

CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Petition for
Reassessment of the 2016 Unitary Value for:

**LA PALOMA GENERATING
COMPANY, LLC (1112)**

Petitioner

Appeal No.: SAU 16-012

Case ID No.: 961716

Oral Hearing date:
December 14, 2016

Representing the Parties:

For the Petitioner:

C. Stephen Davis, Attorney at Law
Antreas E. Ghazarossian, Representative

For the Respondent:

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Attorney for State-Assessed Properties Division

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Richard D. Reisinger, Chief
State-Assessed Properties Division

Counsel for Appeals Division:

Dana R. Brown, Tax Counsel III (Supervisor)

VALUES AT ISSUE

	Value	Penalty	Total
2016 Board-Adopted Unitary Value	\$168,800,000	\$0	\$168,800,000
Petitioner's Requested Unitary Value	\$73,347,569	\$0	\$73,347,569
Respondent's Appeal Recommendation	\$168,800,000	\$0	\$168,800,000
Respondent's Revised Recommendation	\$136,100,000	\$0	\$136,100,000

FACTUAL BACKGROUND

La Paloma Generating Company LLC (petitioner) was formed in 1998, and is based in Houston, Texas. Petitioner is a wholly-owned subsidiary of La Paloma Acquisition Company, LLC. Petitioner

owns and operates a 1,048-megawatt (MW) combined-cycle, natural gas-fired power generation facility near McKittrick in Kern County, California that has been operating since March 2003. Petitioner's facility has four equal-sized ABB GT24-B combustion generation units, coupled with Alstom KA24-1 combined-cycle power units and natural gas and electric transmission facilities. The 2016 Board-adopted unitary value of \$168,800,000 for petitioner's facility is based on 60-percent reliance on the Replacement Cost Less Depreciation (ReplCLD) value indicator and 40-percent reliance on the Capitalized Earnings Approach (CEA) value indicator (income approach).

LEGAL ISSUE 1

Whether petitioner has shown that the ReplCLD value indicator fails to account for all obsolescence in the determination of petitioner's 2016 Board-adopted unitary value.

FINDINGS OF FACT AND RELATED CONTENTIONS

Petitioner contends that its 2016 Board-adopted unitary value should be adjusted for additional obsolescence because low energy prices and a lack of demand for its power generation for a number of years which have resulted in a lower than expected return on its investment. Petitioner also asserts that the 2016 Board-adopted unitary value is based primarily on a cost approach valuation methodology that does not take into consideration the full extent of obsolescence impacting petitioner's facility. Petitioner maintains that the cost approach should either be disregarded or adjusted to the CEA value indicator to account for all obsolescence as required by Revenue and Taxation Code section 51, subdivision (a)(2) and Property Tax Rule 6.

Petitioner argues that a "material differential between the income and cost indicators is strong evidence of economic obsolescence requiring that the income shortfall method of quantifying economic obsolescence be utilized." Petitioner cites *SBE Guidelines for Substantiating Additional Obsolescence for Personal Properties and Fixtures* (2010) LTA No. 2010/030, p.19 for its assertion that "[t]he relationship between replacement cost new and the cash flows the hypothetical replacement is capable of generating – compare the replacement cost new to the income indicator of value for the same property the difference is economic obsolescence." Petitioner concludes that respondent should place 100-percent reliance on the CEA value indicator because the ReplCLD value indicator does not fully account for all obsolescence impacting petitioner's property.

1 Respondent asserts that the ReplCLD value indicator sufficiently accounts for obsolescence in
2 petitioner's 2016 unitary valuation and that petitioner fails to identify or quantify the claimed additional
3 obsolescence. Respondent argues that petitioner's position that the 2016 Board-adopted unitary value
4 should be adjusted to the CEA value indicator is not an acceptable methodology for determining
5 obsolescence in the cost approach. Respondent notes that the ReplCLD value indicator of \$232,371,071
6 for lien date 2016 reflects total adjustments of \$697,456,294 (or 77-percent) of the Replacement Cost
7 New value of petitioner's facility and that the 2016 Board-adopted value is only 40-percent of
8 petitioner's net book value. Respondent asserts that the obsolescence adjustments for petitioner's
9 property are sufficient, and petitioner has not shown that any further adjustments are warranted.

10 In its reply brief, petitioner argues that market conditions for gas-fired power generation
11 facilities without power sales agreements, such as its facility, must "sell into the market" which has
12 "catastrophic" economic consequences and that companies are not building such facilities due to
13 adverse market conditions. Petitioner notes that it has filed a complaint with FERC seeking to compel
14 CalISO to modify the tariff terms under which petitioner must operate.

15 In its reply brief, respondent asserts that its ReplCLD value indicator sufficiently accounts for
16 obsolescence and that petitioner fails to identify or quantify the claimed additional obsolescence.
17 Respondent argues that the fact that no similar facilities are being built does not preclude respondent's
18 use of the ReplCLD value indicator. Respondent notes that the ReplCLD value indicator is reliable here
19 because in "nearly all cases" of the sales of electric generation facilities it has recently reviewed, the
20 sales price was greater than the ReplCLD value indicator for the lien date preceding the sale date.

21 After an appeals conference, petitioner provided the following documents: profit and loss
22 (P&L) statements for the first and second quarters of 2016, California Independent System Operator
23 (CalISO) and merchant generator filings in a proceeding before the Federal Energy Regulatory
24 Commission (FERC), and its updated cash flow analysis. Respondent reviewed the additional
25 information and, based on the information related to the prevailing market conditions in California,
26 respondent calculated two adjustments to the ReplCLD value indicator totaling \$54,431,710, to reflect
27 petitioner's anticipated reduced generation levels and the reduced spark spreads experienced by
28 petitioner. After weighting of the value indicators, respondent recommends a \$32,700,000 adjustment

1 for additional economic obsolescence resulting in a 2016 Board-adopted unitary value of \$136,100,000
2 for petitioner's property.

3 APPLICABLE LAW

4 Burden of Proof

5 Assessing officers are presumed to have properly performed their duties. (Evid. Code, § 664.)
6 The Board has promulgated the Rules for Tax Appeals (RTA) to govern the administrative and
7 appellate review processes for all of the tax and fee programs administered by the Board. (Cal. Code
8 Regs., tit. 18, § 5000.) Of relevance here, RTA 5541, subdivision (a), places the burden of proof upon
9 the taxpayer as to all issues of fact except as otherwise specifically provided by law. Courts have long
10 presumed that the Board assesses all property correctly, placing on the taxpayer the burden of proving
11 that an assessment is incorrect. (*Trailer Train Co. v. State Bd. of Equalization* (1986) 180 Cal.App.3d
12 565, 584.) Therefore, petitioner bears the burden of showing that the assessment is illegal.
13 (*ITT World Communications v. Santa Clara County* (1980) 101 Cal.App.3d 246.)

14 Depreciation and the Replacement Cost Approach

15 In general, the ReplCLD value indicator recognizes three types of depreciation: physical
16 deterioration, functional obsolescence, and external or economic obsolescence, through application of
17 the Board's replacement cost new trend factors and "percent" good factors. Obsolescence may occur
18 when property is outmoded (functional obsolescence) or when some event has substantially diminished
19 the future earning power of the property (economic obsolescence). (*See Assessors' Handbook* section
20 501, *Basic Appraisal* (January 2002), pp. 81-83.) Functional obsolescence is the loss of value in a
21 property caused by the property's loss of capacity to perform the function for which it was intended.
22 (*Id.* at p. 81.) Economic obsolescence is the diminished utility of a property due to adverse factors
23 external to the property being appraised and is incurable by the property owner. (*Id.* at p. 82.)

24 The percent good factors, the basis for adjusting the RCN into an indicator of fair market value,
25 are used to determine the remaining value of a property and are complements of physical deterioration
26 and functional obsolescence. The factors used for a given property type are based on the expected
27 economic life of that property type which is based on a service life study that surveys industry
28 participants who own that type of property. (*Unitary Valuation Methods* (March 2003) (UVM), p. 30.)

1 In addition to economic life, there are four other variables that have an effect on percent good
2 factors. These variables are: the rate of return, the method of calculation, the survivor curve, and the
3 presence of an income adjustment factor. In the State-Assessed Properties Division these variables are
4 determined as follows: rate of return annually established by Property Tax Department, single-life
5 calculation method, R3 survivor curve and the use of an income adjustment factor reflecting a
6 10-percent decline over average life. Petitioner has the burden of establishing the existence of any
7 additional or extraordinary obsolescence. (See Property Tax Rule 6, subds. (d) & (e); Cal. Bd. of
8 Equalization, Assessors' Handbook § 502, *Advanced Appraisal* (December 1998) (AH 502), p. 20-21;
9 UVM, p. 30.)

10 ANALYSIS AND DISPOSITION

11 Respondent is presumed to have correctly determined the value of the property at issue, and
12 petitioner bears the burden of proving otherwise. Here, respondent calculated a total of \$265,071,071
13 (\$232,371,071 + \$32,700,000) in adjustments to the ReplCLD value indicator for petitioner's property.
14 We do not find petitioner's argument that it has been experiencing low energy prices and lower-than-
15 anticipated electricity demand sufficient to warrant respondent not placing any reliance on the
16 ReplCLD value indicator. Additionally, we find that petitioner has failed to identify and quantify any
17 additional obsolescence which it asserts respondent has not recognized in accordance with Rule 8.
18 Accordingly, we find that petitioner has not presented sufficient evidence to meet its burden of proof to
19 show that any further adjustments for additional obsolescence are warranted.

20 LEGAL ISSUE 2

21 Whether petitioner has shown that respondent failed to place proper reliance on the value indicators in the
22 determination of petitioner's 2016 Board-adopted unitary value.

23 FINDINGS OF FACT AND RELATED CONTENTIONS

24 Petitioner contends that 60-percent reliance on the ReplCLD value indicator does not fully
25 account for all of the obsolescence and that 100-percent reliance should be placed on the CEA value
26 indicator. Petitioner asserts that a two-year or three-year "weighted average" of its actual income
27 should be used to develop petitioner's capitalized income because using its "actual performance" would
28 make the CEA value indicator more reliable. Petitioner states that its forecasts are based on the "best

1 available information” at the time, but can be subject to change several months later due to changes in
2 various factors including weather and market conditions. Petitioner contends that this volatility is not a
3 reason for respondent to deem its forecasts to be unreliable because no market participant can
4 accurately predict the future with “the degree of precision [respondent] seems to require.”

5 Additionally, with respect to respondent’s assertion that certain electric generation plants have
6 recently sold at prices higher than petitioner’s unitary value, petitioner contends that no two sales
7 transactions of power generation facilities are alike and, therefore, sales of power generation facilities
8 must be closely examined when valuing petitioner’s property. Petitioner states that its facility is unique
9 in the manner in which it gets power to the grid, in the cost it pays to place its power on the grid, and in
10 the amount of power that is demanded to be put on the grid by CalISO. Petitioner asserts that its
11 property has suffered obsolescence to such a degree that the ReplCLD value approach is unreliable and
12 cites, as an example, the fact that its facility suffers from a material amount of physical depreciation
13 because its power generators are approximately halfway through their lives. Petitioner also asserts that
14 the facility is uniquely located in relation to the power grid, and that there is a lower demand for
15 electricity. For those reasons, petitioner contends that respondent should place 100-percent reliance on
16 the CEA value indicator in determining petitioner’s 2016 unitary valuation.

17 Respondent contends that 60-percent reliance on the ReplCLD value indicator and 40-percent
18 reliance on the CEA value indicator is appropriate for valuing petitioner’s facility. Respondent asserts
19 that 100-percent reliance on the CEA value indicator is not appropriate because petitioner’s income
20 projections for lien date 2016 are unreliable and suggest that petitioner’s assets are impaired when
21 petitioner’s audited financial statements do not reflect impairment and petitioner has not provided the
22 projected cash flows that its independent auditor would have used in testing its assets for impairment.
23 Respondent states that it calculated the CEA value indicator based on petitioner’s actual 2015 appraisal
24 income projected for the remaining economic life of the facility. Respondent asserts that the ReplCLD
25 value indicator is more reliable because it reflects current replacement cost of the latest technology,
26 with adjustments for depreciation and obsolescence. Respondent argues that petitioner’s inability to
27 make short-term operating income projections with any degree of accuracy precludes respondent from
28 placing greater reliance on the CEA value indicator.

Respondent contends that petitioner's value is comparable to the Board-adopted values for similarly-situated companies on a per-MW basis. Respondent contends that petitioner has not provided sufficient evidence showing that the CEA value indicator is more reliable than the ReplCLD value indicator here, thus warranting any change in reliance on the value indicators.

In its reply, petitioner argues that respondent has weighted a valid value indicator for its facility with an invalid, incomplete indicator which is not an accepted appraisal practice. Petitioner contends that "maintaining the separateness or independence of action value methods is a general principle, which in turn must conform to accepted appraisal practice to test the economic feasibility of the cost indicator." Lastly, petitioner argues that, contrary to respondent's position, "testing the validity (economic feasibility) of the cost indicator by means of the income approach, and measuring the degree of obsolescence by means of the income shortfall, i.e., the extent to which the return on the RCNLD indicator is insufficient to render that cost value indicator to be feasible, is well established."

In respondent's reply, respondent renews its contention that its weighting of the value indicators is appropriate here. Respondent asserts that the cash flow statement petitioner provided on Schedule H of its property statement filing for lien date 2016 was unreliable because it implied petitioner's assets should be impaired. Respondent again asserts that petitioner was requested, but failed, to submit the cash flow projections used by petitioner's independent auditors in determining whether an impairment of assets should be recognized. Accordingly, respondent argues that petitioner's inability to make short-term projections with any degree of accuracy does not support petitioner's contention that respondent should place any greater reliance on the CEA value indicator.

APPLICABLE LAW AND APPRAISAL PRINCIPLES

Burden of Proof

Assessing officers are presumed to have properly performed their duties. (Evid. Code, § 664.) The Board has promulgated the Rules for Tax Appeals (RTA) to govern the administrative and appellate review processes for all of the tax and fee programs administered by the Board. (Cal. Code Regs., tit. 18, § 5000.) Of relevance here, RTA 5541, subdivision (a), places the burden of proof upon the taxpayer as to all issues of fact except as otherwise specifically provided by law. Courts have long presumed that the Board assesses all property correctly, placing on the taxpayer the burden of proving

1 that an assessment is incorrect. (*Trailer Train Co. v. State Bd. of Equalization* (1986) 180 Cal.App.3d
2 565, 584.) Therefore, petitioner bears the burden of showing that the assessment is illegal.
3 (*ITT World Communications v. Santa Clara County* (1980) 101 Cal.App.3d 246.)

4 Value Standard

5 Property Tax Rule 2, subdivision (a) states that “in addition to the meaning ascribed to them in
6 the Revenue and Taxation Code, the words ‘full value,’ ‘full cash value,’ ‘cash value,’ ‘actual value,’
7 and ‘fair market value’ mean the price at which a property, if exposed for sale in the open market with a
8 reasonable time for the seller to find a purchaser, would transfer for cash or its equivalent under
9 prevailing market conditions between parties who have knowledge of the uses to which the property
10 may be put, both seeking to maximize their gains and neither being in a position to take advantage of the
11 exigencies of the other.”

12 Reconciliation of Value Indicators

13 Property Tax Rule 3 requires that, in estimating value, the assessor shall consider one or more
14 of the approaches to value “as may be appropriate for the property being appraised,” which includes the
15 comparative sales approach, the replacement or reproduction cost approach (e.g., ReplCLD valuation
16 methodology), or the income approach. The appropriateness of an approach is often related to the type
17 of property being appraised and the available data. (AH 502, p. 109.) In addition, the validity of a
18 value indicator will depend upon the accuracy of data and adjustments made to the approach. That is,
19 the accuracy of a value indicator depends on the amount of available comparable data, the number and
20 type of adjustments, and the dollar amount of adjustments. Finally, if a large amount of comparable
21 data is available for a given approach, the appraiser may have more confidence in that approach. For
22 example, if income, expense, and capitalization rate data can be obtained from many properties
23 comparable to the subject, the appraiser may attribute significant accuracy to the income approach. The
24 greatest reliance should be placed on that approach or combination of approaches that best measures the
25 type of benefits the subject property yields. The final value estimate reflects the relative weight that the
26 appraiser assigned, either implicitly or explicitly, to each approach. (AH 502, p. 112.)

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ReplCLD Value Indicator

Property Tax Rule 6,¹ subdivision (a) provides, in pertinent part, that: “The reproduction or replacement cost approach to value . . . is preferred when neither reliable sales data . . . nor reliable income data are available” In general, the ReplCLD valuation methodology is estimated by applying the appropriate trend factors, including the application of “current prices to the labor and material components of a substitute property capable of yielding the same services and amenities, with appropriate additions” (Property Tax Rule 6, subd. (d).) The resulting adjusted cost amount is “reduced by the amount that such cost is estimated to exceed the current value of the reproducible property by reason of physical deterioration, misplacement, over- or underimprovement, and other forms of depreciation or obsolescence. The percentage that the remainder represents of the reproduction or replacement cost is the property’s percent good.” (Property Tax Rule 6, subd. (e).)

Income Approach to Value

Property Tax Rule 8, subdivision (a) states that “the income approach is used in conjunction with other approaches 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.” Subdivision (b) describes the income approach to value as the valuation method whereby, “an appraiser values an income property by computing the present worth of a future income stream. This present worth depends upon the size, shape, and duration of the estimated stream and upon the capitalization rate at which future income is discounted to its present worth.” Subdivision (c) provides that “the amount to be capitalized is the net return which a reasonably well-informed owner and reasonably well-informed buyers may anticipate on the valuation date that the taxable property existing on that date will yield under prudent management and subject to legally enforceable restrictions as such persons may foresee as of that date.”

ANALYSIS AND DISPOSITION

Respondent is presumed to have determined correctly the value of the property at issue, and petitioner bears the burden of proving error. Here, petitioner argues that respondent should place

¹ All references to Property Tax Rules are to sections of title 18 of the California Code of Regulations.

1 100 percent reliance on the CEA value indicator and that its revenue and expenses forecasts are based
2 on the best information available. While petitioner acknowledges that its forecasts can be subject to
3 volatility due to various conditions such as weather and market conditions, it argues that this volatility
4 is not a reason for respondent to deem its forecasts as unreliable because no market participant can
5 accurately predict the future with “the degree of precision [respondent] seems to require.”

6 Property Tax Rule 8 provides that reliance on the income approach is appropriate when the
7 property has an “established income stream or can be attributed a real or hypothetical income stream by
8 comparison with other properties.” In the view of the Appeals Division, the factors and circumstances
9 that affect electricity prices as described by petitioner and the volatility of petitioner’s income forecasts
10 necessarily indicate a high degree of unpredictability in the level of future income. Therefore, we find
11 that petitioner has not shown evidence of an established income stream for its facility. In addition,
12 petitioner has not presented specific evidence to show that its property may be attributed a real or
13 hypothetical income stream by comparison with other properties. We, therefore, find that petitioner has
14 not presented sufficient evidence showing that respondent failed to place proper reliance on the value
15 indicators in the determination of petitioner’s 2016 Board-adopted unitary value.

DECISION

Accordingly, the petition for reassessment is granted, in part, reducing the 2016 Board-adopted unitary value from \$168,800,000 to \$136,100,000.*

_____, Chairwoman

_____, Member

_____, Member

_____, Member

_____, Member

* The decision was rendered in Sacramento, California on December 14, 2016. This summary decision document was approved on February __, 2017, in Culver City, California.