity in the oil and gas transmission industry was to reconcile the risk premiums developed through his three methods. He determined that because two of the guideline companies "lacked sufficient meaningful data to

Eyre's Income Approach: The Weighted Average Cost of Capital

Eyre's next task was to weigh those percentages to account for the industry's average equity-to-debt ratio. As shown above, Eyre determined that the average capital structure in the industry was comprised of 54% equity and 46% debt. H.R. at 824; Ex. J at 20.

To arrive at the WACC, he multiplied the 12.50% risk premium for equity by 54% to arrive at 6.75%. He similarly multiplied the 5.13% risk premium for debt by 46% to arrive at 1.86%. He then added the 6.75% equity risk premium to his 1.86% risk premium to arrive at the weighted average cost of capital of 8.61%.

Eyre's Income Approach: DCF Valuation

In his report, Eyre stated that because he did not include an interest expense in his estimated cash flows, he needed to adjust the debt portion of his WACC to account for debt financing tax benefits. He used a tax rate of 21% for the adjustment. After that adjustment, he opined that the proper discount rate was 8.61%. Based on all of the above, Eyre concluded to a total unit DCF valuation of \$5,118,988,000.

Reconciliation

Eyre finally reconciled his HCLD value of \$6.226 billion (rounded) and his DCF value of \$5.119 billion (rounded) by giving each equal weight. H.R. at 863; Ex. J at 42. Eyre wrote that he found the cost approach relevant since the pipeline went fully into service just two months before the appraisal date. However, he emphasized that the cost approach does not measure the total value of assets when they combine into an operational pipeline. Ex. J at 42. Consequently, Eyre testified he found sufficient data to support the income approach, which he found relevant because the subject is an income-producing property. He also stated he

found enough financial information from guideline companies to support his approaches. Accordingly, he concluded to a final total unit value of \$5,670,000,000.

Allocation and Deduction of Exempt Property

Eyre next determined what portion of that value should be allocated to Ohio. Eyre used what he deemed the “typical factor” used in the allocation of interstate property, which was the gross cost of investment in property, plant, and equipment. Using that method, Eyre’s allocation percentage, 77.2525%, was similar to Reilly’s allocation percentage. Applying that allocation multiplier, Eyre concluded to an allocated unit value of \$4,380,160,050.

Eyre then addressed exempt property. He pursued a methodology that differed from the one used by Reilly, who was provided with and used an exempt property value for Ohio of \$770 million. H.R. at 697. Eyre testified that “a very specific methodology” exists to eliminate exempt property, which is to eradicate the *contributory* value of the exempt property. H.R. at 798. Eyre explained that the appraisal principle of contribution says that value in a unit appraisal is measured by how much the property contributes (or detracts) from the value of the whole. Accordingly, Eyre calculated the ratio of the reconciled system to its gross cost value and then applied the ratio to the gross cost value of Ohio exempt property. Ex. J at 44.

In his testimony, he explained the procedure he used:

The taxpayer reports to the State of Ohio * * * property that is exempt from property taxation under the laws of the State of Ohio.

They reported to the state that they have exempt property that they have capitalized with the gross cost of just under \$794 million.

So now the contributory value of that invested cost needs to be eliminated from your allocated Ohio value. So the way that assessors do this across the country is to first determine a ratio of your system value, your system market value to the system gross cost * * *.

I determined that ratio taking my reconciled system value of 5.6 million and dividing it by the system gross cost of the system of the 6-billion-331-million, and that comes up with a ratio of the system value to gross cost of .8955.

So in other words, 89.55 percent of their gross cost investment is represented by my reconciled system value.

So if you're trying to determine the contributory value of the exempt property to that system value, and multiply that ratio times the gross cost of the exempt property, so .8955 times that \$794 million, will get you the contributory value of \$710,960,271, and that is what I would deduct from the allocated Ohio value to result in the Ohio taxable value of this taxpayer.

H.R. at 865-866; Ex. J at 44. Eyre next deducted the \$710,960,271 contributory value of the exempt property, which led to a value of \$3,669,200,000.

Eyre's Review Appraisals of Reilly's Original and Amended Appraisals

The Commissioner hired Eyre to review both of Reilly's reports. Eyre stated that Reilly's cost approach was flawed in three major areas: (1) Reilly's improper use of RCNLD; (2) his improper deduction of functional obsolescence through the deduction for cost overruns; and (3) Reilly's improper deduction for economic obsolescence. As to his critiques of Reilly's income approach, Eyre said that they also fell into three major areas: (1) Reilly's improper selection of guideline companies; (2) his improper calculation of the WACC, including (a) improper adjustment for a size premium to the cost of equity; (b) an improper adjustment for property specific risk to the cost of equity; and (c) an improper adjustment for property tax; (3) Reilly's improper determination of net cash flow; and (4) Reilly's improper assumption in his income approach that the subject property has a finite useful life instead of the proper assumption that it will operate into perpetuity as required by the appraisal models. The final area covered was Eyre's critique of Reilly's treatment of Ohio property that was

exempt from tax. In that critique, Eyre said that Reilly improperly “deducted exempt property from each indicator of value rather than deducting the contributory value of exempt property from the allocated unit value.” Ex. J at 8.

Eyre on Blackstone

At the hearing, Eyre testified about the Blackstone transaction, which he argued was consistent with his appraisal, not Reilly’s appraisal. For example, Eyre focused on how the transaction was supportive of his income approach. It will be recalled that Blackstone purchased a 49.9% interest for approximately \$1.51 billion. That effectively gave Blackstone a 32.435% interest in Rover. H.R. at 161, 1071. Rover’s sole asset was the pipeline (and assets associated directly with the pipeline) and related contracts. H.R. at 1075. Eyre testified that based upon the amount paid by Blackstone, the implied value of Rover was at least \$4.8 billion. Eyre compared that amount to the \$5.1 billion valuation he calculated in his income approach, saying they were “pretty close” and explained the variance between them. He testified that the difference could be explained because Blackstone likely paid a discount. After all, it acquired a minority interest, an amount acceptable to Rover to maintain control. Eyre also noted the price was determined before the pipeline was fully operational, so an adjustment for the time value of money was in play. Eyre also suspected some appreciation in value from the date of the contribution to the tax lien date.

Eyre on Reilly’s use of VM&E

Eyre was critical of Reilly’s reliance on *VM&E*. That textbook set a foundation for Reilly’s argument that cost overruns created (or could create) functional obsolescence. Eyre testified that he was familiar with that volume but questioned Reilly’s reliance on it in the

current valuation. *VM&E*, Eyre said, is “typically relied on when you’re valuing separate pieces of machinery and equipment.” H.R. at 808. That treatise was not applicable, Eyre argued, when appraising a unit of assets functioning as an operating unit. H.R. at 808.

Eyre’s Review of Reilly’s Cost Approach: Improper Use of RCNLD

Eyre was critical of Reilly’s use of RCNLD in the cost approach, saying it was improper.

As support for that assertion, Eyre stated that

By an overwhelming majority, the most typical cost approach used by states who perform unit appraisals of regulated pipelines is Historical Cost Less Depreciation (HCLD). I performed a survey of unit appraisal states for the State of Minnesota. This survey discovered that 94% of the states who perform cost approaches in a unit appraisal performed a HCLD cost approach. The two states that did not perform HCLD (Michigan and New Mexico) performed Reproduction Cost Less Depreciation * * *.

Ex. K at 17. Regarding the RCNLD approach, Eyre cited the WSATA handbook, which provides the RCLD is unreliable for regulated utilities because earnings are “directly affected by net book value of existing property without regard to the current cost of a substitute new property.” Ex. K at 17.

Further, Eyre wrote that Reilly incorrectly calculated his replacement cost new. He supported that claim with an excerpt from *The Appraisal of Real Estate*, which provides that for the method to work, the *appraiser* must estimate “the cost to construct the existing structure and site improvements (including direct costs, indirect costs, and an appropriate entrepreneurial profit or incentive) using one of three traditional techniques[.]” Ex. K at 18. Those traditional techniques are the comparative-unit method, the unit-in-place method, and the quantity survey method. Ex. K at 18. Eyre indicated that Reilly’s RCNLD was improper because Reilly did not perform his own analysis using one of the traditional methods. Instead,

Reilly used cost estimates provided by Rover. Because, according to Eyre, the pipeline went into full commercial service less than two months before the appraisal date, the historical costs booked by Rover should be used.

Eyre's Review of Reilly's Cost Approach: Functional Obsolescence

Eyre also addressed (1) Reilly's treatment of excess capital (construction) costs, (2) the role played by a budgeted contingency to address unplanned circumstances, and (3) the percentage of a pipeline's construction budget that should, or would typically, be devoted to such a budgeted contingency amount. He challenged the concept that because Rover had been "over budget" it meant that it had necessarily incurred "excess capital costs" (part of functional obsolescence) in the pipeline's construction, saying that those two concepts are not necessarily the same.

It will be recalled that Reilly was told to use the amount of \$1.35 billion in his amended report as the excess construction costs and that, for purposes of his valuation, he assumed that amount to be an accurate representation of those excess costs. But Eyre questioned whether it was appropriate to consider all of the \$1.35 billion as "excess." Eyre testified that estimated costs were just estimated costs, and the difference between estimated and actual costs was best viewed as a budgeting error, not functional obsolescence. H.R. at 810. Eyre also stated the method was not a generally accepted appraisal principle. H.R. at 811.

Eyre also provided background on how contingencies are estimated for large projects like Rover, based on Eyre's experience as a regulator and consultant. In that regard, there can be planning and an appropriate budget allocation for the occurrence of unplanned events or costs. To determine the amount of the contingency budget, he said that a statistical probability

analysis (sometimes called a Monte Carlo simulation) should be undertaken to analyze negative events that could affect construction, e.g., weather issues, labor disputes, permitting problems, and environmental problems. H.R. at 812. Eyre explained that there could also be events that have a net positive effect and decrease costs. All of those considerations, Eyre testified, should have been considered when setting a proper contingency. H.R. at 812.

Eyre went further when he discussed the amount of contingency budgeting that might be appropriate. He testified that he had been involved with the TransAlaska Pipeline for five consecutive years and that the contingency in that case was as high as 35%-50%. Eyre argued that Rover should have established a larger contingency because the pipeline crossed many political jurisdictions and complex geographic elements like a river. H.R. at 812-813. “These are not excess capital costs,” Eyre said. H.R. at 874.

In further support of his view that the contingency budget for the pipeline was too low, Eyre referred to a draft report commissioned on behalf of Rover prepared by Lummus Consultants International, Inc. (“Lummus”) before the commencement of construction. The report was “a technical environment review of the project on behalf of the company’s potential lenders.” H.R. at 71. Eyre testified that the Lummus report showed the contingency was only 1.3% of the budget and 2.1% of uncommitted capital. Lummus estimated the contingency was too low. H.R. at 814. Eyre interpreted the Lummus report to provide that a minimum 10% contingency was appropriate. In further support of his position, Eyre testified that he agreed with Beth Hickey, Executive Vice-President of Commercial Operations who worked for ET in connection with its U.S. gas transmission team, that “the percentage of contingency for this project was unusually small.” H.R. at 815.

Eyre's Review of Reilly's Cost Approach: Economic Obsolescence

Eyre testified, consistent with his literature, that regulatory depreciation should not be adjusted to account for appreciation, other depreciation, or obsolescence in the HCLD approach. Eyre was also critical of the method used by Reilly in modifying the HCLD approach.

In his original review, Eyre explained that Reilly's method to determine economic obsolescence is commonly known as the income shortfall method. Eyre stated that an appraiser using the income shortfall method would take the difference between the income approach and the cost approach and subtract the amount from the cost approach. The two methods generally create the same opinion of value, more or less. H.R. at 643-644. Eyre stated that the method has been expressly rejected by many courts and tribunals and is not supported in traditional appraisal literature. Eyre relied on *The Appraisal of Real Estate*, which provides that external obsolescence should be measured using market data, capitalization of income loss, and market-extracted depreciation, none of which Reilly used, according to Eyre. Eyre asserted that each of those three methods requires that the appraiser "identify the negative influence and select either a sales price or an income stream of a property that is subject to the negative influence and compare this with a sales price or an income stream of a property that is not subject to the negative influence." Ex. K at 21. Eyre said that Reilly did not make such a comparison and, therefore, Reilly's deduction for economic obsolescence was improper. In addition, Eyre faulted Reilly for failing to test his assumptions about obsolescence with market evidence and sufficient empirical analysis. Eyre contrasted the method with his own HCLD, which he tested with market-to-book ratios for guideline companies.

Eyre's Review of Reilly's Income Approach: Reilly's Guideline Companies

Both Reilly and Eyre used guideline companies in their respective valuations. Those companies provided important information and guidance to both appraisers in areas including the typical capital structure (equity-to-debt ratio) in the oil and gas transmission industry, the industry beta relative to the general investment market, and other key industry financial indicators. Eyre acknowledged that there is an element of subjectivity in the selection of these guideline companies and that because “no two companies are identical or nearly identical,” “approximate” comparables must necessarily be used. Ex. K at 24.

Both Reilly and Eyre used entire unit, “unitary,” appraisals. Eyre distinguished unitary appraisals from more typical real property appraisals, saying that unitary appraisals more closely resemble business and securities appraisals. He claimed that within the subject’s industry class, the guideline companies that are selected should be as comparable as possible to the subject. Ex. K at 24-25.

Eyre asserted that the current trend in the industry was for companies in the oil and gas transmission arena to be structured as corporations. Ex. K at 26-27. He assumed, in forecasting cash flows, that the entity running the pipeline would pay income tax. H.R. at 843-844. Accordingly, all of Eyre’s selected guideline companies were income tax-paying corporations. Ex. K at 26. Based on that, Eyre was critical of Reilly’s selection of guideline companies, five out of seven of which were master limited partnerships. These partnerships, Eyre said, are tax-advantaged passthrough entities that do not directly pay state or federal income taxes. Ex. K at 26; H.R. at 844. As such, Eyre argued Reilly should not have used the

partnerships (or given as much weight to them) as his guidelines companies. Ex. K at 26; H.R. at 844.

Eyre's Review of Reilly's Income Approach: Reilly's Calculation of WACC – The Size Premium

Eyre asserted that Reilly made mistakes in three primary areas regarding his calculation of the WACC: (1) using an improper size premium for the cost of equity, (2) using an improper property-specific risk premium for the cost of equity, and (3) using an improper adjustment for property tax. as noted, Reilly used three models to determine the cost of equity: the CAPM-EX, the CAP-SS, and the BUM models as shown above. In each of those three models, he added a size equity risk premium of 1.6% and a property-specific risk premium of 4%. The addition of both of those premiums, of course, raised the cost of equity substantially.

Eyre first addressed Reilly's addition of a 1.6% size premium to the cost of equity and referred to what he described as "many studies" that disagree with the concept of the premium and say why such a premium should not be added to the cost of equity. H.R. at 853. One study cited by Eyre "outlines a number of problems with the data and the assumptions surrounding the adjustment [premium] for size." Ex. K at 28. For example, one theory is that the concept came to exist because of a mistaken understanding of the "January effect," which Eyre testified is a seasonal stock market anomaly occurring in early January. H.R. at 881; Ex. K at 28-29. The ripple effect stems from the fact that shares are commonly sold in December with January buybacks for tax loss harvesting and repurchasing. Eyre testified the phenomenon is less applicable to small caps than large caps. H.R. at 881; Ex. K at 28-29. Eyre also stated the perception came from other sources, such as the SBBI yearbook. But research about the SBBI yearbook, he said, showed that prior to 1982, the SBBI database did not include firms delisted

from various exchanges because they were performing poorly. Large stocks, Eyre said, “are not affected, because a disproportionate number of small firm’s” stocks are delisted for poor performance, making it appear that smaller stocks were proportionately riskier. But after 1982, that “delisting bias” was eliminated, and subsequent research showed that for the period of 1982 to 1986, “the small firm premium disappears and actually reverses and becomes a large firm premium.” Ex. K at 29.

In addition, Eyre says that Reilly appraised the pipeline assuming it was owned by a stand-alone company, which Eyre stated was obviously incorrect because it is a subsidiary of a quite large energy transmission company. Accordingly, Eyre indicated Rover benefited from its ownership structure and could “take advantage of the central management, synergies and economics of scale that result from being part of a large energy transmission company.” Ex. K at 29-30. As such, it was Eyre’s position that Reilly was wrong to include the premium.

Finally, Eyre quoted Answath Damodaran, PhD, as “one of the country’s most prominent academics regarding corporate finance and cost of capital.” Damodaran, Eyre said, “derided the size adjustment” for three reasons:

1. On closer scrutiny, the historical data, which has been used as the basis of the argument [to add a size premium], is yielding more ambiguous results and leading us to question the original judgment that there is a small cap premium.
2. The forward-looking risk premiums, where we look at the market pricing of stocks to get a measure of what investors are demanding as expected returns, are yielding no premiums for small cap stocks.
3. If the justification is intuitive, i.e., that smaller firms are riskier than larger firms, much of that additional risk is either diversifiable, better adjusted for in the expected cash flows (instead of the discount rate) or double counted.

Ex. K at 30; H.R. at 883-884. Accordingly, Eyre asserted that Reilly's addition of a size premium of 1.6% in his models was improper.

Eyre's Review of Reilly's Income Approach: Reilly's Calculation of WACC – The Property-Specific Risk Premium

As addressed above, each of Reilly's three models to determine the cost of equity had a 4.0% property-specific risk premium. The addition of that percentage, of course, raised the cost of capital under those models. Eyre asserted that Reilly's premium "is a totally arbitrary adjustment * * * and is not based on any empirical market evidence." Ex. K at 30. In his original review, Eyre wrote that

corporate finance texts are adamant that the risk that is measured in the estimate of WACC is known as business risk or systematic risk. This is the risk that you cannot diversify away * * *. Corporate texts are also adamant that the WACC should not include an adjustment for anything other than business or systematic risk. In the CAPM, this systematic risk is measured through the "beta" factor.

Ex. K at 31; H.R. at 884. "The beta factor," Eyre said, "measures the risk that's inherent in the industry that your subject property is in." H.R. at 884. Eyre argued that beta should capture those risks. Ex. K at 31. According to Eyre, the purported "risks" identified by Reilly are all business or systematic risks. Eyre argued any such risks should be addressed in the forecasted cash flows, not in the cost of equity. Ex. K at 31; H.R. at 884-885.

In his original review, he wrote that the income streams that Reilly capitalized and discounted on his amended report and those contained in Rover's 3-year plan are specific to Rover and capture property-specific risks. Ex. K at 31; H.R. at 854. That sufficiently accounts for the risk and, as Eyre concluded, Reilly's use of a "fudge factor to the cost of equity to supposedly account for the risk specific to the subject property would be double counting

because that risk has already been accounted for in the cash flow estimates.” Ex. K at 31-32; H.R. at 854.

Eyre’s Review of Reilly’s Income Approach: Reilly’s Calculation of WACC – Adjustment for Property Taxes

Eyre was critical of the manner in which Reilly adjusted for property taxes in connection with his WACC calculation. Eyre opined that Reilly made a property tax adjustment for this WACC since it was removed from future net cash flows. However, Eyre argued, the pipeline runs through numerous taxing districts with different rates. Eyre argued the approach was improper for a large unitary property because Reilly should have relied on estimates in Rover’s three-year plan. Eyre claimed that Reilly’s blended rate adjustment was “not appropriate for a large unitary property that runs through numerous states, counties, and taxing districts and is only appropriate where for single site properties or properties that run through a minimal number of taxing districts[.]” Ex. J at 33.

Eyre also claimed that Reilly improperly used a 25.7% effective income tax rate in part because approximately 80% of the pipeline is located in Ohio, which has no corporate income tax. Ohio’s excise tax, Eyre argued, is “based on a percentage of gross revenues” as opposed to a corporate income tax. Ex. J at 35. As such, Eyre claimed that Reilly’s effective income tax rate should not be used and that, instead, Eyre’s 21% rate should be considered the appropriate standard. Ex. J at 36.

Eyre’s Review of Reilly’s Income Approach: Economic Life of the Pipeline

Eyre also disagreed with Reilly’s assumption of a useful economic life of 29 years. Eyre argued the models are predicated on a perpetual useful life to establish present value. Eyre explained that Reilly’s appraisal was based on a unit valuation, which, Eyre said, “requires

valuing the subject property as a going concern.” Ex. J at 36. According to Eyre, the method assumes the operation will continue into perpetuity. Ex. J at 37. Eyre was further critical of Reilly because Reilly used accounting principles to establish useful life, which Eyre claimed was contrary to unit valuation principles. Eyre said that “the major asset of any pipeline is pipe in the ground,” although there are also assets above ground, including compressors, meters, valves, etc. While the above-ground assets will require maintenance and replacement, if the pipe in the ground is properly maintained, Eyre said it will “function indefinitely into perpetuity.” Ex. J at 37.

Using “in perpetuity” as the applicable timeframe, Eyre recalculated the values that Reilly had reached in both Reilly’s direct capitalization and DCF approaches. Under the perpetuity assumption, Eyre estimated Reilly’s direct capitalization valuation would have been \$3.685 billion (rounded) instead of \$3.591 billion (rounded). Similarly, Eyre recalculated Reilly’s DCF method and showed a difference of \$149,253,817

Eyre’s Review of Reilly’s Treatment of Exempt Property

As discussed above, at several points in his testimony, Reilly stated that he was told by counsel to assume, for purposes of his appraisal, that the value of the exempt property in Ohio was \$770 million. H.R. at 697. Reilly disclosed the assumption in his amended report. There, he stated he was instructed to use the amount because the Commissioner “allowed on the Ohio property tax returns of Rover approximately \$770.4 million in statutory exemptions.” Ex. 45 at 1. Eyre claimed that the exempt property cannot be valued this way and must be removed according to its contributory value to the unit. Reilly’s method was inconsistent with his overall unitary approach, according to Eyre, who relied on the *The Appraisal of Real Estate*.

Explaining further, Eyre wrote that “[s]ubtracting a cost approach value for exempt property from a unit income approach will violate unitary valuation principles because the cost approach value will not represent the contributory value from the unit value in the same manner by which the exempt property got into the unit value.” Ex. J at 38. Eyre stressed that his own approach using a market-to-book or market-to-cost ratio was widely considered the more reliable way to remove exempt property. Eyre explained how he determined that ratio to be 0.8955, as discussed earlier, and how that produced an Ohio exempt property implying a contributory market value of \$710,960,271 instead of Reilly’s assumed \$770 million value. Eyre concluded, therefore, that the \$770 million amount was incorrect.

Cornell

Credentials and Qualifications

The Commissioner also offered the testimony and reports of Professor Bradford Cornell, Ph.D., an emeritus professor of finance at the University of California, Los Angeles. H.R. at 1054-1055. He received his bachelor’s and master’s degrees from Stanford University. He also earned a doctorate in financial economics from Stanford. In addition to teaching, Cornell offers consulting services and is a senior advisor to two investment firms where he engages in financial valuation.

Cornell’s report shows he has extensive experience in his areas of expertise and has testified as an expert witness on numerous prior occasions. Cornell testified that “valuation has been the focus of [his] research, teaching, investment activities, and consulting for over 40 years.” H.R. at 1057. He testified that one of his specialties includes financial economic theory applied to valuation problems. H.R. at 1057. His report confirms that he has published

extensively in his field and has received numerous awards and honors. He testified that others had recognized him as a worldwide academic leader “in subjects related to applied corporate finance and valuation.” H.R. at 1059.

At this Board’s hearing, Cornell was qualified as an expert in four areas: (1) financial economics, (2) business valuation, (3) estimating the cost of equity, and (4) valuation of personal property. H.R. at 1067. Cornell prepared two documents in connection with the valuation of the pipeline. The first, dated March 4, 2022, was entitled “Rover Pipeline, LLC v. Ohio Department of Taxation, Expert Report of Bradford Cornell,” which we refer to as his original report. Cornell also authored a similarly titled amended report dated July 30, 2022, which was created in response to Reilly’s amended report. Cornell’s amended report was substantially the same as his original report, except that the amended report addresses Reilly’s revised numbers and methods.

As discussed further below, we find Cornell’s testimony and reports reliable and persuasive. Because we now discuss Cornell’s credentials, we must address a criticism leveled by Rover against Cornell related to “professional integrity.” Specifically, at this Board’s hearing, Cornell was cross-examined at length by Rover related to conduct in an earlier, unrelated case before the Delaware Court of Chancery. H.R. at 1139-1152. Rover attempted to attack Cornell’s credibility by raising questions about his professional ethics and integrity in that case. Having heard and observed Cornell’s testimony, we find the attacks on Cornell’s credibility unpersuasive. Cornell’s opinions were well supported, and his reasoning was logical and consistent.

Methodology

Cornell offered conclusions as to both the Blackstone transaction and Reilly's appraisal. Those conclusions were set forth succinctly at the beginning of his amended report. Based on his experience, analysis, and observations, Cornell opined that Reilly's appraisal was unsupported in numerous ways. More specifically, Cornell opined that Reilly's cost and income approaches were unreasonably low. Ex. T at 1.

Cornell agreed with both Reilly and Eyre that a unitary valuation of the property was appropriate because it captured "a combination of assets that, taken together, produce a cash flow stream that gives the property value[.]" H.R. at 1061. Cornell noted that he relied on his specialization in the cost of equity, which is also useful in corporate valuations. By "corporate valuations," Cornell said he meant "[a]n operating unit that produces cash flows." H.R. at 1062. He likened his work to the work done by firms like Blackstone when valuing assets. H.R. at 1065.

Despite Cornell's agreement with Reilly on the need for a unitary valuation, Cornell had significant criticisms of Reilly's appraisal, which, generally, were as follows:

- (1) Reilly's value conclusion was not consistent with market evidence;
- (2) Reilly's cost approach value conclusion was unreasonably low and, in particular,
 - (a) within the cost approach, his RCNLD was unreasonably low because it included an unsupported adjustment for functional obsolescence and
 - (b) within the cost approach, his RCNLD and HCLD methods produced unreasonably low values because they made inappropriate adjustments for economic obsolescence based on the income shortfall method.

(3) Reilly's cost of capital for the income approach was unreasonably high based on several factors, which are addressed further herein.

Cornell on Reilly and the Blackstone Transaction

Before he addressed the above criticisms of Reilly's valuation, Cornell first analyzed the Blackstone transaction. Cornell said he was very familiar with Blackstone, saying that many of his former students and colleagues from UCLA were or are employed by Blackstone. He referred to Blackstone as "very sophisticated," and he emphasized Blackstone's reputation for business savvy. Cornell firmly argued that the transaction "implied a minimum value" of at least \$4.66 billion with actual value in the \$5 billion range. H.R. at 1068-1069. He stated that the figure would represent "the floor" for valuation purposes. H.R. at 1069. Cornell said that the implied sale price of \$4.66 billion for the operating entity was also the value of the pipeline itself. He testified, "Rover Pipeline is the totally dominant asset [of the operating entity]. These entities [limited liability companies, etc.] that hold it are necessary for legal and maybe tax purposes and other things, but the value-generating asset is 99.9 percent the Rover Pipeline. So this distinction between a business [entity] and the pipeline and all, economically, is irrelevant." H.R. at 1094. "The entities," Cornell testified, "obtain their value from the pipeline[.]" H.R. at 1123. Cornell also testified he reviewed the contribution agreement, which he believed confirmed his opinion. He testified as follows:

Blackstone is an investment firm. They're looking to make a reasonable return on their equity and they were purchasing a fraction of the cash flows produced by the entity that owned the Rover Pipeline and for an amount of either -- I don't want to get hung up on this question -- of either 1.571 billion or 1.511 billion, there was a timing adjustment, but for those amounts Blackstone purchased approximately 32.4 percent of the cash flows that would be thrown off by the entity that owned the Rover Pipeline.

H.R. at 1070. He also testified as follows:

Blackstone produced an entity called BCP Renaissance LLC and they purchased 49.9 percent of an entity called ET Rover Pipeline LLC, and that, in turn, owns 65 percent of the Rover Pipeline LLC. That is the entity that collects and throws off the cash flows. So the money flows back to Blackstone via ET Rover Pipeline. And if you multiply 49.9 by 65, that's where you get the 32.4 percent of the cash flows that they purchased.

H.R. at 1071.

Cornell went on to explain the financial reasoning behind Blackstone's purchase. Cornell focused on the purchase of the property that is generating cash flows. H.R. at 1079 ("The economic -- economically what matters [to Blackstone] is cash flow. If I'm Blackstone, I want to know how many dollars I'm spending and what I'm getting back in dollars for those dollars. And Blackstone is going to be aware that it has to pass through an entity or two for legal and negotiating reasons and things that ET wants, but they [Blackstone] recognize effectively they're buying 32.44 percent of the operating pipeline and the contracts and the cash flows that that's going to throw off."). At a minimum, Cornell said Blackstone paid \$1.511 billion for the rights to the cash flows in a transaction that Cornell stated was economically "a very simple transaction." H.R. at 1072.

Cornell then explained why he opined that the \$4.66 billion represented the floor and was likely on the lower end of the value spectrum. He explained two specific reasons. First, Cornell stated his view was based, at least in part, on the fact that Blackstone purchased a minority interest and control has value. The ownership split (49.9% v. 51.1%), Cornell argued, makes little economic difference, but it made a substantial difference in terms of legal control. Cornell testified the contribution agreement makes clear ET negotiated to retain control while still seeking to obtain a partner. Cornell emphasized that control has value, and ET wanted

control, which Cornell believed Blackstone gave ET for a “somewhat lower price.” H.R. at 1082-1083. Cornell also emphasized that Blackstone’s minority ownership was illiquid. H.R. at 1082-1083.

But there was a second reason for Cornell’s belief that the imputed value was on the low end of the range of possible values: the time value of money. As he testified:

The other [reason] is, Blackstone isn’t interested in building pipelines, they’re interested in investing in cash flows, and their -- we’re valuing the pipeline as of December 31st, 2018, when it’s much closer to full operation. The deal was negotiated back in 2017, so there’s going to be a timing difference and that timing difference would be increased value. Because value increases over time, you get closer to the cash flows. So, for that reason, the Blackstone number would also be a lower bound. So I saw 4.66 [billion] as being a very reasonable lower bound on valuation in this case.

H.R. at 1083. In other words, the pipeline value increased, and as completion drew near, the risk of loss of cash flows decreased.

Cornell questioned some of the reasoning that Rover used to attack the validity of the Blackstone transaction as a measure of value. For example, ET’s CFO testified earlier in the hearing that the total unit value of the subject property was closer to \$2.559 billion. H.R. at 162. Cornell found the CFO’s argument to be clearly erroneous because a sophisticated investor like Blackstone would never pay such a price for substantially less of the cash flows. H.R. at 1089. Cornell testified that the CFO’s value made no sense in a commercial marketplace with a knowledgeable buyer. Cornell testified as follows:

Wait a minute. Blackstone, one of the most sophisticated investment firms in the world, is paying 60 percent of the fair market value [60% of the CFO’s \$2.559 billion alleged value] to get 32.4 percent of the cash flows. That absolutely would not happen at Blackstone. If they were paying 32.4 percent, they’d want that to be 32.4 percent of the fair market value, which is how you get to the 4.66. So this simply cannot be right. It does not tell you what the error is, but it tells you there’s got to be an error. This is a flapping red flag.

H.R. at 1089-1090. In short, the financial math simply would make no sense for a sophisticated investor like Blackstone.

Cornell also dismissed the CFO's characterization of the sale as a financing transaction and not a sale of equity. Cornell criticized the CFO for "playing with words" in a self-interested manner and not accurately framing the substance of the transaction. Cornell argued that if the CFO was attempting to imply the sale was a financing transaction "like a bond issue or a borrowing, that [was] clearly not the case." H.R. at 1097. This is so, Cornell stated, because the transaction lacked the hallmarks of a standard financing transaction of the kind referenced by the CFO because there was no indenture, set interest rate, promised payments, or maturity date. H.R. at 1097.

Cornell also incorporated his opinions of the Blackstone transaction into his review of Reilly. For example, Cornell challenged the fact that Reilly's cost of equity did not align with testimony from ET's CFO on the projected rate of return. Cornell testified that Blackstone's projected rate of return on its equity purchase was closer to Eyre's estimated cost of equity than it was to Reilly's. Rover had projected a 12% return on equity, which was close to Eyre's cost of equity at 12.5%. The CFO testified that ET's forecasts expected a return of 12%, which Cornell noted was out of step with Reilly's 15.4% figure. In commenting on the difference between the projected 12% return and Reilly's 15.4%, Cornell testified:

When you say a 12 percent return, I want to be very precise here because this is important. They [Blackstone] estimated that they would earn a 12 percent rate of return. They recognized there was some risk. There could be, you know, problems with the line or a contract, a shipper could go bankrupt, but they felt their 32.4 percent interest would translate into a 12 percent return on equity for them, which is substantially south of Mr. Reilly's 15.4 percent estimated cost of

equity. And it's a little bit north, though, of Mr. Eyre's. It's very close to Mr. Eyre's, as I recall.

H.R. at 1099.

Cornell further said that Reilly's total unit valuation of \$3.3 billion did not comport with Rover's motivations nor make financial sense. Cornell explained that Rover had projected its costs at \$4.209 billion, and Cornell stated that a developer like Rover would need to make a fair rate of return on its efforts. Cornell emphasized Rover had to anticipate a return "significantly north" of \$4.2 billion so as not to lose money in the long term. H.R. at 1103. From there, Cornell turned to the promote. Cornell explained the "promote" as "whenever a development company develops something, they have something called a 'promote' which is what they think the market value is going to be when it's finished and ready to move in into the house or ready to start shipping gas in the pipeline." H.R. at 1086. He indicated that value was initially \$600 million. H.R. at 1086. Cornell analogized the "promote" to a builder's profit when they build a house when he stated:

[I]f they build a house for a million dollars and that's their cost that they put in while they were building the house, they're [the developer] not going to put it on the market for a million dollars, they'd lose the time value [of money] and have no profit for their entrepreneurial efforts.

H.R. at 1086. He testified that the promote in Rover's case was \$600 million, which, added to Rover's construction costs, shows that, at a minimum, the value of the pipeline to be \$4.8 billion, not the \$4.2 billion estimate, and certainly not Reilly's \$3.3 billion estimate. H.R. at 1085-1086. Cornell was critical of Reilly for making no effort in his amended report to reconcile the value implied by the Blackstone transaction with his conclusion of value or to reconcile his report with the rate of return estimates crafted by Blackstone and ET.

Cornell on Reilly's Cost Approach and Functional Obsolescence

Cornell criticized Reilly's obsolescence adjustments in his HCLD and RCNLD calculations. According to Cornell, Reilly's "estimates of value under the Cost Approach suffer from defects resulting from the inclusion of inappropriate adjustments for purported obsolescence." Ex. T at 7. Without those inappropriate deductions, Cornell said that Reilly's cost approach estimates were "comparable to Mr. Eyre's estimate of value under the" cost approach. Ex. T at 8.

Cornell began his review of Reilly's RCNLD method by opining that the method was rarely used as a method "to value a complex going concern because of the difficulty in determining replacement cost new" and is "an inappropriate methodology to estimate the value of regulated utilities." Ex. T at 8. As had Eyre, Cornell considered it an unreliable indicator for a regulated interstate natural gas pipeline. Cornell also noted that most of the costs of construction occurred in 2017-2018, and the closeness of the expenditures to the tax lien date undercut the utility of the RCNLD method because the initial costs are essentially the HCLD. In other words, the RCNLD provides little probative information that cannot be ascertained from the HCLD.

Cornell then discussed that in Reilly's original report, he listed \$2.0 billion as the fiscal obsolescence figure for construction cost overruns but changed that amount in his amended report on the instructions of counsel. He noted that in his amended report, Reilly did not reconcile the difference between those amounts. Cornell emphasized that the purported cost overruns were recorded on Rover's balance sheet and included in the book value of Rover's property. Further, Cornell stated as follows:

The cost overruns were not written-off when they were incurred and no write-off associated with those costs is reflected on Rover Pipeline LLC's balance sheet as of December 31, 2018. In essence, Rover Pipeline LLC's balance sheet treats these costs as contributing to the value of the Rover pipeline.

Ex. T at 9. In other words, at the same time that Rover's books reflected that the purported cost overruns contributed value to the pipeline, Reilly claimed the contrary, that the cost overruns constituted functional obsolescence and should be deducted from value. As stated by Cornell, notwithstanding the handling of the "cost overruns" in Rover's books, Reilly assumed "that the purported cost overruns add no value to the pipeline and would be completely avoided if the project was 'replaced new.'" Ex. T at 9.

Further, Cornell was critical of the fact that Reilly performed no analysis to support his assumption that these were truly cost overruns that did not contribute to value. For example, Cornell stated in his report that Reilly performed:

[N]o analysis demonstrating that the original construction budget was reasonable and adequately addressed uncertainties in weather or regulatory matters. * * * [Reilly did] not compare the construction cost of Rover pipeline to other pipelines, etc. Accordingly [Reilly did] not provide a reasonable basis to exclude costs in excess of the original budget in the analysis of replacement cost new and the \$1.359 billion reduction for functional obsolescence is not supported or warranted.

Ex. T at 10. Cornell testified later that by deducting excess costs, Reilly seemed to be saying:

Oh, I could have built this [the pipeline] for 4.2 [billion]. But he hasn't shown that to be the case. You have to show that that \$1.36 billion [in excess costs] was spent but added no value to the final pipeline. And I just don't see the analysis.

H.R. at 1113. Given the contrary treatment of the cost overruns on Rover's books, and Reilly's lack of any analysis of construction budgets or costs by other pipeline companies, Cornell

reasoned that there was no factual support to exclude those purported cost overruns as functional obsolescence.

Cornell on Reilly's Economic Obsolescence Numbers and Income Shortfall

Cornell was critical of Reilly's economic obsolescence figures; Cornell classified Reilly's method as income shortfall, which is not a "generally accepted economic obsolescence method." H.R. at 646. All experts agreed in principle that the income shortfall method is improper, but Cornell (and Eyre) maintained Reilly's method was income shortfall because Reilly reduced value in his cost approach using his WACC from his income approach. Ex. T at 15.

Cornell wrote that there were numerous problems with the method, including that it conflates the approaches, and both become dependent on the occurrence of the WACC estimate. Ex. T at 10-11. Cornell explained that one of the benefits of the cost approach is that it answers the question of what it costs to build the pipeline without requiring more complicated calculations like determining the WACC. Cornell indicated it was generally accepted that the cost approach was "easier" and did not require additional and "controversial" adjustments. H.R. at 1115. Cornell went on to explain that the method hybridizes the two approaches by making the WACC a foundational piece of the cost approach calculations. He explained:

If you start infecting it [the cost approach] with the WACC, now you're going to lead to -- there's going to be disagreement and maybe the WACC is wrong. I think the WACC is wrong [in this case] for reasons that I'll say in a moment. But that's why you don't want your cost approach to turn into an income approach because we'll have to argue those things when we weight the income approach.

H.R. at 1115. Cornell testified that since the WACC is used in both approaches, if the WACC determination is incorrect, then both approaches will be wrong. To make his point, Cornell reviewed Reilly's RCNLD and HCLD calculations in detail and said that without rounding, both the RCNLD and HCLD methods used by Reilly "result in the identical" total unit value. Ex. T at 12. Cornell said that, as used by Reilly, those two approaches "are not dependent on cost data, but rather are solely dependent on the net cash flows and [Reilly's] yield capitalization rate." Ex. T at 12.

Cornell on Reilly's Income Approach

Cornell believed that Reilly's DCF approach produced a cost of capital that was unreasonably high. He explained that the DCF approach again attaches value to cash flows. Ex. T at 16. Cornell's most significant disagreement with Reilly's DCF approach was Reilly's addition of a size risk premium of 1.6% and a company-specific risk premium of 4.0% to the cost of equity capital. H.R. at 1116-1117. He described the addition of those two premiums to the cost of equity as "the big issue." H.R. at 1125. If those two additional risk premiums were removed, Cornell said, then Reilly's ultimate value conclusions would be close to Eyre (specifically his income approach) and Blackstone. H.R. at 1117.

Cornell understood the size risk premium of 1.6% for Rover's smaller size (relative to larger publicly traded companies) added by Reilly to the cost of equity and said that the finance literature "has turned against there actually being a size premium." H.R. at 1118. If size alone mattered regarding the cost of equity, he reasoned, we would see firms combining smaller companies to lower their discount rates. It was Cornell's opinion that, even if a size premium

was permitted in some cases, it could only be considered at the level of the parent company issuing securities. H.R. at 1118; Ex. T at 26-27.

Cornell also derided the addition by Reilly of a 4.0% property-specific risk premium to the cost of equity, adding that when he saw it in Reilly's calculations, he thought of tennis player John McEnroe's catchphrase, "You cannot be serious." H.R. at 1119. "The addition of a company-specific risk premium, particularly one as large as four percentage points, contradicts finance theory, empirical practice, and common sense." Ex. T at 27. Among other things, Cornell said that Reilly provided "no benchmark as to whether these [property-specific] risks are small or large relative to other firms." Ex. T at 28. "Without any meaningful comparison [Reilly] simply asserts that a 4% firm specific premium is required." Ex. T at 28.

Cornell explained his thinking on the issue that the Rover pipeline is a low-risk endeavor that does not warrant an additional 4% property-specific risk premium. He testified to the following:

[F]irst of all, the theory says you're not supposed to add that [a company-specific risk]. But put aside the theory. If you wanted a company-specific risk premium because of the nature of its business, here we're talking about a pipeline company or a pipeline with contracted payments. Compare the risk of that with, let's say, Rivian, which doesn't know if it can make its cars, or Moderna which doesn't know if it can develop new medicines. I mean, if you wanted anything company-specific, I would think it would be a deduction and not an addition, because this is about as low risk as you can get compared to many American companies.

H.R. at 1119-1120. Emphasizing the pipeline's low risk, he supported his position by citing the fact that Rover was a "fully subscribed, contracted pipeline, for a product that America needs, quite frankly." H.R. at 1120. Cornell testified that "[n]ot only is its revenue stream largely locked in [with shippers' contracts], but it faces minimal risk" from competitors. Ex. T

at 28. Further, he said that whether Rover obtained the shipper's contracts on the assumption that the pipeline would cost the budgeted \$4.2 billion versus the actual costs of \$6.3 billion was irrelevant because it only matters that they were actual contracts with almost guaranteed cash flows. H.R. at 1120.

Having discussed the general outline of Cornell's position, we also note additional (and sometimes theoretical) positions articulated for Cornell that go to Reilly's high equity risk premium. Cornell explained there has been "[a] decline in the U.S. equity risk premium over the last several decades" due to market regulations, mechanisms to prevent market manipulations, and more conservative investment strategies used by an aging population willing to accept lower returns for lower risk. Ex. T at 20-21. In his amended report, Cornell cited a number of studies showing that decline. One study showed that the equity risk premium cited in 150 textbooks on corporate finance between 1979 and 2009 showed "a decline in the 5-year moving average of the equity risk premium cited in those textbooks from 8.4 percent in 1990 to 5.7 percent in 2008 and 2009." Ex. T at 22. A second study showed survey results of the equity risk premium in 81 countries, proving "the average risk premium in the United States for 2020 and 2019 was 5.6 percent, substantially below estimates of the equity risk premium based on historical market returns." Ex. T at 21. Accordingly, in light of these documented trends in equity risk premiums, historical data, as used by Reilly, does not carry the same utility it once did, according to Cornell.

In support of that view on the diminishing utility of historical equity risk premium data, Cornell also cited the work of Damodaran, who compiles annual reports on the subject. Cornell classified those reports as "the most widely downloaded documents on the" subject

in the world. Ex. T at 22. According to Cornell, Damodaran claims that the appropriate solution to determining an accurate equity risk premium “is to use a forward looking” or implied premium instead of historical data. In his report, Cornell wrote that “[i]n essence, historical results are no more applicable to current market conditions than results achieved in the past by an aging athlete who is now nearing retirement.” Ex. T at 22. Based on a comprehensive, forward-looking analysis conducted by Damodaran, Cornell wrote that as of January 1, 2019, “the long run U.S. stock market expected return was 8.64 percent and his estimate of the [equity risk premium] was 5.96 percent.” Ex. T at 23. Finally, in further support, Cornell cited the fact that Duff & Phelps, a widely respected market source, considered Damodaran’s work as one of the factors in “deciding to lower its recommended” equity risk premium. Ex. T at 24.

Based on the above studies and analysis, Cornell’s argument was that Reilly’s equity risk premium was unreasonably high because none of the CAPM models Reilly used to determine the cost of equity “provide an implied, forward-looking measure of the [equity risk premium] based on market conditions as of December 31, 2018.” Ex. T at 24-25. For example, the CAPM-EX and CAPM-SS use or at least consider historical data. In essence, Cornell argued that the historical data on which Reilly based his calculations fails to capture the lower equity risk premium movement in the marketplace in more recent times. Here again, Cornell articulated his belief that if Reilly had adjusted that portion of his report, it would be consistent with Blackstone and Eyre’s income approach.⁸

⁸ During rebuttal, Rover also called Professor Heaton as an expert to offer “comments” related to Eyre’s appraisal. Because he was called as a rebuttal witness, we do not summarize his comments with the other experts. Instead, we address his contentions as we see fit below in our analysis.

STANDARD OF REVIEW

This Board reviews the Commissioner’s findings de novo, and those findings are presumptively valid, subject to rebuttal. *Accel, Inc. v. Testa*, 152 Ohio St.3d 262, 2017-Ohio-8798, 95 N.E.3d 345, ¶¶ 13-14. The Ohio Supreme Court has held the taxpayer’s burden “is simply to prove the findings were incorrect.” *Id.* at ¶ 14. The *Accel* Court rejected the argument that greater deference is required when it held as follows:

For the foregoing reasons, we reject the tax commissioner’s second proposition of law. We hold that the BTA owed no deference to the tax commissioner’s findings beyond placing the evidentiary burden on the taxpayer, Accel, to show them to be, by a preponderance of the evidence, incorrect. And in reviewing the BTA’s own factual findings, “[w]e must affirm * * * if they are supported by reliable and probative evidence, and we afford deference to the BTA’s determination of the credibility of witnesses and its weighing of the evidence subject only to an abuse-of-discretion review on appeal.” *HealthSouth Corp. v. Testa*, 132 Ohio St.3d 55, 2012-Ohio-1871, 969 N.E.2d 232, ¶ 10.

Accel at ¶ 16. In interpreting the law, our role is to “provide a fair reading of what the legislature has enacted: one that is based on the plain language of the enactment and not slanted toward one side or the other.” *Stingray Pressure Pumping, L.L.C. v. Harris*, 172 Ohio St.3d 130, 2023-Ohio-2598, 222 N.E.3d 597, ¶ 22.

As a fact finder, the Board is obliged to review all relevant evidence and make sufficient findings for consideration by a reviewing court. *See, e.g., Satullo v. Wilkins*, 111 Ohio St.3d 399, 2006-Ohio-5856, 856 N.E.2d 954, ¶ 14, quoting *Am. Natl. Can Co. v. Tracy*, 72 Ohio St.3d 150, 152, 648 N.E.2d 483 (1995) (“But ‘[t]he BTA is responsible for determining factual issues and, if the record contains reliable and probative support for these BTA determinations,’ this court will affirm.”); *see also Lutheran Social Servs. of Cent. Ohio Vill. Housing, Inc. v. Franklin Cty. Bd. of Revision*, 150 Ohio St.3d 125, 2017-Ohio-900, 79 N.E.3d 541, ¶ 12 (“[T]he BTA must engage

in sufficient discussion of the evidence to permit the court on appeal to determine whether the BTA acted reasonably and lawfully.”).

This case presents a classic “battle-of-the-appraisals” dispute, and our main responsibility is to “weigh evidence and assess the credibility of the appraisals.” *Lowe’s Home Centers Inc. v. Washington Cty. Bd. of Revision*, 154 Ohio St.3d 463, 2018-Ohio-1974, 116 N.E.3d 79, ¶ 30. We have long recognized that appraisers must make various subjective judgements in appraising property and in selecting relevant data to form a reliable opinion. *See, e.g., Cyclops Corp v. Richland Cty. Bd. of Revision*, BTA Nos. 1982-A-566, et al., 1985 Ohio Tax LEXIS 500 (May 30, 1985). The appraisal of property is not a science but is instead an opinion. *Snyder v. Hamilton Cty. Bd. of Revision*, BTA No. 2018-6, 2018 Ohio Tax LEXIS 2155 (Nov. 14, 2018). We weigh many factors, including an appraiser’s credentials, the data relied upon, the presentation of the data, and other factors that may render an appraisal more or less reliable. *Armco Inc. v. Richland Cty. Bd. of Revision*, BTA No. 2003-A-1058, 2004 Ohio Tax LEXIS 1917 (Nov. 19, 2004). We also consider the testimony provided by the appraiser, and we look to see if the report is consistent with and supportive of the testimony. We also consider demeanor in testifying and the appraiser’s candidness. This Board will further consider if an appraiser complied with generally accepted appraisal principles and professional standards. *Worthington City Schools Bd. of Edn. v. Franklin Cty. Bd. of Revision*, BTA No. 2020-2234, 2023 Ohio Tax LEXIS 1248 (Aug. 15, 2023). However, deviations from such principles and norms can be justified and ultimately go to the weight of the appraisal. *See Columbus City Schools Bd. of Edn. v. Franklin Cty. Bd. of Revision*, 148 Ohio St.3d 499, 2016-Ohio-7466, 71 N.E.3d 988, ¶ 26 (“[W]e have already rejected the assertion that the USPAP imposes legally binding limitations on the

evidence that may be considered by the tax tribunals when valuing real property for tax purposes.”); *see also* *Lowe’s* at ¶ 27 (“The bare fact of such violations [of USPAP] does not by itself make it unlawful to adopt a particular appraisal * * *.”). In this case, specifically, the Board has already notified the parties that the primary focus will be directed to the appraisers’ reports. *Rover Pipeline v. Harris*, BTA No. 2020-1540 (Interim Order, Sept. 19, 2022). Indeed, as outlined below, several experts expressed oral opinions not rooted in their reports, and we discount those opinions, especially when the reports contain no data to support the oral opinions.

ANALYSIS

Reilly’s opinion of value cannot be reconciled with the Blackstone transaction or actual costs of construction. Eyre’s opinion of value can be reconciled with both.

Background

We judge appraisals not only on the appraiser’s methodology and selected data but also against outside clues that guide our review. In this case, we find two important clues: the Blackstone transaction and actual construction costs.

The first clue is the Blackstone transaction. There are few statements in Ohio tax valuation law more established than this: a recent and arm’s-length sale is the best evidence of a property’s true value. It was long the rule in real property valuation cases that a recent and arm’s-length sale was conclusive evidence of value. Sales can serve purposes other than creating presumptions. For example, a sale can serve as a check when a factfinder needs to see if an indicated appraisal value is reliable. A sale of property can also take different forms. For example, a sale price can remain reliable evidence of value despite the fact the parties effectuated the transfer with a sale of a membership interest. *Columbus City Schools Bd. of Edn.*

v. Franklin Cty. Bd. of Revision, 159 Ohio St.3d 283, 2020-Ohio-353, 150 N.E.3d 877 (“*Palmer House*”). A sale price can also remain probative despite the allegation that other, nontaxable property was transferred in the sale. *Cincinnati Schools Dist. Bd. of Edn. v. Hamilton Cty. Bd. of Revision*, 151 Ohio St.3d 109, 2017-Ohio-7650, 86 N.E.3d 308.

The Blackstone transaction is similarly a very important clue but not dispositive evidence of value. The most credible testimony we have analyzing the Blackstone transaction comes from Cornell, but Cornell testified the transaction should be seen as creating a floor with an upward range given the specific circumstances surrounding the sale.

Likewise, it cannot be disputed that actual costs are highly probative evidence of value for new and special purpose property. Both appraisers agreed historical costs are highly relevant. Reilly testified that actual costs translate to actual value for a new asset between 95%-99% of the time. Eyre emphasized the importance of actual costs because transmission companies are regulated entities. This pipeline was in its infancy on the tax lien date, so actual costs guide our review of the appraisals, and the parties must present supported arguments to show actual value is substantially below (or above) actual costs.

Here, while we find the Blackstone transaction and actual costs provide us with general guideposts, they are not themselves conclusive for several reasons, all of which we address in greater detail below. Actual costs must still be adjusted, at a minimum, for physical depreciation, as even Eyre recognized. Moreover, even Eyre acknowledged the cost approach may not capture the complete picture of value for an integrated unit, which is why he also utilized the income approach.

The two measures are best seen as guideposts, which is how we utilize them. We reject the argument that both measures are useless because no party advocated for the strict adoption of those values, which is an argument that appears in the briefs. *E.g.*, Reply at 9 (arguing the Blackstone transaction has no probative value in light of the findings by each appraiser). Our role in valuation cases is to weigh evidence independently based on all the evidence before us and to render a decision based on the best and most persuasive evidence of value wherever we find it. *Columbus City Schools Bd. of Edn. v. Franklin Cty. Bd. of Revision*, 151 Ohio St.3d 458, 2017-Ohio-5823, 90 N.E.3d 846 (collecting cases stating we must independently weigh all the evidence in the record).

The Blackstone transaction established a floor for value, and Reilly's opinion of value is well below the floor.

The Commissioner introduced evidence, primarily through Cornell but also through Eyre, that based on Blackstone's partial equity purchase in ET Rover, the imputed value of the pipeline and associated property established a floor of between \$4.6-\$4.8 billion, depending on the adjustment addressed above. Cornell was critical of Reilly for failing to reconcile the transaction with his valuation, which was substantially different. Reilly offered several responses to that criticism. First, he said that USPAP did not require it; however, even if that is true, there should have been some analysis in the report explaining why such an important financial event had no probative value. We also fault Eyre for failing to do a more thorough analysis of the transaction, although Eyre testified about his analysis and the impact of the transaction, which was at least consistent with his value. This Board has repeatedly stated that an appraiser must make an effort to discuss recent transfers of the property and the impact on the appraiser's opinion of value. *See, e.g., Scott Holding Co. v. Stark Cty. Bd. of*

Revision, BTA No. 2020-59, 2021 Ohio Tax LEXIS 2789 (Nov. 23, 2021). Notwithstanding, only one appraisal is consistent with the transaction, Eyre's appraisal.

Reilly and Rover had other arguments to attack the utility of the Blackstone transaction as a measure of value. In particular, Reilly argued that the Blackstone transaction was not an appropriate measure of value because (1) Blackstone purchased a membership interest, not the pipeline itself, and (2) there was a time lag between the date the Blackstone transaction was consummated and the tax lien date, which made the transaction an invalid indicator of value. We find neither argument persuasive in light of existing case law.

We take those arguments in order. Reilly argued that part of the reason the Blackstone transaction was not a valid indicator of value was because Blackstone did not purchase the subject property but instead a membership interest. H.R. at 1422. Reilly went further and testified that "the sale of an entity that owns the subject property is not relevant to me." H.R. at 1423. He claimed the contribution agreement "related to several corporate entities and several corporate levels above the entity that owns the subject property certainly is not relevant to an appraisal of the subject property." H.R. at 1429-1430. Rover's brief parrots Reilly's argument when it states the "transaction does not provide a value indicator for the Rover pipeline because it does not involve a sale of the pipeline," but rather a sale of an equity interest. Reply at 8.

We disagree with Rover and Reilly and find that the Blackstone transaction did, in fact, have relevance to the value of the subject property. Reilly is certainly correct (and no party disputes) that there was no sale of the subject property apart from the contribution. There is

also no dispute that the transaction occurred at the level of ET Rover, the entity that owned Rover. But that is not the end of the matter.

It will be recalled that Blackstone purchased a 49.9% interest in ET Rover, which, itself, owned a 65% interest in Rover. Multiplying Blackstone's 49.9% interest in ET Rover by ET Rover's 65% interest in Rover gave Blackstone an indirect interest of 32.435% in Rover and its cash flows. H.R. at 161, 1071.

ET's CFO was familiar with the structure and terms of the Blackstone transaction and testified that ET Rover's *sole asset* was a 65% ownership interest in Rover. Other testimony revealed that Rover's *sole asset* was the operating property and contracts to use the operating property. Thus, there is a straight line between Blackstone's purchase of an interest in ET Rover and the pipeline. When Blackstone purchased its interest, it was effectively purchasing an interest in the pipeline. ET's Adam Arthur was involved in negotiating with Blackstone and made the connection clear. In his deposition testimony, he testified as follows:

Q: Okay. So then ultimately Blackstone paid just over \$1.51 billion for a 32.44 percent interest in Rover Pipeline, LLC; is that fair?

A: That's correct.

H.R. at 1075-1076; Ex. M, Attached Deposition at 20.

We have no doubt about what was going on here. Indeed, ET invited potential partners to negotiate because ET had a history of building and operating successful *pipelines*, not limited liability companies that happen to own pipelines. Cornell credibly testified that the agreement showed Blackstone paid \$1.5 billion for property to gain access to cash flows. H.R. at 1072. Those referenced "cash flows" were produced by the subject property, the pipeline. The pipeline created the value that flowed "north" to Rover, ET Rover, and Blackstone.

We are also persuaded by Cornell's testimony and his report, which show it makes no economic difference that there were corporate layers or that those layers affected, enhanced, diminished, or diluted those cash flows. In his original report, he stated that he was asked by the Commissioner to provide an "opinion regarding whether the July 2017 [Blackstone] transaction *** provides relevant information regarding the true value, as defined by the Ohio Administrative Code, of Rover Pipeline LLC's operating property as of December 31, 2018."

Ex. M at 1. Cornell is an expert in the valuation of personal property, and he argued that

Based on my experience and the analysis and observations in this report, the ETO/Blackstone Transaction provides relevant information regarding the true value of Rover Pipeline LLC's *operating property* as of December 31, 2018. Furthermore, the transaction supports the conclusion that the true value of Rover Pipeline LLC's operating property was at least \$4.66 billion as of December 31, 2018.

Ex. M at 1. Cornell was careful to note that the imputed value from the Blackstone transaction implied true value for the pipeline as completed. Ex. T at 6-7.

The second leg of Reilly's challenge to the validity of the Blackstone transaction as a measure of value was based on the time lag between the closing of the Blackstone sale in July 2017 and the tax lien date of December 31, 2018, almost 18 months later. Reilly argued the gap was meaningful in large part because the pipeline was not fully completed by the sale date. H.R. at 1425-1426.

There are a few problems with this response. Reilly is certainly correct that the physical aspects of the pipeline changed between July 2017 and December 31, 2018. What Reilly seems to be implying is that the purchase amount paid by Blackstone in July 2017 was invalid as a value indicator because the pipeline changed in condition during the gap. Reilly's arguments on this point are unpersuasive for a number of reasons.

First, the case law is well-established that temporal proximity is only one factor to be considered in a recency analysis. *Cummins Property Servs., L.L.C. v. Franklin Cty. Bd. of Revision*, 117 Ohio St.3d 516, 2008-Ohio-1473, 885 N.E.2d 222. As explained repeatedly by Cornell, who we credit with having a thorough understanding of this market and the thinking and motivations of sophisticated investors, Blackstone negotiated and purchased an interest in a completed pipeline because of its income-generating potential, not in a partially completed pipeline with limited or no cash flows. An income-generating property is the key for the investor, and the entire income approach is based on such an assumption. Cornell persuasively contradicted Reilly's position when Cornell stated, "Blackstone was investing in a completed pipeline." H.R. at 1195. The contribution agreement made clear, Cornell argued, that Blackstone was not looking to be an operator or development partner. It paid for a completed pipeline that it knew would generate cash flows. H.R. at 1195. Cornell argued his belief was confirmed by the fact the pipeline was the sole or overwhelmingly predominant asset. He discerned this fact from Rover's financial statements. He testified as follows:

Q. And from a review of that document, are you able to tell if Rover Pipeline LLC's sole significant -- sole operating asset was the Rover Pipeline?

A. Yes. If you go to the balance sheet, I don't remember which page it's on in this particular document, but if you go to the balance sheet you'll see that the overwhelming, you know, by several orders of magnitude, asset of this operating entity [] is the underlying pipeline.

H.R. at 1080. This makes Cornell's view clear that the value in the pipeline and property/intangibles used to operate the pipeline are necessary for its success. The value purchased by Blackstone was tied to the hard assets. We agree with Cornell.

We also find Reilly’s recency argument wanting because it raises other problems. Many cases state that recency can be cut off by a substantial change to the character of the legal property. By Reilly’s own reasoning, however, if Blackstone, at best, paid for a partially completed pipeline in July 2017, then the value of the pipeline only got higher as construction progressed, causing a higher valuation as of the tax lien date. That even higher valuation is inconsistent with the value that Reilly has asserted.

Our characterization and the weight we place on the transaction are consistent with Palmer House.

We earlier recognized that a transfer of a membership interest could be an indicator of value—or even create a presumption of value—for property owned by the company transferred. The Ohio Supreme Court addressed that situation in *Palmer House*, a case relied upon by both parties for different reasons. The Commissioner argues that *Palmer House* provides “that the sale of an interest in a corporate entity holding income-producing property is proper evidence to support an appraisal value.” TC Br. at 13. We agree.

The *Palmer House* Court specifically addressed whether this Board “erred by deciding that the sale price paid for the transfer of ownership of a corporate entity, * * * should be presumed to constitute the value of the real estate owned by that entity.” *Id.* at 283. In that case, the Board of Education claimed that the Auditor’s value of the subject property, an apartment complex, should be increased because a sale of the real estate was effectuated by a trans membership interest in a limited liability company. As explained by the Court:

A deed executed October 6, 2015, and recorded October 8, 2015, reflects the conveyance of the real estate from an entity called Palmer Square, L.L.C., to appellant Palmer House Borrower, L.L.C. A contemporaneously filed form declares the transaction exempt from the conveyance fee because the property was not transferred for valuable consideration. *See* R.C. 319.54(G)(3)(m). The supporting affidavit, notarized on October 5, 2015, explained that “[t]he

conveyance of the Real Property constitutes a capital contribution to the Grantee limited liability company.”

Id. at ¶ 6. The parties completed the transfer through a “Purchase and Sale Agreement,” and the purchase price “encompassed items of personal property, both tangible (e.g., clubhouse furnishings and recreational amenities) and intangible (e.g., the ‘Palmer House’ name), all of which related to the business of renting apartments.” *Id.* at ¶ 8.

Like Rover, the owner argued that “the presence of these other assets and considerations means that the transaction involved the transfer of an ongoing business with multiple assets, not just real estate.” *Id.* at 293. The Court rejected that position by saying that “[o]n the record before us, the real estate at issue generates rent income, which is integral to the value of the real estate. No other income is derived from the use of the property that would relate to any business value other than the value of the real estate itself.” *Id.* The Court held that there was no error and affirmed our decision. Those facts should sound familiar.

Rover attempts to distinguish *Palmer House* with *Salem Medical Art & Dev. Corp. v. Columbiana Cty. Bd. of Revision*, 82 Ohio St.3d 193 (1997), a case specifically discussed in *Palmer House*. Rover alleges the *Salem* Court held stock value does not establish the value of an owner’s real property. Reply at 9. The Court in *Palmer House* rejected this “iron rule” when it held as follows:

Palmer reads our decisions in *Salem Med. Arts* and *Gabanna-Jefferson* as articulating an iron rule that the sale of an entity may never, for purposes of invoking the sale-price presumption, be viewed as equivalent to a sale of the entity’s real-estate asset. We disagree. Considering the context of those decisions—the BTA had refused to apply the presumption and we affirmed the BTA’s decision—we conclude that they do not require us to reverse the BTA’s decision in this case.

Id. at ¶ 36. As did the Supreme Court in *Palmer House*, we reject the applicability of *Salem* to the instant circumstances.

Rover seeks to further undermine the applicability of *Palmer House* by arguing that there are factual distinctions between *Palmer House* and this case that make *Palmer House* inapplicable; in particular, that in *Palmer House* the main evidence was a standard real estate purchase agreement as opposed to the contribution agreement that effected the sale in this case. Reply at 10. That factual distinction makes no difference.

Nowhere in *Palmer House* does the Court limit its ruling to situations where a real estate purchase contract is used. Further, in concluding, the Court stated “*the documentation* in this case made it reasonable for the BTA to find that this sale * * * reflected the parties’ intent to sell and purchase income-producing real estate.” (Emphasis added.) *Id.* at 293. What mattered was that the parties intended to transfer an interest in property, not the document’s caption. We think the Court made clear that it was not limiting its ruling to a “real estate purchase agreement,” but rather, was looking at *any* documentation that revealed the “parties’ intent to sell and purchase,” regardless of the name given to those documents.

The contribution agreement shows the primary concern was the pipeline itself and the cash flows generated by the pipeline, and Cornell’s analysis of the agreement is persuasive. The agreement is replete with references to Rover, which is labeled as “Opco” meaning operating company operating the pipeline. The agreement makes this reference even though Rover was not a party to the agreement, which goes to show the layering of the limited liability companies changes little in terms of the economic reality of the transaction or Rover’s operations.

Other clues in the contribution agreement show the pipeline was the true object. There are numerous references to the “Pipeline Project,” including the timing and completion date of the “Pipeline Project.” The agreement references the budget for building the pipeline and permits held not by ET Rover but by Rover. *See, e.g.*, Section 3.07. Environmental studies in the hands of Rover are also referenced. *See, e.g.*, Section 3.11(b). Covenants and the FERC certificate are referenced repeatedly, and those were held by Rover. A covenant by ET Rover was to cause Rover to “use commercially reasonable efforts to continue to implement the development of the Pipeline Project in accordance with the Pipeline Project Budget.” *See* Section 6.02(a)(i). A simple word search of the agreement shows more than 150 references to Rover in the 51 substantive pages. The pipeline project itself is mentioned over 50 times.

The attachments to the contribution agreement, e.g., the limited liability company agreement, also show the pipeline was the true object of the sale. Those include references relating to (1) Rover’s “Approved Construction Project,” (2) Rover’s budget, (3) the “‘Pipeline Project’ [which] means the Rover Pipeline currently under construction by [Rover] as contemplated by the Approved Budget,” and (4) provisions relating to the obligations of ET Rover’s members to make certain contributions to Rover upon request relating to “the construction and development of the Pipeline Project” and the “maintenance costs and expenses in connection with the Pipeline Project.”

It is also noteworthy that the contribution agreement makes clear that the construction of the pipeline was to be undertaken by Rover, a nonparty. The most natural answer is again that the object of the transaction was the pipeline with the cash flows in mind. Were this a “plain vanilla” purchase agreement, where Blackstone was simply interested in owning a piece

of ET Rover instead of its *real* interest, owning a piece of a value-producing pipeline, such extensive references would seem unnecessary. We agree with Cornell, who testified, “Blackstone was investing in a completed pipeline.” H.R. at 1195.

As such, even though it was not a “real estate purchase agreement” as used in *Palmer House*, the agreement and attendant circumstances reveal there is no doubt that Blackstone was effectively purchasing an interest in the pipeline. As in *Palmer House*, this documentation, however it is denominated, exposes the true intent of the parties to sell and buy the pipeline asset, the only asset of meaningful value in this transaction. We reject Rover’s other purported factual distinctions from *Palmer House* as of little consequence.

We acknowledge some rebuttal testimony by Rover’s witness Eric Belz, from Blackstone during rebuttal, but Belz’s testimony does not change the agreement, which speaks for itself. Belz served on a private equity team responsible for “sourcing opportunities.” H.R. at 1229. Belz testified Blackstone considered the fact that Rover had shipping contracts and other smaller assets, but nothing in Belz’s testimony conflicts with Cornell’s assumptions about the property. Rover’s “other assets” argument cannot be squared with case law from the Ohio Supreme Court, finding possible business value and goodwill are properly included in valuation when they are not severable from the property. *See, e.g., Hilliard City Schools Bd. of Edn. v. Franklin Cty. Bd. of Revision*, 128 Ohio St.3d 565, 2011-Ohio-2258, 949 N.E.2d 1. Belz did not testify Rover held assets other than those integral to the operation of the pipeline. *Palmer House* is directly on point because the Court affirmed the validity and probative nature of that sale even when it was transferred with other assets tied to the operation of the property. Furthermore, if anything, Belz’s testimony confirmed Cornell’s suspicions that Blackstone was

buying a piece of property properly managed to generate cash flow like any other piece of income-producing property. Blackstone acted like any institutional investor, as Cornell predicted, purchasing property while keeping cash flows from shipping receipts in mind.

By analogy to the real estate valuation context, it is well established under the income approach that contracts – in the form of leases and the income they generate – are properly considered as adding value to the property. As stated by the Ohio Supreme Court, “when property must be valued and there is no evidence of a recent arm’s-length transaction, an appraisal that takes into account a lease with terms that are typical for the market may be considered and adopted.” *Rancho Cincinnati Rivers, L.L.C. v. Warren Cty. Bd. of Revision*, 165 Ohio St. 3d 227, 2021-Ohio-2798, 177 N.E.3d 256, ¶ 33. In that sense, the producer contracts are akin to a lease, and the Court has rejected the argument that such a sale must be rejected because it is subject to a lease in *Rancho*. Just like commercial leases in traditional commercial real estate valuations, producer contracts are no different; they are based on the pipeline (like leases are based on the real estate) and have no value separate and apart from the pipeline, just as leases have no value separate and apart from the real estate they lease. Indeed, the producers are, in effect, leasing space (capacity) in the pipeline to move their gas to market. As such, there is no meaningful difference in determining the pipeline’s value between the producer contracts and the pipeline itself. The same can be said of the other “assets” (rights-of-way, permits, etc.). Those items, like the producers’ contracts and real estate leases, have no value independent of the pipeline (or real estate) itself. References to permits make no difference in this case because they, again, are tied to the operation of the property. *See Harrah’s Ohio Acquisition Co., L.L.C. v. Cuyahoga Cty. Bd. of Revision*, 154 Ohio St. 3d 340, 2018-Ohio-

4370, 114 N.E.3d 192, ¶ 24 citing *Harold D. Miller, Inc. v. Pub. Util. Comm.* 10 Ohio St.2d 53, 58, 225 N.E.2d 269 (1967) (rights and licenses tied to the use of property have no value except as to the holder of the property).

Rover also relies on a decision in *River Street Partners v. Cuyaboga Cty. Bd. of Revision*, BTA No. 93-P-1411, 1994 Ohio Tax LEXIS 1901 (Nov. 14, 1994), for the proposition that “two people owning equal percentages may have two entirely different values.” Reply at 12. Rover applies that case to these facts when it argues that Blackstone negotiated for liability for cost overruns. Reply at 12-13. We find several problems with that argument. First, there is no credible evidence presented as to what Blackstone’s protection was worth *in dollars*. Having claimed that there were differences in value between the two almost-evenly-divided ownership interests based on Blackstone’s negotiated-for liability protection, it was incumbent on Rover to provide proof, not speculation. Blackstone’s liability protection may or may not have had monetary value, but there was no probative or credible evidence in the record quantifying that assertion by, for example, showing the value *in dollars* of that liability protection.

Rover also fails to mention more recent cases on sales of fractional interests. *See, e.g., Roc Syl Assocs. v. Cuyaboga County Bd. of Revision*, BTA No. 2008-A-1390, 2011 Ohio Tax LEXIS 1544 (Aug. 9, 2011). In *Roc Syl*, the Board considered multiple transfers and observed that the sale price of a fractional interest can be probative of full value when “considered and tested” by additional credible evidence, citing *Canton City School Dist. Bd. of Education v. Stark Cty. Bd. of Revision*, BTA No. 2004-H-1305, 2006 Ohio Tax LEXIS 635 (May 19, 2006).

[W]hen the sale does not involve an entire fee-simple interest, as in this case, the appellant must present more than just evidence of a recent arm’s-length sale. *Cuyaboga Bd. of Revision v. One Euclid Co.* (1968), 16 Ohio St.2d 43, 46. For a sale price of a fractional interest to be probative of full value, it must be “considered

with and tested by” all other credible evidence of value. Id. Consistent with this standard, this board has repeatedly held that while the sale price of a fractional interest in property, when coupled with other competent, probative evidence, may be reflective of the true value of the entire fee simple estate, there is no presumption that the sale price of the partial interest, by itself, is indicative of the value of the entire estate. *Bd. of Edn. of the Cleveland Municipal School Dist. v. Cuyahoga Cty. Bd. of Revision* (July 23, 2004), BTA No. 2003-B-298, unreported; *Bd. of Edn. of the Heath City Schools v. Licking Cty. Bd. of Revision* (Nov. 30, 2001), BTA No. 2000-S-1428, unreported; *Juan E. Chahda/The Alpha Company v. Cuyahoga Cty. Bd. of Revision* (June 15, 2001), BTA No. 1999-S-1905, unreported. See, also, *Great Lakes Industrial Park, Inc. v. Lake Cty. Bd. of Revision* (May 15, 1986), BTA No. 1983-C-1035, et. seq., unreported (finding that we must consider not only the sale of an undivided one-half interest in real property but also other available probative evidence to establish the fair market value of the subject property)

Canton at 5; see also *Proper Inv., LLC v. Lake County Bd. of Revision*, BTA No. 2007-M-1531, 2010 Ohio Tax LEXIS 798 (May 18, 2010). (the value based on an owner who purchased 100% interest in the property through fractional shares is not an extrapolation of fractional interest and is not required to provide additional evidence regarding the reasonableness of the purchase price).

Rover argues that *Canton* is not applicable because “the fractional sale [in *Canton*] was the sale of a partial interest in the realty, unlike this case, in which Blackstone acquired an interest in a corporate entity, not the pipeline.” Reply at 11, fn. 5. This argument fails because, as discussed above, the evidence here clearly shows a through-line effective ownership of the pipeline from ET Rover, through Rover, to the pipeline itself. As such, Rover’s attempt to distinguish *Canton* is unpersuasive and rejected by this Board.

In the present appeal, the Board has the benefit of multiple sources of credible evidence to consider and test the reasonableness of the extrapolated sale price. First and foremost, we have Cornell’s testimony on Blackstone regarding the transaction. Cornell reviewed the

contribution agreement and concluded that the extrapolated sale price provides a floor as to the overall value of the pipeline. He further described his understanding of these kinds of transactions. Cornell has experience with transactions similar to the Blackstone transaction in this case. He is a senior advisor to two investment firms, at which he does fundamental valuation, looking for undervalued companies for investment purposes. H.R. at 1055.

Furthermore, the record contains Eyre's testimony. Eyre testified that he reviewed the sale while preparing his report and extrapolated an implied sale price of \$4.8 billion. He indicated that this was close to the value he reached using the income approach, which he explained was potentially related to Blackstone's purchase of a minority share and the time value of money, as the pipeline was not yet complete at the time of the sale. Additionally, using Rover's reasoning regarding other considerations included in the negotiation over the sale price, ET's majority control over the entity may have also had value, one that might have offset or possibly surpassed the purported value of Blackstone's liability protection (Blackstone agreed to cover some cost overruns). Cornell expressly stated those considerations have independent value.

Based on all of this, we conclude that the amount paid by Blackstone in July 2017 was for the purchase of a completed pipeline and that the amount it paid is both credible and probative in determining the value of the subject property as of the tax lien date. We stress, however, that the Blackstone sale is not the only source or a necessarily dispositive one on the issue of value, but rather, a credible one worthy of our consideration as containing useful market information in our overall review. Just as both appraisers in their appraisals used selected *guideline* companies as imperfect, yet nonetheless useful and instructive, standard-

setters in the oil and gas industry, the Blackstone transaction provides us with an imperfect, yet nonetheless useful and instructive, view of the value that the market places on the subject.

Actual costs of construction are an important indicator of value.

The cost approach is particularly applicable in determining values for both new construction and special purpose properties. Both the Supreme Court and this Board agree with that assertion. Quoting from *The Appraisal of Real Estate*, the Supreme Court has recognized the importance of the cost approach in estimating the market value of new or relatively new construction. *Musto v. Lorain County Bd. of Revision*, 148 Ohio St. 3d 456, 2016-Ohio-8058, 71 N.E.3d 279, ¶ 47. *The Appraisal of Real Estate* also states:

The cost approach may be used to develop an opinion of market value * * * of proposed construction, special-purpose or specialty properties, and other properties that are not frequently exchanged in the market.

The Appraisal of Real Estate 530. In addition, this Board has said that the cost approach is “generally a favored methodology when valuing a special purpose property.” *Lowe’s Home Ctrs., Inc. v. Wash. Cnty. Bd. of Revision*, BTA No. 2011-1664, 2016 Ohio Tax LEXIS 1270 (June 10, 2016). A special-purpose property is “[a] limited-market property with a unique physical design, special construction materials, or a layout that restricts its utility to the use for which it was built[.]” *The Dictionary of Real Estate Appraisal* 272 (4th Ed.2002). Because of their unique aspects, the cost approach is especially useful in the valuation of special purpose properties because comparable sales are difficult, if not impossible, to find. As to new construction, the Supreme Court has made clear the cost approach a favored approach.

It is certainly true that “[t]he cost approach usually works best for newer improvements, because construction costs are easier to estimate and there is less depreciation.” International Association of Assessing Officers (“IAAO”), *Property Assessment Valuation* 127 (2d Ed.1996).

Jefferson Indus. Corp. v. Madison County Bd. of Revision, 148 Ohio St. 3d 18, 2016-Ohio-1789, 69 N.E.3d 701, ¶ 19.

Within the cost approach itself, the use of actual construction costs often plays a significant role. As stated by the Court,

The cost method of valuing improvements seeks to determine what a potential buyer would expect to pay in constructing a replacement for the existing building. That number is significant because “[a] prospective purchaser will not rationally pay \$15,000 for a house * * * if, without serious delay, he can build or buy equally satisfactory substitutes for \$10,000.” 1 Bonbright, *The Valuation of Property* (1937) 157.

Dayton-Montgomery County Port Auth. v. Montgomery Cty. Bd. of Revision, 113 Ohio St. 3d 281, 2007-Ohio-1948, 865 N.E.2d 22, ¶ 12. Further, we have found the use of actual construction costs to be reasonable. *The Higbee Company vs. Cuyahoga County Bd. of Revision*, BTA Nos. 2002-T-2552, 2002-T-2569, 2002-T-2571, 2003 Ohio Tax LEXIS 1878 (December 12, 2003).

Because the subject was essentially a new special purpose property on the tax lien date, we find actual costs without more complicated deductions important to our analysis. *See, e.g., Dayton-Montgomery Cty. Port Auth. v. Montgomery Cty. Bd. of Revision*, BTA No. 2004-A-1227, 2007 Ohio Tax LEXIS 946 (July 6, 2007) (on remand). However, we do not find actual costs are dispositive in this case because, consistent with our case law, some adjustments are necessary, e.g., for physical depreciation. *Independence Bd. of Edn. v. Cuyahoga Cty. Bd. of Revision*, BTA Nos., 2000-A-35, et al., 2002 Ohio Tax LEXIS 897 (May 10, 2002). Nonetheless, we typically expect necessary adjustments to be low when a property is brand new. *LANDIS Lancaster LLC v. Fairfield Cty. Bd. of Revision*, 2006-K-1053, 2008 Ohio Tax LEXIS 1155 (June 10, 2008). When the magnitude of an appraiser’s adjustment decisions is significant, we approach the

adjustment with more skepticism and require more support. *See, e.g., Gammarino v. Hamilton Cty. Bd. of Revision*, BTA Nos., 2018-622, et al., 2019 Ohio Tax LEXIS 2297 (Sept. 30, 2019).

Here, we find the unadjusted costs do serve a function in this case. They provide a general guideline that can help undertake a more thorough review of other appraisal evidence.

Neither actual costs nor the Blackstone transaction are dispositive evidence of value. Notwithstanding, Reilly's opinion of value cannot be reconciled with either.

Reilly's value cannot be reconciled with either the Blackstone transaction or actual costs. Based on the record before us, we find that it is impossible that Blackstone would have paid roughly \$1.5 billion for its 32% share if the value were \$3.3 billion. Simple math shows that if Reilly's \$3.317 total unit value is correct, then Blackstone paid 45% of the total unit value in exchange for a 32.4% interest, a substantial overpayment for what it was getting in return. By contrast, Eyre's opinion of value is sandwiched between actual costs and the floor set by the Blackstone transaction. Rover argues Eyre's value is not "close" to the Blackstone transaction because, depending on whether one agrees with Eyre's imputed value or Cornell's imputed value, Eyre's reconciled opinion is approximately a billion dollars above the floor. However, we are not persuaded by that argument for two reasons. First, Eyre's reconciled value is still above the floor and well below actual costs. Second, Rover's emphasis on "billion" skews the fact that Eyre's value is in the neighborhood of 20% higher than the lower of the two imputed sale prices. In a valuation case, a 20% difference in different measures of value hardly shocks the conscience. Indeed, the difference between Reilly's RCNLD indicated value and his yield capitalization indicated value was in the ballpark of 20%.

Cornell and Eyre credibly showed certain choices made by Reilly in his cost approach are unsupported. Those choices make the appraisal less probative than other evidence of value.

Reilly's functional obsolescence figure is insufficiently supported.

Obsolescence was a primary sticking point between the appraisers in their cost approaches. Neither appraiser argued obsolescence was irrelevant, but they differed in their methods to measure and account for it if it existed. Eyre testified that the income approach was the best place to capture additional obsolescence missed by regulatory depreciation. H.R. at 836. Reilly accounted for functional obsolescence in his cost approach directly with a figure provided by Rover purported to show cost overruns or as part of economic obsolescence in his HCLD. Reilly relied substantially on the definition of functional obsolescence found in the *VM&E*, which states that functional obsolescence can be used to account for excess capital and operating costs. Reilly's amended report quotes portions of the book. Ex. 45 at 35.

We have three primary concerns with Reilly's functional obsolescence calculation. First, Reilly's definition of functional obsolescence is inconsistent with Ohio case law and *The Appraisal of Real Estate*. Second, neither the methodology nor the figure provided to Reilly by Rover were reviewed by an appraiser, even though functional obsolescence is an appraisal concept. Third, the figures from the Veritas report lack support. It appears many of the choices made in the report are arbitrary or based on the mistaken assumption that costs in excess of budget created functional obsolescence.

Reilly's definition of functional obsolescence is inconsistent with Ohio case law, which is largely based on The Appraisal of Real Estate.

Reilly classified excess costs as functional obsolescence. At the hearing, he testified that "functional obsolescence is generally measured by either excess capital costs, or excess operating costs." H.R. at 597-598. Thus, in his amended report and testimony at the hearing, Reilly made clear that he was emphasizing the excess capital costs part of the *VM&E*'s

definition of functional obsolescence, but it does not appear he found other forms of obsolescence were present. For example, he testified he determined no adjustment necessary to adjust for excess operating costs.

We find a lack of support in the Ohio case law for the proposition that excess capital costs constitute functional obsolescence. *The Appraisal of Real Estate* similarly does not seem to treat cost overruns as a feature of functional obsolescence. Ohio law is clear, however, that the proponent of a functional obsolescence adjustment in the cost approach bears the burden of proof. See *Meijer, Inc. v. Montgomery County Bd. of Revision*, 75 Ohio St. 3d 181, 661 N.E.2d 1056 (1996), quoting *Rollman & Sons Co. v. Hamilton Cty. Bd. of Revision*, 163 Ohio St. 363, 56 Ohio Op. 337, 127 N.E.2d 1 (1995); see also *Meijer Stores L.P. v. Franklin County Bd. of Revision*, 122 Ohio St. 3d 447, 2009-Ohio-3479, 912 N.E.2d 560, ¶ 14. When testing that burden of proof, this Board and courts have relied heavily on the definition of functional obsolescence found in *The Appraisal of Real Estate*. That definition varies significantly from the way used by Reilly and Rover. For example, the Ohio Supreme Court relied on the definition in *Higbee Co. v. Cuyahoga County Bd. of Revision*, 107 Ohio St. 3d 325, 2006-Ohio-2, 839 N.E.2d 385. Quoting from *The Appraisal of Real Estate*, the Court stated that

Functional obsolescence is caused by a flaw in the structure, materials, or design of the improvement when compared with the highest and best use and most cost-effective functional design requirements at the time of appraisal.

* * *

Functional obsolescence is attributable to defects within the property * * *.

Functional obsolescence, which may be curable or incurable, can be caused by a deficiency, which means that some aspect of the subject property is below

standard in respect to market norms. It can also be caused by a superadequacy, which means that some aspect of the subject property exceeds market norms.

Id. at ¶ 52. There were no references to cost overruns.

The Ohio Administrative Code mirrors that definition in 5703-25-12, entitled “Valuation of buildings, structures, fixtures and improvements to land[.]” That section provides that when the cost approach is used, depreciation should be accounted for, including “all types of obsolescence.” That section goes on to define functional obsolescence in applicable part as follows:

Functional obsolescence is a loss in value resulting from poor planning, overcapacity or undercapacity, due to age, size, style, technological improvements or other causes *within the property*.

(Emphasis added.) Ohio Adm. Code 5703-25-12(D)(2)(b). Rover has asserted it is well-managed, so the poor planning component is inapplicable. *See* Reply at 13, citing H.R. at 265-266, 321 (“According to both Futch and Poteete, the cost overruns were due to these excess, unanticipated weather and regulatory issues.”). Rover’s witnesses specifically testified this project was well-managed. H.R. at 321. The rest of the definition relates largely to the *physical characteristics* of the subject property. There are no references to excess construction or excess capital costs.

The Appraisal of Real Estate itself provides examples that make clear the focus of functional obsolescence is on the property’s physical characteristics, not costs. For example, the treatise references ceilings that are too high (or too low); buildings with inadequate hot water systems; buildings with insufficient electrical service or wiring; functional inutility when caused by ongoing “technological advances or economic and aesthetic trends”; and a house with a one car garage. *Id.* at 217, 222, 224, 232, 235. Even Reilly’s report refers to the fact that

The Appraisal of Real Estate classifies functional obsolescence as “[a] flaw in the structure, materials, or design that diminishes the function, utility, and value of the improvement[].” Ex. 45 at 33-34.

Reilly’s definition simply does not fit into the existing case law. To be clear, we are not saying functional obsolescence should not be considered. It is well established that functional obsolescence can and should be considered in developing the cost approach. We likewise do not hold there could be times when the cost approach itself becomes less probative because of excessive costs. However, we find a lack of support in Ohio law for the proposition that these costs should be deducted as functional obsolescence.

Functional obsolescence quantification in an appraisal is an appraisal decision that should be reviewed by an appraiser.

There can be no doubt that Rover directed Reilly to use a specific figure to be used in his amended report, and there can be no doubt Reilly did no independent analysis to verify the validity or reliability of the amount. H.R. at 564; Ex. 45 at 24. There also can be no doubt that functional obsolescence affected both his cost approach methods. Ex. 45 at 35.

In his original report, Reilly simply accepted overrun costs in excess of budget, e.g., increased labor costs. Ex. 44 at 24. It will be recalled that Reilly changed the amount of functional obsolescence between his two appraisals despite the fact both appraisals were created years after the pipeline was fully operational. Costs were well known by Rover. His amended report simply states the figure was changed at the direction of legal counsel, who told Reilly to quantify excess costs of \$1.359 billion. Ex. 45 at 9, 24. At the hearing, Reilly testified that he was provided with a new cost overrun amount from counsel during the week of June 20, 2022, shortly before the hearing commenced, and told to use that as the amount

of the overruns. H.R. at 705-706. That number, he said, came to counsel from Veritas. H.R. at 707. Reilly testified that he did not investigate the new number to see if it was warranted, and “[he] accepted that [the new number] without independent verification or confirmation.” H.R. at 707-708. He said he “was told they [the excess costs] did not add value, and that’s why they were considered excess construction costs.” H.R. at 708.

Existing appraisal practice and rules did not strictly prohibit Reilly from using Rover’s calculations as provided by counsel, assuming those were properly disclosed. However, we find Reilly’s appraisal less probative because he relied on Rover to make an appraisal decision without some independent testing. Also, there is an important distinction between the *assumed* accuracy of the counsel-provided excess costs and their *accuracy in fact*. Indeed, one of the purposes of disclosing an assumption in an appraisal is to place the finder of fact on notice that the appraiser is not warranting the accuracy of the assumption so that the fact finder may delve deeper into the underlying facts and test whether the assumption is, in fact, accurate.

The Veritas report is unreliable.

Even if Reilly had fully analyzed Rover’s functional obsolescence amount, a review by an appraiser is not the end of the story. Our task is to look beyond credentials alone to assess the appraiser’s judgment and the choices they made in the course of their appraisals, many of which were necessarily subjective. It is axiomatic that a credible appraisal must be based on accurate and supportable data, no matter how well the appraisal is otherwise crafted, and we have rejected appraisals by licensed, certified appraisers where we found that the appraisal was “not supported with reliable, credible data.” *Medusa Assocs. Ltd. v. Cuyahoga County Bd. of Revision*, BTA No. 2005-A-490, 2007 Ohio Tax LEXIS 723 (May 18, 2007).

There is a question about whether the purported cost “overruns” were, in fact, overruns at all, as opposed to a failure to budget an appropriate amount for contingencies. The record raises more questions for us about the accuracy of the data that Veritas received and how Veritas analyzed the data. Regarding whether the claimed “overruns” were, in fact, cost overruns (as opposed to a case of mistaken budgeting), it is noteworthy that the word “overrun” is neither defined nor found in *The Appraisal of Real Estate* (15th Ed.2020). But the words “overrun” or “overruns” were used frequently throughout the hearing (a search of the hearing transcript shows 258 uses of those words), primarily by witnesses for Rover.

It is important to keep in mind that the word “overrun” necessarily involves *a comparison to something else*. An “overrun” must exceed some quantity or measure that is “known.” It also appears the term was used in different ways during the hearing. Some witnesses appeared to have used the term to refer to costs in excess of the construction budget, while others used it in reference to the Veritas figures. As such, here we are dealing with two numbers: (1) the budgeted contingency number, the known amount, and (2) the “overrun” which will be determined by the amount that it exceeds the known amount. Because the overrun is measured against the known contingency budget, we must have confidence in both the data used to determine and categorize all of the costs and the known budget against which that “overrun” is measured. Of course, if the budgeting process was faulty or incomplete, then what Rover called an overrun may be a technical or literal overrun *from the budget*, but not an overrun *from what should have properly been budgeted based on like or similar projects*.

While the Rover argues it prepared a detailed budget, the budget clearly contained shortcomings. This was made clear in evidence provided by Lummus Consultants, a consulting

group hired on behalf of Rover. ET's Beth Hickey testified that Lummus was hired by Rover in connection with the potential financing of the project and was tasked with preparing a report about the project to give to potential lenders. H.R. at 67. According to Hickey, Lummus was "a consulting company that would come in and kind of review the project, the construction, the facilities, the commercial support, the environment where" construction occurred and to "outline the risk of execution" for the project. H.R. at 68. The Lummus report noted that the level of the proposed contingency fund was only 1.3% of the budget and 2.1% of uncommitted capital. Lummus opined that those contingency levels were low and recommended that the contingency fund should be at least 10% at that stage of the project. H.R. at 814. Even Hickey acknowledged the budgeted contingency was unusually small. H.R. at 112.

While it is true that the budget reviewed in the Lummus report was not the final one, Hickey's testimony, given years after the pipeline was completed, dispelled any notion that the ultimate budgeted contingency amount was appropriate. Her testimony made clear that the contingency included in the budget was atypically small. Rover's arguments to the contrary are not well taken. Rover Br. at 73; Reply at 28. The evidence is clear, and we find that Rover under-budgeted the amount for contingencies in its construction budget. As a result, some of what it characterized as overruns were, in reality, shortcomings in its budgeting process. In other words, some of the expenditures that "overran" Rover's under-budgeted contingency amount would not have been overruns had Rover included larger amounts in the budget for contingencies as recommended by Lummus and agreed by Hickey.

The miscalculation of an appropriate contingency is not a trifling bookkeeping mistake. The size of the contingency is important in this context, of course, because had the budgeted contingency fund been larger and more in line with a typical budgeted contingency for a project of this size, the total budget would have been higher. And had the budget been higher, there would have been less of a cost “overrun.” Had there been less of a cost overrun, there would have been a smaller amount of purported obsolescence. Had there been a smaller amount of obsolescence included in his valuation calculations, all other things being equal, Reilly would have reached a higher valuation. Thus, for valuation purposes, the distinction between what the Rover budgeted for contingencies and what typically *should have been budgeted* for contingencies is significant.

We have already cited the numerous times the term overrun was used during this Board’s hearing, but some witnesses used it to mean costs in excess of the budget. In contrast, others used the term as costs designated by Veritas as overruns and incorporated into Reilly’s amended report. We have concerns about the accuracy and reliability of the data that *Veritas* relied on. Veritas did not develop the data as an auditing company but rather was provided the data by other sources. In addition, there are serious questions about whether Rover properly categorized the purported cost overruns. The proper categorization of those purported overruns was more than a minor bookkeeping entry and, as addressed in Eyre’s testimony discussed below, it played a part in determining whether the funds spent for those overrun amounts were excess capital costs (and, therefore, part of obsolescence as Reilly testified) or expenses (which are not part of obsolescence using Reilly’s definition).

Rover called Ken Monson from Veritas to explain the data his firm compiled. Monson was a construction cost auditor and construction controls professional who worked for Veritas during the pipeline's construction and was involved in the auditing of the pipeline. H.R. at 429-431, 435-436. He testified in detail about the spreadsheet containing the claimed overruns on the project and discussed the meaning of its entries and the spreadsheet categories into which the purported cost overruns were placed. *See* Ex. 67. In explaining a cost category on the spreadsheet entitled "acceleration," he testified the entries were "costs that the contractor paid and Rover reimbursed for overtime work, Sunday work, double shifting of the drilling contractors, and things like that that accelerated the scheduled performance." H.R. at 471. Monson explained that Rover often did not determine the categorizations of the acceleration or cost overruns. Certain columns in the data showed the classification "was determined by the contractor when they submitted their claims." H.R. at 471, 501-502. Then, Veritas would simply "put the associated cost into that category." H.R. at 471. When asked about how certain purported overruns were categorized, Monson testified as follows:

Q. Did you bucketize those, or did you categorize the -- what you said was 1.3-ish billion of cost overruns?

A. Yeah, we explained the cost overruns by assigning them to categories. *To a larger extent the contractors actually did that when they turned in their change order requests at the end of the job. They identified the cause of their additional costs, and then we essentially used those categorizations to identify the overruns by category.*

(Emphasis added.) H.R. at 452-453. In other words, many of the cost overrun categorizations made by the contractors were not questioned by the Veritas auditors and assumed to be correct. As such, Veritas *assumed* that those contractor-determined cost overrun categorizations were correct and then passed that information to legal counsel, who *assumed*

that Veritas's data was correct and then passed it on to Reilly, who *assumed* it was correct and incorporated it into his appraisal.

In addition, Monson's testimony raised further questions as to whether some costs incurred due to the environmental violations that Rover or its contractors caused were properly categorized. There is a difference between funds expended to build a pipeline and those expended not to build the pipeline but to correct environmental violations that occurred during the building of the pipeline. FERC already found that the drilling release resulted in substantial drilling fluid entering wetlands. Ex. 61. Further, FERC stated in a letter to Rover:

Based on this information, as well as the volume, extent, and condition of drilling mud in the wetland, staff has serious concerns regarding the magnitude of the incident (which was several orders of magnitude greater than other documented HDD inadvertent returns for this project), its environmental impacts, the lack of clarity regarding the underlying reasons for its occurrence, and the possibility of future problems. Given that the site of the release occurred near, and extended over Rover's approved centerline, a stoppage of additional drilling is warranted to facilitate a review of Rover's efforts to search for and locate any potential releases.

Ex. 61. Funds expended for an environmental cleanup caused by a violation of law, are not the same – and should not be categorized the same – as funds spent to put pipe in the ground or to build compressor stations. As explained by Eyre, removing sludge from areas adjacent to the pipeline construction does not make the cleanup part of the capital cost of the construction. Monson was asked if the delays encountered as a result of the environmental violations at the Tuscarawas River were included in the cost overruns.

Q. So did you include [the cost of] delays that were perhaps alleged to have been caused by the company's own actions? I mean, are you aware of what happened in Tuscarawas with the incident with the drilling?

A. Yes.

Q. So some of those delays would have been caused by whose ever fault it was, but they used diesel fuel, correct?

A. I understand what caused the suspension of work.

Q. But [the costs associated with] those suspensions are included in here as well, correct?

A. Those were -- yeah, those costs were realized and they were assigned to delay.

H.R. at 503-504. Monson also testified that the cost overruns on exhibit 67 were for the total project, not just the portion of the project in Ohio, and he did not know “how to distinguish [cost overruns] by location.” H.R. at 504. Finally, Monson testified that some of the costs, categorized as excess, were incurred to speed up the construction after delays were encountered. H.R. at 506-507.

While it is understandable from a business and financial perspective why Precision or Rover added crews (and their associated expense) to accelerate the work to catch up to its proposed schedule after experiencing delays and work stoppages, those business decisions aimed to bring the pipeline to market faster. The pipeline would be completed, whether on an accelerated or slower schedule. However, the decision to accelerate the construction and incur extra costs was a financial one. While the evidence supports that rain events caused delays and additional costs beyond Rover’s control, there were also substantial delays occasioned by the shutdown of operations due to the Tuscarawas environmental spill caused by the actions of Rover and/or its contractors.

Eyre testified that Rover still booked the costs as plant in-service on its regulatory forms. Eyre was well within his expertise to opine on those forms and how they should be created. Eyre stated that if those extra costs were incurred as a result of environmental

violations, then they should have been considered an expense on the regulatory forms. As

Eyre testified:

Q. In any event, I'm trying to understand how if a builder of a property makes a mistake, and therefore incurs additional costs because of that mistake, why does that increase the value of the property, and how then that -- how is that document relevant at all to value?

A. Well, it wasn't so much making mistakes, they [Rover] violated -- they violated laws and regulations, but they incurred costs in that violation. You have to figure out whether those costs they had incurred would have been incurred similarly, you know, absent the violations and, you know -- *otherwise you would write it off as an expense. But they capitalized it into a plant in-service account, so they made the determination that it was a valid cost of construction by capitalizing it into a plant in-service account * * ** they would have to prove that the costs they incurred were different than the costs that they would have also incurred if they had done it without the violation.

(Emphasis added.) H.R. at 970-971.

While not mentioned directly by the parties, some case law supports Eyre's view and reasoning that the costs associated with the environmental cleanup should be treated as expenses and not capital costs in the tax setting. Two examples are *Dominion Resources, Inc. v. United States*, 219 F.3d 359 (4th Cir. 2000) and *United Dairy Farmers, Inc. v. United States*, 267 F.3d 510 (6th Cir. 2001). Both Courts addressed whether environmental cleanup costs should be treated as expenses or capital costs for tax purposes. While this case does not deal with those portions of the Internal Revenue Code, the Court's reasoning supports Eyre's position. The *Dominion* taxpayer sought to deduct cleanup costs as a business expense, but the Internal Revenue Service argued the taxpayer had to capitalize the cost as "permanent improvements or betterments made to increase the value of the property." The Court went on to say that:

Courts have articulated the distinctions between a deductible incidental repair and a non-deductible permanent improvement in a number of ways. In *Plainfield-Union Water Co. v. Commissioner*, the tax court explained that "*an*

expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair. A capital expenditure is generally considered to be a more permanent increment in the longevity, utility, or worth of the property.” 39 T.C. 333, 337 (1962).

(Emphasis added.) *Dominion* at 371. Finally, the *Dominion* Court explained how to discern a deductible expense from a capital expenditure:

To distinguish between improvements that constitute deductible repairs [expenses] and those that must be capitalized, the focus must be not on the amount of value added to the property by the improvements, but on the nature of the improvement. *If the improvement permits the property to be utilized in a different way, the improvement is most appropriately considered a capital expenditure. If the improvement only restores value to the property that existed prior to deterioration or to a discrete event that damaged the property, the improvement may be properly treated as a deductible repair expense.*

(Emphasis added.) *Dominion* at 371. In the instant case, at least some of the expenditures incurred for the cleanup of the Tuscarawas contamination did not permit the property to be utilized in a different way. It simply restored the property to its prior condition. However, we are unable to determine the extent to which these expenditures were booked as plant in-service.

We also question whether the expenditures to hire extra crews to accelerate the construction were categorized correctly as overruns. Even before the Tuscarawas River incident occurred, the evidence supports that Rover wanted to bring the pipeline online at the earliest possible date because “time is of the essence” clauses and financial incentives were found throughout the contracts. H.R. at 440-441. For example, in Rover’s construction contract with Precision Pipeline, “far and away [the pipeline’s] largest contractor” with a contract that totaled \$1.6 billion, the phrase “with time being of the essence at all times” is found more than 80 times regarding the completion of a large number of tasks. H.R. at 441;

Ex. 42.

Eyre testified that in preparing his appraisal, he reviewed public documents that indicated that Rover had a “culture of wanting to speed up the process.” H.R. at 972. Eyre argued that Rover’s decision to prioritize speed over cost minimization was what caused any cost overruns, including the expenses generated at the Tuscarawas River. H.R. at 972-973. He testified that the costs to accelerate the construction schedule by adding additional work crews in order to bring the pipeline online faster should not have been categorized as excess capital costs.

For these reasons, we reject Rover’s arguments in favor of Reilly’s functional obsolescence adjustment in the cost approach.

Reilly’s CILM makes the cost approach dependent on the income approach.

The Ohio Supreme Court has generally defined external obsolescence as “loss in value as a result of an impairment in utility and desirability caused by factors to the property * * * and is generally deemed to be incurable.” *Jefferson Indus. Corp. v. Madison County Bd. of Revision*, 148 Ohio St. 3d 181, 2016-Ohio-7089, 69 N.E.3d 701, ¶ 30, quoting *Property Assessment Valuation* 127 (2d Ed.1996). Further, the Court stated, “[e]xternal obsolescence attempts to adjust for a loss in real-property value caused by factors outside the property.” *Higbee Co. v. Cuyaboga County Bd. Of Revision*, 107 Ohio St.3d 325, 2006-Ohio-2, 839 N.E.2d 385, ¶ 33 quoting *The Appraisal of Real Estate* 412 (12th Ed.2001). The Ohio Adm.Code 5703-25-12(D)(2)(c) provides more specificity in defining economic obsolescence.

Economic obsolescence is a loss due to external economic forces, such as changes in the use of land, location, zoning or legislative enactments that might restrict or change property rights and values and other similar factors.

Following that, the rule provides a list of the items to be considered in “arriving at the rate of depreciation and obsolescence to be applied to buildings, structures, fixtures, and improvements to land * * *.” *The Appraisal of Real Estate* provides that “[e]xternal obsolescence is sometimes called economic obsolescence because economic factors outside the control of property owners, like mortgage interest rates and changing employment levels, can have large effects on the value of real estate. However, economic factors are only one form of external obsolescence.” *The Appraisal of Real Estate* 593, fn. 3.

In his amended report, Reilly stated that economic obsolescence is typically beyond the control of the owner. Ex. 45 at 49. In addressing Reilly’s methods in determining economic obsolescence, Rover claims that “[i]n both his replacement cost and historical cost methods, Reilly measured economic obsolescence using his ‘capitalization of income loss method,’ or CILM for short.” Reply at 21. *The Appraisal of Real Estate* acknowledges income loss, but it is unclear if Reilly’s approach perfectly matches the approach in the book. Also, the book states the method is not the most favored but considers it “[a]n alternative to direct comparison.” *The Appraisal of Real Estate* at 594.⁹

According to the Reilly method, economic obsolescence is determined by comparing the return on investment that you have from the property to the amount that you need to pay your investors. H.R. at 646-647. If the return on investment that you need is greater than the return on investment that you have, Reilly said, “then the difference between those two numbers would be the economic obsolescence.” H.R. at 648.

⁹ According to *The Appraisal of Real Estate* at 594: “Direct comparison of similar properties with and without external obsolescence can be the most persuasive measurement of the effect of negative externalities on value when enough data is available for that sort of analysis.”

The Commissioner is critical of Reilly's CILM method, calling it the income shortfall method, a widely rejected method. TC Br. at 22. When asked at the hearing to explain the income shortfall method, Reilly testified:

The income shortfall method is very simple. You take the cost approach value for your property, you take the income approach value for the property. If the income approach value is less than the cost approach value, you measure the difference. That is the income shortfall.

You take that difference, subtract it from the cost approach value to get to an adjusted cost approach value.

* * * what is happening [in the income shortfall method] is your cost approach value exactly equals your income approach value, because you've taken the difference between the two, subtracted it -- subtracting it from the cost approach, so you will get two numbers that are absolutely identical to each other. In other words, what you're doing is you're forcing your cost approach to exactly equal your income approach.

H.R. at 643-644. In short, the flaw in the income shortfall method is that it effectively eliminates one of the valuation approaches by forcing the cost approach to equal the income approach.

Reilly more fully developed his method as having two main steps. First, the appraiser analyzes the market "to quantify the income loss. Next, the income loss is capitalized to obtain the value loss affecting the property as a whole." Ex. 45 at 50, quoting from *The Appraisal of Real Estate* 595. *The Appraisal of Real Estate* explains the income capitalization methodology as follows:

An important concept in the capitalization of income loss is equilibrium rent, which is the market-derived rental rate that would be expected in the market at equilibrium. The equilibrium rent is compared with the actual rent affected by the external factor in the current market * * *.

Id. at 595. While the definition specifically references a rental rate, Reilly argued *The Appraisal of Real Estate's* meaning is clear that market-based information should be used in capitalizing income loss. Reilly's report elaborates on this point:

To perform this [CILM] procedure, the appraiser may compare a measure of the owner/operator current period profitably to either (1) the profitability when there was no identified EO, (2) the profitability of guideline companies, or (3) the profitability based on the projections that led to the investment decision. The appraiser may also consider alternate measures of profitability. Each of the *comparative measures of profitability* represents an estimated fair rate of return for the owner/operator. We measured the amount of EO applicable to the Total Unit.¹⁰

(Emphasis added.) Ex. 45 at 50. The first of his three measures is inapplicable because there was no data on the pipeline's "profitability when there was no identified" economic obsolescence. For his method, Reilly used the third comparison basis discussed above and "compared net cash flow ("NCF") return on the" total unit "to estimate yield capitalization rate." Ex. 45 at 50. His amended report does not explain why he selected *projected* net cash flow as the basis for comparison as opposed to the second method he mentioned, the profitability of guideline companies.

Here, we question the choice to disregard the second measure, which is the profitability of guideline companies in accordance with *The Appraisal of Real Estate's* emphasis on *market-derived* comparative data. In other sections of his analysis, Reilly used data from guideline companies as credible, but here, he eschewed that comparative measure to use *projections* of profitability instead. If real-world data were available, the selection of projections is a curious choice. Unfortunately, he did not explain why he failed to use comparative data from guideline

¹⁰ In his amended report, Reilly cites no source for the use of those three measures.

companies in his amended report. Reilly did argue that he did not have the data to estimate economic obsolescence using market extraction or paired sales analysis. While that explains his reasons for not using either of those two methods, it does not explain why he, in his CILM, favored the use of projections of profitability over the real-world data that would have been supplied by guideline companies.

It is patent, of course, that there can be a significant difference between market-derived comparable data and projected estimates. Indeed, there is no question that some of Rover's budget projections were simply wrong. Undoubtedly, the use of market-derived comparable data from guideline companies would have been preferable as a more verifiable and reliable source of comparative data. Thus, we question Reilly's failure to rely on it and find his reliance on projections to be a curious choice. Eyre described this weakness in Reilly's method:

A. But the description of that method in that textbook [*The Appraisal of Real Estate*] says the way you do that [method] is by first identifying the negative influence that is external to the property that this property is subject to, and then comparing the income stream from the subject property to a comparable property that is not subject to that negative influence, and then capitalizing that difference. That's the capitalized income loss method.

Q. And that stuff was missing from Mr. Reilly's report?

A. Yeah, he had not done that[.]

H.R. at 876.

There are other problems with Reilly's methodology. In exhibit 9 to his amended report (the HCLD Value Summary as of December 31, 2018), Reilly starts with the historical cost of constructing the pipeline (\$6.310 billion) and then deducts accumulated depreciation from that amount to reach the HCLD of the total unit, before deducting functional and economic

obsolescence. Moving to his treatment of functional obsolescence, in a footnote to exhibit 9, he said:

We consider the economic obsolescence measurement for the HCLD method to include the functional obsolescence component that is related to the excess capital costs (that is, the construction cost overruns).

Ex. 45, at 72, fn [b]. As to *why* the functional obsolescence related to the construction cost overruns was included in his economic obsolescence measurement for HCLD (mentioned in the footnote), Reilly had little to offer. He explained that

In our HCLD method analysis, *we relied on the historical costs * * * as reported in the Rover financial statements. * * * [A] large portion of the historical costs capitalize on the Rover balance sheets relate to excess capital costs.*

(Emphasis added.) Ex. 45 at 52. Accordingly, Reilly said:

For the purposes of our HCLD method analysis, we considered *the excess capital costs* discussed in the *Cost Approach and the RCNLD Method*¹¹ section of this amended report as part of the historical cost of the Total Unit.

(Emphasis added.) Ex. 45 at 52. Concluding his reasoning on this point, Reilly came back around to what he said in footnote [b] of Exhibit 9: “[t]herefore, we consider the economic obsolescence measurement for the HCLD method to include the functional obsolescence component that is related to the excess capital costs.” Ex. 45 at 52.

In other words, because Rover *considered* its capital costs (as reported in their financial statements) to include cost overruns, he too would consider them to be excess capital costs. As discussed at length above, under the facts of this case, the characterization of capital costs as purported cost overruns is unsupported.

¹¹ Although referred to by Reilly, the *Cost Approach and the RCNLD Method* adds little by way of explanation.

We agree with Eyre and Cornell that there were problems with Reilly's use of the approach in this case. Ex. K at 21; Ex. T at 10-15. However, we cannot find that Reilly's method is income shortfall, as that term has been used in the case law and literature, and it is unnecessary for this Board to accept the Commissioner's invitation to decide if Reilly's method is income shortfall with a fresh suit of clothes. We simply find Reilly's economic obsolescence determination insufficiently supported, making his appraisal less probative.

Reilly's size risk premium is unsupported.

One of the critical components in Reilly's appraisal was his determination of the cost of equity capital. Generally, the higher the risk involved in an investment, the higher the return an investor will require. Reilly used three models to determine the cost of equity capital (the MCAPM-EX, the MCAPM-SS, and the BUM), as detailed above. Ex. 45 at 76; H.R. at 672. Those models each assess risk using an industry beta, described by Reilly as "a measure of the systematic risk (i.e., risk relative to returns in a measure of the overall equity market, such as the S&P 500 index) inherent in a company's investment returns." Ex. 45 at 115. While the MCAPM-EX and MCAPM-SS explicitly list the beta in Reilly's report, the BUM also includes a measure of industry risk. Ex. 45 at 118.

The formulas used in Reilly's models each produced a different indicated cost of equity capital, but they shared something in common: an additional size equity risk premium of 1.6% that increased the cost of equity in each model. The additional size risk premiums were in addition to the risk premiums already included via the beta. Reilly also added a property-specific risk premium. We find a lack of support for both in the existing record.

It is not unreasonable to assume a higher level of risk, and therefore a higher cost of equity, for an illiquid investment instead of an investment in a share of a company that trades on an exchange. In that regard, we agree with Reilly on that basic premise, in which Heaton also concurred. However, Cornell credibly explained that the models used by the appraisers are designed to be financial models and can be easily manipulated, leading to improper opinions of value. Caution must be used, Cornell persuasively explained. Reilly's report notes that the only difference between the CAPM and his MCAPMs is the inclusion of these two premiums. Cornell is an expert on the subject and testified the CAPM is subject to some dispute, let alone Reilly's MCAPMs.

In Reilly's size premium, he added a premium, an increase, to the cost of equity based on the size of the property. Here, Reilly attempted to explain that he was not adjusting for the company's size but the property's size. The Commissioner disputes this characterization, and she argues we should see through the focus on "property" to see that Reilly's adjustment is really for the size of Rover. While Reilly characterizes the adjustment as one for the property, likely to further his premise, he is valuing the pipeline and not its owner, his method is indistinguishable from an adjustment for the size of its owner. Indeed, in his amended report, Reilly mentions the "higher required rates of return normally associated with smaller, more thinly capitalized companies like Rover." Ex. 45 at 116.

Reilly added a small size premium to Rover's cost of equity because it is a standalone limited liability company, but did not provide the necessary support to show that this was necessary or even appropriate. The Board is not required to ignore the financial or functional realities of the subject property when determining what market-based adjustments are

appropriate. *See, e.g., Johnston Coca-Cola Bottling Co. v. Hamilton Cty. Bd. of Revision*, 149 Ohio St.3d 155, 2017-Ohio-870, 73 N.E.3d 503. We disagree with the Commissioner’s argument that the Board must consider that Rover is not a standalone company and is a subsidiary of a large energy transmission company. *See* TC Brief at 12. However, we do require market data to demonstrate that the modifications Reilly made to the CAPM were appropriate, but he failed to do so.

Eyre also cited studies and academic work showing that the purported small size risk premium may not, in fact, exist. H.R. at 881-884. As stated by Eyre:

The data used by most analysts who make an adjustment for size comes from the annual SBBI Yearbook presently published by Duff & Phelps. The Kania study discusses what has been termed a “delisting bias” in the database used in the SBBI Yearbook. The data base used by the SBBI Yearbook is maintained by the University of Chicago’s Center for Research in Security Prices (CRSP). This database includes the returns from equity securities from 1926 to the present. Research has disclosed that prior to 1982 the database did not include firms who had been delisted from the various stock exchanges because they were performing poorly. Large stock returns are not affected, because a disproportionate number of small firms stocks are delisted for poor performance. Kania shows that if you study the period of 1982-1996 which was not affected by the delisting bias, the small firm premium disappears and actually reverses and becomes a large firm premium. This makes sense because if the small firm premium actually existed, shareholders would be demanding that the large firms be broken up into smaller firms so shareholders could experience these larger returns. But the reality is just the opposite; firms are merging with each other and becoming larger.

Ex. K at 29.

Eyre’s concerns about the small size premium were echoed by Cornell, who pointed out that “[i]t is now widely recognized that expected stock market returns vary significantly over time and have been falling.”¹² Ex. T at 20. In support of that assertion, he cited a number

¹² Cornell was questioned about whether a company that is a subsidiary of a larger company is more valuable than a stand-alone entity, because it is a subsidiary of the larger company. Using the example of Beats, a

of factors, including improvements in the regulatory oversight of capital markets as well as an aging population, nearing or in retirement, willing to accept lower returns (in exchange for greater security against downturns), to name just two. Ex. T at 20. As did Eyre, Cornell testified, “the finance literature has turned against there actually being a size premium.” H.R. at 1118. However, Reilly presumed it was necessary such that he added 160 basis points to his MCAPMs (thereby reducing the indicated value) to account for it.

The Commissioner’s experts persuade us that Reilly made unsupported adjustments in his income approach. Of all the experts who testified in this case, Cornell was clearly the most qualified to render a reliable opinion on the cost of equity. He testified caution must be taken when calculating WACC because controversial choices that undercut the entire opinion of value can be made. H.R. at 1115-1117. This is why, Cornell explained, the cost approach is so important as an independent measure. Cornell also explained that changes in the cost of equity and capital asset pricing model would have significant impacts on the overall opinion of value, which Cornell argued is what occurred in this case. H.R. at 1178-1182. For these reasons, we find Reilly’s size premium unsupported.

Reilly’s property-specific risk premium is unsupported.

Reilly described the procedure he used to estimate a property-specific equity risk premium:

To estimate a [property-specific risk premium] component of the cost of equity capital that is appropriate for the Total Unit or taxable property, we considered specific risk factors surrounding an investment in the Total Unit or taxable property.

subsidary of Apple Computer, Cornell testified that “[t]he fact that you are part of a larger organization could affect the value; it might, it might not.” H.R. at 1182.

We estimated the PSRP based on consideration of the factors discussed (1) in the Functional Analysis section of this report and (2) below.

We considered differences between (1) the appraisal subjects (i.e., the Total Unit, the taxable property, and the subject property) and (2) the theoretical assumptions that support the capital asset pricing model (“CAPM”) formula.

The CAPM formula is based on a hypothetical portfolio of publicly traded equity securities that is (1) perfectly liquid and (2) is fully diversified. Conversely, neither the Total Unit nor the taxable property are marketable, and an investment in them does not represent a diversified portfolio of investments. Based on these differences, an investor in either the Total Unit or the taxable property would likely require a greater return than an investment in the hypothetical portfolio of marketable securities that is assumed to exist in the CAPM formula.

Third, we considered the additional risk of an investment in the Total Unit relative to an investment in the [guideline publicly traded companies]. We performed this comparison since the [guideline publicly traded company] betas are used to estimate the industry-adjusted equity risk premium. The specific individual risk factors that we considered are presented in the table below.

Ex. 45 at 116-117. Reilly explained how he determined the 4.0% property-specific risk premium as follows:

So where does the 4 percent number come from? Well, it's based on what are called quantum of risk. And if you look at all three of the analysis, [Ex. 45, at 76] you can see that there are four quantum of risk.

There's the risk free rate. That's the same in all three cases, about 2.9 percent. There's a general risk premium that is 6.2 percent on top, it's 5.5 percent in the middle. It's the sum of these two numbers, so it's 7 percent on the bottom, right. And then there's the size premium, which is 1.6 percent in all three cases.

If you average all of those numbers together you get the 3.8 percent. So the average return per risk layer...is about 4 percent. I want to recognize one more risk layer here for the fact that I have a property specific risk that is not considered in any of those other risk layers, so that's where I get the 4 percent from.

H.R. at 678-679.

In each of his three models, Reilly added a premium of 4.0% on top of the beta and the size premium, thereby further increasing his calculated cost of equity. Ex. 45 at 75; H.R. 676. Reilly used guideline publicly traded companies for comparison but explained that adjustments needed to be made to those guideline companies to account for the pipeline's property-specific risks. Those risks included:

The geography, the fact that we're talking about one pipeline with a specific starting point, specific ending point, or the finite number of customers that moves one product and one product only, natural gas, where the contracts are fixed-price contracts, where the amount of product that's being shipped is going to be based upon supply and demand of natural gas, *but also the big factor is that there's a total lack of diversification.*

(Emphasis added.) H.R. at 677.

Eyre and Cornell were scathing of Reilly's inclusion of the property-specific risk premium in his cost of equity calculations. Eyre described it as "a totally arbitrary adjustment made by Reilly and is not based on any empirical market evidence." Ex. K at 30. He referred to Reilly's 4.0% premium as a "fudge factor," Ex. K at 31, and said that "[t]he 'risks' that Reilly states that he analyzed in order to justify his [property-specific risk premium] are all business or systematic risks. To make a second adjustment for these risks would be double counting the risk." Ex. K at 31. Eyre explained further that a property-specific risk or a nonsystematic risk "should not be accounted for in the cost of equity, but rather should be accounted for in the forecast of expected cash flows." Ex. K at 31.

Cornell testified similarly. He called Reilly's property-specific risk premium a "plug" and emphasized Reilly simply "found a few factors he could" relate to it. H.R. at 1182. Cornell claimed the premium was illegitimate and a path to a reverse-engineered cost of equity, which

would create a reverse-engineered WACC, which would create a reverse-engineered indicated income approach value. H.R. at 1182.

Further, Cornell persuasively testified contrary to Reilly's claim that Rover's long-term contracts posed a specific property risk.

If you wanted a company-specific risk premium because of the nature of its business, here we're talking about a pipeline company or a pipeline with contracted payments. Compare the risk of that with, let's say, Rivian, which doesn't know if it can make its cars, or Moderna which doesn't know if it can develop new medicines. I mean, if you wanted anything company-specific, I would think it would be a deduction [of risk] and not an addition [of risk], because this is about as low risk as you can get compared to many American companies.

Q. And is that particularly true for this company since they were almost fully subscribed?

A. Yeah, they were fully subscribed, contracted pipeline, for a product that America needs, quite frankly.

H.R. at 1119-1120. Rover's capacity on the pipeline was almost fully subscribed and Cornell said that in addition to having a "locked-in" revenue stream, the Rover faced "minimal risk from competitors." Cornell also reasonably criticized Reilly's property-specific risk premium methodology because Reilly provided no external market benchmark. Cornell concluded his criticism by saying that without any meaningful comparison, Reilly simply asserted a 4% premium was required.

Like his size risk premium, we find that the record lacks support for the inclusion of Reilly's property-specific risk premium. The Commissioner argues that Reilly's adjustment to his cost of equity for "property specific risk" by four hundred basis points was "improper and not based on any empirical market evidence or accepted corporate financial theory." TC's Brief at 25. We agree. Notwithstanding that there is substantial disagreement as to whether

these premiums are appropriate in the first place, we find that Reilly failed to demonstrate they were appropriate in this analysis. Clearly, this model is modified but ultimately emanates from the valuation of securities and corporate ownership. These modifications, which do not have adequate data to demonstrate they are even necessary, do nothing to change this fact. Swapping the word from “company” to “property” does not change the assumptions or approach; it merely changes the semantics. As such, it is susceptible to the same criticisms leveled against a company-specific risk premium, which courts have found unsupported. For example, in *Delaware Open MRI Radiology Associates v. Kessler*, 898 A.2d 290, 339 (Del. Ch. 2006), the Vice Chancellor referred to the company-specific risk adjustment as “heretical to CAPM.”

The Chancellor also found the following:

The calculation of a company specific risk is highly speculative and often is justified as a way of taking into account competitive and other factors that endanger the subject company’s ability to achieve its projected cash flows. In other words it is often a back-door method of reducing estimated cash flows rather than adjusting them directly. To judges, the company specific risk premium often seems like the device experts employ to bring their final results into line with the clients’ objectives, when other valuation inputs fail to do the trick.

Id. Those concerns perfectly mirror Eyre’s argument that the way to account for the risk is by adjusting cash flows, not cash flows and additional adjustments.

An appeals court in Arizona found that *Kessler* analysis was compelling in a case also involving one of Reilly’s appraisals. *Transwestern Pipeline Co. v. Ariz. Dept. of Revenue*, No. 1 CA-TX 19-0006, 2020 Ariz. App. Unpub. LEXIS 1462 (Ct. App. Aug. 6, 2020).¹³ While that Court

¹³ That opinion suggests the CFO’s testimony in that case was similar to his testimony in this case that a reduction was warranted because the construction of that pipeline was a mistake warranting a decrease in taxable value. *Id.* at ¶ 50, quoting the underlying decision by the Arizona Tax Court, (The CFO “testified that ‘we would tell anybody that this (Transwestern) was a big miss...a huge miss...wrong place, wrong time.’”). *See also id.* at ¶ 42 (discussing testimony from Ms. Hickey).

applied law specific to Arizona, its discussion on the company-specific risk premium is helpful and untethered to Arizona law. The main portion of the discussion states as follows:

“[T]he cost of equity capital is not capable of [] mathematical precision * * * and in fact is a judgment call, enlightened by consideration of all the relevant factors.” *Litchfield Park Serv. Co. v. Ariz. Corp. Comm’n*, 178 Ariz. 431, 437 (App. 1994) (citation omitted). However, the company-specific risk premium is controversial. See Kenneth Ayotte & Edward R. Morrison, *Valuation Disputes in Corporate Bankruptcy*, 166 U. Pa. L. Rev. 1819, 1829 (2018) (“Empirical finance research provides evidence against the existence of company-specific risk premia in the real world.”). Courts have noted that, “[t]o judges, the company specific risk premium often seems like the device experts employ to bring their final results into line with their clients’ objectives, when other valuation inputs fail to do the trick.” *Del. Open MRI Radiology Assoc., P.A. v. Kessler*, 898 A.2d 290, 339 (Del. Ch. 2006). Thus, those proposing such adjustments “must overcome some level of baseline skepticism founded upon judges’ observations over time of how parties have employed the quantitative tool of a company-specific risk premium.” *In re Sunbelt Beverage Corp. S’holder Litig.*, C.A. No. 16089-CC, 2010 WL 26539, at *12 (Del. Ch. Jan. 5, 2010) (as revised). A company-specific risk premium can be appropriate only “to the extent that the company has risk factors that have not already been reflected in the general equity risk premium as modified by [the industry] beta and the small company size premium.” *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1157-58 (Del. Ch. 2006) (quoting Pratt 2000 at 125); see also *CNB Int’l, Inc. v. Kelleher (In re CNB Int’l, Inc.)*, 393 +B.R. 306, 320 (Bankr. W.D.N.Y. 2008) (noting company-specific risks are duplicative of small-company risks unless the “particular circumstances indicate a business having risks other than those that would be associated with its status as a smaller enterprise.”), *aff’d on other grounds*, 440 B.R. 31 (W.D.N.Y. 2010).

Id. at ¶ 17. Those statements are completely consistent with Cornell’s report and testimony that Reilly’s adjustments were improper. We agree with Cornell that Reilly did show adequate support for the property-specific risk premium.

Reilly’s method for quantifying exempt property is unsupported.

As previously described, Reilly made two changes to his original report based on instructions from counsel. We have already discussed the shortcomings of Rover’s functional obsolescence instruction, specifically a lack of analysis by Reilly. Even Rover acknowledges

that the first change was “factual in nature” but claims that the second change was based on a legal instruction. Rover Br. at 49. This is not an accurate characterization.

The amount of exempt property is a value determination and not a legal conclusion. For instance, it would have been a legal instruction if counsel directed Reilly to exclude a certain legal category of exempt property. However, counsel gave a specific amount of the excluded property, which is ultimately a factual question that would be in the purview of the expert and not the client’s attorney.

True value is the ultimate question of fact in this matter, and even if the assumptions were consistent with professional appraisal standards, they must be scrutinized by this Board for whether they are supported and accurate. Here, no support was given for the propriety of the “predetermined value of Ohio exempt assets.” Rather, this number appears to come from the same annual report that Rover challenges, including booked costs that purportedly do not contribute to the value of the taxable property. Indeed, both parties have moved on from pure reliance on the statutory method, albeit giving varying weight to the actual costs of construction. In such circumstances, we find Reilly’s increased reduction after he “was supplied with the actual value associated with the Ohio exempt property” was not supported by credible evidence. Rover Br. at 52. The value of the exempt assets that the Commissioner previously approved was based on the statutory method, which has been rejected as an appropriate valuation method by Reilly, who opted for a unit valuation. Ultimately, the contributory value of those components should be based on the unit valuation methodology, which is how Eyre determined the value of his exempt property. Accordingly, we find that Reilly’s value for exempt property is another example of Reilly taking direction from his client

relating to factual conclusions that he should independently review and verify for this Board to review their reliability.

Eyre's appraisal is supported, albeit imperfect. His appraisal is entirely consistent with the Blackstone transaction. We find no reason to reject his appraisal based on Rover's arguments.

Eyre is experienced, and his opinions were derived from his expertise.

Several arguments related to Eyre's credentials were made at the hearing, and those credentials were contrasted with Reilly's credentials in the briefs. Both appraisers have impressive credentials. We glean from the reports that Reilly has more general appraisal experience, while Eyre seems to have more experience appraising natural gas pipelines. Eyre spent decades valuing properties similar to the subject by utilizing the unitary valuation method, which is the method that all appraisers agree is appropriate in this case. H.R. at 792-794. Eyre has also been a certified general licensed appraiser in multiple states for decades, and he holds designations from the American Society of Appraisers in machinery, technical specialties, and utilities. H.R. at 793.

We have already discussed the parties' arguments regarding the WSATA handbook, which Eyre relied upon. Reilly was largely critical of the handbook. Also, Rover faults the handbook because it provides that FERC depreciation captures obsolescence. Rover Br. at 70. We do not reject the manual or its use, nor do we find the manual must be used. The book is another piece of literature that may be considered, such as *The Appraisal of Real Estate*. The Board relies on appraisers to analyze whatever information they think is relevant to conclude to their opinion of value. The fact that Reilly claimed the handbook is not universally revered

does not mean Eyre's appraisal is not credible. We do not categorically accept or reject the handbook because this case does not call for it.

Rover also heavily criticizes Eyre by arguing Eyre's scope of work and highest and best use are flawed because he valued the property as a going concern. Eyre was very clear in his report that he did not value Rover Pipeline LLC. Eyre used the terms as synonymous with property operating at its highest and best use, not as dormant property. According to Eyre, the unit appraisal methodology is the valuation of an integrated group of *operating assets functioning* as a single economic unit without reference to the independent value of its component parts. Emphasis added. H.R. at 880; Ex. J at 9.

It is true that the unit valuation methodology uses tools similar to business valuation, as reflected in the reports for both appraisers. That does not mean Eyre conducted an enterprise valuation, which values the present owner's total business, including the tangible and intangible assets of the corporate entity. However, it includes the inseparable intangible enhancement of the value of an operating business that is produced by the assemblage of the operating assets that allow them to achieve their highest and best use. This enhancement reflects the benefit created by the unitary operation of the tangible personal property that is not attributable to cost or other intangible assets. This is why Eyre relied more on USPAP's divisions related to business valuation because similar tools are employed, notwithstanding that USPAP compliance is only a factor to be considered by this Board and is not required.

It is also fully appropriate to value an asset as though it is operating at market capacity for purposes of ad valorem taxation. For example, in the real property setting, if the Board were to consider the value of a multi-tenant office highrise or an apartment complex, the

presence of leases and any non-taxable property that may be included in the ownership of the building would not make it a business appraisal. Indeed, such is the premise for the income approach, as the ability to generate income from leasing space is considered part of ownership. Instead, the Board would review the value of that building based on market data, then reduce the contributory value of the non-realty that would not be subject to the tax.

Reilly utilizes different terminology but likewise began with a value for the total unit or total bundle of assets that would be included in an operational pipeline. Reilly's projections, CILM, and CAPMs, are all based on the pipeline as used by Rover. The primary difference is that Eyre valued Rover as though it would continue to operate under competent management. Every time Reilly claims to remove the value of the pipeline from the business that owns it, he is attempting to insulate the taxable personal property from the income generated by allowing shippers to utilize the pipeline. In doing so, he understates the value of the total unit to remove the benefit it receives from the operation. Much like the valuation of a building as though vacant rather than leased under market conditions. Thus, it is Eyre that valued the pipeline at its highest and best use - as the central piece of a group of assets that generates income for its owner (after removing the contributory value of those assets that are not taxable), while Reilly valued Rover as though the pipeline were not operating at its highest and best capacity and took further deductions based on Rover's directives.

We cannot conclude Eyre valued Rover Pipeline LLC or any other relevant limited liability company or limited partnership.

Eyre's cost approach is supported.

Eyre argued meaningful weight should be placed on the cost approach when he stated that “[t]he standard cost approach that assessment jurisdictions across the country that perform unit appraisal for properties such as the Rover Pipeline would be historical costs less depreciation.” H.R. at 816; Ex. J at 17. Eyre stated that the cost approach should stand on its own as an independent measure of value. Eyre stressed he did not ignore functional and economic obsolescence outside of regulatory depreciation. Instead, he focused on the cost approach as an independent measure because any additional obsolescence in excess of regulatory depreciation is captured (if it exists) in the income approach. H.R. at 818; Ex. J at 18. Otherwise, Eyre indicated, the two approaches would collapse and render essentially the same result, and the cost approach would no longer be a reliable check on the income approach. Eyre’s primary data came from Rover’s own FERC filings, which included adjustments for amortization and depreciation. To test the reliability of his HCLD valuation, Eyre also engaged in a market analysis of guideline companies operating in the natural gas pipeline industry. That 1.27 market-to-book ratio, according to Eyre, showed that “the market is perceiving that the market value of the debt and equity securities of the industry should be greater than the book value of the industry.” H.R. at 824. In other words, Eyre believed his assumptions were correct and confirmed the HCLD approach should be reduced no further because a “market-to-book ratio of greater than ‘1’ would be an indication of no obsolescence.” Ex. J at 19; H.R. at 824-825.

Rover is primarily critical of Eyre’s assumption that a separate obsolescence study should not be conducted, an assumption that relies on regulatory depreciation or the income approach to capture additional obsolescence. Rover is also critical of Eyre’s use of the market-

to-book ratios to confirm no obsolescence. Heaton was especially critical of Eyre's use of book-to-market, focusing on the fact the ratio, Heaton argued, is premised on securities because the numerator of the ratio represents the value of securities rather than a comparable property. We think the argument clearly lacks merit because Eyre did not use market-to-book ratios as a fundamental feature of his cost approach. Eyre used the measure as a check, and that check indicated no additional adjustment *in the cost approach* was necessary. Eyre reviewed credible sources like the Value Line Investment Survey, and Eyre showed his work in calculating the ratio using some of the same guideline companies used by Reilly in his approaches. Ex. 44 at 179. The reports from both appraisers used common financial metrics for shares and other assets.

We also notice that some of Rover's criticisms of Eyre's market-to-book ratio method assume that the property is an operating business, which Rover also says Eyre did but should not have. For instance, Rover said that "the pipeline owner has the burden of assembling and maintaining a workforce to operate the pipeline, whereas an investor stock does not." Rover Br. at 74. However, this type of burden would be associated with an operator and is not part of the cost of the pipeline or its owner. Similarly, Reilly's assertion that the ratio is meaningless because a stock price includes "assembled workforce, GIS systems, maps and records, contracts and permits" is not entirely valid. Rover Br. at 75. The workforce is associated with the operation of the pipeline, and the presence of the other assets is part of the "going concern" of an operational pipeline.

Further, there is some support in the case law for Eyre's approach, which provides that no separate study is needed because regulatory depreciation captures obsolescence for

regulated entities. For example, the Montana Supreme Court addressed that issue in *PacifiCorp v. State*, 253 P.3d 847 (Mont. 2001), finding it was not improper to rely on regulatory depreciation to capture obsolescence. That Court specifically relied on the federal FERC definition, which states FERC’s filings include “wear and tear, decay, action of the elements, inadequacy, [and] obsolescence * * *. It appears courts and tribunals have considered the issue on a case-by-case basis because of the unique properties and circumstances. *See, e.g., PacifiCorp v. Idaho State Tax Comm’n*, 153 Idaho 759 (2012) (holding the fact-finder’s conclusion that the taxpayer proved some economic obsolescence was not captured by regulatory depreciation was not clearly erroneous).

For the sake of completeness, we also note Heaton drew on at least one example from *The Appraisal of Real Estate* regarding shortfall from unstabilized rent impacting cash flows. Here, again, we find the criticism alone insufficient to disregard the appraisal because Eyre’s cost approach is premised on the idea that obsolescence is being captured just elsewhere, e.g., depreciation and the income approach. Heaton assumed the shipping contracts and tariff limit Rover’s ability to obtain an adequate return, which are facts we cannot find are supported on this record. Rover simply asserts it is being held back by its market-negotiated shipping agreements and the tariff without tying those considerations to actual or market cash flows, which was noted by Cornell. Also, it is unclear to the Board that renegotiation of the shipping contracts or tariff is off the table in the future. It appears the contracts, for example, are often only slated for fifteen years with possible options.

While Eyre’s report and testimony were at times unsatisfying regarding the view that “in theory,” regulatory depreciation should capture obsolescence, there is logical and legal

support for the idea. We find Reilly's approach no more persuasive, as we have already discussed.

Eyre's income approach is supported.

Eyre's income approach is outlined above, and we find nothing clearly wrong with the approach, which is the closest approach to the Blackstone transaction. Rover's primary criticism of Eyre's income approach relates to his calculation of the terminal cash flow. Rover asserts that Eyre improperly based this analysis on projections for the first three years of operation, using inflation to trend the third year over the terminal period. Rover claims that this approach inflated the terminal cash flows because his methodology continued high depreciation and low capital expenditures in the first three years of operation into perpetuity. Rover Br. at 80. Rover argues that it would have been more appropriate for Eyre to let depreciation equal the capital expenditures in his terminal value calculation, which would have resulted in using the net operating income to calculate the terminal value. Rover Br. at 81.

On cross-examination, Eyre acknowledged that he could have made other assumptions, as suggested by Rover, but asserted that his assumptions were reasonable. H.R. at 982. He testified that the rate of growth he used (1.62% based on inflation) was conservative and, as the Commissioner pointed out, was lower than Rover's own assumed annual growth rate of 2.5%. H.R. at 981; TC Br. at 11. Eyre further maintained that the type of approach Rover referenced with equal depreciation and capital expenditures was something he had done when valuing electric utilities but that it would not be appropriate for the subject pipeline. H.R. at 982. We find Eyre's explanation reasonable and supported. As such, we find Rover's challenges to his calculation unpersuasive.

Heaton leveled numerous other criticisms against Eyre's approach, but many appear trivial, others overlap, some could as easily be confused for criticisms of Reilly, and a few did not make it to the briefs. We need not address Heaton's arguments advocating that Eyre should have used methodologies similar to Reilly to the extent we have already rejected Reilly's method, e.g., arguments regarding illiquidity and a size premium.

Heaton was quite critical of Eyre's DGM because the model purportedly held the dividend yield constant and was susceptible to arbitrary choice. All of these models require some degree of discretion by the expert. Also, the DGM was only one of three models used by Eyre, and his final cost of equity was supported by his CAPM-EX and CAPM-SS.

Heaton also argued Eyre used artificially low treasury rates in his CAPMs for the risk-free rate, which Heaton believed were inappropriate because they were drawn during a period of time when the Federal Reserve cut short-term interest rates. Heaton argued earlier years should have been considered to account for the Federal Reserve monetary policy strategies during the time period selected by Eyre. However, Eyre's figure was comparable to Reilly's figure. For example, Eyre selected a risk-free rate of 2.87% for his CAPM-EX, and Reilly selected a risk-free rate of 2.9% for his MCAPM-EX, MCAPM-SS, and BUM.

It is well established that data closer in time to the tax lien date is more probative. Earlier periods may also be unreliable as of the tax lien date because each period has its own economic factors, monetary policies, fiscal policies, market conditions, global events, recessions, government interventions, and possible fiscal stimulus. In fact, Heaton's criticisms of Eyre's CAPMs support Cornell's notion that the CAPM and WACC can be easily manipulated, for example, by arbitrarily adding size and property-specific risk premiums. Here,

again, Heaton fails to show that minor changes to the risk-free rate would have had a significant ripple effect that would have led to a vastly different reconciled opinion of value.

We find none of these criticisms meritorious or sufficient to justify the rejection of Eyre's appraisal.



Eyre's appraisal is the best evidence of value.

Eyre testified that the Blackstone transaction should be seen to create an imputed value floor of at least \$4.8 billion, which he argued was close to his income approach figure. H.R. at 933. In its brief, Rover disputes the implication that Eyre's opinion of value is "close" to the values implicated by the Blackstone transaction, and we find some merit to Rover's arguments. Again, Eyre should have analyzed the transaction in his report if he believed it was probative for an appraisal. Notwithstanding, the evidence is still valid for our consideration, and both possible imputed "floor" values support Eyre's income approach. The floor values are between 6%-13% below Eyre's indicated income approach value. The difference between Cornell's imputed value and Eyre's reconciled value is approximately 22%, which we find is reasonable. Indeed, Eyre's value is sandwiched between actual costs and the Blackstone transaction.

CONCLUSION

For these reasons, the final determination of the Tax Commissioner is reversed. This case is remanded to the Commissioner with instructions to assess the pipeline consistent with Eyre's appraisal.¹⁴

¹⁴ A true and accurate copy of this opinion has been served on the parties and all non-parties required to be served pursuant to R.C. 5717.03(C).

BOARD OF TAX APPEALS		
RESULT OF VOTE	YES	NO
Mr. Harbarger		
Ms. Clements		
Ms. Allison		

I hereby certify the foregoing to be a true and complete copy of the action taken by the Board of Tax Appeals of the State of Ohio and entered upon its journal this day, with respect to the captioned matter.



Kathleen M. Crowley, Board Secretary