CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Consolidated Petitions for Reassessment of the 2013 Unitary Values for:	
GWF ENERGY LLC – HANFORD (1122)	Appeal No.: SAU 13-029 Case ID No.: 743424
GWF ENERGY LLC – HENRIETTA (1123)	Appeal No.: SAU 13-030 Case ID No.: 743425
GWF ENERGY LLC – TRACY (1124)	Appeal No.: SAU 13-031 Case ID No.: 743427
Petitioners	Oral Hearing Date: December 17, 2013

Representing the Parties:

For the Petitioners: Paul Bellon, Director
Duff & Phelps

For the Respondent: Susan Galbraith, Tax Counsel
Attorney for State-Assessed Properties Division

Kurt A. Beck, Senior Specialist Property Auditor Appraiser
State-Assessed Properties Division

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

PROPOSED VALUES

GWF Energy LLC - Hanford (1122)

	Value	Penalty	Total
2013 Board-Adopted Unitary Value	$41,100,000	$0	$41,100,000
Petitioner’s Requested Unitary Value	$13,000,000	$0	$13,000,000
Respondent’s Appeal Recommendation	$41,100,000	$0	$41,100,000

GWF Energy LLC - Henrietta (1123)

	Value	Penalty	Total
2013 Board-Adopted Unitary Value	$35,800,000	$0	$35,800,000
Petitioner's Requested Unitary Value	$16,500,000	$0	$16,500,000
Respondent's Appeal Recommendation	$35,800,000	$0	$35,800,000

GWF Energy LLC – Tracy (1124)

	Value	Penalty	Total
2013 Board-Adopted Unitary Value	$266,400,000	$0	$266,400,000
Petitioner's Requested Unitary Value	$196,500,000	$0	$196,500,000
Respondent's Appeal Recommendation	$266,400,000	$0	$266,400,000

LEGAL ISSUE

Whether petitioners have shown that the 2013 Board-adopted unitary value erroneously includes the nontaxable intangible value attributable to their power purchase agreements as established by a purchase price allocation.

FINDINGS OF FACT AND RELATED CONTENTIONS

On December 13, 2012, GWF Energy Holdings LLC acquired petitioners GWF Energy LLC – Hanford (Hanford), GWF Energy LLC – Henrietta (Henrietta), and GWF Energy LLC – Tracy (Tracy) power generation facilities from affiliates of Harbert Power, LLC. The total purchase consideration amounted to $631 million.

Petitioners Hanford and Henrietta both have peaking power[1] facilities located in Kings County. The Hanford facility is located in Hanford, California, and the Henrietta facility is located approximately 20 miles southwest of Hanford, California. The Hanford and Henrietta facilities each consist of two gas turbine generators. Petitioner Tracy's facility is a combined cycle facility located in Tracy in San Joaquin County. The Tracy facility ceased production as a peaking facility in or around October 2010 and also has two gas turbine generators.

The 2013 Board-adopted unitary values for the Hanford and Henrietta facilities were determined by placing 60-percent reliance on the Replacement Cost Less Depreciation (ReplCLD) value indicator, and 40-percent reliance on the Capitalized Earning Approach (CEA) value indicator for the Hanford and Henrietta facilities. The 2013 Board-adopted unitary value for petitioner Tracy's facility was determined by placing 100-percent reliance on the ReplCLD value indicator.

Petitioners' appraisal report prepared by Duff & Phelps (D&P report) in section 5, titled "Valuation of the Intangible Assets," identifies as intangible assets petitioners' 10-year "tolling agreements"[2] with Pacific Gas and Electric Company (PG&E). Under the tolling agreements, petitioners sell electricity to PG&E in return for payments of stated amounts under specified terms. The D&P report included a purchase price allocation which allocated the $631 million sales price to land, plant and equipment, as well as to the tolling agreements with PG&E. The D&P report relies on *Accounting Standards Codification 805*, which discusses the valuation of identifiable tangible and intangible assets as a result of a purchase, to support the allocation of value to an intangible component such as a tolling agreement. The D&P report determined the fair value of the tolling agreements as follows: Tracy - $305 million, Hanford - $35 million and Henrietta - $35 million.

Based on the D&P report, petitioners contend that their power purchase agreements (PPAs) are intangible assets and that the values of those intangible assets are erroneously included in the 2013 Board-adopted unitary values. Petitioners assert that the unitary values should be determined by calculating the value difference between the revenues generated with their PPAs in place and the revenues that would be generated in an "open market" if they did not operate with their PPAs.

Petitioners contend that the PPAs are "operating agreements," which, they allege, are a type of intangible asset that the California Supreme Court in *Elk Hills Power, LLC v. Board of Equalization* (2013) 57 Cal.4th 593 (*Elk Hills Power*) held must be identified, valued and removed from the total value of petitioners' unitary property. Petitioners cite the court's reasoning that "the value of intangibles that directly enhance the income stream cannot be subsumed in the valuation of taxable property and must be deducted from the unit prior to assessment" as a basis for their position. Petitioners assert that they purchased tangible and intangible assets and that the PPAs were a "significant factor" in the purchase price and represent the majority of the value of the assets acquired in the purchase of the power plant properties.

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[2] The tolling agreements are also referred to as power purchase agreements in this summary decision.

Petitioners acknowledge that in *Watson Cogeneration Co. v. County of Los Angeles* (2002) 98 Cal.App.4th 1066 (*Watson Cogeneration*), the Court of Appeal held that the assessor properly included the value of a PPA in the calculation of the income approach value indicator for the assessment of a cogeneration power facility. However, petitioners contend that *Watson Cogeneration* was overruled by *Elk Hills Power*, which, they allege, specified all "operating contracts," unlike ERCs, must be deducted because they make a direct contribution to the going concern value of the business. Petitioners further contend that *Elk Hills Power* affirms the Board's guidance provided by the Assessors' Handbook section 502, *Advanced Appraisal* (December 1998) (AH 502).

Petitioners posit that a willing buyer of a power plant property will pay more for the intangible right to collect an income stream under a PPA and, thus, the value of the PPA must be excluded. Petitioners further assert that *Elk Hills Power* is merely a clarification of existing law and, therefore, that *Freeport-McMoran Resource Partners v. County of Lake* (1993) 12 Cal.App.4th 634 (*Freeport-McMoran*) and *Watson Cogeneration* are no longer controlling precedent.

Respondent contends that the 60-percent reliance on the ReplCLD value indicator and 40-percent reliance on the CEA value indicator is consistent with the methodology used to value other peaking facilities similarly situated to the Hanford and Henrietta facilities. Respondent also contends that 100-percent reliance on the ReplCLD value indicator is consistent with the methodology used for combined cycle facilities similarly situated to the Tracy facility. Respondent states that its ReplCLD indicator is based on a cost-per-megawatt factor, after updating the cost-per-megawatt based on industry specific information from sources such as Gas Turbine World and the Bureau of Labor Statistics. Respondent asserts that industry representatives and respondent believe these sources are conservative in calculating cost-per-megawatt as they include only the actual cost of purchasing the turbines and related facility equipment.

After adjusting for physical obsolescence and using respondent's value for assessable land, the Board-adopted unitary values were calculated by placing reliance on ReplCLD value indicators, weighted at 60 percent, for petitioners' Hanford and Henrietta facilities as follows: $45,221,169 (approximately $492,000 per megawatt) for the Hanford facility and $35,760,737 (approximately $365,000 per megawatt) for the Henrietta facility. The Board-adopted unitary values were calculated by placing reliance on CEA value indicators, weighted at 40 percent, for petitioners' Hanford and Henrietta facilities from projected generation revenue, fuel costs, and operating expenses petitioners provided as follows: $34,997,809 for the Hanford facility and $35,805,115 for the Henrietta facility. The Board-adopted unitary value for the Tracy facility was calculated by placing 100-percent reliance on the ReplCLD value indicator for a value of $266,400,000 (approximately $800,000 per megawatt).

Respondent states that petitioners attribute an intangible component to the PPAs by calculating the value difference between having a PPA in place and the revenues that might be generated in a hypothetical "open market" scenario where PPAs do not exist, using a discounted cash flow (DCF) model.[3] Respondent asserts that petitioners compare their revenues with revenues from facilities operating in an "open market" even though petitioners' facilities were not built with the expectation of operating without PPAs. According to respondent, this reasoning mistakenly assumes that revenues under the PPAs are not market revenues. Respondent contends that a PPA between a power generating facility and a utility company is common and that most facilities enter into 10-to-15-year contracts, with the duration depending on such factors as location and system needs prior to being constructed. Respondent asserts that PPAs provide a predictable, reliable and stable cash flow for the contract term. Moreover, respondent contends that petitioners operate in a market where most new power plants contract with a utility to provide power generation for a number of years, and thus the market on which a comparison of value must be made is reflected in the contract terms. Thus, respondent concludes that petitioners' PPAs with PG&E to provide electricity on terms different than those available without such an agreement does not necessarily create a nontaxable intangible asset and states that petitioners have cited no statutory, regulatory or judicial authority for this premise.

Respondent contends that *Freeport-McMoran* is controlling precedent and, based on that decision, respondent correctly used the revenue generated from the PPAs to calculate the income approach indicators for petitioners' plants. Respondent states that *Freeport-McMoran* properly interpreted Revenue and Taxation Code (R&TC) section 110, subdivision (e) by holding that a PPA is

[3] A DCF model is an income approach valuation method.

the means by which a power plant sells electricity and that income generated by that PPA "is inextricably tied to the beneficial use of the property and properly considered in assessing its value." Respondent further argues that the court in *Watson Cogeneration* followed the *Freeport-McMoran* court's reasoning by holding that the highest and best use of the subject property was a power plant with PPAs in place. In this regard, the court held that, when the income stream is expected to remain stable, the assessor should use actual income from the PPAs rather than imputed income. On that basis, respondent contends that the proper market for comparison with petitioners' properties is power plants with PPAs.

Respondent also contends that the holding in *Elk Hills Power* is consistent with *Freeport-McMoran* and *Watson Cogeneration* and, therefore, supports respondent's valuation approach. Respondent explains that in *Elk Hills Power* the court held that a deduction from the income stream for an intangible asset is appropriate only if a separate stream or an enhanced stream of income attributable to the enterprise activity is created. However, according to respondent, in this case there was no separate or enhanced stream of income because the PPAs are necessary to the beneficial use of the property and the market that must be used to determine whether an enhanced income stream exists is the market of similarly situated power plants. With respect to the *Elk Hills Power* decision, respondent asserts that the court held the Board may not add any value in its replacement cost method for emission reduction credits (ERCs); but, if no value was added, then no value need be deducted because such a deduction from value would result in a "windfall." Respondent contends that the *Elk Hills Power* court's holding is completely contrary to the position taken by petitioners in this appeal.

Respondent asserts that the D&P report is problematic because there was no cost approach indicator calculated despite the fact that hundreds of millions of dollars were spent reconfiguring the Tracy facility after securing the PPA for that facility. Respondent further asserts that the calculation of a cost approach indicator would have demonstrated that the cost of acquiring the PPA was not consistent with the purchase price allocation adjustment. Respondent contends that the market for electricity in California is controlled by the California Public Utilities Commission (CPUC), the Independent System Operator (ISO) and the California Energy Commission (CEC), which set requirements, including the procurement of a PPA, prior to the construction of a power plant. For that reason, respondent asserts it is correct to value the properties by assuming that PPAs were in place in accordance with R&TC section 110, subdivision (e).

Respondent contends that any intangible value attributable to the PPAs would only be reflected if petitioners negotiated favorable, above-market rates for the sale of electricity in the PPAs, but, under such circumstances, only the above-market portion of the rates would be deducted. However, respondent further contends that these PPAs are contracts required by the regulating agencies to ensure "resource adequacy" to provide sufficient electricity to California customers. Therefore, respondent concludes that the rates negotiated by the parties in the PPAs are not above-market rates.

Respondent contends petitioners anticipated the acquisition of the PPAs and the income generated by them when they purchased the properties so that respondent's position is consistent with Property Tax Rule 8, subdivision (c).[4] Furthermore, respondent contends the existence of PPAs reflect the electricity market and respondent's ReplCLD indicator did not add any value for the PPAs. Respondent contends that petitioners' arguments, which assume that one can value a plant based on electricity sales in the spot market, disregard the configuration of electricity markets in California.

Respondent observes that the Tracy property is a state-of-the-art facility and that respondent has information from 40 other plants in California to make the necessary adjustments to the ReplCLD value indicator for this facility. Respondent maintains that Property Tax Rule 6 provides that the cost approach is appropriate for newly constructed property, such as the Tracy facility, and respondent has data for that plant as well as other plants in California to determine replacement cost after a contract has been procured. Respondent states that the purchase price was well in excess of replacement cost due to business value and some value to the PPA, but not to the extent proposed by the purchase price allocation, which is confirmed by other purchase price allocations that have not valued PPAs in this manner. Respondent further argues that: (1) petitioners failed to identify any economic obsolescence that would invalidate the use of the cost approach indicator and have made no attempt to show that the PPAs are favorable (i.e., reflect above-market rates); (2) adjustments in the

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

PPAs ensure that the rates reflect market pricing, particularly adjustments for the price of natural gas; and (3) under R&TC section 110, respondent is required to estimate cost of replacement assuming the existence of a PPA.

In addition, respondent asserts that the Tracy facility was, for the most part, converted to a more efficient combined cycle plant after the PPA was procured, which makes it clear that this plant must be valued assuming the PPA was in place under R&TC section 110, subdivision (e). With respect to economic obsolescence, respondent contends that no power plant operates at 100-percent utilization due to varying demands for electricity.

In their reply, petitioners dispute use of respondent's ReplCLD indicator for the Tracy facility because it is higher than petitioners' opinion of value for that facility. Petitioners maintain that, based on the open market sales information, the D&P report determined that the value of the tangible property was less than the ReplCLD indicator, which is evidence that respondent did not make a full adjustment for the value of the intangibles which in turn resulted in the overvaluation of petitioners' unitary properties. Petitioners further contend that a cost approach indicator must include an adjustment for all forms of obsolescence, including economic obsolescence, but that respondent failed to consider petitioners' forward-looking projections that did not contemplate 100-percent utilization. Petitioners assert that there is a basis for making an adjustment that would bring respondent's cost approach indicators in line with the D&P report values.

Petitioners contend that respondent failed to make obsolescence adjustments for the Tracy facility because it was a new plant without an earnings history. Petitioners further assert that respondent in its valuation analysis recognized "implicit value" in the PPAs as evidenced by variation in the three value indicators, particularly respondent's comparable sales value indicator of $550 million and ReplCLD value indicator of $266 million.

APPLICABLE LAW AND APPRAISAL PRINCIPLES

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. (AH 502, p. 109.) 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 property, the appraiser may attribute significant accuracy to the income 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.)

<u>ReplCLD Value Indicator</u>

Property Tax Rule 6, subdivision (a) provides, in part: "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 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).) The resulting adjusted replacement 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).)

<u>Income Approach to Value</u>

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." Rule 8, subdivision (e) provides, in relevant part, that income projections may be used if recent income is "reasonably indicative of the income the property will produce in its highest and best use under prudent management." Subdivision (e) further provides that, "[w]hen income from operating a property is used, sufficient income shall be excluded to provide a return on working capital and other nontaxable operating assets and to compensate unpaid or underpaid management."

<u>Revenue and Taxation Code section 110</u>

R&TC section 110, subdivisions (a) and (b) define "full cash value" or "fair market value" for California property tax assessment purposes. Subdivisions (d) and (e) set forth the limitations on taxation of intangible value and provide, in part, that:

> (d) Except as provided in subdivision (e), for purposes of determining the "full cash value" or "fair market value" of any taxable property, all of the following shall apply: (1) The value of intangible assets and rights relating to the going concern value of a business using taxable property shall not enhance or be reflected in the value of the taxable property.
>
> (2) If the principle of unit valuation is used to value properties that are operated as a unit and the unit includes intangible assets and rights, then the fair market value of the taxable property contained within the unit shall be determined by removing from the value of the unit the fair market value of the intangible assets and rights contained within the unit.
>
> [¶] . . . [¶]
>
> (e) Taxable property may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use.

<u>*Freeport-McMoran*</u>

The Court of Appeal in *Freeport-McMoran* examined whether intangible value may be properly assigned to a PPA known as a standard offer contract (SO4 contract) in determining a power plant's unitary value. In *Freeport-McMoran*, the taxpayer owned geothermal power plants and argued that the county assessor overvalued its property by basing the property tax assessment on capitalization of the income derived from PPAs with a public utility at above market rates. The court found that the evidence showed that the power plant would only be offered for sale in conjunction with the SO4 contract because "the contract is integral to the economic viability of the plant" and "a prospective purchaser would be willing to pay more for a plant with an SO4 contract than for a plant without one because the SO4 contract guarantees a higher income." (*Freeport-McMoran, supra,* at p. 644.) Thus, the court held that the proper market for valuation of the taxpayer's power plants was a market consisting of existing facilities with similar power purchase agreements. (*Id.* at p. 645.)

The court also rejected the taxpayer's argument that the income generated from the taxpayer's PPAs was nontaxable intangible property. The court followed the decision in *County of Stanislaus v. Assessment Appeals Bd.* (1989) 213 Cal.App.3d 1445 (*County of Stanislaus*), which involved taxation of a cable television franchise consisting of the right to use public streets for cables and the right to charge fees to subscribers for use of the cable facilities. In *County of Stanislaus*, the court held that the latter component, the intangible right to do business, was necessary to put the possessory interest to its beneficial or productive use and, therefore, should be considered in valuing the possessory interest. By the same reasoning, the *Freeport-McMoran* court concluded that the SO4 contracts were not nontaxable intangibles because they were the means "by which appellant's properties are put to beneficial use and must be considered in assessing the properties' 'full value.'" (*Freeport-McMoran, supra,* at pp. 645-646.)

Finally, the court rejected the taxpayer's argument that consideration of the value of the SO4 contract "improperly taxes appellant's enterprise activity or business skill." (*Freeport-McMoran, supra*, at p. 646.) The court acknowledged that under the income approach indicator of value "income derived in large part from enterprise activity may not be ascribed to the property." (*Ibid*.) However, the court held that the SO4 contract was the means by which the taxpayer sold its electricity and, therefore, "the income generated by the SO4 contract is inextricably tied to the beneficial use of the property and [is] properly considered in assessing its value." (*Ibid*.) The court further found that there was no evidence the increased value of the SO4 contract over a market rate was due to appellant's enterprise activity. (*Ibid*.) Thus, the court concluded that the higher price received under the SO4 contract was not "the result of appellant's successful operation of its plants but of the regulatory scheme that allowed appellant the benefit of a long-term fixed contract price." (*Ibid.*)

<u>*Watson Cogeneration*</u>

The Court of Appeal in *Watson Cogeneration* held that the assessor properly included the value of a PPA in the calculation of the income approach value indicator for the assessment of a cogeneration power facility. In that case, the taxpayer owned and operated a cogeneration power facility which was developed as a "qualifying facility" under federal law. Under federal regulations, utility companies were required to purchase electricity from qualifying facilities at the utility's "avoided cost" and, to assist in implementation of this federal requirement, the CPUC approved a series of "standard offer contracts" for the purchase of power from qualifying facilities. A qualifying facility that met the terms of a standard offer contract was assured of selling its output to a public utility. (*Watson Cogeneration, supra*, at p.1068.)

The taxpayer entered into a 20-year standard offer contract with a public utility that, as of the valuation date, provided for above-market prices for its electricity output. The taxpayer contended that the assessor should not have included the full value of its standard offer contract because that favorable contract was an intangible asset exempt from property taxation. The taxpayer framed the issue as whether the assessor could assess its property based upon income that the taxpayer received by operating the plant under an "above-market" contract with the public utility. (*Watson Cogeneration, supra*, at p. 1069.)

The court found that the highest and best use of the property was as a qualifying facility selling electricity under the standard offer contract, which guaranteed the sale of its output at an above-market price. (*Watson Cogeneration, supra,* at pp. 1071-1072.) Thus, the court concluded, in accordance with prior case law, that the value of the taxpayer's property was best estimated by using the actual income under the standard offer contract rather than imputed income. (*Id*. at p. 1072.) The court also noted that, as of the valuation date, the taxpayer's own expert witness testified that the plant would not have operated as profitably without the standard offer contract; and, on that basis, the court concluded that the evidence showed that the highest and best use of the property was as a qualifying facility with a power purchase agreement. (*Id*. at p. 1074.) Thus, the court held that the reasoning of *Freeport-McMoran* was still applicable and that the assessor properly assumed the presence of the standard offer contract in the valuation of the taxpayer's cogeneration power facility. (*Ibid.*)

The court distinguished cases in which the courts held that an assessor is required to segregate and exclude intangible rights and assets, such as franchise rights, concession rights, cable licenses, liquor licenses and other assets attributable to the enterprise value of the business. (*Watson Cogeneration*, *supra*, at pp. 1075-1076.) The court stated that the power generation facilities in *Freeport-McMoran* and in *Watson Cogeneration* were a different type of business and the PPAs were a different type of intangible than in those other cases. (*Id*. at p. 1075.) In that regard, the court noted that the power generation projects were "the result of government incentives and regulations specifically intended to encourage their development," such as the PPAs, which were "inextricably intertwined with the creation and operation of the project as a qualified facility." (*Ibid*.) Therefore, the court held that as long as the property operated as a qualifying facility and received the predictable income stream under the standard offer contract, the assessor appropriately valued the property based on its actual income. (*Id.* at p. 1075.)

<u>*Elk Hills Power*</u>

In *Elk Hills Power*, the California Supreme Court addressed the question of how to properly value, for property tax purposes, a power plant whose construction and operation had required the owner to acquire and apply certain ERCs, which were undisputed to be intangible assets that provided legal rights that were necessary for the beneficial and productive use of the power plant. (*Elk Hills*, *supra*, 57 Cal.4th at p. 619.)

Primarily at issue in *Elk Hills Power* was the interpretation of RT&C section 110, subdivisions (d) and (e) and RT&C section 212, subdivision (c). The court explained:

> Sections 212(c) and 110(d) prohibit the direct taxation of certain intangible assets and rights, including the ERCs in this case. However, in assessing taxable property under section 110(e), the Board may "assum[e] the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use." The key issue is whether section 110, subdivisions (d) and (e) are mutually exclusive provisions, as the Court of Appeal held, or whether they can be applied together. We conclude that subdivisions (d) and (e) can be applied together.

(*Elk Hills Power*, *supra*, 57 Cal.4th at p. 602.)

The court further explained:

> Section 110(d)(1) prevents *the value* of intangible assets from enhancing or being reflected in the valuation of taxable property. Section 110(e) allows assessors to enhance the valuation of taxable property, not by including *the value* of intangible assets in the valuation (see § 110(d)(1)), but simply by *assuming the presence* of intangible assets when valuing the taxable property put to beneficial or productive use. While the value of the taxable property is enhanced, it is not enhanced by *the value* of intangible assets. That would violate section 110(d)(1) as well as section 212(c). Rather, it is enhanced by *the presence* of intangible assets.

(*Elk Hills Power*, *supra*, 57 Cal.4th at p. 615, original italics.)

Based on this reasoning, the court held that that "the Board directly and improperly taxed the plaintiff's ERCs when it added their replacement cost to the power plant's taxable value." (*Elk Hills Power*, *supra*, 57 Cal.4th at p. 602.) However, the Court also made clear that "[w]here the taxpayer does not proffer evidence that the Board included the fair market value of an intangible right or asset in the unit whole, the Board would not have to make a deduction prior to assessment. For example, if the Board does not add the value of ERCs to its replacement cost valuation, it obviously would not have to deduct their value prior to assessment, because that would produce an unwarranted windfall for the taxpayer." (*Elk Hills Power*, *supra*, 57 Cal.4th at p. 617, fn. 11.)

With respect to the CEA approach, the court concluded that the Board correctly "estimated the amount of income the property is expected to yield over its life and determined the present value of that amount." (*Elk Hills*, *supra*, 57 Cal.4th at p. 602.) Specifically, the court held that "the Board was not required to deduct a value attributable to the ERCs under an income approach." (*Elk Hills*, *supra*, 57 Cal.4th at p. 602.) The court reasoned that, "under an income stream approach, not all intangible rights have a quantifiable fair market value that must be deducted." (*Elk Hills*, *supra*, 57 Cal.4th at p. 617.) The court then concluded "[t]here was no credible showing that there is a separate stream of income related to enterprise activity or even a separate stream of income at all that is attributable to the ERCs in this case." (*Elk Hills Power*, *supra*, 57 Cal.4th at p. 602.)

In reaching this conclusion, the court explained that there are two lines of cases relating to intangibles where an operating property is being valued by use of the CEA approach. In the first line of cases, "courts have upheld income-based assessments that properly assumed the presence of intangible assets necessary to the productive use of taxable property without deducting value for intangible assets." (*Elk Hills Power*, *supra*, 57 Cal.4th at p. 618.) In this line of cases, the intangible asset authorizes the construction or use of the operating tangible property, and thus has only an *indirect* contribution to the income produced by the tangible property.

In the second line of cases, courts "disapproved assessments that failed to attribute a portion of a business's income stream to the enterprise activity that was *directly* attributable to the value of intangible assets and deduct that value prior to assessment." (*Elk Hills Power*, *supra*, 57 Cal.4th at p. 602, italics added.) The court explained the difference in the two lines of cases as follows:

> The difference is one of degree; intangible rights like ERCs merely allow for the taxable property to generate income when put to its beneficial or productive use. Thus, their contribution to the income stream is indirect, whereas intangible assets like the goodwill of a business, customer base, and *favorable* franchise terms or operating contracts all make a direct contribution to the going concern value of the business as reflected in an income stream analysis. *Only the latter category of intangible assets and rights has a quantifiable fair market value that must be deducted from an income stream analysis prior to taxation*.

(*Elk Hills Power*, *supra*, 57 Cal.4th at pp. 618-619, italics added.)

Thus, the court differentiated between, on the one hand, intangible assets that indirectly enhance the value of tangible property (and the income stream produced by the tangible property) by authorizing the beneficial and productive use of the tangible property (hereafter indirect intangibles), and, on the other hand, intangible business or enterprise assets that directly enhance the business income stream (hereafter direct intangibles). (*Elk Hills Power*, *supra*, 57 Cal.4th at p. 618.) Therefore, a deduction from the income stream based on the assumption of the presence of indirect intangibles is inappropriate while a deduction from the income stream may be appropriate for direct intangibles if the taxpayer adequately proves that the direct intangibles have created a separate stream of income or have enhanced the income stream.

ANALYSIS AND DISPOSITION

The issue here is whether petitioners have shown entitlement to deductions from the 2013 Board-adopted unitary values based on an allocation of nontaxable intangible value to their PPAs. Pursuant to *Elk Hills Power*, no deduction from respondent's cost approach calculation is appropriate since no cost related to the PPAs was added to the ReplCLD value indicator. Moreover, *Watson Cogeneration* and *Elk Hills Power* make clear that no deduction from the income approach is warranted in this case.

In *Watson Cogeneration* (which followed the court's reasoning in *Freeport-McMoran*), the court held that the assessor was not required to segregate and exclude the PPAs as intangible rights and assets because they were necessary for the beneficial use of the property. (*Watson Cogeneration*, *supra*, at p. 1073.) In the language of *Elk Hills Power*, the PPA is, therefore, an indirect intangible for which no deduction is necessary because such power plants may not be built without a PPA in place. In that way, the PPA is necessary to the beneficial use of the property in similar fashion to the necessity of ERCs to operate a power plant.

However, even if the PPAs were considered to make a direct contribution to the income stream, no deduction would be warranted here. *Elk Hills Power* determined that a deduction is appropriate for intangibles that directly enhance the income stream if the taxpayer adequately proves that such intangibles have created a separate stream of income or an enhanced income stream. Pursuant to Rule 8, subdivisions (c) and (e), such a separate or enhanced stream of income for the PPAs at issue would require a showing of an income stream that is greater than what the property would produce in its highest and best use under prudent management. Here, the PPAs at issue are standard operating contracts that necessarily would be entered into under prudent management and, therefore, no exclusion from the income approach to value is warranted for these PPAs under Rule 8 subdivisions (c) and (e).

Petitioners' principal argument is that their PPAs directly enhance the income stream and therefore fall into the category of intangible assets that must be deducted prior to taxation. Petitioners contend that the purchase price allocation is the only evidence in the record of the "quantifiable fair market value" of the PPAs and, therefore, the values established by the purchase price allocation must be deducted from Board-adopted unitary values. However, petitioners provided no evidence that the PPAs create a separate stream of income or enhance the income stream above that of other similarly situated, prudently managed and operated power plant facilities in California built and operated with a PPA in place. In other words, as in *Watson Cogeneration*, the market that must be used to determine whether the PPAs have enhanced the income stream is the market of other power plants with PPAs in place. However, like the plaintiffs in *Watson Cogeneration* and *Freeport-McMoran*, petitioners' purchase price allocation erroneously uses a hypothetical "open" market to posit that the value of their PPAs enhance their respective income streams. Therefore, we find that the PPAs in question are intangible assets that do not create a separate or enhanced stream of income and, thus, they do not have quantifiable fair market value that must be deducted from the income stream.

With respect to petitioners' objections to the value determinations, petitioners have presented no evidence demonstrating error in the ReplCLD or CEA value indicators calculated by respondent or in the methodological reliance on those indicators. Petitioners merely state that the purchase price allocation values determined by the D&P report were less than the ReplCLD indicator, which petitioners assert is evidence that respondent failed to make a full adjustment for the value of nontaxable intangible assets. Petitioners also contend that respondent failed to make an adjustment for all forms of obsolescence but have not presented any evidence to support that contention. Therefore, we find that petitioners have not met their burden of proof to demonstrate error in the determination of the fair market value of petitioners' properties. (Cal. Code Regs., tit. 18, § 5541, subd. (a).)

DECISION

Accordingly, the consolidated petitions for reassessment are denied and the 2013 Board-adopted unitary values are affirmed.*

Jerome E. Horton, Chairman

Betty T. Yee, Member

John Chiang, Member

* 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.