Louis A. Ambrose
Tax Counsel IV
Board of Equalization, Legal Department
450 N Street, MIC:85
PO Box 942879
Sacramento, CA 95814
Tel: (916) 445-5580
Fax: (916) 324-2618

Attorney for Appeals Division

STATE OF CALIFORNIA

BOARD OF EQUALIZATION

In the Matter of the Petition for Reassessment of the 2010 Unitary Value for: **Lodi Gas Storage, LLC (0198)** Petitioner	**APPEALS DIVISION'S HEARING SUMMARY FOR ORAL HEARING ON PROPERTY TAX PETITION** Appeal No.: SAU 10-026 Case ID No.: 538665

Representing the Parties:

For the Petitioner:	Antreas E. Ghazarossian Cost Containment Advisors
For the Respondent:	Matthew F. Burke, Tax Counsel III Attorney for State-Assessed Properties Division Donald Jackson, Principal Property Appraiser State-Assessed Properties Division
Counsel for Appeals Division:	Louis A. Ambrose, Tax Counsel IV

PROPOSED VALUES

	Value	Penalty	Total
2010 Board-Adopted Unitary Value	$289,700,000	$0	$289,700,000
Petitioner's Requested Unitary Value	$172,400,880	0	$172,400,880
Respondent's Appeal Recommendation	$280,600,000	0	$280,600,000
Respondent's Revised Recommendation	$276,600,000	$0	$276,600,000

ISSUES

1. **Whether respondent State-Assessed Properties Division (respondent) placed an appropriate amount of reliance on the Reproduction Cost Less Depreciation (ReproCLD) value indicator in the determination of petitioner's 2010 unitary value.**

2. **Whether the Board-adopted unitary value properly treats petitioner's pad gas as taxable property.**

Appeals Division's Recommendation[1]

The Appeals Division recommends that the Board grant the petition for reassessment in part by reducing the 2010 Board-adopted unitary value by $13,100,000 in accordance with respondent's revised recommendation.

Background Information

Petitioner Lodi Gas Storage, LLC is a wholly owned subsidiary of Buckeye Partners, L.P., which is one of the largest independent common carrier pipeline companies in the United States in terms of volume delivered. Petitioner is a natural gas storage utility company that has been operating in Northern California since 2002 and serves the Pacific Gas & Electric Citygate marketplace with direct connections to Lines 400 and 401. Petitioner's original facility is located approximately 30 miles south of Sacramento, near Lodi, California and has been in service since 2002. Petitioner completed its first expansion project, known as Kirby Hills Phase I, in the Montezuma Hills, nine miles southeast of Fairfield, California, in 2007. Petitioner substantially completed a second expansion project, Kirby Hills Phase II, in 2009. These facilities collectively have a maximum injection and withdrawal capability of approximately 550 million cubic feet per day ("MMcf/day") and 750 MMcf/day, respectively. Petitioner is regulated by the California Public Utilities Commission and all services are contracted under petitioner's California Public Utilities Commission tariff. (Petition, p.3.)

The 2010 Board-adopted unitary value is based on 100 percent reliance on the ReproCLD value indicator.

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[1] Unless the Board otherwise holds, the Board shall take official notice of: the property statement filed with the Board, together with any attachments, including without limitation any reports to regulatory agencies such as the U.S. Securities and Exchange Commission and the California Public Utilities Commission, and any annual reports to shareholders; the Appraisal Data Report (ADR) prepared by the State-Assessed Properties Division (SAPD) together with any workpapers; the Notice of Unitary Value; and any correspondence between SAPD and petitioner.

Issue 1: Whether respondent placed an appropriate amount of reliance on the ReproCLD value indicator in the determination of petitioner's 2010 unitary value.

Contentions

Petitioner's Contentions

Petitioner contends that the 2010 Board-adopted unitary value should have been calculated by placing 50 percent reliance on the ReproCLD indicator and 50 percent reliance on the Capitalized Earnings Approach (CEA) indicator. Petitioner argues that a 50 percent reliance on the CEA indicator is necessary to account for unfavorable economic conditions affecting its facilities' earning capacity. Petitioner calculated its 2010 unitary value by placing equal reliance on the ReproCLD and CEA indicators and removing the proportionate (based on unitary value/unitary historical cost) values of goodwill, other intangibles and inventory (pad gas) for a total unitary value of $172,400,880. (Petition, p.3 and p.8.)

In support of its position, petitioner maintains that natural gas storage facilities compete for market share with other storage facilities and pipelines. Specifically, petitioner argues that some of petitioner's competitors have greater financial resources and could expand or construct transportation and storage systems to compete with petitioner. As a result, petitioner's customer base would shrink thereby reducing its ability to maintain current revenues and cash flows. (Petition, p.4.)

In addition, petitioner states that it relies on third-party pipelines to move its customers' natural gas to and from its facilities and petitioner cites the following events that could have an adverse impact on petitioner's financial condition:

- Interruption of service or decline in utilization of the pipelines.
- Adverse change in the terms and conditions of service for the pipelines that have a material adverse effect on the ability of its customers to transport gas.
- Increase in rates charged by interconnected pipelines for transportation of gas to and from petitioner's facilities.
- Significant decrease in the production of natural gas could reduce the volume stored at petitioner's facility.

- Material change in the supply or demand of natural gas could result in a decline in the volume stored at petitioner's facility.

(Petition, p.5.)

By placing 100 percent reliance on the ReproCLD value indicator, petitioner contends that respondent has failed to measure or consider obsolescence because depreciation tables do not recognize the influence of functional obsolescence that are property-specific and not dependent on age and do not include any consideration of external obsolescence. (Petition, p.7.)

<u>Respondent's Contentions</u>

Respondent states that Property Tax Rule[2] 6, subdivision (a) provides that the ReproCLD approach is the preferred approach "when neither reliable sales data … nor reliable income data are available and when the income from the property is not so regulated as to make such cost irrelevant." Property Tax Rule 8, subdivision (a) provides that the income approach is used to value property in conjunction with other approaches when the property being appraised 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." Furthermore, petitioner states that, in calculating the income indicator, Rule 8, subdivision (e) provides that future income should be estimated by using recently derived income of the property and comparable properties "if, in the opinion of the appraiser, they are reasonably indicative of the income the property will produce in its highest and best use under prudent management." (SAPD Analysis, p.2.)

Respondent states that it recognizes that the Kirby Hills II facility is not operating at full capacity due to the current economic downturn, and that it produces lower than expected earnings as a result. However, respondent asserts that its CEA model assumes that the property is being used at its highest and best use and has an established income stream. Respondent contends that the Kirby Hills II facility has greater income potential based on industry reports than petitioner's own projections which take a less optimistic view and do not include increases in projected performance more in line with industry

[2] "Property Tax Rule" or "Rule" references are to sections of title 18 of the California Code of Regulations.

analysts' reports that an informed investor would reasonably expect. Therefore, respondent contends that petitioner's income projections are unrealistic and a CEA indicator should not be based on them.

In addition, respondent contends that the current CEA indicator is not reliable because it is based on historical income data for only the past year, and multiple years' income data would be required to calculate a reliable indicator. Nonetheless, respondent believes that 10 percent reliance should be placed on the CEA indicator to reflect current economic conditions, but contends that no more reliance is justified due to the lack of a reasonable future income projection. Respondent states that increased reliance on the CEA indicator will be considered in future years as the earnings of the Kirby Hills II facility stabilize. The adjustment of 10 percent reliance on the CEA indicator reduces respondent's value recommendation by $9,100,000, from $289,700,000 to $280,600,000. (SAPD Analysis, p.3.)

Appeals Conference

At the appeals conference held on November 9, 2010, the parties discussed placing greater reliance on the CEA indicator. Respondent stated that petitioner would need to provide additional information before respondent could consider further adjustments. Petitioner provided the following information requested by respondent:

- Income sources including the life-cycle of a customer storage contract and the background of the types of long- and short-term income.
- An explanation of the volatility of petitioner's five-year income projections.
- An explanation for the increase in projected expenses for the current year and future years, a breakdown of controllable, non-controllable and non-cash lease expenses and any detailed account names for each category, and identify the category for property tax expenses.
- Capital expenditures for the next 3 to 5 years by amount and type.
- Any information about FAS No. 144 impairment write downs.

In its post-conference reply, petitioner states that its income is dependent on (a) the rate at which gas is being bought and sold in the marketplace and (b) the amount of market volatility. Low prices generally indicate low volatility and high prices lead to high levels of volatility. Petitioner states that presently and for the foreseeable future, its capacity is fully subscribed and gas prices are very low so volatility is minimal. Petitioner asserts that storage rates are expected to remain flat and its revenues are projected to drop after 2011 because of the expiration of long-term leases. Petitioner describes its business model as primarily "Fee for Service" based on the following:

- Monthly reservation fees for physical capacity.
- Fee-based injection and withdrawal.
- Park & Loans - Short term storage using excess injection and withdrawal capacity.
- Wheeling - Transporting gas on the facility's header system for customers in order to capture basis differential between pipelines.

Petitioner further states that the two sources of its revenues are long-term leases that comprise 70 percent of its income and short-term hub services that comprise 30 percent. With respect to the long-term leases, petitioner states that most of its leases have 1 to 3 year terms and renewal rates will be significantly lower because current prices for natural gas are far lower than they were two years ago. For that same reason, revenue projections may be further reduced in 2011 due to the expiration in 2011 of one lease that comprises 10 percent of the facility's capacity and was negotiated when rates were much higher. Thus, while storage rates are expected to remain flat, the expiration of higher rate leases is eroding income as reflected in future years' projections. Petitioner states that the short-term hub service leases have terms of less than a year and are the most volatile portion of petitioner's business.

Petitioner explains that its 5 year projections are based on the assumption that "Lodi will be fully leased, and storage rates will reflect the anemic state of gas prices." Petitioner also provided a breakdown of expenses and states that most of the line-item expenses under controllable expenses grow 2 to 3 percent per year (except LTIPs) [3] and a large increase starting in 2012 is the Kirby Hills expansion rental expense of $250,000 followed by approximately $1 million in 2013 and 2014. With respect to capital expenditures, petitioner states that for the next 3 to 5 years, annual capital expenditures are estimated at approximately $1 million to $1.5 million for all three facilities, and include maintenance of wellbore, replacement of production liners, pipeline pigging, installation of pig launchers and receivers at well sites.

[3] According to petitioner, LTIPs are a form of incentive stock compensation for employees.

Petitioner further describes the industry and market conditions impacting gas storage in 2009 as characterized by relatively abundant supply and weak demand due to the economic downturn and strong domestic production. Petitioner points out that even with lower gas prices, consumption declined from 2008 due to a combination of weather and economic factors and over the long term a significant decrease in consumption has resulted from appliance efficiency and improved housing construction. (Petitioner's Post-Conference Submission.)

After reviewing the additional information, in an email dated November 22, 2010, respondent recalculated the CEA indicator based on petitioner's forecasted revenue with adjustments for property taxes and leased property expenses. Respondent also used petitioner's own estimate of its capital replacement expenditures. The recalculation resulted in a CEA indicator of $236,425,143. Respondent also determined that the additional information indicated that it is appropriate to place 25 percent reliance on the CEA indicator. However, respondent contends that no greater reliance on the CEA indicator is warranted because most of petitioner's operating property is relatively new, petitioner has a short operating history and the volatility of the gas and storage industries reduces the reliability of income projections. Respondent recommends a revised value of $276,600,000. (Respondent's Post-Conference Submission.)

In an email reply to respondent's revised valuation analysis dated November 24, 2010, petitioner asserts that "disproportionate" reliance on the ReproCLD indicator overvalues petitioner's "underlying assets." Petitioner further asserts that this value approach is appropriate for "regulated entities whose income is based on their investment; but [petitioner's] income is determined by market forces." Petitioner also states that "extraordinary market events" have changed the landscape of the gas storage business and "the emergence of shale as a source of gas is a 'game changer' for the storage industry" even if the economy improves over the next 18 to 24 months. Petitioner also notes that respondent valued petitioner based on a 50 percent reliance on the CEA indicator in prior years. (Petitioner's Post-Conference Submission.)

<u>Petitioner's Additional Submission</u>

By email message dated December 3, 2010, petitioner provided a "draft valuation with various scenarios which are under discussion" and presenting the following three scenarios:

1. 50/50 weighting of the ReproCLD and CEA indicators excluding income from intangibles (43%).
2. 75/25 weighting of the ReproCLD and CEA indicators excluding income from intangibles (43%).
3. 75/25 weighting of the ReproCLD and CEA indicators including income from intangibles.

The message specifies that the scenarios are based on:

1. Petitioner's revised EBITDA numbers as of December 2, 2010.
2. Respondent's Working Cash Expense percentage – 1.38% for each of the years.
3. $3 Million for the capital replacement expenditure allowance.
4. Respondent's land rights cash expenses.

Attached to the email message is a schedule titled "CCA DRAFT" with net operating income and appraisal income projections for 2010 to 2014, a calculated CEA value indicator of $183,761,630 and "taxable CEA" indicator of $79,017,501. The schedule also breaks down the three scenarios, described above, and the values are $184,339,303 for the 50/50 weighting without intangibles, $237,000,204 for the 75/25 weighting without intangibles, and $263,186,236 for 75/25 weighting with intangibles. (Petitioner's Additional Submission.)

By email message dated December 6, 2010, respondent replied to petitioner's additional submission as follows:

- Petitioner's cash flow projections are based on information that only became available several months after the January 1, 2010 valuation date and should not be considered in the determination of the 2010 unitary value because a prospective knowledgeable purchaser would not be aware of that information. However, those cash flow projections will be relevant for the 2011 unitary value determination.
- Petitioner's adjustment to its CEA indicator to account for 57 percent nontaxable intangible value is mainly an adjustment for goodwill. Respondent contends that such an adjustment is not supported by standard appraisal theory because goodwill is not an earning asset. In this instance, goodwill is represented only as a financial account that was recorded as part of the 2008 purchase price allocation as a premium paid over and above the fair market value of the tangible property. If there is a material reduction in business value as petitioner contends, then

respondent asserts that accounting rules require the reduction of goodwill first. However, no such reduction has been made on petitioner's financial statements.

- Capital expenditure allowance should only reflect annual capital expenditures but petitioner stated in an email message that one-time capital expenditures cannot be easily segregated from annual capital expenditures. In prior discussions, petitioner projected annual capital expenditures at between $1 million and $1.5 million but now projects them at $3 million per year. Respondent does not believe that petitioner has provided adequate support to revise the original estimate of annual replacement capital expenditures related to petitioner's current property. In addition, respondent states that it believes annual capital replacement expenditures "should be minimal" because petitioner operates a gas storage facility with pipes and wells. (Respondent's Additional Submission.)

Applicable Law and Appraisal Principles

Burden of Proof Assessing officers are presumed to have properly performed their duties. (Evid. Code, § 664.) Therefore, the 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, § 5080 subd. (a).)

Fair Market Value Standard 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." R&TC section 722 provides that state-assessed property shall be assessed at its fair market value as of 12:01 a.m. on the first day of January.

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 includes 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 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. For example, if income, expense, and capitalization rate data can be obtained from many properties comparable to the subject, the appraiser may attribute significant accuracy to the income approach. The greatest reliance should be placed on that 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.)

<u>The Reproduction Cost Approach to Value</u> Property Tax Rule 6, subdivision (a) provides, in 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 "reproduction cost of a reproducible property may be estimated either by (1) adjusting the property's original cost for price level changes and for abnormalities, if any, or (2) applying current prices to the property's labor and material components, with appropriate additions for entrepreneurial services, interest on borrowed or owner-supplied funds, and other costs typically incurred in bringing the property to a finished state". (Property Tax Rule 6, subd. (b).) The resulting adjusted cost is the reproduction cost new (ReproCN) which is then "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 under improvement, and other forms of depreciation or obsolescence". (Property Tax Rule 6, subd. (e).)

ReproCN is an estimate of the current cost to replace the existing property with a new property that is an exact replica, or virtually so, of the existing property. Data for the derivation of the ReproCN index factors can be obtained either from prices quoted by current vendors of the property or by applying an appropriate index factor to the historical or original acquisition cost of the property. The use of published index factors is the preferred method when performing mass appraisals. Numerous trade publications provide index factors for the conversion of historical cost to ReproCN. The publishers of these index factors generally survey industry participants and equipment manufacturers and compare current prices to a historical cost database. The ratio of price change for a given year period is the ReproCN index factor.

The calculation of the ReproCLD indicator is basically a two-step process. First, the reproduction cost new (ReproCN) is calculated by applying an index factor (also known as "trend factors") to the historical acquisition cost of property, segregated by year of acquisition. Second, the ReproCN is adjusted for normal depreciation by the application of a percent good factor to the ReproCN. The product of this calculation is the ReproCLD value indicator. (*Unitary Valuation Methods* (March 2003) p. 11.)

For the ReproCLD indicator, depreciation is the difference in value between a new identical substitute property and the existing property. The difference is recognized as the complement to the percent good factors. Respondent conducts service life studies to assist in determining the appropriate percent good factors. The usefulness of the ReproCLD in the appraisal process depends on whether or not the market recognizes an exact replica of the subject property as having adequate utility for the operational needs of a contemporary business. If there are economical substitutes (i.e., a property of lower cost or greater utility for the property being appraised), the ReproCLD indicator may not be a reliable method to determine the fair market value of a subject property.

<u>Income Approach to Value</u> 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."

Treatment of Nontaxable Intangibles The provisions of R&TC section 110, subdivisions (d) (e) & (f) are the statutory basis for respondent's determination of whether intangible value is properly included in the derivation of value indicators. In the CEA value indicator, respondent removes intangible values by imputing an income to the intangible items and deducting the imputed income from the income to be capitalized in accordance with Property Tax Rule 8 (e). (Unitary Valuation Methods, p.91.)

Testing for Impairment of Goodwill Financial Accounting Statement No. 142 states that goodwill will be tested for impairment at least annually using a two-step process: The first step tests for potential impairment, and the second step measures the amount of impairment, if any. (FASB, Summary of Statement No. 142 <http://www.fasb.org/st/summary/stsum142.shtml>.) In the first step, the fair market value of the reporting unit is calculated as of a specific date and repeated annually at the same time each year. The fair market value is then compared to the carrying value of the reporting unit and if the fair market value is less than the unit's carrying value, goodwill of the reporting unit is considered to be impaired. In the second step, the implied fair market value of goodwill is estimated and compared to the carrying value of goodwill for the reporting unit. If the carrying amount of goodwill exceeds its implied fair market value, an impairment loss equal to this excess is recorded. After a goodwill impairment loss is recorded, the adjusted carrying amount of goodwill becomes the new accounting basis for subsequent goodwill impairment tests. (Feldman, A Primer on Calculating Goodwill Impairment, Valuation Issues Raised by Financial Accounting Statement No. 142, Axiom Valuation Solutions (April 2004) <http://www.axiomvaluation.com/documents/2004.04.27-GoodwillImpairmentPrimer.pdf>.)

Capital Replacement Expenditure Allowance With respect to the theoretical bases for the capital replacement expenditure allowance in the income approach valuation model, the AH 542 states:

> The [CEA] perpetual life model assumes that the income stream is sustained into perpetuity because individual assets are replaced as they are retired. Therefore, the amount of capital replacement required to perpetuate the income stream is allowed as an expense.

The Board's Unitary Valuation Methods book (2003), at page 43, is to the same effect.

Appeals Division's Analysis and Conclusions

Respondent is presumed to have correctly determined the value of the property at issue, and petitioner bears the burden of proving otherwise. Here, the parties agree on the use of the ReproCLD and CEA indicators to value the unitary property but they differ over the appropriate amount of reliance on each indicator. Rule 8 provides that reliance on the income approach is appropriate when the property has an "established income stream or can be attributed a real or hypothetical income stream by comparison with other properties". There is no dispute that the first and second phases of the Kirby Hills facility became operational in 2007 and 2009, respectively, so that there is only one year of total facility income information. Despite the lack of earnings history, petitioner believes that its business model, which is highly dependent on the natural gas market, provides a reliable basis for projecting an income stream. Essentially, petitioner's projected income stream assumes a fully leased facility based on storage rates that are expected to remain flat due to forecasted low natural gas prices. While respondent believes that some reliance on the CEA indicator is justified, in the view of the Appeals Division there are insufficient earnings data to accord that indicator the same degree of reliance as the ReproCLD indicator.

At the hearing, petitioner should be prepared to discuss the reliability of petitioner's cash flow projections as January 1, 2010. Respondent should be prepared to explain how it determined that a 25 percent reliance on the CEA indicator is justified.

Petitioner's methodology for calculating its revised CEA indicator is based on the following:

1. Use of the average of its projected adjusted EBITDA for years 2010 through 2014 which petitioner indicates was determined on December 2, 2010.
2. An adjustment of 57 percent for the removal of intangible value to the CEA value indicator based on the average of petitioner's projected adjusted EBITDA.

With respect to petitioner's projected adjusted EBITDA, Property Tax Rule 8 (c) provides, in relevant part, that "the amount to be capitalized 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 such legally enforceable restrictions as such persons may foresee as of that date." Thus, for a 2010 CEA indicator, that provision contemplates that the information necessary to make petitioner's adjusted EBITDA projections would have been known and available on the January 1, 2010 valuation date. At the hearing, petitioner should be prepared to address the date by which such information was known and available and, if it was not known and available by the valuation date, to cite any authority for the proposition that later acquired information may be used to calculate a 2010 CEA indicator.

Petitioner has not explained its method or provided appraisal support for its adjustment for the removal of intangibles from its proposed CEA indicator. According to the Board guidelines, intangible values are removed from the CEA value indicator by imputing an income to them and deducting the imputed income from the income to be capitalized. At the hearing, petitioner should be prepared to provide an explanation and any supporting authority for its method of removing intangible value from its proposed CEA indicator.

Issue 2: Whether the Board-adopted unitary value properly treats petitioner's pad gas as taxable property.

<u>Contentions</u>

<u>Petitioner's Contentions</u>

As follow-up to a telephone conference with respondent on August 24, 2010, petitioner submitted a document that set forth petitioner's argument that pad gas is either exempt or should be assessed at a substantially lower value.[4] Pad gas, otherwise known as base gas or cushion gas, is the permanent volume of gas needed in an underground storage facility to maintain adequate reservoir pressures and deliverability rates throughout the withdrawal season. Petitioner states that it has classified pad gas as an asset as a result of an accounting procedure but believes that pad gas should be treated as exempt business inventory for the following reasons: 1. The pad gas is co-mingled with customers' working gas, which is exempt as business inventory; and 2. Pad gas cannot be separated from customers' working gas. Petitioner further asserts that even if the Board pad gas is taxable a good portion of the pad gas will be unrecoverable due to seepage over time. Furthermore, because the remaining pad gas will be sold at the end of the facility's life cycle, the proper taxable value in 2010 is

[4] This document also sets forth substantially all of the information and argument presented in petitioner's post-conference submission.

the present value of the sale price at that time less selling expenses. (Petitioner's Supplemental Submission.)

Respondent's Contentions

Respondent cites R&TC section 129 which defines business inventories as "goods intended for sale or lease in the ordinary course of business and [including] raw materials and work in process with respect to such goods." Respondent contends that pad gas is not intended for sale or lease in the ordinary course of business but is used to dispense gas from a gas storage facility and would only be removed upon the discontinuance of operations. Thus, respondent concludes that pad gas is not exempt business inventory and is taxable unitary property. (SAPD Analysis, pp. 3-4.)

Applicable Law

R&TC section 219 provides that business inventories are exempt from property taxation and R&TC section 129 generally provides that business inventories includes "goods intended for sale or lease in the ordinary course of business." Property Tax Rule 133 subdivision (b)(1) excludes from the definition of business inventories "[p]roperty of any description in the hands of a vendee, lessee or other recipient on the lien date which has been purchased, leased, rented, or borrowed primarily for use by the vendee, lessee or other recipient of the property rather than for sale or lease or for physical incorporation into a product which is to be sold or leased." Subdivision (b)(2) provides another exclusion for "[p]roperty being used by its owner for any purpose not directly associated with the prospective sale or lease of that property."

Appeals Division's Analysis and Conclusions

Petitioner's argument that pad gas is exempt fails to recognize that petitioner has purchased the pad gas for use in the operation of petitioner's facilities. As such it does not qualify as business inventory under Property Tax Rule 133, subdivision (b)(1) because the fact that it commingles with customers' working gas due to its physical properties does not transmute pad gas into business inventory. Rather, by commingling with the working gas, the pad gas fulfills its purpose of maintaining adequate reservoir pressures and deliverability rates which is required for petitioner's business operation. At the hearing, petitioner should be prepared to explain how pad gas meets the definition of business inventory when petitioner purchases it primarily for its own use rather than for sale or lease.

The Appeals Division also takes issue with petitioner's argument that the proper taxable value of the pad gas in 2010 is the present value of the price at when it is sold at the end of the facility's life cycle less selling expenses. In the view of the Appeals Division, if petitioner concedes that the pad gas is taxable, then it is assessable at its fair market value as of the January 1, 2010 lien date as unitary property owned by petitioner pursuant to R&TC sections 721 and 722. Petitioner has not cited any exception to this legal requirement. If petitioner believes that the pad gas will be salvaged and sold at the end of the facility's life cycle when it ceases operation then that salvage value should be added to petitioner's unitary value. At the hearing, petitioner should be prepared to explain and provide authority for its argument that pad gas is not taxable at its fair market value as of the current lien date.