STATE OF NEW HAMPSHIRE
PUBLIC UTILITIES COMMISSION

DOCKET No. DE 15-464

IN THE MATTER OF: Petition for Approval of Lease Agreement Between Public Service Company of New Hampshire d/b/a Eversource Energy and Northern Pass Transmission LLC.

DIRECT TESTIMONY

OF

John Schmick
Vice President and Director of Special Projects
Consultant to Staff

September 18, 2017

Introduction

Q. Please state your full name?

A. John T. Schmick

Q. By whom are you employed and what is your business address?

A. Shenehon Company, located at 88 South Tenth Street, Suite 400, Minneapolis, MN, 55403

Q. Please summarize your education and professional work experience.

A. I have a Bachelor Degree in Finance from St. Cloud State University (SCSU) in Minnesota. After working for three years I went back to SCSU and completed a MBA degree with an emphasis in real estate. During that time I was a graduate assistant to Dr. George Karvel, Minnesota Chair in Real Estate and eventually taught a basic real estate course.

I served in the United State Air Force from 1971 to 1975. From 1978 to 1982, I worked in the banking industry as an internal auditor. I left banking to pursue my MBA degree. Upon completion, I started work for Shenehon and Associates, a predecessor to Shenehon Company. I have been with Shenehon since January 1986, or almost 32 years.

Q. My primary responsibility is to provide appraisal services to solve a wide range of appraisal problems presented by our clients. This includes appraisal reports, appraisal review and consulting services. The majority of my work is related to litigation including eminent domain work and civil litigation while a small portion of my work relates to such things insurance claims, financing and buy/sell decisions. I have worked for many private property owners and most levels of government including local, county, state and federal. Over the course of my career, I have been involved in hundreds of easement cases or assignment. I currently teach part time at the University of St. Thomas in Minneapolis. I teach commercial appraisal and market studies at the graduate student level.

Q. Have you written or published any works professionally?

A. I have been privileged to have 14 articles or papers published over the years on valuation topics, including larger parcel theory, impact of pipelines on Midwest farmland, consistent use theory, impact of medians, new valuation theory for churches, and problems with Across-The-Fence methodology. A list of my articles is attached as Attachment A.

Q. What is the purpose of your testimony in this proceeding?

A. My initial assignment was to perform an appraisal review of an appraisal report work titled "Market Value Appraisal of Northern Pass Transmission Project" from "Dummer to Bethlehem and Bridgewater to Deerfield, New Hampshire" prepared by Mr. Robert LePorte, Jr., MAI, CRE and Mr. Gintaras Cepas of Colliers International (Colliers) in Boston, dated November 12, 2014. Depending on the outcome of that review, I was to prepare my own opinion of value related to report the Northern Pass Project.

Q. Are there professional standards for performing reviews of other people's appraisal?

A. Yes, Standard Rule 3 of the Uniformed Standards of Professional Appraisal Practice (USPAP) establishes minimum requirements as well the Ethical section of USPAP that addresses ethics, record keeping, competency, and scope of work requirements. Most states license appraisers and as part of that licensing process, appraisers are required to abide by professional standards which most states consider to be USPAP.

Q. Does your appraisal review comply with USPAP?

A. Yes, it complies with the current edition of USPAP, the 2016-2017 Edition which was in effect when I did the review.

Q. What steps did you take to get started with the review?

A. I first defined the appraisal question to be addressed in the review and then determined the scope of work necessary to address that question. The appraisal question was to determine if the work under review was credible. The scope of work was to identify the standards in effect at the time the appraisal was written, November of 2014. We also gathered other reference material that included what we believed would be helpful in understanding the work under review. A copy of the complete appraisal review report is attached as Attachment B.

Q. What areas of the Colliers appraisal did you review and what did you find?

A. We divided our review into four parts: Completeness of Material, Adequacy and Relevance, Methods and Techniques, and Analysis and Opinions.

Q. What did you find under Completeness of Material?

A. This section focuses on compliance with minimum appraisal requirements under USPSP. While the work under review was compliant with some minimum requirements, we found several deficiencies in other requirements. Specifically, SR 2-2(a)(iii) requires the appraiser to "summarize information sufficient to identify the real estate involved in the appraisal, including the physical, legal and economic property characteristics relevant to the assignment." Public Service Company of New Hampshire's (PSNH) right to lease to others is a legal issue that was not discussed in the Colliers' appraisal. Because 99% of PSNH ownership is easement right, it is incumbent on the appraiser to determine if those rights include leasing to others. PSNH's ownership is defined by the limits of their easement. However, the Colliers appraisal does not address whether or not PSHN has the right to lease to others. Second, SR 2-2(a)(xi) requires the appraiser to "clearly and conspicuously state all extraordinary assumptions and hypothetical conditions; and state that their use might have affected the assignment results." Section 4.4 of the proposed lease requires Northern Pass Transmission L.L.C. (NPT) to pay for relocating and rebuilding any of PSNH's facilities that are required to accommodate the NPT project. However, there is no discussion by Colliers on how this impacts the proposed transaction. For example, relevant and apparent areas of examination would have included: Is there any credit against rental payments for the added cost? Is there any additional rent for higher PSNH operating cost? Is there a benefit to PSNH in terms of new poles, wires, etc? Third, we found an inconsistency in that the appraisal was reported to be based on the terms of the lease but then analyzed by Colliers as market value. The proposed lease includes many terms, however, the Colliers report does not adequately address which terms were considered, not considered, or why. Lastly, SR 2-2(a)(x) requires that "when an opinion of highest and best use was developed by the appraiser, summarize the support and rational for that opinion;.." We found inconsistencies and insufficient support for the economic demand portion of the Highest and Best Use section of the Colliers report.

Q. What did you find under Adequacy and Relevance?

A. SR 2-2(a)(viii) requires the appraiser to "summarize the information analyzed, the appraisal methods and techniques employed, and the reasoning that supports the analysis, opinion, and conclusion.." We found three significant issues under this requirement. First, the Colliers appraisal report states it was based on the proposed lease terms and some of the lease terms were included in the appraisal. However, upon examination of the lease, we also found that significant and relevant terms were omitted from the report. This includes the fact that the parties to the lease are related, that the financial burden of the transaction shifts from the lessor to the lessee including the moving and rebuilding of part of PSNH's facility, and that the agreement transfers ownership of a significant part of NPT's facility if terms can be reached between the related parties. Combined, these omitted terms paint a picture of a one sided transaction which the reader of the Colliers appraisal would never know about. Consequently, there is a failure to connect the terms of the lease to the market value concept in the appraisal report that is hidden from the reader.

Secondly, there is a violation of the Project Rule in the presentation of economic demand for the rights that NPT proposes to lease from PSNH. The Project Rule states that the value of a property cannot be influenced by the purpose for which it is being taken.[1] This rule is found in eminent domain cases but is relevant beyond eminent domain appraisal work. In the present case, the Colliers appraisal gives the reader the impression that the only demand for the space to be leased is from the project itself. Thus, the stated market rent is based on economic demand that NPT brings to the project. This is similar to asking NPT to pay rent for their own demand when there is no demonstrable market demand from any other source.

Lastly, the appraisal includes a statement that there is a benefit to a buyer to use an existing corridor over assembling a new corridor. However, this assertion is contradicted by Colliers themselves through their selection of a corridor factor of 2.3 times across-the-fence (ATF) value which closely resembles the one example they provide of the cost to assemble a new corridor which results in an equivalent corridor factor of 2.38 times ATF value.[2] More importantly, market value is not viewed from the perspective of what a buyer gains, but rather from what the seller has to offer or lose. If market value was based on what the buyer gains, there would be a different market value for every potential buyer.

Q. What did you find under Methods and Techniques?

[1] Eaton, J.D., MAI, *Real Estate Valuation in Litigation Second Edition*, The Appraisal Institute, pp 120-124
[2] Across The Fence (ATF) is commonly used in corridor valuation. The concept presumes that land in a corridor is worth at least as much as the value of the land through which it passes.

A. Colliers used a mass appraisal technique to handle the large volume of data in this assignment. That process was reasonable. Colliers also employed a commonly used corridor valuation model but referenced the term “enhancement factor” which is an outdated term. The transition to the term “corridor factor’ was recognized as far back as 2002 as appraisers began to recognize the relationship between sale prices and ATF value could be negative, or a factor of less than one. By using the older term, the appraiser implies that corridor value is always a multiple of ATF value which is not an accurate statement.

Q. What did you find under Analysis and Opinions?

A. This section refers to the analysis and opinions provided in the appraisal report. The relevant guideline is USPAP Standard Rule 1-1(b) and (c), which relate to error and carelessness in the appraisal assignment that impacts the credibility of the conclusion. Specifically the rule states that the appraiser may not: “(b) …commit a substantial error of omission that significantly affects an appraisal;” and “(c) ...not render appraisal services is a careless or negligent manner, such as by making a series of errors that, although individually might not significantly affect the results of an appraisal, in the aggregate affects the credibility of those results.” We have identified three significant issues under this section. First, Colliers’ demand analysis discussed earlier focused on replacing the NPT generated demand for the corridor with the lack of market demand from other sources. However, what was not addressed in the appraisal was demand for use of space within the boundaries of the PSNH corridor. Several pictures in the Colliers appraisal report show pipeline markers for underground pipelines. Pipelines and power lines have similar impacts on the land in that they do not allow buildings, require vegetation management, allow movable or temporary surface uses and allow agricultural use of the land. With pipelines under the PSNH powerlines, and both having similar impacts, it calls into question Colliers use of a 75% factor valuation capture rate by both the PSNH easement and the NPT lease. That is, 75% of fee for a power line and 75% of fee for a pipeline leads to 150% of fee value. This is not discussed in the appraisal. Secondly, no analysis of transaction data used to determine a corridor factor was presented. This data included four sales between 1973 and 1977 with an average corridor factor of 1.74 times ATF value. Four of the six narrative examples occurred between 1969 and 1988 with an average corridor factor of 1.97 times ATF value. In 1989, The Appraisal Standards Board adopted the first Uniformed Standards of Professional Appraisal Practice (USPAP). At the same time states began to license appraisers. In the two narrative examples that occurred after the adoption of professional standards, 1998 (Londonderry and Manchester) and 2002 (Scituate) in the Colliers appraisal, the average corridor factor was 1.23 time ATF value. The Assemblage Cost New (ACN) reflected in the Bangor Hydro-Electric Company (BHE) example from 2000 reflects an equivalent corridor factor of 2.38 times ATF value. Consequently, the data does not support Colliers conclusion of 2.3 times ATF value.

Lastly, we focused on the capitalization rate used to calculate rent. Capitalization rates are a reflection of investor's perceived risk of losing their investment. As risk goes up, investors require a higher rate of return to justify their risk and vice versa. The 7.0% capitalization selected in the Colliers appraisal is not consistent with the data presented. Mortgage interest rates are the lender's perception of risk of default. The Colliers appraisal includes a listing of Overall Capitalization Rate Forecasts by PriceWaterhouseCoopers (PwC). Net leased property is listed as 6.98%. Within this rate is the rate for the building and the rate for the land. Since buildings are wasting assets and land is not, the rate of return on the building is higher than for the land. If you were to assume a land-to-building ratio of 50%, the resulting allocation of the capitalization rate in the PwC Net Lease data would be greater than 3.49% for the building and less that 3.49% for the land. Yet, Colliers selected a capitalization rate for an intra-company land lease with a well-regarded utility company on both sides of the transaction that suggests the proposed lease has nearly twice the risk of an investment grade improved commercial property. Failure to analyze the default risk of the transaction has resulted in an unsupported conclusion.

Q. Did you reach a final conclusion for in your analysis of the Colliers appraisal report?

A. Yes. We found the Colliers appraisal report of the Northern Pass Transmission lease value to be not credible.

Q. After you concluded the Colliers appraisal report was not credible, were you then asked to appraise the leased property?

A. We were asked to prepare our own opinion of value but we started with a blank page. We started with identifying the appraisal problem or the appraisal question and the scope of work necessary to answer the appraisal question. A copy of the complete appraisal report is attached as Attachment C.

Q. How did you define the appraisal question and what did you consider in formulating your appraisal questions?

A. We started with some basic facts. First, we knew PSNH had a partial interest in the land and that the fee owners retained some rights in the land, therefore we needed to start with determining what portion of fee value was captured by PSNH. We also knew NPT wanted to lease some portion of the value captured by PSNH through its easement rights. Accordingly, we needed to determine what portion of PNSH's interest is captured by the NPT lease. This is a case of measuring a partial interest of a partial interest. Second, we knew the parties to the lease were related in that they are both wholly owned subsidiaries of Eversource Energy, and we knew that the space to be leased was surplus space for PSNH in that they reported no demand for the space other than the proposed lease. As a result, we were looking at an intra-company lease of surplus space, restricted in use that is a partial interest of a partial interest. Therefore, we defined the appraisal question as, "what is the value impact, or value captured by the proposed lease?"

Q. After defining the appraisal question, how did you proceed?

A. The next step in the process is to determine the scope of work necessary to answer the appraisal question. We decided we needed to do a site inspection of the PSNH's easement corridor, so we traveled to New Hampshire for a visual inspection of every point the PSNH power line crossed over a public street. We took photographs of each crossing point and, where permitted and physically possible, we flew a drone a short distance in each direction of each crossing point to create a video of the area. We determined it was likely that the land sales data base provided in the Colliers appraisal report was a reasonable data base of our work, therefore, we adopted the Colliers sales data base by reference for our analysis. At some point in the appraisal process, we did a random site visit to approximately 40% of the sales data base to verify the sales were a reasonable representation of the land under the PSNH easement. Lastly, we determined our analysis should be based on the larger parcels that make PSNH's easement corridor.

Q. What do you mean by "large parcels?"

A. Larger parcels are defined as having three components: unity of title, unity of use (including unity of highest and best use), and contiguity. In this case, the PSNH corridor has unity of title, including both fee title and easement rights held by PSNH, unity of use in the form of electrical power transmission usage, and it is contiguous. Therefore, we defined each larger parcel as the space between physical interruptions including streets, rivers and other physical barriers like railroads, highways, etc. Valuing the larger parcels allows us to avoid valuing each tax parcel that was presented in the Colliers appraisal and on the proposed route maps. Using the tax parcel list and the proposed route maps, we identified the start and end point of each larger parcel and determined which tax parcels were included in each larger parcel. Total size, relevant widths and approximate lengths for each larger parcel were then determined.

Q. What did you do next?

A. We employed various techniques to determine an overall adjustment factor for market conditions, frequently referred to as a time adjustment. By graphing the sales data separately for the north section and the south section of the project area, we were able to determine general trends in the data as well as other factors that influenced the data. In this case size of the sale property influenced the data so we analyzed the data in difference size groups. In the process, we determined that the sales-data for the Concord area needed to be analyzed as a separate group as the commercial and industrial property values in this urban area were skewing the overall data base analysis.

Q. There are a lot of towns and zoning differences in the sales data base. How did you account for those differences?

A. When dealing with corridors, we follow a two-step highest and best use (HBU) analysis. First we consider the HBU of the overall corridor or a macro viewpoint with four possible outcomes: liquidate, continue in use with no excess/surplus land, continue in use with excess/surplus land but no identifiable demand for longitudinal secondary uses, or continue in use with excess/surplus land but with identifiable demand for longitudinal secondary uses. Second, we do a second HBU analysis for each larger parcel or a micro viewpoint of HBU. This helps us look for issues that might impact usage or value of the underlying land or to PSNH's easement rights.

Q. When in your appraisal process did you look at ~~the~~ how PSNH's easement impacted the fee interest value of the land?

A. Determining the impact of PSNH's easement rights on fee interest value occurred over a period of time. First we needed to inspect the power line corridor. During this process we observed pipeline markers, a valve or pump station, an adjacent gas turbine site with large storage tanks for natural gas with an Eversource sign on the gate, plus other various occupancies. From past experience related to easements, and from published literature, we knew that subsurface pipeline~~s~~ easements have a similar impact on fee interest value as a power line easement. The final piece of the puzzle was the permitted use limitations in the PSNH easement documents. A cursory review of a sample of these easements indicated that some rights were retained by the fee owner, or the servient estate. We recognize that PSNH's easement shares space with other uses and did not dominate, or capture, a majority of fee interest. Consequently, we recognized a fee interest capture rate of 45% for PSNH's easement throughout their corridor.

Q. Was it at this point you started valuing the larger parcels?

A. Yes, we reviewed the larger parcels and where there were similarities, we grouped them together and selected sales data that represented the overall land characteristics of the underlying servient estate. If the large parcels passed over small size servient estate, we include small size sales data; if they passed over large size servient estate, we included larger size sales data, and so on. We then analyzed and where appropriate, adjusted for size, shape, topography, zoning, location, and other issues that may be unique to an individual land sale data point.

Q. How did you reflect PSNH's value impact on the fee interest land value?

A. After considering the adjusted land sale prices and weighting those prices by the size component of the servient estates within each larger parcel, we determined a unit price for the fee interest value of each larger parcel. We then applied the value capture rate for the PSNH easement rights to determine a value for each larger parcel in PSNH's easement corridor.

Q. What did you determine to be the market value of PSNH's easement rights in the corridor at issue here?

A. It is our opinion that as of the date of valuation, November, 14, 2014, PSNH's easement rights have a market value of $708,300 for the North Section and $6,478,000 for the South Section, for a combined total of $7,186,300. This is our starting point.

Q. What was the next step in your process?

A. The next step in our process was to calculate the size of the various components of the proposed lease. This includes the space referred to as exclusive to NPT, the space shared with PSNH, and the space declared an uneconomic remnant. We again relied on the individual tax maps and proposed route maps to identify the amount of space within each the three categories within each of the defined larger parcels.

Q. Did you then value each of those components and how did you approach that task?

A. Our starting point in valuing each of these components of the proposed lease was the lease itself. Just as we looked at the easement documents supporting PSNH's easement rights, we looked to the proposed lease to determine the rights and limitations contained in the proposed lease. Relevant terms and conditions are presented in our appraisal report. Probably the most noteworthy issue presented in the terms of the lease relevant to valuing the rights captured by the proposed NPT lease are terms that are similar to PSNH's own easement rights. That is, in the proposed lease, real estate taxes and operating costs (costs) are allocated to the various defined components of the leased space. As a result, 100% of the cost is allocated to the space identified as exclusive to NPT, 50% of cost to the Shared Space, and 50% of cost to the uneconomic remnant. However, the allocation of costs does not address the right captured by NPT in the proposed lease. Section 1.8(b) of the lease, "Quiet Enjoyment/Encumbrances" states "*Lessor may grant subsequent to the date of this Lease rights or easements in the Leased Properties to others, provided (i) that all such rights or easements shall… not interfere in any material manner with the Leased Use…*" It is clear from this section of the lease that PSNH intended to retain some rights in the leased space just as the servient estates retained some rights in the land burdened by PSNH's easements. Therefore, the rights granted to NPT in the so-called 'exclusive space' is not actually exclusive to NPT. We have defined the rights retained by PSNH in this space as likely nominal and not more than five percent of PSNH's easement rights. As a result, it is our opinion the NPT lease captures 95% of PSNH's easement value in the space categorized as exclusive to NPT. From there, we applied the NPT value capture rate to ~~the~~ PSNH's easement value for the defined space to determine the total market value of the PSNH easement rights captured by the proposed NPT lease.

Q. After determining PSNH's easement value and the value captured by the proposed lease, is it at this point that you determine rent and what do you consider in determining market rent?

A. Yes, this is where we look to at the proposed lease in terms of the general market to determine a market based rent. In this case, we do not have examples of rental rates for partial interests in partial interest for electric power transmission easements. Therefore, we look to the market for rates of return for an equivalent level of risk. Here again we start by looking at the proposed lease. Section 14.1, Lessee's Right to Encumber or Transfer, describes NPT's right to use their facility, once constructed, as collateral for financing activities. More importantly, the lease describes what happens in the event of default to a Leasehold Lender. Essentially, under the terms of the lease, a Leasehold Lender, or anyone that takes possession of NPT's facility after default, takes NPT's property subject to the proposed lease. If the Leasehold Lender or subsequent party who takes possession does not continue payments under the lease, PSNH can cancel the lease and order the power line facility removed. This constitutes a significant safety net for PSNH regarding the risk of default by NPT. The other part of PSNH's safety net is the related party aspect of the proposed lease with the presence of the parent company Eversource Energy on both sides of the lease transaction. That component, combined with the market perception of PSNH and Eversouce Energy as low risk investments, results in a very low risk of default for the proposed NPT lease. For example, Eversource Energy's average cost of debt is 4.251% reported in 2016 and the PSNH average cost of debt is 4.244% in the same reporting period. Thus, PSNH's corporate debt is judged by the market as only slightly higher than the average commercial mortgage rate for investment grade improved property, 3.98% reported by

PriceWaterhouseCoopers in the Colliers appraisal report. Since the proposed lease is a related party transaction for a partial interest in a partial interest, PSNH's easement rights, limited to electric power transmission by a well-regarded public utility company in a regulated, monopolistic industry, we judge the risk of default to be very low.

Q. What rate of return did you determine to be appropriate?

A. It is our opinion that given the low rate of risk reflected by the proposed transaction, a market based rate of return for an equivalent level of risk is equal to PSNH's cost of debt or 4.25%.

Q. Do you believe that the opinions of value that you have presented here today are market value?

A. Yes. PSNH's easement value was based on market sales data and market literature that directs appraisers to evaluate the impact of the PSNH easement on the fee interest value. Our field observations identified co-occupancies that demonstrated the level of PSNH's easement impact. Secondly, the value capture rate of NPT's proposed lease was based on rights captured by the proposed lease which are a partial interest in a partial interest based on market data. Lastly, the rate of return for calculating rent is market based equivalent level of risk of default that is comparable to the Eversource Energy and PSNH market cost of capital (debt), the average mortgage rate on investment grade commercial property and the limited risk involved in a related party transaction in the utility industry. Our opinion of market rent reflects the risk of default in the proposed transaction.

Q. Does this conclude your testimony?

A. Yes, it does.