Memorandum

To : Mr. Verne Walton Date March 28, 1990

From : Robert R. Keeling

Subject : Assessment of Electrical Generating Qualifying Facilities

I have reviewed a cleaned up copy of a draft of a proposed assessors letter dated 4/6/88 dealing with the subject "The Assessment of Electrical Generating Qualifying Facilities". (Copy attached.) I accept without review the first five pages of the draft dealing with background information concerning the history and regulation of these qualifying facilities (QF). My analysis and discussion herein deals with the section beginning on page five entitled "Summary and Board's Position". In particular, I will be dealing with the staff's conclusion that the Board considers QF's, subject to standard offer contracts (SO), to be enforceably restricted within the meaning of section 402.1 of the Revenue and Taxation Code.

On June 9, 1988, industry representatives met with the staff to voice concerns with regard to the subject draft. The primary thrust of industry speakers was that section 402.1 does not apply to this property as the staff proposes. The position held by the industry was briefed by way of opinion letters to us (copies attached). The industry's position can be stated as set forth in a letter to Mr. Peter Gafney dated January 4, 1988 by attorney John E. Carne with the law firm Crosby, Hefey, Roach, and May. Attorney Carne says section 402.1 legal restrictions do not apply to QF property because:

"1. The restriction must limit the uses to which the property may be put. Neither power purchase agreements nor the QF laws imposed restrictions on the use of property.

"2. The use restriction must be imposed by government. Power purchase agreements are not enforceable restrictions imposed by government.

"3. The restriction must run with the land. Power purchase agreements do not create restrictions that run with the property.

"4. The use restriction must prohibit the property from being employed in its highest and best use. Power purchase agreements do not prevent the highest and best use of QF property."

Revenue and Taxation Code Section 402.1 provides in part:

> "In the assessment of land, the assessor shall consider the effect upon value of any enforceable restrictions to which the use of the land may be subjected. Such restrictions shall include but are not limited to: (a) zoning; (b) recorded contracts with governmental agencies other than those provided in section 422; (c) exercising land use powers currently with local governments, including the California Coastal Commission and regional coastal commissions, the San Francisco Bay Conservation and Development commission, and the Tahoe Regional Planning Agency; (d) Development controls of local government in accordance with any local coastal programs certified pursuant to Division 20 (commencing with section 3000) of the Public Resources Code; (e) development controls of a local government in accordance with the local protection program, or any component thereof, certified pursuant to Division 19 (commencing with section 29000) of the Public Resources Code; and (f) environmental constraints applied to the use of land pursuant to provisions of statutes.
>
> "There shall be a rebuttable presumption that restrictions will not be removed or substantially modified in the predictable future and that they will substantially equate the value of the land to the value attributable to the legally permissable use or uses.
>
> "Grounds for rebutting the presumption may include but are not necessarily limited to the past history of like use restrictions in the jurisdiction in question and the similarity of sales prices for restricted and nonrestricted land. The possible expiration of a restriction at a time certain shall not be conclusive evidence of the future removal or modification of the restriction unless there is no opportunity or likelihood of the continuation or renewal of the restriction or unless a necessary party to the restriction has indicated an intent to permit its expiration at that time."

Your draft memorandum on page 2 states:

> "[C]ogeneration facilities and small power production facilities which have applied to FERC and received QF status are eligible to sell their power output to electric utilities. The FERC rules provide that electric utilities must purchase energy and capacity made available by QF's at a rate that reflects the utilities avoided cost; that is, the incremental cost to the utility which, but for the purchase from a QF, such utility would sustain in generating

the added power itself or in purchasing it from another source. QF's include nonutility-owned cogeneration facilities and facilities using geothermal energy, wind, solar power, municipal waste, biomass (organic material not derived from fossil fuels) and hydroelectric power."

After matching the enumerated elements of restriction set forth in 402.1 with the factual elements of a QF plant, it can be seen that QF property does not become enforceably restricted within the meaning of 402.1 as your memorandum has depicted. To illustrate, I will analyze and discuss each of the elements of restriction under 402.1 as follows:

Section 402.1 land use restriction "(a) zoning" causes the assessor to recognize the zoning of a property for the assessment of land. The Dictionary of Real Estate Appraisal, published by the American Institute of Real Estate Appraisers, 1984 Edition, Third Printing, October 1987, defines zoning as "the public regulation of the character and intensity of real estate use through police power; accomplished by establishing districts or areas with uniform restrictions relating to improvements, structure heights, areas, bulk, density of population, and other limitations on the use and development of private property". It can be seen that zoning is a limitation on the highest and best use of the land. This dictionary also defines "highest and best use" as:

"1. The reasonable and probable use that supports the highest present value of vacant land or improved property, as defined, as of the date of the appraisal.

"2. The reasonable probable legal use of land or sites as though vacant, found to be physically possible, appropriately supported, financially feasible, and that results in the highest present land value.

"3. The most probable use.

"Implied in these definitions is that the determination of highest and best use takes into account the contribution of a specific use to the community and community development goals as well as the benefits of that use to individual property owners. Hence, in certain situations the highest and best use of land may be for parks, green belts, preservation, conservation, wild life habitats, and the like."

Applying the concept of zoning and highest and best use against the factual use of the land for a cogeneration plant it can be seen that 402.1 only limits the assessor to the assessment of

the land at a use for which the land is zoned. Since the land is zoned for use to build a cogeneration facility then the assessor could not assess the land for a higher or better use unless he could rebut the presumption as set forth in 402.1. The assessor is not entitled to utilize the "zoning" provision of 402.1 to justify using the income of an SO contract specifically for the assessment of QF properties. The assessor is only justified under 402.1 to consider the zoning of the land for "the assessment of the land" and "the effect upon value of any enforceable restrictions" due to the fact that the land is zoned as it is.

Section 402.1 land use restriction, "(b) recorded contracts with government agencies other than those provided in section 422" would not apply to SO contracts unless they were recorded and unless they were with a governmental agency. There is no evidence presented that an SO contract is either recorded or with a governmental agency, so the enumerated restriction "(b) recorded contracts..." does not appear to apply to QF properties.

Section 402.1 land use restriction, "(c) permit authority of, and permits issued by, governmental agencies exercising land use powers currently with local governments..." does not appear to factually apply to QF properties because factually the use of the property to generate electricity is a function of a contract between the QF owners and a public utility rather than a permit issued by local government. The assessor is obligated under section 402.1 to recognize the permits issued by local government to build a QF property but the assessor is not obligated under 402.1 to recognize the contract for the generation and sale of power between the QF property owner and a public utility.

Section 402.1 land use restriction, "(d) development controls of a local government in accordance with any local coastal program..." does not apply to QF properties because factually there is no evidence that the QF property is part of a coastal program development.

Section 402.1 land use restriction, "(e) development controls of a local government in accordance with a local protection program..." does not apply factually to QF properties because there is no evidence that a QF property is a part of a local protection program.

Section 402.1 land use restriction, "(f) environmental constraints applied to the use of land pursuant to provisions of statutes" applies only to the extent environmental constraints factually impact the economics of the plant.

It appears then that section 402.1 is not a viable vehicle for a basis to assess QF properties. The utilization of section 402.1 as a basis for the assessment of QF properties at contract rent is mistaken and a tortured interpretation of the scope of section 402.1. However, I have concluded QF properties can be appraised without using section 402.1 as I will develop next.

All property is assessable at fair market value unless otherwise provided by the California Constitution or the laws of the United States. (California Constitution, Article XIII section 1.) "Except as otherwise provided in section 110.1 of the Revenue and Taxation Code, full cash value or fair market value means the amount of cash or its equivalent which property would bring if exposed in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other and both with knowledge of all of the uses and purposes to which the property is adapted and for which it is capable of being used and of the enforceable restrictions upon those uses and purposes." (Revenue and Taxation Code, section 110(a).) Board Rule 2, "The Value Concept", states ". . . '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 in a position to take advantage of the exigencies of the other."

The Norby Lumber case states:

> "Assessor's have developed three basic methods for determining full cash value: (1) the market data method; (2) the income method; and (3) the cost method. Under the market data method, the assessor examines and correlates the prices resulting in other transactions involving comparable properties. The validity of this method rests upon the assumption comparable properties have comparable full cash values. Under the income method, the assessor capitalizes the sum of future income attributable to the property, less an allowance for the risk of partial or no receipt of income. This method rests upon the assumption in an open market a willing buyer would pay a willing seller an amount approximately equal to the present value of the future income to be derived from the property. Under the cost method, the assessor determines the cost of replacing reproduceable property with new property of similar utility or of reproducing the property at its present site and at present price levels less the extent to which the value has been reduced by depreciation, including both physical

> deterioration and obsolescence." (Norby Lumber Co. v. County of Madera, 22 Cal.App.3d 1352, 1365 citing Bret Hart Inn Incorporated v. City and County of San Francisco, 16 Cal.3d 14; Cal. Code Regs., tit. 18, Sections 3-8.)

The staff must not stray outside these determinative parameters when giving advice on how to determine "full cash value" or "fair market value". The problem at issue essentially involves the staff's advice as to the use of the income approach to determine fair market value of the QF properties. The staff advises the capitalization of actual income generated by the property while industry critics say the income utilized must be "market income" that is generated by the sale of electrical power in the market place generally. I have concluded the staff is correct as I will develop in the following analysis and discussion.

The income capitalization approach is defined by The Dictionary of Real Estate Appraisal as "[A] set of procedures in which an appraiser derives a value indication for income producing property by converting anticipated benefits into property value. This conversion is accomplished either by (1) capitalizing a single year's income expectancy or an annual average of several year's income expectancies at a market derived capitalization rate or a capitalization rate that reflects a specified income pattern, return on investment, and change in the value of the investment; or, (2) discounting the annual cash flows for the holding period and the reversion at a specified yield rate". (The Dictionary of Real Estate Appraisal, 1984 Edition, American Institute of Real Estate Appraisers.) Board Rule 8, "The Income Approach To Value" defines the approach as the valuation of "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." (Board Rule 8, section (b).) "The amount to be capitalized is the net return which a reasonably well informed owner and a reasonably well informed buyer 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. Net return in this context is the difference between gross return and gross outgo. Gross return means any money or moneys worth which the property will yield over and above vacancy and collection losses, including ordinary income, return of capital, and the total proceeds from sales of all or part of the property. Gross outgo means any outlay of money or moneys worth

including current expenses and capital expenditures (or annual allowances therefore) required to develop and maintain the estimated income. Gross outgo does not include amortization, appreciation, or depletion charges, debt retirement, interest on funds invested in the property, or rents and royalties payable by the assessee for the use of the property. Property tax, corporation net income taxes, and corporation franchise taxes measured by net income are also excluded from gross outgo." (Board Rule 8(c).)

"Recently derived income and recently negotiated rents or royalties (plus any taxes paid on the property by the leasee) of the subject property and comparable properties should be used in estimating the future income if in the opinion of the appraiser, they are reasonably indicative of the income the property will produce at its highest and best use under prudent management." (Board Rule 8(e).)

Market rent is defined by the American Institute of Real Estate Appraisers as "the rental income that a property would most probably command in the open market; indicated by current rents paid and asked for comparable space as of the date of the appraisal". (The Dictionary of Real Estate Appraisal, supra.) The assessor's handbook AH 501, titled "General Appraisal Manual", states "the income to be processed must be the anticipated economic income from the property to be appraised". (AH 501, March 1975, revised September 1982, page 45.)

"To derive pertinent income and expense data an appraiser investigates comparable sales. . . as well as competitive income-producing property in the same market. For investment properties, current and recent incomes are reviewed. . . and typical operating expenses are studied." (The Appraisal of Real Estate, Ninth Edition, the American Institute of Real Estate Appraisers, pg. 148.) To be comparable to the property being valued, property "shall be sufficiently alike in respect to character, size, situation, usability, zoning or other legal restrictions as to use unless rebutted pursuant to section 402.1 of the Revenue and Taxation Code." (Revenue and Taxation code section 402.5.) Therefore, in order to find "market income" for QF properties, the appraiser must judgmentally determine that the generating plants in the market place utilized to reflect market income for the subject QF property are by definition comparable to the subject QF property. The appraiser would be in violation of good appraisal practice and principles and in violation of statutory law if the appraiser utilizes noncomparable properties to determine market income for the subject QF property. Board Rule 8, titled "The Income Approach to Value" supports this principle wherein the rule states "(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."

I am informed from your historical development that owners of QF properties built the plants in anticipation of selling power to the large utilities; and that under the standard offer contracts (SO) the utilities are required by regulation to purchase such power. In accord with the principle of "anticipation" (The Appraisal of Real Estate, supra, P. 32) any reasonable person, building or purchasing QF properties would anticipate selling its power to large utilities under these conditions. It would be an absolute absurdity to conclude a builder or purchaser of a QF property would build or purchase in anticipation of competing in the open market with large hydro-electric generating facilities and large nuclear steam or fossil fuel steam electrical generating facilities. QF properties are simply not in the same league as such larger properties. The QF properties are not comparable with such larger properties as to the economy with which QF properties can generate electrical power for sale. The QF properties, to be viable in the market place, are therefore wholly dependent upon sale of their power at a bonus rate to a large utility. Otherwise, the QF property is not a viable income producing property. Without government regulations forcing large utilities to pay a bonus value for power generated by QF properties then many such QF properties would never be built (unless other use for their electrical power is needed). Such reasoning was recognized by the California Attorney General when in its opinion dealing with HUD 236 housing projects said:

> "(w)ithout the federal subsidy in question no one would invest in a 236 project with the attendant use restrictions discussed in the proceeding portion of this opinion. In light of the above it is clear that the subsidy in question could be regarded as income attributable to the property rather than the particular owner and that therefore it should be included within the net income to be capitalized". (59 Ops. Cal. Att. Gen. 293, 297.)1/

1/ For policy reasons, the appraisal of 236 housing was statutorily directed by the enactment of R&T Code section 402.9 by Stats. 1978, Ch. 737 in effect January 1, 1989.

Likewise, the income to be capitalized in QF properties is the income generated by the property whether by a favorable SO contract or by a not so favorable SO contract, and the income should be attributable to the QF property.

I conclude the income actually generated by the QF property meets the definitions of market income and thus indicates income to be capitalized as discussed above herein. Any other income forecast would simply not meet the definition of market income, as evidenced by comparable properties.

Industry critics present the proposition that QF properties should be appraised by the income approach utilizing a market value of power as would be generated in the market place generally. They cite Clayton v. County of Los Angeles, 26 Cal.App.3d 390 to support their proposition. The Clayton court was faced with the issue of whether the assessor should be forced to utilize the actual rent from the lease of a department store to arrive at an indicator of value by the income approach. The court held "that in determining the full cash value of a taxable fee interest the assessor should take into account the economic rental of the property rather than the lesser actual rental income under a bad lease of the property". (American Airlines Inc. v. County of Los Angeles, 65 Cal.App.3d 325, 330, footnote 7.) The case stands for the proposition that fair market value of property is indicated only if the rent to be capitalized is at an economic level. The fair market value of a property under lease is the sum of "the present worth of a contractual income stream" at economic rent "and the present worth of the future rights in the property that are scheduled to revert to the lessor at the expiration of the lease". (Capitalization Theory and Techniques Study Guide, Charles B. Akerson, MAI, 5th printing 1/88, American Institute of Real Estate Appraisers, P. 65.) The Clayton case does not stand for the unqualified proposition that QF properties must be assessed only by the income approach to value or only by utilizing the price of electrical power in the market place generally as industry critics say. There are at least two reasons why they are mistaken. First, the income from a QF property is not from a lease (as was the situation for the property in Clayton) but is from a contract for the sale of its electrical power. The QF property is like any industrial property producing a product. It is dependent for income upon the sale of its product in the market place, whether by contract or not. The Clayton case therefore does not directly apply to QF properties since a lease of the property is not an issue. Secondly, market rent or market income imputed to QF properties (or any subject property) must be made from data gathered from comparable income producing properties. The utilization of electrical power sales in the market generally is reflective of the sale of power by large

hydro electric generating plants, etc. This is not a comparable market to measure the market sales of power generated by smaller QF properties. As discussed above, QF properties are not similar or comparable to large power generating properties. Therefore, the market place generally does not reflect the market level for sales of power for QF properties.

I am informed that some or maybe many QF properties have proven to be an uneconomical investment. The income produced has proven not to be sufficient to justify the original investment. Since the definition of market value indicated by the income approach is the present value of expected or anticipated future income, it becomes obvious that the value of such property, earning less than sufficient income, is to be recognized in the market place as property that has lost value. In appraisal terms this is a case of externalities impacting the property (economic obsolescence). As a part of the appraisal process, the appraiser must recognize such loss in value.

The concluding theme of this discussion is that the appraiser may consider the income generated by a QF property whether the income is generated under a good contract or bad contract. If the QF property enjoys a good contract, then the capitalized income approach indicates a value that is indicative of the expectations of a prospective purchaser for the plant. On the other hand, if the QF plant has an income generated by a bad contract, and an improvement in income cannot be forecast in the future, then the income approach that finds a low value indicates a loss in value of the plant because of externalities (economic obsolescence).

Some critics have also said that the staff cannot use representative income from a QF property because such income would simply represent the income of the QF property contract itself. They say, therefore, such income would not represent income to the property that could be capitalized to represent market value of the QF property. Such an issue is not new to the appraisal profession. The California Portland Cement Case (California Portland Cement Company v. State Board of Equalization, 67 Cal.2d 578) handled the question of what earnings should be considered in the capitalization of income method to find value. The court held that "the net earnings to be considered or capitalized are those that would be anticipated by a prospective purchaser". The court also held that "income derived in large part from enterprise activity. . . ascribed to the property being appraised" should not be used and instead "the earnings from the property itself or from the beneficial use thereof" is the income to be considered. "When no sound practical basis appears for apportionment of income as between enterprise activity and the property itself, then a method may

be employed which imputes an appropriate income to the property." (California Portland Cement Company v. State Board of Equalization, supra, pg. 584.) The court cautioned that if a property's "ultimate profits arise largely from enterprise, that fact must be given full weight" by the appraiser "in order that use of the capitalization of income method of appraisal not result in a tax on income rather than a tax on property." (California Portland Cement Company v. State Board of Equalization, supra, pg. 585.) Admonitions of the court should be well taken. If there is income generated by a QF property that can be attributable to enterprise value, then such income should be excluded from the income to be capitalized. The American Institute of Real Estate Appraisers identifies this type of income as reflective of "going-concern value". It identifies going-concern value as "the value created by a proven property operation; it is considered a separate entity to be valued with an established business. This value is distinct from the value of the real estate only. Going-concern value includes an intangible enhancement of the value of an operating business enterprise which is associated with the process of assembling the land, building, labor, equipment, and marketing operation. This process leads to an economically viable business that is expected to continue. Going-concern appraisals are commonly conducted for hotels and motels,restaurants, bowling alleys, industrial enterprises, retail stores, and similar properties. In appraising these properties the physical real estate assets are integral parts of an ongoing business, so market values of the land and building are difficult, if not impossible, to segregate from the total value of the business." (The Appraisal of Real Estate, 9th Ed., supra, pg. 22.)

The determination of whether income of an industrial property is going-concern income or not is largely a determination of whether the income is properly represented and identified at the correct profit center. What I mean by profit center is that point in the production of a saleable unit when net income can be found by subtracting the cost of production from the market value of the unit produced. It is in the nature of measuring property income at the correct trade level. "Trade level" deals with "the principle that property normally increases in value as it progresses through production and distribution channels". It "normally attains its maximum value as it reaches the consumer level". (Board Rule 10 entitled, "Trade Level For Tangible Personal Property" subsection (a); Beckman Instruments Inc. v. County of Orange, 53 CA 3d 767, 779, County of San Diego v. Assessment Appeals Bd. No. 2, 140 Cal.App.3d 52; Xerox Corporation v. County of Orange, 66 Cal.App.3d 746; Ex-Cell-O Corporation v. County of Alameda, 32 Cal.App.3d 135.) This principle also applies to the identification of net operating income to be capitalized for an income producing property. The

net operating income must be that income identified with the use and operation of the property to be appraised. The capitalization of such income reflects the market value of the property by the income approach with no going-concern value included. Any income generated later from increases in the value of the produced product, such as marketing, advertising, merchandising, mark-up, etc. that could be considered going concern value, is not income attributable to the operation of the plant. Relating this principle to QF properties it can be seen that the profit center of a QF property is in truth the property itself. There is no marketing, advertising, merchandising, mark-up, etc. connected with the sale of electrical power by a QF property. All income generated under a QF contract is for the product (electrical power) produced by the QF property itself. Said differently, the proper trade level for the measurement of power generated by a QF property is the selling price of the power delivered by the QF property. Therefore, the appraiser can conclude that there is no going-concern element, no enterprise value, or no contract value in a QF property that needs to be considered when determining net operating income from a QF property.

Furthermore, a QF property is constructed for the sole purpose of producing electricity for sale to a major electrical utility or at least a significant portion of the power is so dedicated. The customer for a QF plant's product (electricity) is predetermined when the plant qualifies for a contract with such a major electrical utility. There is no significant effort or expense involved in developing a customer base for the product or power of a QF property. So again I say, enterprise value or going-concern value or contract value is nonexistent in a QF property.

Moreover, the mere fact that possession of the contract is valuable to the property does not in and of itself cause such income not to be considered as income to be capitalized. The courts handled a like situation in the case of Michael Todd & Co. v. County of Los Angeles, 57 Cal.2d 684. The plaintiff, Michael Todd Co., contended that its copyright in its motion picture was being taxed when the County of Los Angeles assessed the plaintiff's negatives of the film entitled "Around the World In 80 Days". Like the QF protective contracts we see here, this plaintiff argued that but for the protective copyright, the film negatives would have no value. The court held that intangible values (such as a copyright) "that cannot be separately taxed as a property may be reflected in the valuation of the taxable property. Thus, in determining the value of property, assessing authorities may take into consideration earnings derived therefrom which may depend on possession of intangible rights and privileges that are not themselves regarded as a separate

class of taxable property". (Michael Todd Company v. County of Los Angeles, supra, p. 693.) Applying the reasoning utilized by the Todd court, although the QF contract cannot be directly assessed as taxable property, its value nevertheless may be reflected in the valuation of the taxable QF property. Therefore, the appraiser may utilize QF property income generated as a result of a QF contract for the purchase of QF electrical power by a public utility, and to capitalize such income to develop an income approach value indicator for the QF property.

I have not discussed the cost approach to value or the comparable sales approach to value. The assessor may use these two approaches to value in addition to the income approach to value as is appropriate. The Norby Lumber court, as cited, supports the assessor's election to use any of the three approaches to value that the assessor in his discretion believes to be proper.

ROBERT R. KEELING
Tax Counsel
Property Tax Legal

RRK:mw
3103H

cc: Mr. John Hagerty
Mr. Tom McClaskey
Mr. Darold Facchini
Mr. Gene Palmer
Mr. Dick Johnson