STATE OF NORTH CAROLINA

COUNTY OF WAKE

BEFORE THE PROPERTY TAX COMMISSION
SITTING AS THE STATE BOARD OF
EQUALIZATION AND REVIEW

In the matter of
The appeals of Southern Railway Company,)
Norfolk Southern Railway Company and)
Seaboard Coastline Railroad Company from)
the valuation of their property by the)
North Carolina Department of Revenue for)
1980.)

FINAL

DECISION

This matter, coming on to be heard, and being heard, before the Property Tax Commission, sitting as the State Board of Equalization and Review, in the City of Raleigh, Wake County, North Carolina, on October 21, 22 and 23, 1980, pursuant to the appeals of the above taxpayers from the valuation of their property by the Department of Revenue for 1980.

STATEMENT OF CASE

Southern Railway Company is a Class I Railroad with its principal office in Washington, D. C. It has total track mileage of 8,912 miles -- 21.15% of which is in North Carolina. Total 1979 operating revenues amounted to $9,939,819,000, 15.51% of which was generated in North Carolina.

Norfolk Southern Railway Company is a Class II Railroad with its principal office in Washington, D. C. It is a subsidiary of Southern Railway Company. 82.33% of its total track mileage of 1,061 miles is in North Carolina. Its 1979 operating revenues amounted to $47,238,000 with 75.92% generated in North Carolina.

Seaboard Coastline Railroad Company is a class I Railroad with its principal office in Richmond, Virginia. It has total track mileage of 13,713 miles, 17.84% of which is in North Carolina. North Carolina operating revenues amounted to 14.84% of the total 1979 figure of $1,049,747,000.

All three companies are regulated by the Interstate Commerce Commission and are therefore public service companies as defined in G. S. 105-333(15). Accordingly, their property is subject to appraisal, apportionment and allocation under the provisions of G. S. 105-335 through 105-338 and certification for taxation under G. S. 105-339 and 105-340. As they relate to these appeals, these sections require the Department of Revenue to (1) appraise the system property of each public service company at its true value in money under the unit method of appraisal; (2) apportion to North Carolina a fair and reasonable share of the unit value; (3) allocate North Carolina's share of the unit value to the counties and municipalities in which the property is subject to taxation; and (4) certify the allocations to these counties and municipalities for taxation by them.

Upon completion of its appraisals each year, the Department of Revenue is required to notify each public service company of its proposed valuation. The public service company has twenty days to appeal the Department's proposed value to the Property Tax Commission. Notices of the Department's proposed North Carolina valuations of the subject railroads were mailed to the firms on September 4, 1980. The notices reflected the following figures.

Southern Railway Company	- $185,000,000
Norfolk-Southern Railway Company	- $ 50,000,000
Seaboard Coastline Railroad Company	- $141,250,000

G. S. 105-342(a) provides that public service companies are entitled to a copy of the workpapers prepared by the Department of Revenue in arriving at the valuation of their property. Copies of the workpapers for the subject railroad companies were furnished to Mr. J. I. Wilkerson, Ad Valorem Tax Director for Seaboard, for delivery to the respective companies on September 10, 1980. Following a review of the workpapers, representatives of the railroads and the Department of Revenue met in Raleigh on September 11, 1980, to review the appraisals. As a result of these discussions, the Department reduced its North Carolina valuation of Seaboard from $141,250,000 to $136,000,000. On the same date, the railroads gave notice of appeal to the Property Tax Commission on the ground that the Department's appraisals of the subject properties were in excess of their true value in money as of January 1, 1980. These appeals relate only to the total system valuations of the properties. There is no dispute about the apportionment of the system values to North Carolina nor to the allocation of the apportionment to the local taxing units.

Prior to and following the hearing before the Property Tax Commission on October 21, 22 and 23, attorneys for the railroads and the Department of Revenue filed Briefs outlining their respective positions. At the request of attorneys for the railroads, the parties were also given an opportunity to make final arguments on March 25, 1981.

The railroads were represented by the following attorneys:

Southern and Norfolk - Mr. Everett B. Gibson, Mr. Gregory G. Fletcher,

Mr. L. P. McLendon, Jr., Mr. Edward C. Winslow, III, Mr. William C. Antoine,

and Mr. James W. McBride.

Seaboard - Mr. Armistead J. Maupin, Mr. Charles B. Neely, Jr., Ms. Nancy S.

Rendleman, and Mr. William C. Basney.

The Department of Revenue was represented by Assistant Attorney General George W. Boylan

ISSUE

Are the Department's appraisals of the subject properties in excess of their true value in money as of January 1, 1980?

APPLICABLE LAW

The law governing the taxation of property in the State of North Carolina is found in the "Machinery Act" N.C. General Statute 105-271, et seq.

G. S. 105-283 provides as follows:

" 105-283. Uniform appraisal standards. -- All property, real and personal, shall as far as practicable be appraised or valued at its true value in money. When used in this Subchapter, the words "true value" shall be interpreted as meaning market value, that is, the price estimated in terms of money at which the property would change hands between a willing and financially able buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all the uses to which the property is adapted and for which it is capable of being used. For the purposes of this section, the acquisition of an interest in land by an entity having the power of eminent domain with respect to the interest acquired shall not be considered competent evidence of the true value in money of comparable land."

G. S. 105-284 provides as follows:

" 105-284. Uniform assessment standard. -- All property, real and personal, shall be assessed for taxation at the valuation established under G. S. 105-283, and taxes levied by all counties and municipalities shall be levied uniformly on assessments determined as provided in this section."

G. S. 105-333 provides in pertinent part as follows:

" 105-333. Definitions. -- When used in this Article unless the context requires a different meaning: . . . .

(14) 'Public service company' means railroad company, pipeline company, gas company, electric power company, electric membership corporation, telephone company, telegraph company, bus line company, motor freight carrier company, airline company, and any other company performing a public service that is regulated by the Interstate Commerce Commission, the Federal Power Commission, the Federal Communications Commission, the Federal Aviation Agency, or the North Carolina Utilities Commission except a water company, a radio common carrier company as defined in G.S. 62-119(3), a cable television company, or a radio or television broadcasting company. (For purposes of appraisal under this Article, this definition shall include a pipeline company whether or not it performs a public service and whether or not it is regulated by one of the agencies named in the preceding sentence.)

(15) 'Railroad Company' means a public service company engaged in the business of operating a railroad to, from, within or through this State on rights-of-way owned or leased by the company. It also means a company opearting a passenger service on the lines of any railroad located wholly or partly in this State.

(17) 'System property' means the real property and tangible and intangible personal property used by a public service company in its public service activities. It also means public service company property under construction on the day as of which property is assessed which when completed will be used by the owner in its public service activities."

G. S. 105-335 provides in pertinent part as follows:

" 105-335. Appraisal of property of public service companies. -- (a) Duty to Appraise. — In accordance with the provisions of subsection (b), below, the Department of Revenue shall appraise for taxation the true value of each public service company (other than bus line, motor freight carrier, and airline companies) as a system (both inside and outside this State.) Certain specified properties of bus line, motor freight carrier, and airline companies shall be appraised by the Department in accordance with the provisions of subsection (c), below, and all other properties of such companies shall be listed, appraised, and assessed in the manner prescribed by this Subchapter for the properties of taxpayers other than public service companies.

(b) Property of Public Service Companies Other Than Those Noted in Subsection (c). —

(1) System Property. — Each year, as of January 1, the Department of Revenue shall appraise at its true value (as defined in G. S. 105-283) the system property used by each public service company both inside and outside this State. Property leased by a public service company shall be included in appraising the value of its system property if necessary to ascertain the true value of the company's system property.
(2) Nonsystem Personal Property. -- Each year as of January 1, the Department shall appraise at its true value (as defined in G.S. 105-283) each public service company's nonsystem tangible personal property subject to taxation in this State.
(3) Nonsystem Real Property. — In accordance with the county in which the public service company's nonsystem real property is located and the schedules set out in G.S. 105-286 and 105-287, the Department of Revenue shall appraise at its true value (as defined in G.S. 105-283) each public service company's nonsystem real property subject to taxation in this State."

G. S. 105-336 provides in pertinent part as follows:

" 105-336. Methods of appraising certain properties of public service companies. — (a) Appraising System Property of Public Service Companies Other Than Those Noted in Subsection (b). -- In determining the true value of each public service company (other than one covered by subsection (b), below) as a system the Department of Revenue shall give consideration to the following:

(1) The market value of the company's capital stock and debt, taking into account the influence of any nonsystem property.
(2) The book value of the company's system property as reflected in the books of account kept under the regulations of the appropriate federal or State regulatory agency and what it would cost to replace or reproduce the system property, less a reasonable allowance for depreciation.
(3) The gross receipts and operating income of the company.
(4) Any other factor or information that in the judgment of the Department has a bearing on the true value of the company's system property. "

G. S. 105-342 provides as follows:

" 105-342. Notice, hearing and appeal. -- (a) Right to Information. -- Upon written request to the Department of Revenue, any public service company whose property values are subject to appraisal, apportionment, and allocation for purposes of taxation under this Article shall be entitled to be informed of the elements that the Department considered in the appraisal of the company's property, the result in dollars produced by each element (including the methods and mathematical calculations used in determining those results), the specific factors and ratios the Department used in apportioning the appraised valuation of the company's property to this State, and the factors and the specific mathematical calculations the Department used in allocating the company's valuation among the local taxing units of this State. Upon written request to the Department of Revenue, any local taxing unit in this State shall be entitled to the same information with regard to any public service company whose property values are subject to appraisal, apportionment, and allocation for purposes of taxation under this Article.

(b) Appraisal and Apportionment Review. -- The appraised valuation of a public service company's property and the share thereof apportioned for taxation in this State under G.S. 105-335, 105-336, and 105-337 shall be deemed tentative figures until the provisions of this subsection (b) have been complied with. As soon as practicable after the tentative figures referred to in the preceding sentence have been determined, the Department of Revenue shall give the taxpayer written notice of the proposed figures and shall state in the notice that the taxpayer shall have 20 days after the date on which the notice was mailed in which to submit a written request to the Property Tax Commission for a hearing on the tentative appraisal or apportionment or both. If a timely request for a hearing is not made, the tentative figures shall become final and conclusive at the close of the twentieth day after the notice was mailed. If a timely request is made, the Property Tax Commission shall fix a date and place for the requested hearing and give the taxpayer at least 20 days written notice thereof. The hearing shall be conducted under the provisions of subsection (d), below.

. . . . .

(d) Hearing and Appeal. -- At any hearing under this section, the Property Tax Commission shall hear all evidence and affidavits offered by the taxpayer and may exercise the authority granted by G. S. 105-290(d) to obtain information pertinent to decision of the issue. The Commission shall make findings of fact and conclusions of law and issue an order embodying its decision. As soon as practicable thereafter, the Commission shall serve a written copy of its decision upon the taxpayer by personal service or by registered or certified mail, return receipt requested."

EVIDENCE

The matters and evidence presented by the railroads and considered by the Commission consisted of the following:

(1) Oral testimony of Dr. Arthur A. Schoenwald.

(2) Oral testimony of Dr. Thomas F. Keller.

(3) Exhibits:

Southern, Norfolk

Exhibit 1 - Appraisal Report of Dr. Schoenwald

Exhibit 2 - Resume of Dr. Keller.

Exhibit 3 - Form 10-K and 1979 Annual Report.

Exhibit 4 - Schedule showing effect on deferred taxes upon cessation of purchases of assets.

Exhibit 5 - 1979 Statistical Report

Exhibit 6 - Form R-1 for 1975.

Exhibit 7 - Form R-1 for 1976.

Exhibit 8 - Form R-1 for 1977.

Exhibit 9 - Form R-1 for 1978.

Exhibit 10 - Form R-1 for 1979.

Exhibit 11 - Sheets 1-32 of Dr. Schoenwald's oral testimony.

Exhibit 12 - Income with Investment Tax Credit Normalized.

Soo Line R.R. v. Wisconsin Department of Revenue

Pacific Power & Light Co. v. Department of Revenue

San Antonio v. U. S.; Excerpts from A.P.B. 11, 16, 18;

ICC Ex. Parts 338, 353, Finance Docket No. 28614.

Seaboard

Exhibit 1 - Appraisal report of Dr. Schoenwald.

Exhibit 2 - Resume of Dr. Keller.

Exhibit 3 - 1979 Annual Report.

Exhibit 4 - Schedule showing effect on deferred taxes upon cessation of purchases of assets.

Exhibit 5 - 1979 Statistical Supplement.

Exhibit 6 - Form R-1 for 1975.

Exhibit 7 - Form R-1 for 1976.

Exhibit 8 - Form R-1 for 1977.

Exhibit 9 - Form R-1 for 1978.

Exhibit 10 - Form R-1 for 1979.

Exhibit 11 - Sheets 1-32 of Dr. Schoenwald's testimony.

Exhibit 12 - Three page schedule with adjustments to income

Exhibit 13 - Schedule showing excess tax over (under) book depreciation and deferred taxes at statutory rates.

The matters and evidence presented by the Department of Revenue and considered by the Commission consisted of the following:

(1) Oral testimony of Mr. W. R. Underhill.

(2) Exhibits

Exhibit A - Appraisal Report of W. R. Underhill for Southern.

Exhibit B - Appraisal Report of W. R. Underhill - Seaboard.

Exhibit C - Appraisal Report of W. R. Underhill - Norfolk Southern

Exhibit D - Schedule showing investment tax credit for both total tax credit and tax credits currently payable.

Exhibit E - Page 21 of Mr. Underhill's appraisal report with handwritten calculation showing the inclusion of subsidiary debt and an attached schedule of non-operating influence prepared by Southern in AV-18.

In addition to the matters and evidence presented by the appellant and the County, the Commission considered the following exhibits:

Southern Railway Company

C-1 Letter to Mr. Maupin dated September 4, 1980, enclosing notices of 1980 values.

C-2 Twenty day letter dated September 4, 1980, giving notice of proposed 1980 valuation.

C-3 Letter from Mr. Maupin dated September 9, 1980, requesting copies of workpapers.

C-4 Copy of workpapers.

C-5 Notice of appeal dated September 11, 1980.

C-6 Letter from Mr. Maupin dated September 11, 1980, requesting additional information.

C-7 Letter dated September 11, 1980, giving notice of appeal for 11 railroads.

C-8 Letter dated September 11, 1980, giving notice of appeal for 8 railroads.

C-9 Letter giving notice of date and time of hearing.

C-10 Letter dated October 10, 1980, enclosing copy of appraisal by Mr. Underhill.

C-11 Letter from Mr. McBride dated October 10, 1980, enclosing appraisal reports by Mr. Schoenwald and related information.

C-12 AV-18 and attachments (17 pages).

Seaboard Coastline Railroad Company

C-1 Letter to Mr. Maupin dated September 4, 1980, enclosing notices of 1980 values.

C-2 Twenty day letter dated September 4, 1980, giving notice of proposed 1980 valuation.

C-3 Letter dated September 9, 1980, from Mr. Maupin requesting copies of workpapers.

C-4 Copy of work papers.

C-5 Notice of appeal dated September 11, 1980.

C-6 Letter dated September 18, 1980, from Mr. Wilkerson concerning leased rentals.

C-7 Letter dated September 19, 1980, with revised 1980 valuation.

C-8 Letter giving notice of date and time of hearing.

C-9 Letter dated October 10, 1980, enclosing copy of appraisal by Mr. Underhill.

C-10 Letter from Mr. Neely dated October 10, 1980, enclosing appraisal reports by Mr. Schoenwald and related information.

C-11 AV-18 and attachments (21 pages).

Norfolk Southern Railroad Company

C-1 Letter to Mr. Maupin dated September 4, 1980, enclosing notices of 1980 values.

C-2 Twenty day letter dated September 4, 1980, giving notice of proposed 1980 valuation.

C-3 Letter from Mr. Maupin dated September 9, 1980, requesting copies of workpapers.

C-4 Copy of workpapers.

C-5 Notice of appeal dated September 11, 1980.

C-6 Letter giving notice of date and time of hearing.

C-7 Letter dated October 10, 1980, enclosing copy of apppraisal by Mr. Underhill.

C-8 AV-18 and attachments (4 additional pages).

FINDINGS OF FACT

The facts outlined in the Statement of Case are hereby made a part of this section by reference. After addressing itself to, and carefully considering all of the evidence of record, as set forth above, the Property Tax Commission makes the following additional findings of fact. Findings # 1 through 25 relate to Southern, #26 to 45 to Seaboard, and 46 to 52 to Norfolk Southern.

(1) The Department of Revenue (Department) appraised the system property of Southern Railway Company (Southern) at $1,025,000,000, based upon its consideration of two income indicators of value of $1,020,500,000 and $1,018,438,000 and two stock and debt indicators of value of $1,040,995,000 and $1,083,388,000.

(2) Dr. Schoenwald appraised Southern's system property at $690,166,000, based upon the average of an income indicator of value of $587,469,000 and a stock and debt indicator of $792,862,000.

(3) The Department also calculated and considered a cost indicator of value of $1,047,968,000 but assigned no specific weight to it.

(4) Dr. Schoenwald calculated a cost indicator of value of $733,499,000 but assigned no weight to it in his estimate of value.

(5) The Department's income appraisal was based on actual 1979 net railway operating income of $117,787,000 with adjustments for excessive investment tax credit, deferred income taxes and leased equipment, resulting in income to be capitalized of $122,460,000.

(6) Dr. Schoenwald's income appraisal was based on a five-year average of net railway operating income of $87,819,000 with an adjustment for leased equipment of $1,770,000, also based on a five-year average, resulting in an income to be capitalized of $89,589,000.

(7) Dr. Schoenwald made no adjustment for deferred income taxes or investment tax credit but did deduct estimated income taxes of 43% in his leased equipment adjustment.

(8) The Department's leased equipment adjustment was based on current year figures with no deduction for income taxes.

(9) Except for a negligible amount in 1977, no income taxes have been paid by Southern during the past five years.

(10) Both the Department and Dr. Schoenwald relied on the band of investment method to develop their capitalization rates.

(11) The Department's capitalization rate of 12% was based on the actual or embedded cost of Southern's preferred stock and long-term debt and a 15% return to common equity.

(12) Dr. Schoenwald's capitalization rate of 15.25% was based on the current cost of preferred stock and long-term debt and an 18% return to common equity.

(13) The average monthly high and low market price of Southern's common equity for 1979 was $872,053,000 compared with the book value on December 31, 1979, of $1,234,193,000, the latter figure including retained earnings of subsidiaries in the amount of $317,043,000.

(14) Although Southern's earnings/price ratio for 1979 was 18.42%, the $160,622,000 net income figure represented only a 13% return on the book

equity figure of $1,234,193,000, which was used by both appraisers to develop their capitalization rates.

(15) Southern has experienced an 80% increase in its net railway operating income from 1975 to 1979, as follows:

1979	$117,787,000
1978	93,608,000
1977	88,101,000
1976	72,566,000
1975	65,509,000

(16) During the same period, the firm invested $838,920,000 in new property as follows:

1979	$295,110,000
1978	212,280,000
1977	130,510,000
1976	91,770,000
1975	109,250,000

(17) The net book value of Southern's transportation property, materials and supplies, and leased equipment as of December 31 of the respective years was as follows:

1979	$1,497,849,000
1978	$1,236,568,000
1977	$1,236,568,000
1976	$1,149,391,000
1975	$1,141,176,000

(18) The deferred income taxes and investment tax credits reflected in the net operating income for these years were as follows:

	Deferred Income Tax	Investment Tax Credit
1979	$22,274,000	$29,511,000
1978	17,622,000	21,228,000
1977	12,860,000	13,051,000
1976	12,538,000	9,177,000
1975	12,328,000	10,925,000
	Average – $15,524,000	Average – $16,778,400

(19) Although the two appraisers treated certain elements of debt differently in their stock and debt appraisals, they based their appraisals on approximately the same gross stock and debt figure — $1,444,937,000 for the Department and $1,495,848,000 for Dr. Schoenwald.

(20) Both appraisers also used the income influence method to remove non-operating influence from the gross figures.

(21) The Department made a deduction of 30% for non-operating property whereas Dr. Schoenwald made a number of direct deductions, then deducted 36.26% for non-operating influence.

(22) Although the market value of equity figure used by both appraisers included the equity in Southern's subsidiaries, neither appraisal included the market value of the subsidiary debt, which amounted to $254,929,000.

(23) Southern's 1979 Statistical Report reflects the following relationships between figures for Southern and those for the consolidated company.

Non-Operating Influence Factors	Southern	Consolidated	%
Gross Income	$ 939,819	$1,467,270	64.05%
Total Operating Expenses	807,399	1,208,917	66.79%
Interest Expense	45,580	68,327	66.71%
Long Term Debt	626,391	919,750	68.10%
Retained Earnings	670,221	955,006	70.18%
Total Assets	2,181,178	2,886,863	75.56%
		Average -	68.57%

(24) In addition to the comparisons in #23 above, Southern's net income for 1979 constituted 89.8% of total consolidated income.

(25) There is a 35% difference between Dr. Schoenwald's two indicators of value.

(26) The Department appraised the system property of Seaboard Coastline Railroad Company (Seaboard) at $880,000,000, based essentially upon an income indicator of value of $877,025,000 but also giving consideration to a cost indicator of $1,013,371,000.

(27) Dr. Schoenwald appraised the property at $600,465,000 based upon the average of an income indicator of value of $559,258,000 and a stock and debt indicator of $641,672,000.

(28) Dr. Schoenwald also calculated a cost estimate of value of $683,066,000 but assigned it no weight in his appraisal.

(29) The Department's income appraisal was based on actual net railway operating income — averaged on a weighted basis for the most recent three years — with adjustments for excessive investment tax credit and leased equipment, resulting in income to be capitalized of $109,628,093.

(30) Dr. Schoenwald's income appraisal was based on a five-year average of net railway operating income of $75,210,000 with an adjustment for leased equipment of $11,475,000, also based on a five-year average, resulting in an income to be capitalized of $86,685,000.

(31) Neither the Department nor Dr. Schoenwald made an adjustment for deferred income taxes.

(32) All deferred income taxes for the past five years were offset by carry-forward investment tax credits.

(33) The investment tax credits used to offset deferred income taxes were not used by the Department in calculating its excessive investment tax credit figure.

(34) The Department based its leased equipment adjustment on the current year's figures with no adjustment for income taxes whereas Dr. Schoenwald based his adjustment on a five-year average with a 43.1% deduction for income taxes.

(35) Seaboard has paid no income taxes during the past five years.

(36) Seaboard's net railway operating income for the past five years was as follows:

1979	$ 99,487,000
1978	105,478,000
1977	80,591,000
1976	56,397,000
1975	34,098,000

(37) In addition to the investment tax credits generated during these years, as shown in column 1 below, Seaboard also used previously accrued investment tax credits, as shown in column 2, to offset total current taxes due.

	Column 1	Column 2	Total
1979	$17,199,855	$ 7,011,083	$24,210,968
1978	13,808,007	71,977	13,878,984
1977	13,816,343	14,322,810	28,139,153
1976	7,454,542	1,905,216	9,359,758
1975	7,764,062	(6,876,553)	887,509
	Average -$12,008,582		Average -$15,295,274

(38) Deferred income taxes reported by Seaboard for these years was as follows:

	1975	1976	1977	1978	1979
Deferred Income Tax Shown on Income Statement	$2,561,036	$1,053,309	($2,057,372)	($1,897,857)	($ 759,812
Deferred Tax Off-Set by Investment Tax Credit	4,342,465	5,066,376	1,894,038	25,920,828	8,906,473
Total Deferred Tax-	$6,903,501	$6,119,685	($ 163,334	$24,022,971	$8,146,661

5 Year Average Deferred Tax - $9,005,897

(39) Both appraisers relied on the band of investment method to develop their capitalization rates.

(40) The Department's capitalization rate of 12.5% was based on the embedded cost of Seaboard's preferred stock and long-term debt and a 15% return to common equity.

(41) Dr. Schoenwald's capitalization rate of 15.5% was based on the current cost of money for preferred stock and debt and an 18% return to common equity.

(42) Seaboard's net income of $135,466,000 for 1979 represents a 10.18% return on the book equity figure of $1,330,560,000 which was used by both appraisers to develop their capitalization rates.

(43) Seaboard is the wholly owned subsidiary of Seaboard Coastline Industries, Inc. and the parent company of Louisville and Nashville Railroad.

(44) The Department did not calculate a stock and debt indicator of value for Seaboard because the common stock of the railroad company is not traded and has no quoted market value.

(45) The market value of common stock used by Dr. Schoenwald in his stock and debt indicator of value for Seaboard is actually that of Seaboard Coastline Industries, Inc.

(46) The Department appraised the system property of Norfolk Southern Railway Company (Norfolk Southern) at $59,500,000 based essentially upon an income indicator of value of $59,624,725 but consideration was also given to a cost indicator of $51,121,000.

(47) The Department's income appraisal was based on actual net railway operating income — averaged on a weighted basis for the most recent two years — with adjustments for excessive investment tax credit and deferred income taxes, resulting in income to be capitalized of $7,130,667.

(48) The Department added $202,500 to its income indicator of value for leased equipment.

(49) The Department used a 12% capitalization rate for Norfolk Southern based on the figure established for its parent, Southern.

(50) The Department did not make a stock and debt appraisal for Norfolk Southern.

(51) Dr. Schoenwald did not make an appraisal of Norfolk Southern.

(52) Both appraisers used basically the same appraisal methodology and both agree that the income approach is the most reliable method for estimating the value of operating property of Railroads.

CONCLUSIONS, DECISION AND ORDER

From our review of the applicable law, the evidence and our findings of fact, we conclude as a matter of law that the Department's appraisals of the system properties of the subject railroads do not exceed the true value in money of the properties. It is our opinion that the appellants have not overcome the presumption of correctness given such appraisals by our Court in the Albemarle Electric Membership Corp. v. Alexander 282 N.C. 402(1972) and Appeal of Amp, Inc. 287 N.C. 547(1975) decisions and that the Department's appraisals are supported by substantial competent evidence of record. Such evidence shows that the methods used by the Department were not "arbitrary" or "illegal" because the appraiser for the railroads used almost identical methods in his appraisals. Although the differences in the final figures are substantial, they are attributable to the different treatment of a limited number of complex questions involving the exercise of appraisal judgment. These questions will be discussed in detail below, but as a general statement, we find nothing about the Department's treatment of these items to be unreasonable or arbitrary.

Since both appraisers testified that, in their opinion, the income approach was the most reliable method of estimating the value of the operating property of a railroad company, we will discuss the income appraisals first.

I. Income Approach - Southern

The Department calculated two income appraisals for Southern -- one indicating a value of $1,020,500,000 and the other a value of $1,018,438,000. The difference between the two appraisals is the manner in which the appraiser handled deferred income taxes, which is discussed below. Dr. Schoenwald's income appraisal for Southern indicated a value of $587,469,000.

A. Income to be Capitalized - Southern

1. Current Year vs. Five-Year Average - Southern

Although both appraisers used net railway operating income (NROI) as the starting point for their calculations, they differed in the way they handled the figures. The Department used the NROI figure for the most current year whereas Dr. Schoenwald used a five-year average. The purpose of averaging figures in appraisals is to stabilize figures which are likely to fluctuate up and down -- in other words, to level out the peaks and valleys. In view of the fact that Southern's NROI has risen steadily from

$65,509,000 in 1975 to $117,787,000 in 1979, we find no basis for averaging the income figures. To us, the current figures are a better indication of future earnings than the average for a five-year period in which the firm invested $838,920,000 in new property.

2. Investment Tax Credit - Southern

The Department made an adjustment for excessive investment tax credit, which reduced Southern's NROI by $12,733,000. The purpose of this adjustment was to normalize the credit which has become a significant item on the income statement. Dr. Schoenwald did not make such an adjustment but stated that he did not disagree with the Department's treatment of the investment tax credit.

3. Deferred Income Taxes - Southern

The Department added the five-year average for deferred income taxes of $15,524,000 to NROI in arriving at income to be capitalized. This adjustment was also made to normalize the deferred income tax figure. Dr. Schoenwald did not adjust the income figure for deferred income taxes. Southern contends that deferred income taxes — which arise from the difference between the accelerated depreciation allowed under the income tax laws and the depreciation allowed by the ICC based on the economic life of the property — should be treated as an expense in the year the deferrals are created. Southern argues that under generally accepted accounting principles, the deferred taxes must be recognized when they arise for a proper matching of revenues and expenses. The Department's position is that deferred taxes should not be deducted as an expense until they become payable. Thus, under the Department's method, the deferred taxes will be allowed as an expense when they are actually payable. In stabilizing the income figure for this item, however, the Department has added back only the average amount of deferred taxes for the most recent five years. The Department's treatment of deferred taxes is consistent with the holding of the North Carolina Supreme Court in Broadwell Realty Corporation v. Coble, 291 NC 608(1977). Although that case involved franchise taxes and a different issue, the Court held that "future federal income taxes are not an outstanding indebtedness -- they are a mere contingency." There is no evidence in the record to indicate that Congress will take any action in the forseeable future to eliminate the benefits of accelerated depreciation. It would be unrealistic, therefore, to believe that a knowledgeable investor would be unaware of the impact of a factor of such importance on the income stream of a railroad company. Any knowledgeable purchaser would look at the pattern of deferred taxes created over a period of time to estimate what could be expected in future years.

If the Department had allowed deferred income taxes as an expense but treated accumulated deferred taxes as an interest-free loan, the Department's income appraisal would have been reduced by less than 1%, from $1,020,500,000 to $1,018,438,000. We believe, however, that the method used by the Department is preferable because it is consistent with accepted appraisal principles and attempts to recognize the factors an investor would consider.

4. Leased Equipment Addback - Southern

Both appraisers made an adjustment to income to be capitalized to treat leased equipment as if it were owned. The Department's adjustment amounted to $1,882,000 in additional income whereas Dr. Schoenwald's figure was $1,770,000. Here again, the Department used current year's figures and Dr. Schoenwald used a five-year average. Dr. Schoenwald also made a deduction for income taxes of 43%. The Department did not deduct income taxes because, except for a negligible amount in 1977, Southern has paid no income taxes for at least the last five years. This adjustment is not a significant factor in Southern's appraisal but is so for Seaboard and will be discussed further in our comparison for Seaboard.

Notwithstanding the differences between the two appraisers in arriving at the income figure to be capitalized, Southern's income figure would have been $119,557,000 — only $2,903,000, or 2.4% below the Department's figure of $122,460,000, except for Dr. Schoenwald's use of the five-year average — which we have held is unjustified.

B. Capitalization Rate - Southern

Both appraisers used the "band of investment" method to determine their capitalization rates. In arriving at the "bands" of investment, they both also used the actual capital structure of the railroad. The appraisers disagreed, however, on the rates of return required for the two elements of the capital structure — equity and debt. The Department calculated a capitalization rate of 12% based on a return to common equity of 15% and actual cost of debt of 7.2%. Dr. Schoenwald's capitalization rate was 15.25% based on a return to equity of 18% and a current cost of debt of approximately 10.5%.

1. Return to Equity - Southern

There is no precise method for determining a rate for the equity component. The calculations involve a knowledge of the market and of the railroad being appraised, as well as the exercise of sound judgment. The figure sought is the percentage return that investors in the type of property being appraised require to invest their money. Dr. Schoenwald's 18% return to equity was based on an analysis of the earnings to price ratio of the railroad industry. This analysis indicated an earnings to price rate of 20.13% for 1979. This comparison relates net earnings to the market price of the stock. If, however, the earnings figure is related to the book equity figure, which both appraisers used in their band of investment calculations, the ratio is only 13%. We therefore believe that the Department's 15% return on the book equity figure is both fair and reasonable.

2. Cost of Debt - Southern

In determining its cost of debt, the Department used the embedded cost method which is based on the actual interest rates set forth in the debt instruments. Dr. Schoenwald, on the other hand, applied the current rates of interest to the outstanding debt.

We have approved the use of the embedded cost method in two prior cases -- one involving a closely regulated electric utility and the other a petroleum pipeline company, formerly regulated by the ICC and now by the FERC. We recognize that railroads are not regulated to the same extent as electric utilities with respect to the rate bases and rates of return. They are, however, subject to substantial regulation and the ICC unquestionably considers the debt structure and the interest payments thereon in setting rates. We therefore believe it is more reasonable to expect a purchaser to assume the debt and pay it off as provided in the actual existing instruments than it would be to expect him to refinance the transaction at current interest rates.

The railroads argue that the method of financing should have no effect on the value of the property being appraised and point to the fact that local assessors have to appraise similar properties alike regardless of the financing. We recognize that local assessors must eliminate differences in sales prices caused by favorable or unfavorable financing when determining the value of real estate. It is our opinion, however, that there are substantial differences between the appraisal of regulated and non-regulated properties. Whereas local assessors use typical income and expense figures in the county to appraise non-regulated properties, utility and railroad appraisers almost invariably base their calculations on the financial statements of the company under appraisal. Local assessors capitalize net income before income taxes whereas utility and railroad appraisers capitalize the figure after payment of income taxes. Local assessors rely heavily on comparable sales data in their market approach appraisals. Railroad and utility appraisers, on the other hand, must use a substitute method called the stock and debt method as their market approach because, as both parties testified, bona fide sales of railroad companies almost never occur. The unit method of appraisal used in the appraisal of railroad and utility properties in most of the states is almost totally inapplicable to the appraisal of unregulated properties. Since the unit method of appraisal contemplates heavy reliance on the financial statements of the company whose property is being appraised, we see no basis for disregarding the portions dealing with the firm's corporate structure. Accordingly, we hold that the Department's use of the railroads' embedded cost of debt is proper.

II. Stock and Debt Approach - Southern

There is very little difference between the gross stock and debt figures used by the two appraisers. They also agree that the value of Southern's common stock reflects its equity in the firm's subsidiaries. Although there was some disagreement between the appraisers regarding the inclusion of subsidiary debt in the debt component, since neither appraiser included it, we do not consider it an issue to be resolved. The principal difference between the two appraisers in their stock and debt appraisals was the manner in which they arrived at the deduction for non-operating property. Both appraisers used the income influence method to arrive at the deduction, the Department using a straight percentage deduction of 30% whereas Southern's appraiser made a number of direct deductions, then used a percentage factor of 36.26%. In our opinion, the Department's 30% figure is clearly supported by the statistics set forth in our findings #23 and #24 relating Southern's figures to the consolidated figures. These findings reflect a 68.57 percentage for operating property for a number of important statistics and in probably the most important factor of all - net income - a percentage of 89.8%. If the 30% figure were applied to Dr. Schoenwald's gross stock and debt figure of $1,495,848,000, the resulting estimate of value would be $1,047,094,000. This would be almost twice the amount of his income estimate of value of $587,469,000. Conversely, the Department's stock and debt indicator was $1,040,995,000, only slightly different from its income indicator of $1,020,500,000

III. Cost Approach - Southern

Although both appraisers calculated a cost indicator of value for Southern, neither considered it a very reliable indicator of market value. Dr. Schoenwald gave it no weight in his appraisal and the Department considered it but gave it very little weight. The Commission recognizes the difficulty in using book cost figures to determine the fair market value of a railroad company because of the heavy economic obsolescence. We believe, however, that the cost approach should not be disregarded. Southern invested $295,110,000 in new property during 1979 and $637,900,000 over the past three years. The latter figure is 92% of Dr. Schoenwald's appraisal of Southern of $690,166,000.

IV. Income Approach - Seaboard

The Department's income appraisal of Seaboard was $877,025,000, based on income to be capitalized of $109,628,093 and a capitalization rate of 12.5%. Dr. Schoenwald's income appraisal of Seaboard was $559,258,000 based on income to be capitalized of $86,685,000 and a capitalization rate of 15.5%.

A Income to be Capitalized - Seaboard

1. Three-Year Average vs. Five-Year Average - Seaboard

As in Southern, Dr. Schoenwald used the five-year average of NROI for Seaboard. The Department used a three-year weighted average for NROI for Seaboard because of a decline from 1978 to 1979. For the reasons stated in our discussion of Southern, we believe the most reliable indicator of future earnings is the figure for the current year. Because of the fluctuations in Seaboard's income from $80,591,000 in 1977 to $105,478,000 in 1978 and down to $99,487,000in 1979, however, we believe the Department's use of a three-year average is appropriate. It has the effect of leveling out the income stream which is the purpose of averaging in appraisals. In addition, we do not believe that the earliest two years in the five-year period --

1975 and 1976 — have any real relationship with the figures for 1978 and 1979. The income figures for 1975 and 1976 were $34,098,000 and $56,397,000, whereas the 1978 and 1979 figures were $105,478,000 and $99,487,000.

2. Investment Tax Credit and Deferred Income Taxes - Seaboard

The Department made an adjustment to NROI for excessive investment tax credit, reducing the income figure by $12,202,386. It did not make an adjustment to add a five-year figure for deferred income taxes, as it did in Southern, because all of Seaboard's deferred income taxes were offset by carryforward investment tax credits. As in Southern, Dr. Schoenwald made no adjustment for either of these items. Seaboard argued that the Department's treatment of the deduction for investment tax credit for Seaboard was not consistent with that for Southern. The Department maintains that the appearance of inconsistency was caused by Seaboard's use of its carryforward investment credit tc offset deferred income taxes. Since the Department made no adjustment to add the average figure for deferred income taxes because of the offset by investment tax credits, it did not use the amounts used as offsets in its calculations of the excessive investment tax credit. If the Department had followed exactly the same methods of handling deferred income taxes and investment tax credits for Seaboard that it did for Southern, Seaboard's income figure to be capitalized would have been greater than the figure used by the Department. In our opinion, the the confusion on this point comes primarily from the complicated manner in which these two items were set forth in the records furnished to the Department by Seaboard. In any event, we do not believe the effect of the Department's adjustment was to deny Seaboard a proper deduction for deferred taxes.

3. Leased Equipment Addback - Seaboard

As explained in the discussion on Southern, both appraisers used the same basic method to treat leased equipment as if it were owned in the income approach to value. As it did in Southern, the Department used the current year's figures in arriving at its addback whereas Dr. Schoenwald used a five-year average figure, then deducted income taxes of 43.1%. The Department did not make a deduction for income taxes because Seaboard has paid no income taxes for at least the last five years. Since the purpose of this adjustment is to add the leased property on hand as of the date of assessment, we believe the current year's figures are more reliable than the average over the last several years. This is especially true in the case of Seaboard because of the significant increase in leased equipment during the past four years. The number of cars on hand in 1975 would appear to have almost no relationship with the number on hand in 1979.

We also believe the Department was correct in not deducting a theoretical income tax expense because if Seaboard had purchased the equipment rather than leasing it, the firm would have had the benefit of the 10% investment tax credit, would have incurred additional interest expense and could have initiated new schedules of deferred income taxes, all of which would have the effect of reducing or eliminating future tax liability. Southern's experience in this area is instructive. Instead of leasing property, Southern has made substantial investments in equipment over the past five years and has paid no net federal income tax during that period.

V. Stock and Debt Approach - Seaboard

The Department did not make a stock and debt appraisal of Seaboard because its stock is not traded. Dr. Schoenwald's stock and debt appraisal of Seaboard was $641,672,000 -- $82,414,000 greater than his income appraisal. The stock used by Dr. Schoenwald is that of Seaboard Coastline Industries, Inc. -- Seaboard's parent company. While it may be true that Seaboard is Seaboard Coastline Industries, Inc.'s only asset, Seaboard itself is the parent company of more than thirty subsidiary corporations, including Louisville and Nashville Railroad Company (L & N), which is approximately equal in size to Seaboard. Seaboard is therefore not the dominant factor in Seaboard Industries, Inc., that Southern is with respect to its consolidated financial statements. The Department believes that these factors and L & N's depressed earnings picture over the past several years make it extremely difficult to calculate a reliable indicator of value for Seaboard under the stock and debt approach. We concur in that opinion and find no error in the Departmment's failure to complete a stock and debt appraisal for Seaboard.

VI. Cost Approach - Seaboard

Although both appraisers calculated a cost indicator of value for Seaboard neither considered it a very reliable indicator of market value. Dr. Schoenwald gave it no weight in his appraisal and the Department considered it but gave it very little weight. The Commission recognizes the difficulty in using book cost figures to determine the fair market value of a railroad company because of the heavy economic obsolescence. We believe, however, that the cost approach should not be disregarded because of the controversial nature of several of the elements of the other two approaches to value.

VII. Norfolk Southern

The Department's appraisal of Norfolk Southern was $59,500,000, based on essentially the same methodology used for the other two companies. The income to be capitalized was based on a two-year weighted average for the most recent two years. This was done because of the inordinate increase in the firm's earnings over the past few years. The income was capitalized at 12% -- the figure used for Southern. Because of the relatively small amount of leased equipment held by Norfolk Southern -- less than 1% of the total appraisal -- The Department did not use the same method for Norfolk Southern as it did for the other two. It simply added back one-half of the depreciated cost of the equipment.

Dr. Schoenwald did not make an appraisal of Norfolk Southern but the firm made the same contentions as Southern regarding deferred income taxes and the calculation of the capitalization rate. For the reasons stated earlier in our discussion of Southern, we hold that the Department's treatment of these items was proper.

DECISION AND ORDER

WHEREFORE, IT IS ORDERED, ADJUDGED AND DECREED that the Department's appraisals of the operating properties of the subject railroads as set forth below are sustained.

Southern	$1,025,000,000
Seaboard	$ 880,000,000
Norfolk Southern	$ 59,500,000

This the nineteenth day of May, 1981.

NORTH CAROLINA PROPERTY TAX COMMISSION

Charles H Mercer, Jr.

Charles H. Mercer, Jr., Chairman

Attest:

D. R. Holbrook

D. R. Holbrook, Secretary