

CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Petition for
Reassessment of the 2022 Unitary Value for:

SFPP, L.P. (0461)

Petitioner

Appeal No.: SAU 22-015

Nonappearance Hearing Date:
December 13, 2022¹

Representing the Parties:

For the Petitioner:

Jeffrey Durrant, Authorized Agent
Claremont Tax Associates

Peter Michaels, Attorney
Law Office of Peter Michaels

For the Respondent:

Christian J. Younger, Tax Counsel
Attorney for State-Assessed Properties Division

Jack McCool, Chief
State-Assessed Properties Division

Appeals Attorney:

Sonya Yim, Tax Counsel IV

PROPOSED VALUES

	Value	Penalty	Total
2022 Board-Adopted Unitary Value	\$419,400,000	\$0	\$419,400,000
Petitioner's Requested Unitary Value	\$382,400,000	\$0	\$382,400,000
Petitioner's Revised Requested Value	\$306,500,000	\$0	\$306,500,000
Respondent's Appeal Recommendation	\$419,400,000	\$0	\$419,400,000
2022 Board-Determined Value on Appeal	\$419,400,000	\$0	\$419,400,000

¹ At the nonappearance hearing, the Board denied the petition for reassessment and affirmed the 2022 Board-adopted unitary value, by a unanimous vote of the Members present, with Chair Cohen, Vice-Chair Schaefer, Member Vazquez, and Controller Yee voting aye, and Member Gaines absent.

Factual Background

SFPP, L.P. (Petitioner), a subsidiary of Kinder Morgan Inc. (KMI), is one of the largest refined petroleum product pipelines in the United States, serving six Western states with approximately 2,845 miles of common carrier pipelines with 1,853 pipeline miles in California.² Petitioner's pipeline assets include interstate common carrier pipelines regulated by the Federal Energy Regulatory Commission (FERC), intrastate pipelines regulated by the California Public Utilities Commission (CPUC), and certain non-rate regulated and military pipelines.

The 2022 Board adopted unitary value of \$419,400,000 was based upon a 50 percent reliance on the Assessee-Furnished Estimate of Rate Base (Rate Base or cost) value indicator³ and a 50 percent reliance on Capitalized Earning Ability – Perpetual Life premise (CEA-PL or Income) value indicator.⁴ Petitioner filed a timely petition, raising two issues that the unitary value should be adjusted for additional economic obsolescence and extraordinary risk, and requesting a value of \$382,400,000.

Then, Petitioner's Reply brief revised its income shortfall analysis to reflect additional depreciation for external obsolescence, reducing the cost (Rate Base) value indicator further from \$521,219,221 to \$343,653,141, and increasing the basic capitalization rate from 11.740 percent to 13.740 percent, reducing Petitioner's requested Income value indicator from \$317,540,328 to \$269,414,873. As a result, Petitioner's revised requested 2022 unitary value is \$306,500,000.

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² Petitioner's lines are also connected to its sister company, CalNev Pipe Line, LLC (SBE #0402).

³ The Assessee-Furnished Estimate of Rate Base value indicator is a form of the cost approach to value. As explained further below, regulatory agencies generally use historical cost less depreciation (with various adjustments) as the rate base; regulatory agencies establish a rate base and a rate of return, and utilities are permitted to earn at this established rate on the rate base. Where available, the rate base cost approach is considered, consistent with Property Tax Rule 3. (*See* State Board of Equalization, *Unitary Valuation Methods* (UVM), (Revised March 2003), <https://www.boe.ca.gov/proptaxes/pdf/methodsbook2003.pdf>, p. 1.) See also Property Tax Rule 6. All references to "Property Tax Rule" or "Rule(s)" are to sections of title 18 of the California Code of Regulations.

⁴ The CEA-PL is a capitalization technique, one of two CEA models, typically used by Respondent in the income approach to valuation. Under the perpetual life concept, the capital investment necessary to maintain a perpetual income flow is deducted from expected revenues. With the necessary capital investment, the income stream is sustained into perpetuity. (*See UVM, supra*, pp. 38-40.) The income approach is considered in conjunction with the cost approach here, consistent with Property Tax Rule 8.

Legal Issue 1:

Whether Petitioner has demonstrated that Respondent Erred by Not Including an Adjustment for Economic and Functional Obsolescence in the Assessee-Furnished Estimate of Rate Base Value Indicator.

Findings of Fact and Related Contentions

Petitioner contends that an additional economic obsolescence adjustment is necessary to the Assessee-Furnished Estimate of Rate Base value indicator because the State of California's environmental policies will reduce future demand for gasoline and diesel. Petitioner relies on Executive Order N-79-20 (Order), also known as the Zero Emissions Mandate, issued on September 23, 2020, by Governor Newsom to support its argument for an economic and functional obsolescence adjustment. According to Petitioner, the Order established a zero emissions goal for sales of new passenger cars and trucks in California to be zero-emission by 2035 and all medium- and heavy-duty vehicles to be zero-emission by 2045, and emphasizes reducing supply and demand for petroleum and oil, including expediting closure of oil extraction sites and repurposing oil production facilities. Petitioner also states that new laws and state budget expenditures instituted campaigns to reduce fossil fuels by accelerating development of non-petroleum based fuel sources, infrastructure and budget incentives to use zero emission vehicles.

Because Petitioner generates revenue through regulated pipeline tariffs, it contends the Order will reduce future shipments of gasoline and diesel and therefore reduce its revenue. Petitioner offers as evidence the fact that the Order has already caused three refineries that use Petitioner's pipelines to begin conversion to non-crude oil feedstocks, with a reduction of capacities by two-thirds each.

Petitioner also contends that a prospective purchaser would recognize that functional obsolescence exists and must be cured by upgrading pipeline units to transport biofuels at lower volumes. Petitioner asserts that certain facilities will become useless, possibly reduced to salvage value, and offers as evidence that it is investing in two new facilities to handle renewable biodiesel that must remain separated from Petitioner's other refinery products to retain its customer's incentives and credits. Petitioner further states that there is uncertainty in acquiring new contracts to handle renewable diesel in California as biofuel refinery plants will not have to be concentrated in Petitioner's two main locations,

1 Los Angeles and the Bay Area, which concerns Petitioner's income potential as it has shipped
2 approximately 60 percent of the output from California's refineries in 2021.

3 Thus, Petitioner contends that based on the cited California goals, market conditions, and trends,
4 that its economic obsolescence calculation should recognize a lower rate of return by 2035, corresponding
5 to its requested adjustment of \$25,758,364. Petitioner contends that obsolescence adjustments are
6 inherently premised on uncertainty in marketplace dynamics, and asserts that it is certain that Petitioner
7 will be affected by the Zero Emissions Mandate, EO N-79-20, as the future will not be gasoline product
8 based.⁵

9 Petitioner further contends that its parent company, KMI, does recognize that industry
10 transformation will require new investments in renewable fuel storage capacity, terminals, fuels
11 blending, delivery facilities, and origination points, which show that elements of Petitioner's system are
12 economically obsolete. Additionally, Petitioner asserts that SAPD's focus on the uncertainty of the
13 phase out of gasoline powered vehicles is only one part of the story, as in Petitioner's view, all three
14 sources SAPD has cited (see *infra*, p. 5-6) expressly support the transition to electric vehicles, often at
15 an increasing pace.

16 Based on this context, Petitioner submitted a revised income shortfall analysis in support of the
17 requested obsolescence adjustment; this calculation includes Petitioner's assumption that the expected
18 rate of return will decline, yielding an income shortfall of 4.87 percent and for a 36 year life, this
19 equates to Petitioner's requested additional external obsolescence adjustment of 34.067 percent. Based
20 on its assumptions, Petitioner contends that while it is not certain what the maximum external
21 obsolescence adjustment should be, though the reasonableness of its request can be tested through
22 testing its assumptions, it is clear that a minimum adjustment should be made at this time based on the
23 Zero Emissions Mandate. Petitioner also notes it utilizes a .85 scale factor in this calculation, and that it
24 is reasonable, in its opinion, as it does not overstate the decline in rate of return with lower throughput.
25 Based on its revised calculation, Petitioner requests that the historical Rate Base (cost) value indicator
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28 ⁵ Petitioner's parent company KMI's 10-K states, "In addition, irrespective of supply of or demand for products we handle, implementation of new regulations or changes to existing regulations affecting the energy industry could have a material adverse effect on us." (KMI 10-K, p. 21.)

1 be reduced from \$521,219,221 to \$343,653,141.

2 Respondent contends that although the Order states ambitious goals to reduce the use of fossil
3 fuels, whether and to what extent those goals will be realized is wholly uncertain based on the data
4 Petitioner has submitted and the data SAPD has reviewed. Additionally, while Petitioner asserts a
5 negative forecast of future economic conditions, its own parent company, KMI, recently issued a
6 statement that was inconsistent with the petition's assertions, as KMI reported in its 2021 Form 10K
7 filed with the U.S Securities and Exchange Commission, that it "cannot predict the impact of future
8 economic conditions."⁶

9 Respondent asserts that there are numerous hurdles and factors that can significantly affect or
10 delay the possible impacts of the Order's goals. For example, the Alliance for Automotive Innovation, a
11 group of manufacturers that produce 98 percent of new cars and light trucks in the US, recently issued a
12 statement stating that whether electric vehicle (EV) sale mandates are realistic is directly linked to
13 external factors such as inflation, charging/fuel infrastructure, supply chains, labor, critical mineral
14 availability and pricing, and the ongoing semiconductor shortage. Respondent further asserts that EVs
15 require more rare-earth materials than internal combustion vehicles. According to the International
16 Energy Agency, the data shows a looming mismatch between climate ambitions and the availability of
17 critical materials essential to realizing those ambitions. EVs require six times the mineral inputs of
18 conventional cars, and the top 3 producers of rare earth materials account for over 75 percent of the
19 supplies. Respondent additionally states that increased demand for these rare-earth materials pose
20 geopolitical, expansion, and quality risks due to geographical concentration of minerals, long lead time
21 for expansion, and decline in resources.

22 Moreover, Respondent contends, the Order does not apply to pre-owned cars; only 2 percent of
23 the cars in California were zero emissions in 2020, and according to the Environmental and Natural
24 Resources Program at the Harvard Kennedy School, cars last around 15 years, so most gasoline-
25 powered cars will not be gone until 2050.

26 In sum, Respondent contends, the Order is a statement of ambitious goals. Whether those goals
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⁶ Kinder Morgan, Inc. (2021), Form 10-K. U.S. Securities and Exchange Commission. [kmi-20211231 \(sec.report\)](#), p. 21.

1 will be realized is uncertain, and to what extent they would be realized is uncertain, as many factors,
2 such as those described above, could affect the actual outcome of the Order.

3 Finally, although Petitioner argues that the Order creates functional obsolescence with
4 Petitioner's existing pipeline system, Respondent notes it is unclear how functional obsolescence is
5 created as a matter of certainty.

6 Apart from Respondent's review of the California specific and general market conditions
7 Petitioner raises, Respondent additionally believes Petitioner's requested calculation methodology is
8 invalid because Petitioner has provided no explanation or source of the derivation of its utilized "Scale
9 Factor." Respondent notes, that consistent with Board adopted guidelines, "Scaling factors used in
10 inutility submitted to the Board should be applicable to the property in question."⁷

11 Respondent concludes that because appraisal methodology requires that future events be
12 substantiated with verifiable evidence before affecting value, it is inappropriate and premature to make
13 an adjustment for obsolescence based on Petitioner's contentions.

14 At the appeals conference on November 9, 2022, Petitioner reiterated the marketplace dynamics
15 and environmental policies that could potentially negatively affect Petitioner. Respondent affirmed that
16 although those factors were aspirational or anticipated, Petitioner had not provided any practical data
17 that would verify or quantify the effects those factors had on Petitioner's unitary property value with any
18 certainty. Additionally, the parties also engaged in discussion on how to improve data sharing earlier in
19 the appraisal process for future assessment years, as the parties agreed the Order will impact Petitioner's
20 operations, even though the timing and certainty of its impact remain in dispute.

21 Additionally, the parties discussed various types of evidence that may assist in substantiating
22 economic obsolescence, whether in this year or in the future. During the discussion, Petitioner stated it
23 would follow up on whether or not there were any recent rate base appeals filed by Petitioner before
24 FERC and/or CPUC, including the status of, and basis of, the appeals.

25 After review of Petitioner's additional submissions, Respondent maintained that no adjustment is
26 appropriate at this time based on the evidence and arguments submitted due to the lack of certainty, and
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28 ⁷ California State Board of Equalization, *Guidelines for Substantiating Additional Obsolescence for State-Assessed Telecommunication Properties*, p. 5.

specifically that there was not sufficient documentation to verify the accuracy of Petitioner's updated calculations.

Applicable Law and Appraisal Principles

Burden of Proof

Assessing officers are presumed to have properly performed their duties. (Evid. Code, § 664.) Therefore, petitioner has the burden of showing that the assessment is incorrect or illegal. (*ITT World Communications v. Santa Clara* (1980) 101 Cal.App.3d 246; see also Cal. Code Regs., tit. 18, § 5541, subd. (a).)

Value Standard

Section 1 of article XIII of the California Constitution states that all property must be valued at fair market value. Property Tax Rule 2, subdivision (a), states that "in addition to the meaning ascribed to them in the Revenue and Taxation Code, the words "full value", "full cash value", "cash value", "actual value" and "fair market value" mean the price at which a property, if exposed for sale in the open market with a reasonable time for the seller to find a purchaser, would transfer for cash or its equivalent under prevailing market conditions between parties who have knowledge of the uses to which the property may be put, both seeking to maximize their gains and neither being a position to take advantage of the exigencies of the other."

Historical Cost (Rate Base) Value Indicator

Property Tax Rule 3, subdivision (d) provides the Historical Cost Less Depreciation (HCLD) approach to value shall be considered "[i]f the income from the property is regulated by law and the regulatory agency uses historical cost or historical cost less depreciation as the rate base, the amount invested in the property or the amount invested less depreciation computed by the method employed by the regulatory agency." HCLD, with some modification, approximates the rate base that regulators use in establishing revenue requirements. (See *UVM*, p. 1.) HCLD reflects the market value contribution of all taxable property including the depreciated historical cost of plant in service, possessory interests, construction work in progress, and materials and supplies. (AH 502, p. 146.) HCLD is, one of the more important indicators of value for closely regulated public utilities. The general practice of the California Public Utilities Commission (CPUC) and most other regulatory agencies is to use historical or original cost less depreciation (with various adjustments) as the

1 rate base. The regulatory agencies establish a rate base and a rate of return; utilities are
2 permitted to earn at this established rate on the rate base.

3 (UVM (2003), p. 1.) Further, Board guidance states,

4 Appraisal depreciation in the form of obsolescence may be present in utility property and
5 deducted from HCLD. Such deductions may be proper when the utility's economic income has
6 been impaired and the rate or tariff-setting regulators have recognized such impairment.

7 (UVM, p. 1.)

8 **Depreciation and the Cost Approach**

9 In general, the cost approach recognizes three types of depreciation: physical deterioration,
10 functional obsolescence, and external, or economic, obsolescence, through the application of the Board's
11 replacement cost new trend factors and "percent" good factors. Obsolescence may occur when property
12 is outmoded (functional obsolescence) or when some event has substantially diminished the future
13 earning power of the property (economic obsolescence). (See Assessors' Handbook section 501, *Basic*
14 *Appraisal* (January 2002), pp. 80-83.) Functional obsolescence is the loss of value in a property caused
15 by the property's loss of capacity to perform the function for which it was intended. (*Id.* at p. 81.)
16 Economic obsolescence is the diminished utility of a property due to adverse factors external to the
17 property being appraised and is incurable by the property owner. (*Id.* at p. 82.) The existence of any
18 additional or extraordinary obsolescence must be supported with verifiable documentation and evidence,
19 consistent with Board Guidelines, and Petitioner has the burden of establishing the existence of any
20 additional or extraordinary obsolescence. (See Property Tax Rule 6, subds. (d) & (e); Cal. Bd. of
21 Equalization, Assessors' Handbook section 502, *Advanced Appraisal* (Reprinted January 2015) (AH
22 502), pp. 20-21; UVM, p. 30; and Cal. Bd. of Equalization, *Guidelines for Substantiating Additional*
23 *Obsolescence*, at p. 1.)

24 **Analysis and Disposition**

25 Respondent is presumed to have correctly determined the value of the property at issue, and
26 Petitioner bears the burden of proving otherwise. Here, Petitioner has put forth the State's
27 environmental policies that it claims will reduce future demand for gasoline and diesel. However, we
28 find that Petitioner has cited no legal or appraisal authority, or verifiable evidence that would
substantiate the effect on its current unitary property value. While Petitioner has noted economic

1 uncertainty and general concerns about marketplace dynamics and the potential for changing
2 infrastructure, we concur with Respondent that verifiable data is needed to substantiate obsolescence
3 adjustments, consistent with the Board's guidance. Accordingly, we find that Petitioner has not met its
4 burden of proving Respondent erred by not including an additional adjustment for economic and/or
5 functional obsolescence in Petitioner's Rate Base Value Indicator, as utilized in Petitioner's 2022
6 Board-adopted unitary value.

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8 **Legal Issue 2:**

9 **Whether Petitioner Has Shown That Respondent Should Increase Its Basic Capitalization Rate to**
10 **Account for Additional, Extraordinary Risk.**

11 **Findings of Fact and Related Contentions**

12 Petitioner contends that its 2022 Board-adopted unitary value does not take into account
13 extraordinary additional risks to revenues specific to Petitioner, particularly those risks triggered by the
14 Executive Order and Zero Emissions Vehicle goals, and requests that a 2 percent adjustment be added to
15 Petitioner's basic capitalization rate. Petitioner has generally asserted that it differs in many respects from
16 pipeline companies in its peer group such that the Mandate has a greater impact on Petitioner: (1) other
17 companies are larger, and do not have the same exposure to the Zero Emissions Mandate or reliance on
18 a small number of refineries; (2) Petitioner has been subject to far greater regulatory oversight; it has
19 faced annual challenges to its tariffs and revenues, resulting in almost \$800 million in refunds over the past
20 15 years; it has been forced to reduce almost all of its tariffs; and (3) Petitioner has 13 rate cases pending.
21 In addition, Petitioner cites several concerns, including environmental activism, tariffs from the trade wars,
22 price hikes, unstable product demand, tax and indexing rate instabilities, and the emergence of electric
23 vehicles. Based on these factors and Petitioner's contention that the basic capitalization rate does not
24 reflect the heightened risks of the Zero Emissions Mandate and the competitive market of zero emission
25 vehicles, geographically dispersed biofuel, and refineries choosing less expensive modes of transportation
26 for products, Petitioner requests a 2 percent adjustment for risk be added to its basic capitalization rate, to
27 reflect that prospective purchasers would recognize and consider that the earning ability of the company is
28 exposed to heightened risk.

Respondent contends that Petitioner did not provide sufficient data, calculations, or an alternative capitalization rate study to support the proposed adjustment, but only mere speculation of lower revenues, increased costs, and increased competition in the future, based on speculation of the effects of the 2020 Executive Order.

Additionally, Respondent notes that despite the risks Petitioner is alleging, Petitioner's parent company, Kinder Morgan, Inc, reported a 13 percent increase in revenue from its West Coast Refined Products group, which primarily consists of Petitioner and one other pipeline company.

Further, Respondent notes that Petitioner has provided no evidence that a 2 percent increase is even appropriate, or more appropriate as opposed to any other percentage.

As a matter of process, Respondent states that it develops basic capitalization rates for all state assesseees annually, published in the Board's annual Capitalization Rate Study; and contrary to Petitioner's requested capitalization rate, the 2022 Study's rate chosen for the pipeline industry is the result of analysis of economic conditions and financial data listed in the supporting schedules and is the product of the staff's informed appraisal judgment.

Accordingly, Respondent maintains that Petitioner has not provided sufficient data to support additional adjustments to the overall capitalization rate for "extraordinary risks," and recommends no adjustment as to this issue.

At the Appeals Conference held on November 9, 2022, the parties generally renewed their contentions and noted the briefings adequately reflected their positions.

Applicable Law and Appraisal Principles

Burden of Proof

Assessing officers are presumed to have properly performed their duties. (Evid. Code, § 664.) Therefore, petitioner has the burden of showing that the assessment is incorrect or illegal. (*ITT World Communications v. Santa Clara* (1980) 101 Cal.App.3d 246; see also Cal. Code Regs., tit. 18, § 5541, subd. (a).)

Capitalized Earning Approach

The capitalized earning ability or income approach to value is used when the property under appraisal is typically purchased in anticipation of a money income and either has an established income

stream or can be attributed a real or hypothetical income stream by comparison with other properties. (Property Tax Rule 8, subd. (a).) The income approach to value may generally be described as any method that converts future anticipated income into present value using a capitalization rate. The conversion process is commonly known as income capitalization. (Assessors' Handbook 501, *Basic Appraisal*, (Jan. 2002) (AH 501), p. 95.) The calculation of the total capitalization rate consists of four basic components: a basic capitalization (or yield) rate component, a recapture component, an ad valorem property tax component, and an income tax component.

Capitalization Rate Development

Property Tax Rule 8, subdivision (g)(2) provides the authority for the method by which the capitalization rates are developed. The basic capitalization rate is derived by applying a weighted average of the yield rates for debt and for equity capital calculated by the band-of-investment method. The rates of debt and equity capital are weighted by the respective amounts of capital deemed most likely to be employed by prospective purchasers. (Rule 8, subd. (g)(2).)

2022 Capitalization Rate Study

Each year, SAPD develops basic capitalization rates for all state assessees and mails the staff's capitalization rate study to each state assessee in January.⁸ Then, the rates are presented to the Board at its February meeting, with an open invitation to all state assessees to present additional information for SAPD to consider in its development of the rates.⁹ The Board publishes the capitalization rates in the annual Capitalization Rate Study (Study).¹⁰

In 2022, no state assessees presented information at the February Board Meeting.

Analysis and Disposition

Respondent is presumed to have correctly determined the value of the property at issue, and Petitioner bears the burden of proving otherwise. Here, Petitioner has argued the risk that it faces as a company is unique due to specified market conditions, etc., and as such it should be accounted for by adding a 2 percent risk premium to its basic capitalization rate. However, we concur with Respondent

⁸ Pursuant to the 2022 Calendar for the Valuation of Public Utilities and Railroads, <https://www.boe.ca.gov/proptaxes/pdf/lta21050.pdf>.

⁹ Pursuant to Rules for Tax Appeals, 18 Cal. Code. Regs., section 5322.

¹⁰ Cal. St. Bd. Of Equalization, 2022 Capitalization Rate Study.

1 that Petitioner has not provided evidence to prove that Respondent erred by not utilizing Petitioner's
2 requested extraordinary risk adjustment, nor has Petitioner provided any evidence that a 2 percent
3 adjustment is more appropriate over any other alternative, including the 2022 Study's capitalization rate
4 that was utilized in Petitioner's 2022 Board-adopted value. In sum, we find that Petitioner has cited no
5 legal or appraisal authority that indicates an extraordinary risk adjustment to its basic capitalization rate
6 must be made by Respondent. Accordingly, we find that Petitioner has not met its burden of proving
7 Respondent erred by not increasing Petitioner's basic capitalization rate by 2 percent.

8 Decision

9 Accordingly, the petition for reassessment is denied, and the 2022 Board-adopted unitary value
10 of \$419,400,000 is affirmed.*

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12 Malia M. Cohen, Chair

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14 Mike Schaefer, Vice Chair

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16 Antonio Vazquez, Member

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18 Betty T. Yee, Controller

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20 * The decision was rendered in Sacramento, California on December 13, 2022. This summary decision
21 document was approved on February 22, 2023 in Sacramento, California.