State of California

Bo: *590.0035*

Memorandum

To : Mr.

Date: August 5, 1996

From :

Subject: Proper Assessment of Mining Property Relative to Acquisition of Permits To Extract Proved Reserves.

This is in response to your request for an opinion regarding the obligations of the assessor under Property Tax Rule 469 in appraising mining properties when the operator has not secured all of the necessary federal, state and local permits.

Your concern arises from discussion with industry at the meeting on April 19, 1996, regarding revisions to the Mining Handbook AH 560, in which certain situations were described indicating that one or more assessors have assessed "unpermitted" proved reserves prior to production, as if production had commenced.

Specifically, you question whether unpermitted proved reserves, which cannot be produced/extracted due to the absence of permits, are assessable. The answer to this question, based on the provisions in Rule 469 as hereinafter discussed, is no, unless actual production of the proved reserves has commenced.

Rule 469 - Two Events But Not Including Acquisition of Permits, Trigger Assessment of Proved Reserves.

As you are aware, assessors are required to follow the procedures and methodology adopted by the Board in Rule 469 for the valuation of all mines, minerals and quarries (and all rights and privileges pertaining thereto), which might at any point in time exist in land. (Revenue and Taxation Code Section 104(b).) Per subdivisions (a) and (b)(2) of Rule 469, it is the right to explore, the right to develop, and/or the right to produce minerals that is being valued and assessed, not the physical quantity of resources existing on the valuation date. On any given date, some, none or all of these rights may have

ascertainable value and are assessable separately or collectively. (Rule 469(b)(1).)

The specialized appraisal techniques for the assessment of mining properties per Rule 469 identify two events as the dates for establishing the base year value of mineral rights: (1) the date when such rights undergo a change in ownership, and (2) the date when the production of proved mineral reserves commences. The acquisition of any permits necessary to extract minerals is not such an event. While the acquisition of the necessary permits may have impact on the value of the proved reserves (when either of these two events occur), it is not, in and of itself, an event triggering change in ownership or the commencement production of the proved reserves. Likewise, the failure to acquire permits does not prevent a change in ownership and does not automatically preclude production.

With regard to any mid-development or pre-production sales of mineral properties which have unpermitted proved reserves, the language in subdivision (b)(4) provides that the assessor shall establish a new base year value whenever a change in ownership in the right to explore, develop or produce has occurred. The assessor is further directed to apply any appropriate valuation method in appraising the property so transferred.

Reasons Commencement of Production is Event for Establishing Base Year Value under Rule 469.

The theory underlying Rule 469 (also consistent with the theory of Rule 468) is that the date of commencement of production of the "proved reserves" is the date established for making the base year value assessment for those reserves. Whether permits authorizing such production are issued to the operator, may influence the value of the reserves. However, issuance is not the point identified for establishing the base year value. Subdivision (f) of Rule 469 expressly states:

> "The value of the right to produce minerals shall be established as of the date that the production of minerals commences and the value shall be placed on the roll as provided by law. When the value of the right to produce minerals is enrolled, the roll value of the exploration or development rights for the same reserves shall be reduced to zero."

The problem of acquiring permits for the exploration, development and production of minerals was previously considered by all parties interested in and contributing to the drafting of Rule 469. The fact that actual production of proved reserves generally cannot commence until all permits are obtained from the responsible regulatory agencies was one of the many reasons assessors were initially opposed to identifying the commencement of production as the event for making a final determination of the base year value of proved reserves. Inherent in the permitting process is a "waiting period."

The "commencement of production" trigger was vigorously debated at numerous committee meetings, public hearings and Board meetings from 1988 through 1990. Assessors generally contended that they should not be required to wait until production commences as the point in time (other than change in ownership) when the mineral rights are assessable, because the marketplace attributes substantial value to proved reserves long before this point, which value increases once permits are obtained. Thus, withholding valuation until production commences (while permits are sought) results in the illegal temporary exemption of the property. (See Delaney Memorandum, September 15, 1989, p.5, copy enclosed.) For this reason, the regulation drafted by the assessors incorporated an approach which treated the valuation of proved reserves in the same manner as the valuation of continuing new construction. This approach was the only one which assessors believed would address the problems created by mid-development sales of mining properties, (for example, before-production sale of property with unpermitted proved reserves).

In the Board's view, this continuing "new construction" approach to the valuation of mineral interests had been rejected in Lynch v. State Board of Equalization, (1985) 164 Cal.App.3d 94 (and was later again rejected in *Phillips v. Lake County*, (1993) 15 Cal.App.4th 180), and was therefore inappropriate for incorporating into the rule. (See "Initial Statement of Reasons," copy attached.) Further, the Board recognized that because of the application of Proposition 13 to mineral properties, some definite point in time had to be chosen for the establishment of the original base year value of the mineral rights. The approach finally adopted by the Board followed a middle ground. The Board recognized that while "proved reserves" can be discovered at any time, valuation of mining reserves upon initial discovery is highly speculative in situations where there is an extensive time delay between discovery and production and where there are uncertainties regarding permitting and related development processes. Due to

these uncertainties, through Rule 469 the Board established a procedure where proved reserves are first assessed (and a base year value established) at the time when most of the speculation and uncertainties have been eliminated. For properties where production has not commenced, that time is when production commences. For producing properties, the value of new proved reserves can be ascertained reliably, so such new reserves are assessed on the first lien date following discovery.

Proper Assessment During Three Phases of Mineral Properties.

As a direct consequence of the middle ground approach, Rule 469 treats each right on mining properties - the right to explore, the right to develop, and the right to produce - as a separate taxable property interest. This artificial "phasing" accommodates the timing problem during the exploration and development (including permitting) of this unique property for valuation purposes. The Board concluded that while there may be a rather long continuum over a series of events in time during which it might be possible to state that "proved reserves" were identified, all things considered, the optimum point for that assessment was the time when **production commenced.** In the "Initial Statement of Reasons," page 6, it was expressly stated with respect to the Board's adoption of the commencement of production methodology in subdivision (e):

> "Under the theory of this rule and in conformity with the theory of Rule 468, the market value of mineral rights associated with producing mineral properties, i.e., the right to produce, is determined by reference to the estimated quantity of proved reserves which are producible during the period the right is exercisable. This subdivision is necessary to make clear when a base year value for the mineral rights in a newly developed producing mineral property is to be established, i.e., when production commences, and to make clear that increases in the quantity of proved reserves constitute additions to the measure of the mineral right and reductions in the quantity of proved reserves constitute reductions in the measure of the mineral right which are properly recognizable by the assessor under the provisions of Proposition 13." (See Eisenlauer Memorandum, June 14, 1989, "Initial Statement of Reasons," p.6, copy enclosed.)

Inherent in this approach was the recognition that acquiring permits is part of the first and second "phases," the right to explore and the right to develop. Thus, subdivision (d)(1) allows the assessor to consider permit costs as part of the value of new construction. However, permit costs related to the development of the mineral rights are not allowed.

Since permits merely represent a right or privilege to perform an act, and are presumed to be the prerequisite to the performance of the act, they were not deemed assessable. The date of completion of new construction resulting from actual physical construction on any site must be determined by reference to Rule 463.5. The base year value trigger focuses not on the acquisition of permits to perform an act, but on the existence of the act, (e.g., the completion of construction or the commencement of mineral production). Consequently, if permits are not obtained but the completion of new construction occurs, or a mineral operation commences production even though lacking the required permits, the assessor is required to value the structure or the proved reserves as of that date, (i.e. the absence of permits does not preclude establishment of the base year value in such cases). Alternatively, if the permits are secured but completion of new construction never occurs, or production of proved reserves never begins, the assessor is prohibited from establishing a base year value on the new construction or from establishing the base year value of mineral rights associated with producing mineral properties (i.e., the acquisition of permits does not require establishment of the base year value).

Permits During the Exploration and Development Phases.

Subdivision (d)(1) makes it clear that the base year value for the right to explore cannot properly include value from future production or from costs of permits attributable to (future) production of the property. The permit costs for new construction are treated differently than the permit costs for operations, taking ore samples, etc. The assessor is expressly instructed, as follows:

> "The right to explore for mineral is taxable to the extent it has value separate from the rights to develop and produce any discovered minerals. The right to explore shall be valued by any appropriate method or methods as prescribed in Section 3 of Title 18 of this code taking into consideration appropriate risks; however, in no event shall the right be considered to be under

> construction. While the construction of structures or the physical alterations to land, e.g., access roads, fencing, drainage or water systems, land clearing, etc., during exploration constitutes assessable new construction (subject to the provisions of Section 463 of Title 18 of this code), it does not add to or diminish the value of the right to explore. Costs associated with obtaining government approval related to new construction should be considered when valuing new construction. Costs of obtaining governmental approval to operate, taking ore samples, assaying for mineral content or testing processing methods, shall not be considered for purposes of valuing the right to explore. These latter elements of costs may appear in the value of the mineral rights when production starts."

Thus, a mineral property assessee who constructs a building during the exploration phase with a permit cost of $10,000, should expect that the $10,000 will be included in the assessor's base year value of the building. On the other hand, the costs of obtaining permits to operate, to take ore samples, to assay, or to test processing methods shall not be considered by the assessor in valuing the property during the exploration phase, with the result that the assessor cannot add the $100,000 cost of an Environmental Impact Report to the value of the property during the exploration phase. Some of these costs, however, may indirectly appear in the value of the mineral rights when production starts, (per subdivision (d)(1)) to the extent that they have contributed to the value of the quantity of proved reserves that can reasonably be expected to be produced.

Permits During the Production Phase.

Once production of the proved reserves has commenced initiating the third "phase" or right to produce, the assessor is required to establish the base year value of mineral rights associated with mineral producing property by "the valuation of the proved reserves ... based on present and reasonably projected economic conditions ...normally considered by knowledgeable and informed people engaged in operating, buying, or selling such properties or the marketing of production therefrom." (Subdivision (e)(1).) There is no prerequisite that the necessary permits authorizing production have been secured. Rather, the requirement is to establish the base year value "as of the date production of proved reserves commences." However, there must

be a reasonable certainty that the permits can be obtained. If such reasonable certainty does not exist, then the new ore should not be classified "proved reserves" as defined by subdivision (c)(2).

Therefore, two questions arise with regard to permits during the production phase: 1) would the **withdrawal or cancellation of an existing permit**, causing a halt in the production, necessitate a reduction in the base year value of the proved reserves so affected, and 2) would the discovery and/or addition of **new unpermitted proved reserves** necessitate an increase in the value of the current proved reserves. Based on the instructions concerning valuation during production in subdivision (e)), the answer to each question is a qualified "yes".

In response to the first question, subdivision (e) requires the assessor to make a reduction in value whenever "reductions in recoverable amounts of minerals occurs," as follows:

> "Reductions in recoverable amounts of minerals caused by production or by changed physical, technological or economic conditions or a change in the expectation of future production capabilities constitute reductions in the measure of the mineral rights and shall correspondingly reduce value on the subsequent lien date."

Therefore, where the withdrawal or cancellation of a permit, and/or the issuance of a judicial writ, or the adoption of a local referendum which invalidate a permit and forces an operator to cease or severely reduce the production of the proved reserves, the rule would require the assessor to allow a corresponding reduction in value on the subsequent lien date (based on supporting data regarding the expectations of future production). While it should be assumed that an operator works within the confines of the law, the operator continued mineral production with no decline in production capability, the assessor would make no reduction in value. Certainly, the lack of a permit or an order to cease and desist an illegal activity reduced the reasonable certainty of recovery.

In answer to the second question, where increases in proved reserves occur as the result of additions to the mineral right, the assessor is required to add the value of new proved reserves or increases in proved reserves whether or not they are permitted, based on the following language in subdivision (e):

> "Increases in proved reserves that occur following commencement of production and that are caused by claimed physical, technological or economic conditions constitute additions to the mineral rights which have not been assessed and which shall be assessed on the regular roll as of the lien date following the date they become proved reserves. The increased quantity of proved reserves shall be used to establish the value of the addition to the property interest which value shall be added to the adjusted base-year value of the reserves remaining from prior years as the separate base-year value of the addition."

Thus, new additions to proved reserves must be treated as "additions to the mineral rights which have not been assessed," regardless of whether permits for their extraction have been obtained. This does not apply to additions which have already been included in the "proved reserves currently assessed" (already included in the base year value). New permits or amendments/supplements to existing permits may be required before any production of the additional proved reserves can begin. The foregoing provision seems to authorize assessment, regardless of permits, on the lien date following the date when the "additions to the mineral rights" become "proved reserves," rather than on the lien date following the commencement of production of the added reserves. The test, however, is reasonable certainty of recovery. If the assessor determines that a reasonably prudent operator would attempt to acquire the permits and that the general practice of the regulatory agencies is to issue such permits, then the assessor may estimate the additional proved reserves as if the permits had been acquired. On the other hand, if it appears that the regulatory agencies are unlikely to issue the necessary permits or that the operator will not seek the permits due to other restrictions on the property, etc., the assessor may not assess the reserves for which there is no reasonable certainty of recovery.

Because the Rule 469 methodology is based on the commencement of production of the proved reserves and is not specifically dependent on the acquisition and/or cancellation of permits, assessors have sufficient flexibility to deal with both additions and depletions.

<u>Permits As Land Use Restrictions Under Section 402.1.</u>

The statutory provisions in Revenue and Taxation Code Sections 402.1 and 1603 are also applicable where enforceable restrictions, local government controls, environmental restraints, etc., are imposed on a mining property and require the issuance of permits.

With regard to permits issued by governmental authorities, Section 402.1(a) provides in pertinent part:

> "(a) 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. Those restrictions shall include, but are not limited to all of the following:
>
> (1) Zoning.
>
> * * *
>
> (3) Permit authority of, and permits issued by, governmental agencies exercising land use powers concurrently with local governments, including the California Coastal Commission and regional coastal commissions,....
>
> (5) Development controls of a local government in accordance with a local protection program certified pursuant to Division 20 (commencing with Section 29000) of the Public Resources Code.
>
> (6) Environmental constraints applied to the use of land pursuant to provisions of statutes.
>
> (7) Hazardous waste land use restriction pursuant to Section 25240 of the Health and Safety Code."

The foregoing language clearly provides that the "assessor shall consider" the effect upon value of any enforceable restrictions (per the non-inclusive statutory listing) to which the use of the property may be subjected. Most types of zoning, the necessity to obtain building permits, use (e.g. production) permits, etc. all impose obvious constraints on the use of property which assessors must routinely consider in determining value. Thus, where property is zoned "Residential," but intended for use as a hardrock mineral operation, a zoning change, a conditional use permit, and numerous other permits (grading, soil, building, etc.) will generally be required before actual mineral use is realized. In applying both Section 402.1 and Rule 469, the assessor's valuation would be based on the present residential use of the property on the

lien date, not on the future mineral use pending permit approval.

The more difficult question is whether the assessor, in valuing the property during actual production and use, must consider either the cancellation of permits or new environmental constraints requiring additional permits. The sole California case related to this subject, Firestone Tire & Rubber Co. v. County of Monterey (1990) 223 Cal.App.3d 382, did not apply Sections 402.1 and 402.3 in finding that toxic waste cleanup costs must be considered in determining the value of the property. Rather, the court held per Section 110 that where the assessor on the lien date has knowledge of pollution and/or environmental constraints reducing the fair market value of property, there is a basis for a reduction in that property's assessed valuation. Had there been sufficient evidence to establish that the assessor knew or should have known as of the 1980 lien date that the property was contaminated, the county would have been required to make an appropriate reduction in fair market value based on the costs of toxic waste cleanup.

Based on the foregoing, the assessor should value a producing mineral property on the lien date, subject only to the enforceable restrictions which his office has knowledge of and which affect production on the lien date. As previously discussed, the existence of the required permits and/or enforceable restrictions is related to the measure of reasonable certainty that the reserves will be recovered/produced.

In short, both Section 402.1 and Rule 469 are applicable to numerous circumstances which result in reductions in the production and thereby require the assessor to consider the effect upon the value of the proved reserves.

KEC:ba
Attachments

cc: Mr. [redacted]
Mr. [redacted]
Mr. [redacted]
Mr. [redacted]

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State of California — Board of Equalization

Memorandum

To: Honorable Paul Carpenter
Honorable Conway H. Collis
Honorable William M. Bennett
Honorable Ernest J. Dronenburg, Jr.
Honorable Gray Davis

Date : September 15, 1989

From : James J. Delaney

Subject: Rule 469 - Hearing on Proposed Amendments

Amendments to the subject rule are scheduled for hearing on September 27. Because of the difficulty in describing the theories expressed in the proposal and the controversy between the staff and some assessors, I am providing you with this rather lengthly explanation of the reasons for the staff recommended changes and have included the material submitted by the assessors and staff comments on their proposal.

Industry representatives are also not pleased with all aspects of our proposal, however, it does appear that they find it more acceptable than the assessors do. It is almost certain that both the assessors and industry will make presentations during the hearing.

Mr. Richard Ochsner prepared the staff material and I reviewed it. Either or both of us are prepared to discuss it with any member or his deputy.

J. J. Delaney

JJD:fr

Attachments

cc: Ms. Cindy Rambo
Mr. James Todd
Ms. Nina Ryan
Mr. Earl Cantos
Ms. Delpha Hacker Flad
Mr. John Davies
Mr. John W. Hagerty
Mr. Richard H. Ochsner
Mr. Verne Walton
Mr. Eric F. Eisenlauer

RULE 469

BACKGROUND

Section 1 of article XIII of the California Constitution provides generally that all property shall be taxed in proportion to its full value. Thus, prior to Proposition 13, property was assessable annually at its current market value. If there was a change in the value of property from year to year, the assessor could reflect the full amount of the change in the assessed value. Of course, if property had no value then, in accordance with section 1, it was not taxable.

Proposition 13 imposed limits on real property assessed values. The limit, known as the base year value, is determined by reference to the value of the property on March 1, 1975, or, thereafter, the current market value on the date of a change in ownership. The base year value can also be increased to reflect the market value of additions to the property in the form of completed new construction. With the exceptions mentioned, the base year value of real property can be increased only to reflect inflation not to exceed two percent per year. Thus, once the base year value for real property is established, its market value can increase greatly, perhaps doubling or tripling as in the case where agricultural property is rezoned industrial or commercial, while the assessed value of the property will remain unchanged except to reflect inflation or declines in value.

The Proposition 13 base year value limitation created serious interpretational problems when applied to mineral properties. When valuable minerals in the form of oil, gas, gold, etc., are discovered, is the assessor precluded from assessing the mineral right to reflect the value of these newly discovered minerals because they existed in the property at the time the original base year value was established? If the original base year value of land were considered to also reflect the base year value of any minerals which might later be discovered, then the Proposition 13 base year value concept could virtually exempt the State's mineral wealth from property taxation.

While generally county assessors took the position that Proposition 13 just didn't apply to minerals and industry claimed that new reserves only increased the value of the mineral right and did not provide a basis for changing the base year value, the Board followed a middle ground. Since a mineral interest like all other property is not taxable until it has value and since the value of a mineral right is measured by the existence of proved reserves (i.e., reserves which are economically recoverable) the Board adopted a rule based on the theory that mineral rights do not become taxable until proved reserves are identified through the exploration and development process and that increases in proved reserves should be treated by assessors like new property the value of which is added to

the original base year value of the mineral right? The Board's Rule 468 Oil and Gas Producing Properties was held a proper interpretation of article XIIIA by the court in Lynch v. SBE, 164 Cal.App.3d 94.

In 1987, a different court applied the same approach in finding that the gas storage rights in certain lands were properly valued and assessed for the first time in 1978, when they were discovered, since that was the year in which they attained value due to the confluence of certain economic and technological factors which made the gas storage rights in the underground structures valuable. Because the rights were undiscovered and, consequently had no value, prior to 1978, they were not included in the 1975 valuation base year value. Tenneco West, Inc. v. Kern County, 194 Cal.App.3d 596.

Rule 468 deals only with oil and gas interests and with the valuation of producing properties. It does not attempt to deal with the valuation of oil and gas interests during the exploration and development phase. This apparently has not presented a great problem because the exploration and development of oil and gas properties have, typically, not spanned long periods. Thus, while Rule 468 has worked well for oil and gas properties, it does not address the serious problems arising from the valuation of hard rock mineral interests which typically take several years to bring into production. Nevertheless, the proposed Rule 469 amendments attempt to apply the court approved theories of Rule 468 to the valuation of hard rock minerals.

Since the development of a hard rock mineral resource may span a period of five years, or more, from the time of commencement of serious exploration until the time production begins, a new element, time, which is not of concern in producing oil and gas properties is added to the valuation equation. Since the value of the mineral right is to be determined by estimating the value of the proved reserves, and such reserves come into being over time, disputes have arisen as to the appropriate point in time that the existence of proved reserves should be recognized. If the proved reserves are recognized in the first year but production will not commence until the fifth year, the value of the estimated income stream from those reserves must be discounted for this time delay. Further, as indicated in the attached article on mineral reserves estimation (exhibit 2), the identification or discovery of resources which may constitute possible, probable or proved reserves is only one part of a rather circular process which involves not only the geologist but also the mining engineer in determining the ultimate proved ore body. Things such as mining methods, processing systems, and other operating costs,

as well as the fluctuating market price of the mineral, all play a part in determining the volume of economically recoverable reserves. For these and other reasons, the most realistic estimation of proved reserves probably cannot be made until about the time that production is ready to commence. Further, commencement of production is a much more readily identifiable event then are other points in time during the transitional periods leading from exploration and development to production. For these reasons, the staff determined that while there may be a rather long continuum covering a series of points in time at which it might be possible to state that proved reserves have been identified, it was concluded that, all things considered, the optimum point for that determination was the time when production commenced. The staff's discussions with representatives of the mining industry and county assessors also confirm that while the selection of any single point on the continuum has its pluses and minuses, the point at commencement of production is probably the best time at which to estimate proved reserves from the standpoint of bringing uniformity to assessment procedures.

The objections raised by assessors are primarily based upon the belief that they should be permitted to place a base year value on the proved reserves at some unidentified point early in the process and then be permitted to make regular changes in that value through the development stage and make a final determination of the base year value at the time of commencement of production. This theory is reflected in the assessor's proposed regulation (exhibit 1). It reflects an approach which treats the valuation of proved reserves like the valuation of continuing new construction. This continuing "new construction" approach to valuation of mineral interests was rejected in the Lynch decision and more recently by the Lake County Superior Court in connection with the valuation of certain geothermal interests. (Perhaps this explains the assessor's interest in including the valuation of geothermal interests within their proposed Rule 469.)

It should be recognized that proved reserves are not static. Changing physical or economic conditions can, from time to time, bring about the recognition of additional or diminished proved reserves. Both Rules 468 and 469 make provision for this. For example, if it is determined on the lien date that a particular oil and gas property has an additional 1,000 barrels of proved oil reserves, Rule 468(c)(4)(E) provides that the new reserves shall be valued by multiplying the new volume by the current market value per unit of the total reserves. Thus, if the current market value of the total reserves is $16 per barrel, then the value of the new proved reserves is $16,000. This approach has not been objected to by the oil industry

because production is typically increased when new reserves are discovered and, thus, the new reserves are produced without significant delays.

Typically, there is a much different time dimension in the hard rock mineral situation. Various factors, such as the production capacity of the mine or the demand in the marketplace for the minerals may limit the ability of the hard rock miner to increase production. If current proved reserves of a mine represent a 20-year supply at current production levels, the discovery of additional reserves below the existing ore body may mean that the new reserves cannot be produced for another 20 years. Any projected income stream from those new reserves must, therefore, reflect that delay. For that reason, Rule 469 does not follow the same approach used in valuing new reserves as does Rule 468.

Rule 469(e)(1)(A)(v) values added proved reserves by determining the current market value of all proved reserves, including the added reserves, and subtracting the current market value of the old reserves. Of course, in determining these values, the appraiser must consider the effect on the value resulting from the timing of the various income streams resulting from production of the reserves. If the mine has the capacity to increase production as new reserves are added, that can be reflected in the estimated value. If there will be a long delay before the added reserves will produce income, that also can be properly reflected. Thus, the valuation formula included in Rule 469 allows the appraiser to take into consideration the added time dimension typically present in hard rock mineral properties.

ASSESSORS' OBJECTIONS

The Assessors Association has provided its own draft of proposed amended Rule 469 and a listing of about twenty objections to the staff's proposed amendments (exhibit 1). Most of these objections, however, relate to two specific areas of disagreement. Items 1 and 2 below reflect those two areas. Also included are comments on certain other objections and a copy of the assessors' listing of the "specific errors" contained in the staff's proposed draft of the Rule.

1. PROVED RESERVES - TIMING

The assessors primary objection to the rule is that it delays determination of the base year value of mineral rights until commencement of production. It is argued that the marketplace attributes substantial value to reserves long before this point and that withholding valuation of

the rights until production results in the illegal temporary exemption of this property.

The staff response is that due to the unique nature of mineral interests and the requirements of article XIIIA, the assessor must select the one point in time when the mineral right will be valued. Once the base year value is established, it cannot be increased except as permitted under Proposition 13. Of the available times for setting the value of mineral rights, the date of commencement of production appears the fairest both to the county and the taxpayer. Although a method of valuing proved reserves as though it were continuing new construction has recently been rejected by at least one superior court (Aminoil Inc. v. County of Lake, Lake County Superior Court No. 20285) (exhibit 3), it is apparent that the true objection of the assessors is that proposed Rule 469 will not permit them to use the new construction approach to valuing proved reserves. Staff believes that if assessors had to choose the one point in time at which reserves are to be quantified and the mineral right valued, they would arrive at the same conclusion proposed by the staff.

One of the arguments used by assessors in objecting to the proposed rule is that it creates problems when properties are bought and sold in mid-development because the marketplace does reflect some value attributable to anticipated reserves. If the value of those reserves subsequently declines, assessors contend that the rule prevents them from recognizing that decline.

The staff believes that the provisions of the rule contains sufficient flexibility to permit assessors to appropriately deal with these situations. (See top of page 7 and paragraph (e)(1)(C) on page 10 of proposed Rule 469.)

2. RECOGNITION OF NEW RESERVES.

The second major objection is to the way in which the value of newly discovered reserves are added. Rather than adding these proved reserves at the current unit market value of all reserves, Rule 469 adds them at a value which, where appropriate, will reflect a discounted value due to the fact that the income from the reserves will not be received until some future time. Assessors contend that this will always result in the lowest possible value. Assessors also object to the fact that while the value of new reserves may be reduced because such discounting is required, the amount of reserves depleted are valued at the weighted average base year value of the total reserves. This, states the

assessors, results in putting low value in and taking high value out. The assessors have offered several diagrams to illustrate this point.

The staff responds that while the assessors have focused on the results in certain hypothetical situations, they have not demonstrated that the theory on which the staff method is based is invalid. It seems beyond dispute that the value of an income stream must be discounted if the income will not be received for ten or twenty years. Therefore, if reserves are not to be produced for a period of time, their current value is less than the reserves produced today.

A subsidiary argument of this objection is that the treatment of new reserves in Rule 469 requires that Rule 468 be conformed to this treatment. It is argued that Rule 468 should be amended prior to the adoption of Rule 469.

Staff responds that while the two rules are based on similar principles, each stands on its own footing. Further, although the staff had indicated earlier that a change in Rule 468 might be required, further study has lead them to conclude that a change in Rule 468 is not necessary at this time.

3. STOCKPILED ORE

Assessors object to that portion of the value calculation, contained in subdivision (e)(1)(A)(ii) which provides for a segregation of the value of the mineral right from the value of land, improvements, and personal property "including any resources severed from the land and held for future production." Assessors contend that this language converts stockpiled ore from real property which should still be included in the value of reserves to personal property which is eligible for the inventory exemption. Of particular concern is the gold ore which is removed from the ground and placed in large piles and subjected to a leaching process which extracts the gold.

The staff response is that under general property law and as reflected in Board Rule 121, ore removed from the ground, whether being processed or stored for future production, is excluded from the definition of land. The proposed rule merely reflects what is already the law.

4. APPROPRIATE RISK

Assessors object to language found in the instructions on the valuation of exploration rights, in subdivision (d)(1),

which states that the right to explore shall be valued by any appropriate method "taking into consideration appropriate risks." Although the assessors do not quarrel with the correctness of the instruction, they find it insulting because consideration of appropriate risks is fundamental to any valuation method.

The objectionable language was added at the request of the mining industry and reflects their specific concerns. While the instruction is rather basic, it is, nevertheless, correct. For that reason, the staff has not felt it necessary to remove this language. It is obvious, however, that removal of this language would not seriously impair the effectiveness of the rule.

5. GEOTHERMAL RESOURCES

Assessors object to the fact that Rule 469 does not include geothermal resources as does their proposed draft. Assessors argue that in order to be complete the rule should include geothermal interests.

The staff responds that inclusion of geothermal resources may be related to litigation currently in progress in Lake County (Aminoil, Inc. v. County of Lake; supra, in which the superior court found that geothermal proved reserves may not be reappraised annually at full market value as new construction in progress as the facilities to develop the resources are constructed. Staff believes that geothermal resources are sufficiently unique that a separate rule for their valuation is justified. Such a rule will be developed after Rule 469 is finally adopted.