TO: **Aaron Bjorkman, Director Tax**
NorthWestern Energy

FROM: **Doug Roehm, Unit Manager**
Centrally Assessed Property

DATE: **April 28, 2023**

SUBJECT: **Response to Comments on the 2023 Capitalization Rate Study, Electric Utilities**

Dear Mr. Bjorkman:

The department would like to thank you for taking the time to review our study and for providing additional information for us to consider. We received your submission email on April 13, 2023.

The comments received are posted along with these responses on our website at:
https://mtrevenue.gov/dor-publications/cap-rate-studies/

The comments received were:

1. Both the NOI and GCF "Direct Capitalization Rates," which are used in the Direct Capitalization appraisal models, value the company, not the property. Our concerns with company valuation versus property valuation were discussed with Montana DOR personnel in December 2022.

2. The determination of the debt rate used in the NOI and GFC "Dividend Discount Models" calculations makes the false assumption that a willing buyer (in the willing seller/willing buyer definition of fair market value) has access to lower interest rates than what was available on January 1, 2023.

Based on the comments, and our analysis discussed below, no adjustments were made to the capitalization rates study. The comments primarily apply to valuation methods and not development of the capitalization rates. The appraisal concerns are best addressed through the appraisal process.

A more detailed discussion on how we arrived at these conclusions follows.

Direct Capitalization Rates

Administrative Rule of Montana (ARM) 42.22.111 directs the department to use the Unit Method of valuation to appraise centrally assessed companies.

The Unit Method of Valuation is defined in ARM 42.22.101 as:

> a method for determining the market value of a centrally assessed company. This involves appraising, as a going concern and as a single entity, the entire unit, wherever located, then deducting the intangible personal property value and then ascertaining the part thereof in this state. The resulting value is referred to as the state allocated value.

This is further supported by ARM 42.22.113, 42.22.114 as well the adopted appraisal methods and standards in ARM 42.22.109.

Debt Rate in Direct Capitalization

The narrative on page 2, posted with the study, explains current yield is used in direct capitalization and yield to maturity is used in yield capitalization:

> The measure of the rate for debt used in the direct capitalization rate is the current yield. Current yield is equal to the annual coupon rate divided by price (expressed as a percent). The measure of the cost of debt capital for the yield rate is yield to maturity. The yield to maturity is the interest rate that equates the present value of a bond's cash flow to its current price (expressed as a percent). Yield to maturity assumes that the bond will be held to maturity. If the bond is not held until maturity, or if the interim cash flows are reinvested at a rate that differs from the yield to maturity, an investor's actual yield will differ from the yield to maturity. The yield to maturity calculation equates a bond's cash flows to its current price; this yield calculation considers both coupon and income and any capital gain or loss the investor will realize by holding the bond to maturity.
>
> Valuation theory typically requires the use of current yields (the annual coupon rate divided by price) for direct capitalization and the use of yield to maturity for yield capitalization, the two rates will generally not vary significantly for seasoned issues (except under certain circumstances) and they will be the same for new issues.

The WSATA appraisal manual also explains on page III-29 that, "The theoretically correct debt rate to use in a direct capitalization rate is the current yield. The current yield is the current interest expense divided by the market value of debt."