CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Petition for Reassessment of the 2013 Unitary Value for:	
LA PALOMA GENERATING CO. LLC (1112)	Appeal No.: SAU 13-015 Case ID No.: 742923
Petitioner	

Representing the Parties:

For the Petitioner: Antreas E. Ghazarossian
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Donald Jackson
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For the Respondent: Richard Moon, Tax Counsel IV
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Richard D. Reisinger (Principal Property Appraiser)
State-Assessed Properties Division

Counsel for Appeals Division: Dana R. Brown, Tax Counsel III (Specialist)

VALUES AT ISSUE

	Value	Penalty	Total
2013 Board-Adopted Unitary Value	$333,300,000	$0	$333,300,000
Petitioner's Requested Unitary Value	$279,770,000	$0	$279,770,000
Respondent's Appeal Recommendation	$333,300,000	$0	$333,300,000

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LEGAL ISSUE 1

Whether petitioner has shown that the 2013 Board-adopted unitary value was based on improper reliance on the Replacement Cost Less Depreciation (ReplCLD) and Capitalized Earning Approach (CEA) value indicators.

FINDINGS OF FACT AND RELATED CONTENTIONS

La Paloma Generating Company LLC (petitioner) was formed in 1998, and is based in Houston, Texas. Petitioner owns and operates a 1,022-megawatt (MW) combined cycle, natural-gas-fired power generation facility near McKittrick in Kern County, California that has been operating since March 2003. Since August 16, 2005, petitioner has operated as a subsidiary of Complete Energy Holdings, LLC. 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 2013 Board-adopted unitary value for petitioner's facility is based on 60-percent reliance on the ReplCLD value indicator and 40-percent reliance on the CEA value indicator.

Petitioner contends that there was improper reliance placed on the value indicators for lien date 2013 and, as a result, the Board-adopted unitary value is overstated. Petitioner asserts that the 60-percent reliance on the ReplCLD value indicator does not take into consideration all of the obsolescence impacting petitioner's property. Petitioner further asserts that the 40-percent reliance on the CEA value indicator only recognizes a portion of the obsolescence impacting petitioner's property.

Petitioner asserts that it has been experiencing lower energy prices and lower demand for several years resulting in a lower return on investment than expected, and petitioner does not anticipate any improvement in the foreseeable future. Petitioner also states that it does not expect its income stream to return to the levels forecast at the time of the purchase of the facility. Because petitioner does not have reliable comparable sales data available and its property has suffered from a material amount of depreciation and obsolescence, petitioner contends that the CEA value indicator should be given greater reliance. Petitioner also contends that income forecasts are not necessarily unreliable despite the volatility of its income streams due to the complexity of electric generation pricing, contracts, and supply and demand.

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In response to respondent's claim that certain electric power generation plants have recently sold at prices higher than petitioner's unitary value, petitioner contends that no two sales transactions of power generation facilities are alike; therefore, respondent must closely examine such sales of power generation facilities when valuing petitioner's property. Petitioner asserts that while there may be some similarities in the type of power generation facilities sold, there is no comparison in other factors such as the size, type, age, location, and grid connection. Petitioner states that its facility is unique 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 the amount of power that is demanded to be put on the grid by the California Independent System Operator (ISO).

Finally, petitioner asserts that its property has suffered so much depreciation and obsolescence that the ReplCLD value indicator is less reliable in determining the value of petitioner's facility. Petitioner, therefore, contends that greater reliance should be placed on the CEA value indicator in determining the 2013 unitary valuation which would result in a value of $279,770,000.

Respondent contends that 60-percent reliance on the ReplCLD value indicator and 40-percent reliance on the CEA value indicator are consistent with the methodology used to value all other similarly-situated electric generation facilities for lien date 2013. Respondent asserts that the ReplCLD value indicator is a more reliable market value indicator for electric power generation facilities because price and demand uncertainty exists in the electricity markets. Further, respondent asserts the ReplCLD value indicator is a more reliable value indicator for petitioner's facility because it reflects the current replacement cost of the latest technology, with adjustments for depreciation and obsolescence.

Respondent also contends that the ReplCLD value indicator is more reliable here because petitioner's income projections are very unreliable. Respondent notes that petitioner anticipates negative net cash flow for the next ten years based on factors such as interest expense and property taxes, but respondent asserts that these are not valid deductions in calculating its income projections pursuant to Property Tax Rule 8.[1] For these reasons, respondent concludes that it is inappropriate to place additional reliance on the CEA value indicator.

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

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Finally, respondent contends that when petitioner's assessed value is compared with the Board-adopted values for similarly-situated facilities on a per-MW basis, petitioner's assessed value is not only reasonable, but it is also below the average per-MW value for similarly situated, combined-cycle facilities. Respondent contends that petitioner has not provided any evidence showing that the CEA value indicator is more reliable than the ReplCLD value indicator here. Accordingly, respondent asserts that no change in reliance on the indicators is warranted.

In a reply brief, petitioner states that the 2003 Board-adopted unitary value was based on 100-percent reliance on the ReplCLD value indicator for combined-cycle gas turbine (CCGT) facilities. Petitioner also states that reliance on the ReplCLD value indicator has been gradually reduced since that time and is currently a 60-percent reliance on the ReplCLD value indicator and a 40-percent reliance on the CEA value indicator for CCGT facilities, which has also been used for the last several years. Petitioner asserts that the declining reliance on the ReplCLD value indicator for CCGT facilities is a reflection of the fluid marketplace economics for CCGT facilities in this state.

Petitioner asserts that the changed reliance on the value indicators is the result of respondent's belief that the facility's income-producing ability has become more stable. Petitioner asserts that CCGT facilities' earning ability has not, however, become more stable and that they have not been able to earn large profits since 2003, when companies such as Enron were sued by the federal government. Petitioner reiterates its contention that the CEA value indicator should be given more reliance with respect to the valuation of petitioner's property. Petitioner states that the CEA value indicator is the most reliable approach to value petitioner's facility in the current operating and economic environment. Petitioner contends that its operating history and financial projections should be considered the best information for valuing petitioner's property. Petitioner asserts that the ReplCLD value indicator is less reliable than the CEA value indicator given the property's age, its location on the transmission grid, and its proximity to end-users. Petitioner contends that these factors are the cause of its significant amounts of depreciation and obsolescence.

APPLICABLE LAW

ReplCLD Value Indicator

Property Tax Rule 6, subdivision (a) provides, in part: "The reproduction or

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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 trend factors-price level changes, 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 as specified . . ." (Property Tax Rule 6, subd. (d).) Then, 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 Value Indicator

Property Tax Rule 8, subdivision (a) states that "[t]he income approach to value 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 "[t]he 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."

Reconciliation of Value Indicators

Property Tax Rule 3 requires that, in estimating value, the assessor shall consider one or more of the approaches to value "as may be appropriate for the property being appraised," which include the comparative sales approach, the replacement or reproduction cost approach (e.g., ReplCLD valuation methodology), or the income approach. The appropriateness of an approach is often related to the type of property being appraised and the available data. (Assessors' Handbook section 502, *Advanced Appraisal* (December 1998) (AH 502), p. 109.) In addition, the validity of a value indicator

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will depend upon the accuracy of data and adjustments made to the approach. That is, the accuracy of a value indicator depends on the amount of available comparable data, the number and type of adjustments, and the dollar amount of adjustments. Finally, if a large amount of comparable data is available for a given approach, the appraiser may have more confidence in that approach. The greatest reliance should be placed on the approach or combination of approaches that best measures the type of benefits the subject property yields. The final value estimate reflects the relative weight that the appraiser assigned, either implicitly or explicitly, to each approach. (AH 502, p. 112.)

ANALYSIS AND DISPOSITION

The Board is presumed to have correctly determined the value of the property at issue, and petitioner bears the burden of proving otherwise. (Cal. Code Regs., tit. 18, § 5541, subd. (a).) Here, the parties agree on the use of the ReplCLD and CEA value indicators to value the unitary property, but differ over the appropriate amount of reliance placed on each value indicator. Petitioner contends that less reliance should be placed on the ReplCLD value indicator because its property suffers from a material amount of physical depreciation and obsolescence due to its location on the grid and lower electricity demand. Petitioner also contends that greater reliance should be placed on the CEA value indicator, although petitioner acknowledges that its income forecasts are subject to the complexities of electric generation pricing contracts, weather, market conditions, and supply and demand uncertainty.

We find that the variable factors and circumstances described above which affect electricity prices necessarily indicate a large degree of unpredictability in the level of future income. Hence, we find that petitioner has not shown evidence of an established income stream for the facility. Moreover, petitioner has not presented specific evidence to show that the property may be attributed a real or hypothetical income stream by comparison with other properties. Accordingly, we conclude that petitioner has failed to meet its burden of proving that 60-percent reliance on the ReplCLD indicator and 40-percent reliance on the CEA value indicator as a basis for the 2013 Board-adopted unitary value was in error.

LEGAL ISSUE 2

Whether petitioner has shown that the 2013 Board-adopted unitary value fails to account for all

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depreciation and obsolescence in petitioner's unitary property.

FINDINGS OF FACT AND RELATED CONTENTIONS

Petitioner contends that the 2013 Board-adopted unitary value should be adjusted to reflect additional depreciation and obsolescence. In support of its contention, petitioner asserts that its projected revenues in 2013, in comparison with its revenues reported to the Board in 2012, were substantially lower. Petitioner also asserts that even though it has a 1-year contract, with subsequent 1-year additions, the revenue generated from the contract only accounts for approximately 10 percent of petitioner's total revenues.

Petitioner also contends that, while generation revenues increase throughout the life of a plant, fixed costs, low spreads, increased carbon costs and major maintenance as the plant ages all contribute to lower net operating income over the life of the plant. Assuming its interest expense and property taxes remain constant using its 2013 estimates, petitioner asserts that its forecasted net cash flow will result in an actual loss of $291,086,153 for petitioner from 2013 through 2023.

Petitioner states that California is preparing to be a model for other states with its 33-percent renewable energy standard by 2020. Petitioner asserts that this formula is favorable for renewable generation facilities, and also for gas-fired generation facilities that will be needed to supplement intermittent renewable generation.

Moreover, petitioner contends that its negative outlook for its facility reflects its anticipated decline in cash flow over the next few years and could lead to a debt-service coverage ratio (DSCR) "below 1.0 times and potential draws on internal liquidity." Petitioner contends that its rating could, however, either stabilize or decline, depending on whether it is able to sustain "a consolidated DSCR of at least 1.10 to 1.20 times and funds from operations (FFO) to consolidated debt of 2 percent, maintain healthy operations, preserve internal liquidity, and successfully execute a settlement that provides for a recovery of carbon costs under the [Morgan Stanley Capital Group] toll."[2] Petitioner asserts that the probability of these events is uncertain at this point. Due to its negative financial

[2] Petitioner sells power to Morgan Stanley Capital Group (MS) from three of its four units under tolling agreements through 2012, and MS can renew the toll for one unit annually from 2013 to 2017. The tolling agreement does not allow petitioner to recover carbon costs under California's cap-and-trade program from MS, which is a substantial credit negative.

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outlook, petitioner contends that the 2013 unitary value should be adjusted for further depreciation and obsolescence.

Respondent asserts that the ReplCLD value indicator sufficiently accounts for depreciation and obsolescence in petitioner's 2013 unitary valuation. Specifically, respondent states that the 2013 Board-adopted unitary value includes a $120,000,000 adjustment for obsolescence, which equals a 22-percent reduction in the ReplCLD value indicator. Respondent asserts that the adjustment for petitioner's depreciation and economic obsolescence is appropriate, and petitioner has not shown that any further adjustment is warranted.

In its reply, petitioner asserts that the following five factors have adversely impacted petitioner's income stream, and will continue to do so going forward: (1) the ISO's Market Redesign and Technology Upgrade (MRTU) implementation; (2) carbon taxation; (3) the uncertainty of the San Onofre Nuclear Generating Station's (SONGS) future; (4) increased solar power demand; and (5) the proliferation of shale and fracking technology.

Petitioner asserts that the ISO implemented MRTU in 2009, which changed the way Load Servicing Entities procure ancillary services, and that, after the ISO's implementation of MRTU, plants in the Zonal Path (ZP), such as petitioner's, were prohibited from providing power to the South Path Power Transmission System (SP) and North Path Power Transmission System (NP) zones. Petitioner asserts that there is little demand for power in the ZP, relative to its capacity, in comparison with the SP and NP zones where the population centers are located and more power is needed. Petitioner also asserts that the capacity market is not robust, and it is unable to sell its power as anticipated after the MRTU implementation. Consequently, petitioner alleges that it is currently unable to derive loss capacity revenue from the market.

Petitioner also asserts that the carbon taxation law, enacted by Senate Bill (SB) 32 in 2009, has also adversely impacted petitioner's income stream. Petitioner states that, as a result of SB 32, fossil fuel plants, such as petitioner's, are required to procure carbon credits to offset their carbon footprint. Petitioner contends that the market was supposed to provide for these credits through higher energy prices, but entities are still burdened with significant administrative and holding costs that are associated with procuring the credits. Petitioner asserts that a secondary result of SB 32 is that

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utilities and service providers are required to increase procurement from eligible renewable energy resources to 33 percent of total procurement by 2020 in accordance with California's Renewables Portfolio Standard (RPS), which has also adversely impacted its income stream.[3]

Petitioner contends that SONGS's uncertain future has also been financially damaging for petitioner due to SONGS's unpredictable long-term future and potential decommissioning which has caused the loss of voltage support by the derating of Path 26 500-kilovolt lines that transport power from northern California to southern California. Petitioner asserts that when demand for power is lower in southern California (i.e., during the winter and spring), the transmission lines are further derated to prevent instability in the grid. Petitioner alleges that SONGS typically gets a great deal of voltage support that keeps it stable, but, when SONGS went down with congestion, it adversely impacted petitioner because, when voltage travels a longer distance, a destabilization of frequency occurs. Consequently, petitioner alleges that any generator with a contract to sell power in either southern California or northern California pays a loss charge associated with congestion when trying to transport power to the load areas of Los Angeles and San Francisco.

Petitioner also contends that there is growth in the increase in demand for solar-power-generated electricity associated with Behind the Meter (BTM) solar installations, resulting in decreased demand for petitioner's natural-gas-fired electricity.[4] Petitioner alleges that it has received less demand for power by thousands of MW during peak times of the year because customers are opting for solar power. Petitioner states that, when an entity adds a solar array, demand is permanently reduced, even though the installation does not appear on the ISO supply plan, because users offset their energy use with solar production, which creates an oversupply of in-ground capacity and reduces capacity payments for the ISO's Resource Adequacy Program. Petitioner also alleges that the increased demand for solar power has decreased demand for its power and, therefore, also resulted in a decrease in petitioner's income stream since approximately 2011. Petitioner states that it is apparent that the

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[3] Established in 2002, under SB 1078, accelerated in 2006 under SB 107, and expanded in 2011 under SBx1 2, California's RPS program requires investor-owned utilities, electric service providers, and community choice aggregators to increase procurement from eligible renewable energy resources to 33 percent of total procurement by 2020.

[4] A BTM customer is an entity with a solar array installed to offset its current utility bill.

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demand for solar power will continue to grow, which will thus continue to adversely impact petitioner's income stream going forward.

Lastly, petitioner contends that the proliferation of shale and fracking technologies depresses the price of natural gas, which also adversely impacts the income of natural-gas-fired power generation plants. Petitioner asserts that lower gas prices increase petitioner's costs of power generation, with petitioner's profits reduced by nearly one-half. Petitioner alleges that petitioner has been earning lower profits since about 2008 to 2009, when gas prices decreased due to the recession and the proliferation of shale and fracking technologies. Petitioner states that it expects gas prices to continue to decline, which will have a continued adverse impact on petitioner's income stream.

APPLICABLE LAW AND APPRAISAL PRINCIPLES

In general, the ReplCLD value indicator recognizes three types of depreciation: physical deterioration, functional obsolescence, and external, or economic, obsolescence, through application of the Board's replacement cost new trend factors and percent-good factors. Obsolescence may occur when property is outmoded (functional obsolescence) or when some event has substantially diminished the future earning power of the property (economic obsolescence). (See Assessors' Handbook section 501, *Basic Appraisal* (January 2002), pp. 81-83.) Functional obsolescence is the loss of value in a property caused by the property's loss of capacity to perform the function for which it was intended. (*Id.* at p. 81.) Economic obsolescence is the diminished utility of a property due to adverse factors external to the property being appraised and is incurable by the property owner. (*Id.* at p. 82.) Petitioner has the burden of establishing the existence of any additional or extraordinary obsolescence. (See Property Tax Rule 6, subd. (d) & (e); AH 502, pp. 20-21; *Unitary Valuation Methods* (March 2003), p. 30.)

ANALYSIS AND DISPOSITION

This board is presumed to have correctly determined the value of the property at issue, and petitioner bears the burden of proving otherwise. (Cal. Code Regs., tit. 18, § 5541, subd. (a).) Here, the 2013 Board-adopted unitary value includes a $120,000,000 adjustment for obsolescence, which equals a 22-percent reduction in the ReplCLD value indicator. Nonetheless, petitioner contends that the $120,000,000 adjustment does not adequately account for all depreciation and obsolescence

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resulting from: (1) the ISO's MRTU implementation; (2) carbon taxation; (3) the uncertainty of SONGS's future; (4) increased solar power demand; and (5) the proliferation of shale and fracking technology. While the foregoing factors may impact the entire electric generation industry, we note that petitioner has not provided evidence quantifying the specific effect of those conditions on its facility.

Because petitioner has not provided sufficient evidence specific to its facility to justify any further adjustments for obsolescence, we find that petitioner has not met its burden of proving that the 2013 Board-adopted unitary value does not represent the current fair market value of its property.

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DECISION

Accordingly, the petition for reassessment is denied and the 2013 Board-adopted unitary value is affirmed.*

_____, Chairman

_____, Member

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* The decision was rendered in Sacramento, California on December 17, 2013. This summary decision document was approved on March 25, 2014, in San Francisco, California.

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