

BACKGROUND AND FACTS

Merrill Creek is a consortium of electric utility companies. The Subject Property is comprised of 10 out of 15 parcels under the ownership of Merrill Creek within Harmony, consisting of approximately 840 acres.² The ten individual parcels under appeal for the 2011, 2012, and 2013 tax years,³ contain various improvements or are vacant land.⁴

A 16.6 billion gallon +/- capacity reservoir was constructed on the Subject Property between 1985 and 1987. The reservoir is not used for drinking water; it was required by the Delaware River Basin Commission (DRBC), as a water storage reservoir for the purpose of replacing the freshwater equivalent of water evaporated by electric power generation units during drought years and low flow conditions in the Delaware River. There have been only a few number of releases from the reservoir since its construction (only four by best count); there is no dispute that the reservoir has more capacity than necessary for its intended purpose.⁵

For tax years 2011 and 2012, the total assessment of the Subject Property was:

| | |
|---------------------|----------------------|
| Land | \$ 5,470,800 |
| <u>Improvements</u> | <u>\$215,351,500</u> |
| TOTAL | \$220,822,300 |

For tax year 2013, the total assessment of the Subject Property was:

| | |
|---------------------|----------------------|
| Land | \$ 5,374,400 |
| <u>Improvements</u> | <u>\$215,351,500</u> |
| TOTAL | \$220,725,900 |

² 840.38 acres according to Merrill Creek; 835.70 acres according to Harmony.

³ See APPENDIX A for individual breakdown of assessment per lot, per tax year.

⁴ See APPENDIX B for specific improvements per lot.

⁵ According to Merrill Creek's expert appraiser, the reservoir has twice the capacity than required. He further indicated that given the few number of release over the years, it is clear that a smaller reservoir would have been sufficient.

Both parties utilized the services of a professional real estate appraiser who worked in conjunction with a cost estimator, to render an opinion of value for the Subject Property for each year at issue. It was stipulated that each professional real estate appraiser and cost estimator was qualified to testify as an expert; and each expert appraiser prepared a written report which was entered in evidence, also without objection.

The experts agreed that the highest and best use of the Subject Property is its current use as a reservoir. Furthermore, they agreed, and the parties stipulated, that the Subject Property is a Special Design Property and therefore the cost approach is the appropriate method of valuation. It was also agreed and stipulated that the total land value for all years at issue is \$4,800,000.

According to Merrill Creek’s expert appraiser, the Subject Property’s true value on the relevant valuation dates was:

| <u>AMOUNT</u> | <u>TAX YEAR</u> | <u>VALUATION DATE</u> |
|---------------|-----------------|-----------------------|
| \$104,905,000 | 2011 | October 1, 2010 |
| \$107,356,000 | 2012 | October 1, 2011 |
| \$103,385,000 | 2013 | October 1, 2012 |

In contrast, Harmony’s expert appraiser determined that the Subject Property’s true value on the relevant valuation dates was:

| <u>AMOUNT</u> | <u>TAX YEAR</u> | <u>VALUATION DATE</u> |
|---------------|-----------------|-----------------------|
| \$355,000,000 | 2011 | October 1, 2010 |
| \$365,750,000 | 2012 | October 1, 2011 |
| \$375,250,000 | 2013 | October 1, 2012 |

Merrill Creek also presented a witness who tracked the actual costs of the original construction of the reservoir on the Subject property which he estimated to be about \$217 million. This witness testified as to numerous factors which he believed accounted for excess cost of construction including environmental issues, weather issues, delays, quality

of management, contractor error, consistency of the underlying rock, etc. The court found his testimony to be credible.

APPLICABLE LAW

a. Burden of Proof

This court has consistently held,

It is a “settled rule [] that there is a presumption that an assessment . . . is correct and the burden of proof is on the taxpayer to show otherwise.” Aetna Life Ins. Co. v. City of Newark, 10 N.J. 99, 105 (1952); See L. Bamberger & Co. v. Div. of Tax Appeals, 1 N.J. 141, 159 (1948). However, “it is not sufficient for the taxpayer merely to introduce evidence: the presumption stands until sufficient competent evidence is adduced to prove a true valuation different from the assessment. Such evidence must be definite, positive and certain in quality and quantity to overcome the presumption.” Aetna Life Ins. Co., *supra*, 10 N.J. at 105 (1952).

Moreover, “[i]n a non-revaluation year . . . the Tax Court may increase the assessment even in the absence of a counterclaim . . . if the proofs justify same.” Campbell Soup Co. v. City of Camden, 16 N.J. Tax 219, 226 (Tax 1996) (citing Passaic St. Realty Assoc., Inc. v. City of Garfield, 13 N.J. Tax 482, 484 (Tax 1994)). However, “[i]n a revaluation year, absent a *counterclaim* by the taxing district, the Tax Court *may not increase the assessment* above the original assessment . . . without substantial evidence . . . [demonstrating] the assessment . . . is so far removed from true value and that the assessment methodology is arbitrary or capricious.” Campbell Soup Co., *supra*, 16 N.J. Tax at 226 (emphasis added); See F.M.C. Stores Co. v. Borough of Morris Plains, 100 N.J. 418, 431 (1985); See also Short Hills Assoc./Taubman Co. v. Township of Millburn, 20 N.J. Tax 352, 357-58 (Tax 2002).

[Gale & Kitson Fredon Golf v. Township of Fredon, 26 N.J. Tax 268, 278-79 (Tax 2011).]

b. Valuation Methodology

With regard to the valuation of real property in this state,

“New Jersey courts have held, consistent with established appraisal principles, that property can be valued according to three valuation methods: comparable sales, capitalization of income[,] and . . . cost.” 43 New Jersey Practice, State and Local Taxation, 7.3, at 101 (David E. Crabtree) (1st ed. 2007); See Pantasote Co. v. City of Passaic, 100 N.J. 408, 411 (1985); Glen Wall Assoc. v. Township of Wall, 99 N.J. 265, 279 (1985).⁶

However, in evaluating the valuation methodologies presented here, the court is not bound by the opinions of expert witnesses. See Wright v. Purepack Corp., 82 N.J. Super. 100, 111 (Cty. Ct. 1963). “[A]n expert’s opinion is only as good as the data upon which the expert relied.” Greenblatt v. City of Englewood, 26 N.J. Tax 41, 54-55 (Tax 2010). See also Dworman v. Tinton Falls, 1 N.J. Tax 445, 458 (Tax 1980) (An expert’s opinion “depends upon the facts and reasoning which form the basis of the opinion. Without explanation as to the basis, the opinion of the expert is entitled to little weight in this regard.”). An expert’s opinion may be adopted in whole or in part or completely rejected. See Atlantic City v. Atlantic City Bd. of Tax, 2 N.J. Tax 30, 42-43 (Tax 1980).

Although the court is required to apply its expertise in valuation matters, see Glen Wall Assocs. v. Wall Township, 99 N.J. 265 (1985), it must be in conjunction with the data submitted by the parties. See Greenblatt, supra, 26 N.J. Tax at 56, (emphasis added) (finding that the court can “deduce[]” the value of the property at issue “*only* . . . when there is sufficient substantial and competent evidence in the record to support that determination”). See also Global Terminal & Container Services v. Jersey City, 15 N.J. Tax 698, 703 (App. Div. 1996) (this court’s duty to “make an independent determination of value . . . is not boundless, [and, therefore] [t]he court need not make such determination in the absence of sufficient compliant evidence”) (citations and internal quotations omitted).

[Gale, supra, 26 N.J. Tax at 279-80.]

c. **Cost Approach**

The court has previously observed that

⁶ See also Transcon. Gas Pipe Line Corp. v. Township of Bernards, 111 N.J. 507 (1988).

Value estimation through the cost approach is an accepted and commonly used technique of property appraisal that requires the appraiser to follow a series of defined steps. See American Institute of Real Estate Appraisers, The Appraisal of Real Estate (9 ed. 1987) at 345-55. The first step is the determination of a value for land. The appraiser then computes the replacement cost of improvements, including all direct and indirect elements of cost expected to be incurred. Next, the appraiser examines the question of entrepreneurial profit and determines whether any adjustment to the total improvement cost previously derived is required to account for a market value differential. Then, depreciation accrued on the improvements by virtue of physical, functional and economic (or external) factors is deducted. Finally, the land and improvement values are added together.

[Texas Eastern Transmission Corp. v. Township of East Amwell, 13 N.J. Tax 24, 29 (Tax 1992), aff'd, 18 N.J. Tax 126 (App. Div. 1999).]

There are two variations of the cost approach method to value property: *the reproduction cost* and *the replacement cost*.

*i. **Reproduction Cost***

The reproduction cost approach, is defined as:

the estimated cost to construct [at current prices], as of the effective appraisal date, an exact duplicate or replica of the building being appraised, insofar as possible, using the same materials, construction standards, design, layout, and quality of workmanship and embodying all the deficiencies, superadequacies, and obsolescence of the subject improvements.

[The Appraisal of Real Estate 385 (13th ed. 2008).]

Merrill Creek's expert appraiser used the reproduction cost to construct an exact replica of the reservoir on the Subject Property. Said expert worked in conjunction with Merrill Creek's cost estimator, utilizing the *as built* plans to estimate costs at current values; they did not consider the actual costs of construction which was about 220 million. The

conclusions of Merrill Creek's expert appraiser for the current costs were \$192 million, \$202 million, and \$200 million for 2010, 2011, and 2012 respectively, all less than the actual cost of construction.⁷ Said expert testified that the reservoir could be built for less money in 2010 than when it was originally built.

His reproduction cost approach involved four steps: (1) estimate the value of the land, (2) estimate the cost to construct the existing structure and site improvements (including direct costs, indirect costs, and an appropriate entrepreneurial profit), (3) deduct all accrued depreciation, including obsolescence, in the property being appraised from the cost of the new structure,⁸ and (4) add the value of the land to the new depreciated cost of the structure.⁹

ii. Replacement Cost

The replacement cost approach is defined as “the estimated cost to construct, as of the effective appraisal date, a substitute of the building appraised using *contemporary* materials, standards, design, and layout.” The Appraisal of Real Estate, *supra*, at 385 (emphasis added).

Harmony's expert testified, that there is no new reservoir construction technology today different from the 1980s when the Subject Property's reservoir was constructed. Furthermore, he testified that he employed a *replacement cost analysis*, utilizing the same design as the existing reservoir. However, the approach of Harmony's cost estimator in trending the original costs forward to *replace* the exact same reservoir, appears to the court

⁷ This is a result more typically seen in the Replacement Cost approach, not the Reproduction Cost approach. See The Appraisal of Real Estate 386 (13th ed. 2008) (“a replacement cost figure is usually lower and may provide a better indication of the existing structure's contribution to value.”)

⁸ Merrill Creek's expert estimated physical depreciation of 32.96%, 34.28%, and 35.78% for 2010, 2011, and 2012 respectively. Merrill also estimated 15% functional obsolescence due to super-adequacy.

⁹ Merrill Creek's expert did not add Entrepreneurial Incentive which he determined was not appropriate for a Special Purpose Property because there was no expectation of reward.

to be more in line with a *reproduction cost analysis*. Incorporating that trended cost analysis, Harmony's expert appraiser used the following six steps to conclude value: (1) estimate the value of the land, as if vacant and available for development to its highest and best use, (2) estimate the replacement cost of the improvements, as of the effective date of the appraisal,¹⁰ (3) estimate the *Entrepreneurial Profit* as a percentage of replacement cost new,¹¹ (4) estimate the accrued depreciation – the losses in value from physical deterioration, functional obsolescence, and external obsolescence,¹² (5) deduct the accrued depreciation from the replacement cost new, to arrive at a depreciated improvement cost estimate, and (6) add the estimated land value to the depreciated improvement costs, to arrive at an indicated value via the Cost Approach.

Analysis

The court may affirm or deny an assessment by adopting portions from both parties. “[A] judge may adopt ‘so much of it as appears sound, reject all of it, or adopt all of it.’” Jersey City, Div. of Water v. Township of Parsippany-Troy Hills, 16 N.J. Tax 504, 528 (Tax 1997), aff’d, 17 N.J. Tax 538 (App. Div. 1998).

Both expert appraisers and cost estimators produced generally credible valuation reports and rendered credible testimony. However, Merrill Creek's cost estimator is an engineer who specializes in contamination sites, whereas, Harmony's cost estimator is an engineer who spent his career specializing in dams; he testified that he designed many dams

¹⁰ Harmony's expert used the actual costs of construction and trended the numbers forward to the tax years at issue. Merrill Creek's expert attempted to prepare a trending analysis but discontinued the effort finding that he was unable to identify various components. He concluded that trending was not reliable in the present matters given the 25+ year age of the reservoir on the Subject Property.

¹¹ Harmony's expert estimated a 10% entrepreneurial incentive for each year.

¹² Harmony's expert estimated 20% depreciation for each year. No functional obsolescence was deducted.

and supervised the construction of dams.¹³ Accordingly, the court finds the testimony and cost conclusions of Harmony's cost estimator to be more compelling. Furthermore, the court is satisfied that the trended cost approach utilized by Harmony's appraisal expert is most appropriate under the current facts. (See section a. below). To that end, by making certain adjustments to the cost approach used by Harmony's expert, and utilizing various aspects of Merrill Creek's expert, the court arrives at true values that affirm the original assessment of the Subject Property for each tax year in issue. The court's reasoning is set forth below.

a. Harmony's Trended Cost Analysis

The court observes that the approaches to value of each party's experts produce certain anomalies. Merrill Creek's *reproduction cost* approach yielded construction costs for each tax year lower than the original cost of construction; a result more typical of the replacement cost approach. See The Appraisal of Real Estate, supra, at 386. On the other hand, in Harmony's *replacement cost approach*, the original costs of construction are trended forward to ascertain the current cost of *reproducing* the existing reservoir. This appears to be more in line with the reproduction cost approach. See id. at 385. Harmony's expert explains that in this case, for the trending method he utilized, there is little distinction between the *reproduction* and *replacement* cost approaches. The court finds Harmony's trended cost approach more compelling.

The Appraisal of Real Estate indicates that while “[t]he theoretical base (and classic starting point) for the cost approach is reproduction cost, . . . replacement cost is commonly used because it may be easier to obtain and can reduce the complexity of depreciation

¹³ The expert testified that he was involved with 60-70 dam rehabilitation projects and 20-25 dam construction projects during his career.

analysis.” Id. at 385. “Under the cost approach as it applies to special purchase property [like the reservoir in the present matters] . . . the determination made in applying the cost approach is how much would a prudent person pay to *replace* the property.” Transcon., supra, 111 N.J. at 531 (emphasis added). Under the current facts, however, the analyses of *reproducing* or *replacing* the reservoir on the Subject Property constitute *a distinction without a difference*.¹⁴

While the particular trending methodology utilized to arrive at replacement cost of a gas pipeline in Transcon. was rejected by the Court, see id. at 527-28, the Court found that *trending* was an acceptable approach to determine *replacement cost*:

[C]are must be taken to determine an equitable manner of calculating *replacement costs*. Cf. Haworth, supra, 178 N.J. Super. at 261, 2 N.J. Tax at 313 (describing the elements of trended original cost methodology). The approach used by the Township's expert in this case was . . . an acceptable method of determining *replacement cost*, as long as economic obsolescence is properly reflected, *but there are others*. In particular, the *trended original cost approach*, suggested in Hackensack Water Co., supra, 77 N.J. at 217-18, and outlined in Haworth, in which the original cost is subject to yearly adjustments to reflect depreciation and increased costs of *replacement*, *may in some cases be a more convenient valuation methodology*. See Northern Natural Gas Co., supra, 208 Kan. at 349-51, 492 P.2d at 158-59 (describing the trended cost approach).

[Id. at 542, (emphasis added).]¹⁵

¹⁴ The phrase “distinction without a difference” appears to generate from the circa 1776 correspondence of American loyalist Samuel Curwen, Judge of Admiralty, while exiled in England. See Bartlett Jere Whiting, Early American Proverbs and Proverbial Phrases 11 (1977).

¹⁵ The Transcon. Court observed that the Court in Hackensack Water Co. v. Old Tappan, 77 N.J. 208 (1978) “accepted the acquisition cost of the property as its fair market value . . . in the absence of any evidence concerning the replacement cost and indicated *that valuing such property* [i.e. a reservoir] *according to its trended original cost would be proper*.” Id. at 529 (emphasis added). The Transcon. Court, however, found Hackensack Water Co., and “the handful of [other similar] cases . . . in which evidence of original cost was considered probative of fair market value . . . *readily distinguishable*.” Id. (emphasis added). “The validity of these opinions are . . . limited to the particular facts before the courts at the time of decision, and in light of our decision today have no precedential authority with respect to the issue of valuation.” Id. at 529-530.

In Benefit Facilities Corp. v. Borough of Peapack & Gladstone, 11 N.J. Tax 359, 378 (Tax 1990), the court found that “the most reliable indicator of the value [of a unique village-style office building campus] is the actual cost of construction trended up to the applicable assessment dates.” However, in Hoechst Celanese Corp. v. Township of Bridgewater, 12 N.J. Tax 532, 540 (Tax 1992), the court found that “[t]rending up construction costs over a twenty-year period is not a reliable indication of current costs. American Institute of Real Estate Appraisers, The Appraisal of Real Estate 362 (9th ed. 1987).”¹⁶

This court is satisfied that the trended original cost approach utilized by Harmony’s expert is the most appropriate valuation methodology in the present matters. First, the trended original cost approach is an accepted methodology. See Transcon., *supra*, at 542; see also Benefit Facilities, *supra*, 11 N.J. Tax at 378. “The replacement Cost Approach *frequently* makes use of cost conversion factors which indicate the *trend of building costs over a period of time* and for different locations.” Handbook for New Jersey Assessors 373 (2013) (emphasis added).

Second, while the reservoir on the Subject Property was more than twenty years old on the assessment dates for each of the tax years at issue, it was not contested that the reservoir would be built the exact same way today as it was in the 1980s. Furthermore, the court finds that the original costs of construction are accurate. These factors diminish the concern over the age of the improvements on the Subject Property as well as the reliability of a cost trending analysis.

¹⁶ “Appraisers who use cost-index trending should recognize that recent costs are more accurate than older costs adjusted with the index.” The Appraisal of Real Estate 362 (9th ed. 1987).

b. Entrepreneurial Incentive

The court finds that Entrepreneurial Incentive should not be added to the cost of the improvement. Entrepreneurial Incentive is

“[a] market-derived figure that represents the amount an entrepreneur receives for his or her contribution to a project and risk” . . . Whether called "entrepreneurial profit" or "entrepreneurial incentive," it represents the difference between the total of (1) the cost of acquiring land plus (2) the cost of constructing an improvement and the improved property's market value.

[Westwood Lanes, Inc. v. Borough of Garwood, 24 N.J. Tax 239, 249-250 (Tax 2008) (citation omitted).]

Furthermore,

An anticipated profit is often the primary motivation for developing property. The total cost of a project before entrepreneurial profit should be less than the market value of the completed property to reward investors for their risk. The difference between the cost of development and the value of a property after completion is the entrepreneurial profit or loss.

[Texas, supra, 13 N.J. Tax at 40 (citation omitted).]

Our courts have recognized various criteria for the inclusion of Entrepreneurial Incentive. “New Jersey courts include entrepreneurial profit within the market value of property where the developer or owner-operator makes improvements to property with the anticipation of realizing a profit on its subsequent resale.” Westwood, supra, 24 N.J. Tax at 249. Furthermore, “although they generally do not recognize entrepreneurial profit where there is no market data supporting its inclusion within market value . . . New Jersey courts may still infer entrepreneurial incentive, and thus recognize and include entrepreneurial profit within a property's value, if they find, despite the absence of

supporting market-evidence, that such property would not be improved but for the likely compensation of a developer's or owner-operator's efforts.” Id. at 250 (citations omitted).

In Texas, the court explained that

[a]n adjustment for entrepreneurial profit has not been allowed when the market provided no basis for it or when the property was not of a kind whose development is undertaken to realize a real estate development profit. Badische Corp. v. Kearny, 11 N.J. Tax 385, 402 (Tax 1990) (improvements had suffered substantial economic obsolescence); Litton Business Sys., Inc. v. Morris Plains Bor., 8 N.J. Tax 520, 533 (Tax 1986) (income and market approaches supported no increment in value for entrepreneurial profit); Berkley Arms Apartment Corp. v. Hackensack, 6 N.J. Tax 260, 272 – 73 (Tax 1983) (advanced age of improvements and limited extent of entrepreneurial effort required to convert rental apartment building to cooperatives rendered factor inappropriate) . . . In Lawrence Assocs., the court found that an entrepreneurial profit factor was appropriately applied to the reproduction cost of the shopping mall’s buildings and site improvements, but not to the cost of a highway overpass constructed for access to the mall “because the overpass *per se* is not a commercial venture which an entrepreneur would be induced to construct with the expectation of earning a profit separate from that derived from the Mall itself . . .”

[13 N.J. Tax at 41-42.]

Here, Entrepreneurial Incentive should not be included because it is clear to the court that profit was not the primary motivation for developing the Subject Property. The court is persuaded by Harmony’s argument that “[t]he development and construction of the property did not involve any entrepreneurial risk or expertise. The construction of the subject property did not involve any expectation of a reward, which is the definition of entrepreneurial profit.” As Harmony’s expert testified, the principle of uniformity does not require that the reservoir “be treated in the same manner as investment or speculation type properties.” The reservoir, according to said expert, is “not an investment grade . . . Nobody

builds a reservoir and then goes to sell it on the market to see if they can make a[n] entrepreneurial profit.”

The consortium of power companies constructed and operated the reservoir under mandate of the DRBC. Unlike Westwood, where a catering hall was built to operate a business as a potential investment, here, the reservoir was built because the DRBC required it be built. The reservoir was clearly not a potential investment. See Westwood, 24 N.J. Tax at 252.

In Texas, the court concluded that a pipeline was

a kind of property for which entrepreneurial profit or loss analysis is inappropriate. There is simply no indication of any market against which to compare replacement cost. Pipeline is not constructed by developers in the expectation of profit on its sale. It is exclusively constructed by regulated operating companies for use in their business at costs which are passed through to the ratepayers. The absence of actual market transactions impelled [the court] to reject the pipeline sales offered to establish value No entrepreneurial profit or market adjustment is therefore to be employed in valuing the subject property.

[13 N.J. Tax at 42.]

Similarly, here, the reservoir is also a regulated entity that was not constructed with the expectation of profit. Accordingly, no Entrepreneurial Incentive should be added.

c. Functional Obsolescence

It is clear to the court, as stated in the report of Merrill Creek’s appraisal expert, that

[t]he major item of functional obsolescence at the Merrill Creek Reservoir is the superadequacy of the reservoir’s capacity. The reservoir was built to a capacity of approximately 16 billion gallons as required by the DRBC. However, releases required by the DRBC have occurred only four times since Merrill Creek has been in operation.

New Jersey courts have provided little guidance with regard to functional obsolescence. In one decision, the Tax Court found that functional obsolescence from a superadequacy should be deducted from the cost of the improvement.

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. A building that was functionally adequate at the time of construction can become inadequate or less appealing as design standards, mechanical systems, and construction materials change over time.... It can also be caused by a superadequacy, which means that some aspect of the subject property exceeds market norms.

[BASF Corp. Coating & Ink Div. v. Town of Belvidere, 23 N.J. Tax 551, 571 (Tax 2007), aff'd 24 N.J. Tax 416 (App. Div. 2009)]

Court decisions in other jurisdictions which have addressed functional obsolescence are instructive. The Oregon Supreme Court held that superadequacy is “an asset present in the subject property that is not present in the replacement property and does not contribute to value an amount equal to its cost.” Hewlett Packard Co. v. Benton Cnty. Assessor, 356 P.3d 70, 80 (2015). Additionally, Michigan’s Appeals Court found that although “[b]y definition, replacement cost eliminates functional obsolescence due to excess construction or superadequacy,” this is not always true. See Meijer Inc. v. City of Midland, 610 N.W.2d 242, 246 (2000). According to Meijer, an assessment must account for various types of functional obsolescence, and the court must determine if the sources of functional obsolescence are *in fact* eliminated by use of the replacement cost approach. See id.

An example of an incurable superadequacy is excess construction. In Oregon, the Supreme Court determined that the non-core space of Hewlett Packard's property had a superadequacy. "[O]nly 1.2 million square feet of the property provided utility to a potential owner. But the subject property was 2 million square feet. As a result, the subject property had 800,000 square feet of superadequate space, which corresponded to the non-core space." Hewlett-Packard, *supra*, 356 P.3d. 80.

New York's Court of Appeals found that functional obsolescence due to excess construction costs has been allowed for a regulated electric generating property. See Matter of Consolidated Edison Co. of N.Y., Inc. v. City of New York, 869 N.E.2d 634. Moreover, Alaska's Supreme Court found that a superadequacy can be present on regulated property even when excess capacity is required.

Any obligation the owners may have to maintain excess capacity does not make an obsolescence deduction for superadequacy improper. If there were no requirement to maintain excess capacity then . . . a deduction for superadequacy would be appropriate because the too-large pipeline is no more valuable than a smaller, less expensive pipeline. The addition of a legal requirement to maintain a certain operating capacity does not change [the] analysis. Such an obligation cannot make the pipeline worth more; if anything, this constraint would make the pipeline less valuable than before. A deduction for superadequacy, therefore, is still appropriate.

[BP Pipelines (Alaska) Inc. v. State, 325 P.3d 478, 493 (2014).]

Here, the court finds that functional obsolescence from a superadequacy should be deducted. Merrill Creek's expert provided credible evidence for a 15% deduction for functional obsolescence due to an incurable superadequacy. Similar to Hewlett-Packard, where the court determined that nearly half of the property was superadequate, *non-core*

space, here, only 50% of the consumptive use was used. Moreover, Harmony’s appraisal expert also recognized that the reservoir’s minimal usage over the years; according to him, the reservoir had been used for its intended purpose for only 105 days over 12 years.

“The use of replacement cost can eliminate the need to measure many, but not all, forms of functional obsolescence such as superadequacies and poor design.” Appraisal of Real Estate 386 (13th ed. 2008). In theory then, the replacement cost should implicitly eliminate functional obsolescence. Harmony’s expert acknowledged such design factors as the reservoir’s size and infrequent usage over the years, its limited sedimentation load that enhances its effective capacity and function, its current capacity to handle future rainfall and seismic activities, and its anticipated continued functionality due to superior maintenance. However, the expert failed to account for much of the excess construction costs testified to by Merrill Creek’s witness.

Furthermore, the court is satisfied that functional obsolescence can occur on regulated properties even when excess capacity is required. The court is persuaded by the reasoning of the New York Court of Appeals in Consolidated Edison, where a regulated property owned by an electric generating company was found to have functional obsolescence, see id., supra, 869 N.E.2d 634, and the Alaska Supreme Court in BP, where it was found that “any obligation the owners may have to maintain excess capacity does not make an economic obsolescence deduction for superadequacy improper.” Id., supra, 325 P.3d at 493. Similarly, here, a deduction for functional obsolescence is not improper merely because the reservoir is a regulated entity and its “[o]wners may have to maintain excess capacity . . .” Id. The court is satisfied that a deduction for functional obsolescence is appropriate in the present matters.

Conclusion

The court finds that Harmony's cost approach is more compelling. However, while Harmony's expert used an improvement cost estimate and depreciation estimate acceptable to the court, he also added entrepreneurial incentive and dismissed functional obsolescence. The court finds that including entrepreneurial incentive and dismissing functional obsolescence is inappropriate under these facts. Accordingly, the court will conclude value in these matters by revising Harmony's cost approach to eliminate entrepreneurial incentive and include functional obsolescence.

To that end, in valuing the Subject Property for the tax years of 2011, 2012, and 2013 using Harmony's cost approach adjusted to eliminate entrepreneurial incentive, and to include Merrill Creek's 15% deduction for functional obsolescence, the court arrives at true values of \$263,700,000, \$271,461,000, and 279,022,000, respectively (see Appendix C). The ratios between the court's determined true value for each tax year and the original assessments are 83.7%, 81.3%, and 79.1% for 2011, 2012, and 2013 respectively.¹⁷ These ratios fall within the established Chapter 123 limits.¹⁸

Therefore, for the foregoing reasons, the Subject Property's tax assessments for tax years 2011, 2012, and 2013 are affirmed. The Tax Court shall issue judgments consistent with this opinion.

¹⁷ 2011: $\$220,822,300 \div \$263,700,000 = .8373997$ (say 83.7%); 2012: $\$220,822,300 \div \$271,461,000 = .81345866$ (say 81.3%); and 2013: $\$220,725,900 \div \$279,022,000.00 = .79106988$ (say 79.1%).

¹⁸ 2011: upper limit 86.58%, lower limit 64%; 2012: upper limit 94.04%, lower limit 69.50%; and 2013: upper limit 100.43% (say 100%) and 74.23%.

Appendix A

2011 – Original Assessments

| Block-Lot | Land | Improvements | Total |
|--------------|--------------------|----------------------|----------------------|
| 9-56 | \$73,600 | | \$73,600 |
| 9-57 | \$121,500 | \$342,800 | \$464,300 |
| 20-1 | \$96,900 | | \$96,900 |
| 21-1 | \$1,228,900 | \$23,370,100 | \$24,599,000 |
| 24-1 | \$3,648,500 | \$176,638,500 | \$180,287,000 |
| 24-6 | \$10,000 | | \$10,000 |
| 24-23* | \$0 | | \$0 |
| 38-4 | \$122,300 | \$100 | \$122,400 |
| 39-35 | \$92,100 | | \$92,100 |
| 300-2.01 | \$77,000 | \$15,000,000 | \$15,077,000 |
| Total | \$5,470,800 | \$215,351,500 | \$220,822,300 |

2012 – Original Assessments

| Block-Lot | Land | Improvements | Total |
|--------------|--------------------|----------------------|----------------------|
| 9-56 | \$73,600 | | \$73,600 |
| 9-57 | \$121,500 | \$342,800 | \$464,300 |
| 20-1 | \$96,900 | | \$96,900 |
| 21-1 | \$1,228,900 | \$23,370,100 | \$24,599,000 |
| 24-1 | \$3,648,500 | \$176,638,500 | \$180,287,000 |
| 24-6 | \$10,000 | | \$10,000 |
| 24-23* | \$0 | | \$0 |
| 38-4 | \$122,300 | \$100 | \$122,400 |
| 39-35 | \$92,100 | | \$92,100 |
| 300-2.01 | \$77,000 | \$15,000,000 | \$15,077,000 |
| Total | \$5,470,800 | \$215,351,500 | \$220,822,300 |

2013 – Original Assessments

| Block-Lot | Land | Improvements | Total |
|--------------|--------------------|----------------------|----------------------|
| 9-56 | \$73,600 | | \$73,600 |
| 9-57 | \$121,500 | \$342,800 | \$464,300 |
| 20-1 | \$500 | | \$500 |
| 21-1 | \$1,228,900 | \$23,370,100 | \$24,599,000 |
| 24-1 | \$3,648,500 | \$176,638,500 | \$180,287,000 |
| 24-6 | \$10,000 | | \$10,000 |
| 24-23* | \$0 | | \$0 |
| 38-4 | \$122,300 | \$100 | \$122,400 |
| 39-35 | \$92,100 | | \$92,100 |
| 300-2.01 | \$77,000 | \$15,000,000 | \$15,077,000 |
| Total | \$5,374,400 | \$215,351,500 | \$220,725,900 |

* It appears from both experts that the original assessment for Block 24 Lot 23 was zero.

Appendix B

Improvements

- 9-57
 - Operations and Maintenance Building
- 24-1
 - Main Dam
 - South East Saddle Dike
 - North West Saddle Dike
 - North West Saddle Dike 2
 - Relief Spillway
 - Conservation Outlet Building
 - Inlet/Outlet Tower
 - Tunnel/Pipeline & Surge Tank
 - Visitor Center
 - Boat Ramp, Stone Bridge, Landscaping
- 38-4
 - Electric Substation
- 300-2.01
 - Pump House Building

| Block-Lot | Acres | Improvement |
|-----------|--------|---|
| 9-56 | 1.86 | None |
| 9-57 | 5.07 | Operations & Maintenance |
| 20-1 | 4.98 | None |
| 21-1 | 152.34 | Portion of an underground pipeline; no above ground improvements. |
| 24-1 | 650 | Dam/Dikes/Relief Spillway/Conservation Outlet/Inlet Tower/Pipeline & Surge Tank/Visitor Center/Boat Ramp/Stone Bridge/Landscaping |
| 24-6 | 0.5 | None |
| 24-23 | 4.68 | None |
| 38-4 | 14.56 | Electric Substation |
| 39-35 | 4.19 | None |
| 300-2.01 | 2.20 | Pump House Building |

Appendix C

In arriving at value, the court accepts Harmony's improvement cost estimate less Entrepreneurial Incentive. The court also accepts Harmony's depreciation estimate. The court accepts Merrill Creek's functional obsolescence estimate. The court's conclusions of value for each tax year at issue is as follows:

| | 2011 | 2012 | 2013 |
|---------------------------------------|----------------|----------------|----------------|
| Original Cost | 199,000,000.00 | 199,000,000.00 | 199,000,000.00 |
| Comparative Cost Multiplier (Eastern) | 2.00 | 2.06 | 2.12 |
| Total Replacement Cost New | 398,000,000.00 | 409,940,000.00 | 421,880,000.00 |
| Less Depreciation (20%) | 79,600,000.00 | 81,988,000.00 | 84,376,000.00 |
| Less Functional Obsolescence (15%) | 59,700,000.00 | 61,491,000.00 | 63,282,000.00 |
| Depreciated Cost of Improvement | 258,700,000.00 | 266,461,000.00 | 274,222,000.00 |
| Land Estimate | 4,800,000.00 | 4,800,000.00 | 4,800,000.00 |
| Overall Cost Approach Value Estimate | 263,500,000.00 | 271,261,000.00 | 279,022,000.00 |
| | | | |
| Total Original Assessment | 220,822,300.00 | 220,822,300.00 | 220,725,900.00 |
| Ratio – Assessment to True Value | 0.838035294 | 0.814058416 | 0.79106988 |