In the Supreme Court of the State of California

ELK HILLS POWER, LLC,

Plaintiff and Appellant,

v.

CALIFORNIA STATE BOARD OF EQUALIZATION AND COUNTY OF KERN,

Defendants and Respondents.

Case No. S194121

Fourth Appellate District, Division One, Case No. D056943
San Diego County Superior Court, Case No. 37-2008-00097074-CU-MC-CTL
The Honorable Ronald L. Styn, Judge

ANSWER BRIEF ON THE MERITS

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INTRODUCTION

Article XIII, section 1 of the California Constitution requires the assessment of property at "fair market value" (sometimes referred to as "full value" or "full cash value"). (Cal. Const., art. XIII, § 1; art. XIIIA, §1(a).) Article XIII, section 19 of the California Constitution requires the State Board of Equalization (the Board) annually to value state-assessed property on a unitary or going concern basis. (Cal. Const., art. XIII, § 19; *ITT Communications, Inc. v. City and County of San Francisco (ITT No. 1)* (1985) 37 Cal.3d 859, 863-865.) The objective of unit taxation is to prevent "*real but intangible value*" from escaping tax. (*ITT No. 1, supra,* 37 Cal.3d 859, 863, italics added.)[1]

Revenue and Taxation Code[2] section 110 clarifies and implements the above rules. It defines "fair market value" and "full cash value," and provides specific rules and guidelines for their determination, including the treatment of intangible rights. "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." (§ 110, subd. (e).) In addition, "intangible attributes of real property shall be reflected in the value of the real property." (§ 110, subd. (f).)

This case involves assessment of a power plant property, which was constructed using building permits that required the application of emission

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[1] Because the Board assesses the unitary or going concern value of state-assessee property under article XIII, section 19 of the California Constitution, and not discrete items of real and personal property, this Court held that the "valuation rollback" provision of article XIIIA, section 2, subdivision (a), of the California Constitution, part of the 1978 initiative known as Proposition 13, does not apply to the unit assessment of public utility property. (*ITT No. 1, supra,* 37 Cal.3d 859.)

[2] All further statutory references are to the Revenue and Taxation Code unless otherwise noted.

reduction credits (ERCs) and which continues to need the applied ERCs to operate and function as intended, to make energy and money. Elk Hills Power, LLC (Elk Hills) acquired ERCs to obtain the permits and certifications necessary for construction and operation of its power plant at its current level of productivity and emissions.

Elk Hills' tax-refund lawsuit claimed that the Board improperly assessed its property either by illegally imposing a tax directly on the intangible ERCs, or by failing to deduct the value of the ERC's from the unitary fair market value of its property.

The Court of Appeal ruled that because the ERCs were needed to construct and to operate the power plant and, thus, were necessary for the beneficial and productive use of the power plant at its highest and best use, the Board properly considered the deployed ERCs in determining the unitary fair market value of Elk Hills' power plant for property taxation purposes under section 110, subdivision (e). (Opinion, 6, 38.)[3]

The California Constitution and section 110 have mandated that the Board follow the fundamental principle of fair market valuation by valuing the power plant at its highest and best use, 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." (§110, subd. (a).) The Board correctly considered the ERCs in its determination of the unitary fair market value of Elk Hills' power plant, and the Court of Appeal reached the right result based on a

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[3] The Court of Appeal, in affirming the trial court's judgment, departed from the trial court's ruling, which found that the deployed ERCs are intangible attributes of real property that relate directly to the power plant and, therefore, should be reflected in the power plant's assessed value under section 110, subdivision (f).

sound application of existing law. Accordingly, its opinion should be affirmed.

QUESTION PRESENTED

Did the Court of Appeal correctly rule that section 110, subdivision (e) allows the assessment of taxable property at full market value when emission reduction credits are deployed to that property to permit its use, without a deduction for the use of the ERCs?

STATEMENT

In order to reduce the emission of air pollutants, the California Clean Air Act enables certain air quality control districts to establish an "emission credit system" and a "district banking and offset system" involving the use of ERCs. (Health & Safety Code, § 40709 et seq.) A district issues ERCs to an emission source when the source achieves qualifying reductions of its emissions, e.g. by adding controls, replacing or removing equipment, or closing a plant. (II CT 295; Health & Safety Code, § 40709, subd. (a); San Joaquin Valley Air Pollution Control District Rules 2201 and 2301, § 3.6; II CT 297-334 and 337.) Once issued, the ERCs can be applied to a specific property (i.e., deployed), "banked" to offset future emissions, or sold to other companies in need of emission offsets. (II CT 255 and 295; Health & Safety Code, § 40709, subd. (a); San Joaquin Valley Air Pollution Control District Rule 2301, § 3.2, § 3.3; II CT 336.)

An entity seeking approval to emit certain air pollutants in certain districts must deploy ERCs to "offset" their emissions as part of the process of obtaining "authority to construct" a plant and obtaining other required operating permits. (II CT 254 and 273; Pub. Resources Code, § 25523, subd. (d)(2); San Joaquin Valley Air Pollution Control District Rule 2201, §§ 3.25-3.27; II CT 304-05.)

Elk Hills is the owner and operator of an electric power plant located in Tupman, California, which is located in the San Joaquin Valley Air Pollution Control District (the District). (II CT 254.) In order to construct and operate its plant, Elk Hills expended approximately $11 million to acquire the ERCs necessary to "offset" planned plant emissions. (II CT 348.) Elk Hills surrendered five ERCs -- three for nitrogen oxides, one for volatile organic compounds, and one for sulfur oxides -- to the District to enable it to produce at its continuous capacity of 500 megawatts of power. (II CT 275.) Once surrendered, such ERCs are associated with the specific plant for which they are used and may not be otherwise used or transferred until the plant ceases operation. (II CT 274.) Once deployed, the ERCs are directly attached to the emission source they are used to permit, for as long as the permitted emissions continue. (II CT 274.)

For tax years 2004, 2005, 2006, 2007, and 2008, the Board valued Elk Hills' plant on a unitary basis, using the "replacement cost" approach.[4] For tax years 2006, 2007, and 2008, the Board also factored in a "Capitalized Earning Ability" (CEA) valuation approach to arrive at the assessed value, but gave it far less weight than the replacement cost value indicator.[5] (II CT 351.) Both methods are commonly used, either separately, or in

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[4] This approach includes costs that must be incurred in bringing a substitute property to a finished state capable of yielding the same services and amenities (i.e., electrical power generation levels and resulting revenue-producing levels). (See Board of Equalization Property Tax Rules, Rules 3 and 6, at Cal. Code Regs., tit. 18, §§ 3, 6.)

[5] There are three basic methods of valuation: the reproduction cost or replacement cost method, the comparable sales method, and the income capitalization method. (*Pacific Mutual Life Ins. Co. v. County of Orange* (1985) 187 Cal.App.3d 1141, 1147; Cal. Code Regs., tit. 18, § 3.) The Board has the discretion to select any valid method. (*County of Riverside v. Palm-Ramon Development Co.* (1965) 63 Cal.2d 538; *De Luz Homes, Inc. v. County of San Diego* (1955) 45 Cal.2d 546, 564.)

conjunction with each other as was done here. (Opinion, 36; Cal. Code Regs., tit. 18, §§ 3, 6, 8; Board's State Assessment Manual, pp. 12-21.)

The Board valued the entire plant as a unitary operating appraisal unit. (II CT 351, III CT 652-654.) Under the replacement cost approach, the Board estimated the normal costs that would be necessary to obtain a permit to construct and operate a replacement power plant. (II CT 351-352, III CT 653-654.) None of Elk Hills' ERCs that were banked or not deployed to its power plant were taken into consideration. (II CT 351; see Opinion, p. 36.)

The Board's approach in assuming the presence of ERCs in valuing Elk Hill's plant is similar to the approach it uses with other government permits that authorize property use, including building and operating permits necessary to replace the taxable property with facilities of equal productivity, and including costs associated with building permits, grading permits, water costs, and intangible costs such as filing fees, engineering fees, and lawyers' fees. [II CT 352; *Cal. Code Regs.*, tit. 18, § 6.] In fact, "millions of dollars of other intangible costs, such as labor, workers compensation, and other work force benefits are also capitalized" in the replacement cost approach." (III CT 653.) This is because such costs constitute necessary replacement costs and also are necessary for the beneficial and productive use of the property. (*Ibid.*) With respect to the CEA approach, "the Board calculated the income indicator without any deduction for applied ERCs." (III CT 654.)

Elk Hills disagreed with the Board's assessment and eventually filed a complaint (and two amended complaints) against the Board and the County of Kern under section 5148, subdivision (a), for refund of state-assessed property taxes paid from 2004 to 2008, and for declaratory judgment. (I CT 1, 18, 38.)

After responsive pleadings were filed, each party filed or joined in a motion for summary judgment. (I CT 105, II CT 226, III CT 476.)

Elk Hills claimed that the Board's assessment violated section 110, subdivision (d)(2), which provides that fair market value in "unit valuation" is determined by "removing . . . the fair market value of the intangible assets and rights" (Opinion, 4, 17, 19, and section 212, subdivision (c), which provides that "[i]ntangible assets and rights are exempt from taxation" (Opinion, 9).

The trial court granted the Board's motion for summary judgment. (IV CT 731, 841.) It found that because the ERCs were necessary to construct the power plant, they relate directly to the real property; "thus, they fall within Revenue and Taxation Code section 110, subdivision (f). Therefore, the Board properly included these rights in its replacement cost approach and was not required to subtract such rights from its income analysis." (IV CT 841-42.) Elk Hills appealed.

The Court of Appeal affirmed, but on different legal grounds. It found that the Board's unitary taxation determinations properly assessed Elk Hills' power plant "as a going concern," (*ITT No. 1, supra*, 37 Cal.3d 859 at pp. 863-65) and the Board properly took into account the ERCs as contributing to the value and earnings of the property as a whole. (Opinion, 6.) Specifically, the court found that because the power plant cannot operate and function as intended -- to make energy and money -- without the presence of the deployed ERCs, the power plant was correctly "assessed and valued" under section 110, subdivision (e) "by assuming the presence of intangible assets or rights necessary to put the taxable property to beneficial or productive use." (*Ibid.*)

With respect to Elk Hills' claim that the Board improperly used a "site-specific adjustment" attributable to the ERCs in calculating the replacement cost, the Court of Appeal affirmed the trial court's finding that

the Board's replacement cost calculation was based on an analysis of normal costs necessary to obtain a permit to construct and operate replacement power plant facilities, including the standard statewide replacement costs of the ERCs. (Opinion, p. 35; II CT 351-52.) The court found that neither Elk Hills' actual ERC costs nor its booked ERC costs were taken into consideration in estimating the power plant replacement cost. (Opinion, p. 37; II CT 351.)

The Court of Appeal correctly concluded that "[s]ince the valuable ERCs were necessary to the ongoing productive use of the property, they were properly considered here, under section 110, subdivision (e)." (Opinion, 38.)

On August 24, 2011, this Court granted Elk Hills' Petition for Review.

STANDARD OF REVIEW

A grant of summary judgment on undisputed facts is reviewed *de novo*. (*Sea World, Inc. v. County of San Diego* (1994) 27 Cal.App.4th 1390, 1397; *Independent Energy Producers Assn., Inc. v. State Bd. of Equalization, supra,* 125 Cal.App.4th 425, 436.)

The primary issue, statutory interpretation, is a question of law, and is also reviewable *de novo*. (*Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 7-8.) "When construing a statute, the courts will strive to harmonize and give effect to both constitutional and statutory provisions and will uphold the legislative act unless it clearly conflicts with a state constitutional provision. (*Professional Engineers in California Government v. Wilson* (1998) 61 Cal.App.4th 1013, 1025.)

ARGUMENT

I. THE BOARD PROPERLY ASSESSED THE FAIR MARKET VALUE OF ELK HILLS' POWER PLANT BECAUSE THE EMISSION REDUCTION CREDITS ARE NECESSARY TO PUT THE PLANT TO BENEFICIAL OR PRODUCTIVE USE

A. The Valuation of Property Assumes the Presence of the Intangible Rights Necessary for the Beneficial or Productive Use of Tangible Property.

Article XIII, section 1 of the California Constitution requires generally that for property taxation, property must be valued at fair market value, which requires that the assessor assume the presence of those intangible rights and assets necessary for the beneficial or productive use of tangible property. Similarly, article XIII, section 19 requires the same in the specific case of state-assessed property, such as Elk Hills' power plant. These rules are clarified and implemented by section 110.

Article XIII, section 1 requires the assessment of property at full "fair market value." (Cal. Const., Art. XIII, § 1.) It has long been held that "fair market value" must be based on highest and best use. (*Sacramento Southern R. Co. v. Heilbron* (1909) 156 Cal. 408, 412.)

The "highest and best use" of real property is defined as "[t]he most profitable use of a property at the time of the appraisal . . . ." (Assessment Appeals Manual (2003), Glossary, p. 167; see Assessors' Handbook (AH) 501, pp. 47-53; see also Cal. Code Regs., tit. 18, §§ 3, 6; § 110, subd. (a) & 402.1; Black's Law Dictionary, 9th ed. at p. 1682.) Under the "fair market value" principle, "highest and best use" is equivalent to the "beneficial or productive use" of property. (*Watson Cogeneration v. County of Los Angeles* (2002) 98 Cal.App.4th 1066, 1070-1071.)

Property typically is defined as a bundle of intangible rights. (*Union Oil Co. v. State Bd. of Equal.* (1963) 60 Cal.2d 441, 447; Civ. Code §§ 654, 655; 63C.Am.Jur.2d Property, § 1.) The value of private property stems

from the owner's rights to enjoy and make use of it, and these legal rights are intangible in nature. In other words, property has value because ownership includes intangible rights and privileges to use and exploit the property. Thus, in order to value the "beneficial or productive use" of tangible property, one must assume the presence of any intangible rights and assets necessary for that use.[6]

Article XIII, section 19 of the California Constitution requires the Board annually to value state-assessed property, including Elk Hills' power plant, on a unitary or going concern basis. (*ITT No. 1*, *supra*, 37 Cal.3d at pp. 859, 863-865, see *Independent Energy Producers Assn., Inc. v. State Bd. of Equalization*, *supra*, 125 Cal.App.4th at p. 425.) "Unit taxation prevents real but intangible value from escaping assessment and taxation by treating public utility property as a whole, undifferentiated into separate assets (land, buildings, vehicles, etc.) or even separate kinds of assets (realty or personalty)." (*ITT No. 1*, *supra*, 37 Cal.3d at p. 863.)

Section 110 defines "fair market value" and "full cash value," and provides rules for the treatment of intangible rights. Section 110, subdivision (e) explicitly states that "[t]axable 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." Section 110, subdivision (f) provides that the "intangible attributes of real property shall be reflected in the value of the real property." Application of the rules set forth above in the context of unitary assessment of a power plant requiring ERCs for its construction and operation leads

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[6] As explained in *Michael Todd v. County of Los Angeles* (1962) 57 Cal.2d 684, 691, "[t]he right to ride one's horse is an attribute of the ownership of the horse itself; and he who owns the material object ordinarily has both the physical ability and the legal right to use it for any lawful purpose."

logically to the conclusion that a unitary value assessment of the plant based upon replacement costs must include the replacement cost of the ERCs. Elk Hills has applied or deployed the ERCs to make the highest and best use of its power plant, in light of the enforceable restrictions upon its use of the property. Elk Hills contends that the Board's assessment of its power plant was improper because the assessment purportedly included a value for the ERCs. (AOB 10-11.) But Elk Hills confuses the concept of assessing its power plant property at fair market value or full cash unitary value with assessing and taxing the ERCs themselves as separate "assets." Once this distinction is recognized and applied within the constitutional and statutory framework outlined above as the Court of Appeal aptly did, it becomes clear that the Board properly assessed the power plant.

B. The Express Language of Sections 110, Subdivision (e) and 212, Subdivision (c) Supports the Board's Assessment of the Elk Hills Property at Full Value.

Elk Hills contends that section 110, subdivision (d)(2) required the Board to value its power plant without any consideration of the ERCs. That subdivision provides:

> (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.

(§ 110, subd. (d); italics added.)

To ascertain legislative intent, courts look first to the words of the statutes. (*Lennane v. Franchise Tax Bd.* (1994) 9 Cal.4th 263, 268; *Standard Oil Co. v. State Board of Equalization* (1974) 39 Cal.App.3d 765, 768.) "If there is no ambiguity in the language of the statute, 'then the Legislature is presumed to have meant what it said, and the plain meaning of the language governs.'" (*Lennane*, *supra*, at p. 268, quoting *Kizer v. Hanna* (1989) 48 Cal.3d 1, 8.)

This is a case where the language of the statute is clear. Section 110, subdivision (d) operates only as *not otherwise provided* in subdivision (e). But subdivision (e), which provides that "[t]axable 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," clearly does apply because the ERCs are needed "to put the taxable property to beneficial or productive use." (§ 110, subd. (e).) Since section 110, subdivision (e) does apply, it therefore overrides subdivision (d)'s definitions of "full cash value" and "fair market value," and the Board properly appraised Elk Hills' power plant under subdivision (e). This is not some new test developed by the Court of Appeal as claimed by Elk Hills; rather, it is a direct result of the plain language of the statute.

Elk Hills also relies upon section 212, subdivision (c), which provides that "[i]ntangible assets and rights are exempt from taxation and, *except as otherwise provided in the following sentence*, the value of intangible assets and rights shall not enhance or be reflected in the value of taxable property." (Italics added.) However, "the following sentence," which contains language identical to section 110, subdivision (e), and which provides that "[t]axable 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" (Rev. & Tax. Code, §212, subd. (c)), clearly does apply because the ERCs are needed "to put the

taxable property to beneficial or productive use." (§ 212, subd. (c).) Since the second sentence of section 212, subdivision (c) does apply, it overrides the first sentence's limitations on the treatment of intangibles.

Thus, under both section 110 and section 212, the exclusion of value contributed by intangible assets is expressly applicable only where the intangible asset is not necessary for the beneficial or productive use of the tangible property. As Elk Hills has admitted that it could not have built and operated its power plant without the ERCs, the Board properly considered the ERCs in assessing the plant. (AOB 9-10; II CT; II CT 348; IV CT.)

"If there is no ambiguity in the language of the statute, 'then the Legislature is presumed to have meant what it said, and the plain meaning of the language governs.'" (*Lennane*, *supra*, at p. 268, quoting *Kizer v. Hanna* (1989) 48 Cal.3d 1, 8.) In this case, there is no ambiguity in either section 110, subdivision (e) or section 212, subdivision (c).

C. Even if the Language of Section 110, Subdivision (e), Or Section 212, Subdivision (c) Is Ambiguous, the Rules of Statutory Construction Compel the Adoption of the Board's Interpretation.

Only if there is ambiguity in the statutory language do courts resort to extrinsic rules and sources to determine legislative intent, including the ostensible legislative object to be achieved and the legislative history. (*Freedom Newspapers, Inc. v. Orange County Employees Retirement System* (1993) 6 Cal.4th 821, 828; *Jones v. Lodge at Torrey Pines Partnership* (2008) 42 Cal.4th 1158, 1163.)

1. Tax Exemption and Exclusion Statutes Are Strictly Construed.

As the Court of Appeal noted, "[S]tatutes providing an exemption from tax are reasonably, but strictly, construed against the taxpayer." (*Standard Oil Co.*, *supra*, 39 Cal.App.3d 765, 769-70; see also *Chevron U.S.A. v. State Bd. of Equalization* (1997) 53 Cal.App.4th 289, 295-296.)

An exemption or exclusion from taxation will not be inferred from doubtful statutory language, and "'settled principles of statutory construction require that any doubt be resolved against the right to the exemption. . . .' [Citation.]" (*Ibid.*) If any ambiguity is found in section 110, it must be strictly interpreted against providing an exclusion from assessment at "fair market value," as required by the California Constitution. (Cal. Const., art. XIII, § 1.)

2. The Legislative History is Consistent with the Statutory Language.

A court cannot simply "ignore the plain words of the statute unless it appears the words used were, beyond question, contrary to what was intended by the Legislature." (*Pratt v. Vencor, Inc.* (2003) 105 Cal.App.4th 905, 911.) In this case, though, it is clear that the Board's interpretation is consistent with Legislative intent.

In 1995, subdivisions (d), (e) and (f) were added to section 110 expressly to "reflect preexisting law." (1995 Cal. Stats. Ch 498, § 5; II CT 387-472; see *American Sheds* (1998) 66 Cal.App.4th 384, 392.) Section 110, subdivision (e), provides that in determining full value, an assessor may assume the presence of intangible property rights "necessary to put the taxable property to beneficial or productive use." The same legislation added section 212, subdivision (c), which also provides that in determining full value, an assessor may assume the presence of intangible property rights "necessary to put the taxable property to beneficial or productive use." As already noted, section 110 subdivision (d), which removes the fair market value of the intangible assets and rights contained within the unit, is overridden by section 110, subdivision (e). And, similarly, the first sentence of section 212 subdivision (c), which excludes the value of intangible assets from enhancing the value of taxable property, is overridden by the second sentence of section 212, subdivision (c).

The legislative history behind section 110, subdivision (e), supports the Board's application of the statutory language and does not contradict that language. (See Exhibits 4-6 to the Board's Request for Judicial Notice at II CT 409-422.) Subdivision (e) was included to make the other amendments to section 110 constitutional, including subdivision (d), because excluding the values contributed by intangible rights necessary for use of tangible property would violate the constitutional requirement that property be taxed at full cash value. (II CT 387-472; see Cal. Const., art. XIII, § 1.) The Senate Bill Analysis dated April 19, 1995, stated that:

> **[E]xisting law provides that in valuing taxable property, assessors may consider the presence of whatever intangible rights and privileges are necessary to put the property to beneficial or productive use, even though such intangibles are not themselves taxable as property.**
>
> . . . For example, a developer's interest in a parcel of vacant land might be worth little without the necessary building permits to build. **Although a building permit would be intangible personal property which is not taxable as property in and of itself, the assessor must consider the presence of the necessary permits in arriving at the full value of the developer's taxable property. The permit itself is not assessed, but the ability to build houses on the land, made possible by the permit, is assessed as part of the developer's real property interest.**
>
> COMMENTS: Proponents indicate that these changes are merely clarifying, and are reflective of recent court decisions. Indeed, since most of the property tax law is based in the Constitution, most of what we know about the property tax comes from the courts. If the courts agree that these changes are merely clarifying, then they make no change to the law. However, to the extent that they would be used to grant an exemption of real property, then they would be unconstitutional.
>
> **These changes should be viewed in light of the fact that most economic value is essentially intangible.** A vacant lot has value not as a vacant lot but by virtue of its ability to hold a structure or to serve another purpose. **The value of real**

> **property derives from the economy and society in which it exists as this is essentially an intangible value.**"

(II CT 408-09 (emphasis added); see also *American Sheds v. County of Los Angeles*, *supra*, 66 Cal.App.4th at pp. 392-93.)

The legislative history in support of the Board's interpretation is further supported by the Legislative Counsel's Digest, which explained that the amendment to section 110 adding the new subdivision (e) was to ensure that property would be assessed and valued by assuming the presence of any intangible assets necessary to put taxable property to beneficial use.

> Existing property tax law requires that all property subject to taxation be assessed at its full value.
>
> This bill would specify that intangible assets and rights are not subject to taxation. This bill would also provide that intangible assets and rights may not enhance or be reflected in the value of taxable property, except that taxable property may be assessed and valued by assuming the presence of intangible assets and rights that are necessary to put taxable property to beneficial or productive use.

(II CT 428.)

"It is the duty of this court to give force and effect to the statutes of the state unless clearly unconstitutional." (*Richfield Oil Corp. v. County of Los Angeles* (1950) 100 Cal.App.2d 535, 540.) As the foregoing demonstrates, the Legislature enacted subdivision (e) of section 110 to ensure that the 1995 amendments to section 110 were consistent with the constitutional requirement of fair market valuation, and to reflect existing law "which provides that in valuing taxable property, assessors may consider the presence of whatever intangible rights and privileges are necessary to put the property to beneficial or productive use, even though such intangibles are not themselves taxable as property." (II CT 408-409.)

D. Under Elk Hills' Interpretation, its Power Plant Would Be Impermissibly Assessed at Less Than Fair Market Value, and Not at Its Highest and Best Use.

Elk Hills contends that "while the 'presence' (or existence) of intangible assets and rights necessary to the beneficial and productive use of tangible property may be 'assumed' for purposes of property taxation - under subdivision 110(e) - the value of such intangibles must still be excluded from property taxation-under subdivision 110(d)". (AOB 21-22, emphasis in brief omitted.) In other words, Elk Hills argues that "assume the presence" means, for all intents and purposes, "assume the absence."

Such an interpretation, however, is contrary both to the plain meaning and legislative intent of section 110, subdivision (e), and makes that provision meaningless despite the fact that the Legislature deemed it necessary to add the additional statutory language to make the amendments constitutional. Elk Hills' position, if applied, would lead to substantial undervaluation of its power plant properties.

E. The Board Did Not Assess ERCs

Elk Hills alleges that "[T]he Board admittedly and expressly added a cost component for ERCs to the valuation of the Plant." (AOB 3, emphasis in original.) Elk Hills misstates both the facts and the Court of Appeal's holding, arguing incorrectly that the Court of Appeal decided that the value of intangible assets "can be expressly added to the value of the taxable real and personal property." (AOB 49.) In fact, the Court of Appeal correctly determined that the Board "*considered the value added to the power plant by the ERCs*, in their nature as intangible rights that contributed to the productivity and value of the power plant property." (Opinion 3, italics added.)

The Board did not tax or assess ERCs, or consider their separate value, and this case is not about the taxation of ERCs. Instead, in

determining the plant's fair market value under the replacement valuation approach, the Board properly included standard estimated replacement costs for the deployed ERCs, as well as other permitting and "soft costs" necessary to use the property. (II CT 351.) The standardized ERC costs included in the Board's replacement cost calculation were just another cost of the building and operational permits, along with engineering fees, filing fees, attorneys fees, and other such standard soft costs of construction.

No special exclusion was made for Elk Hills' power plant simply because it chose to deploy ERCs in lieu of cleaner technology equipment, to maximize productivity and revenues while still meeting the District's air pollution emission requirements. (II CT 351-52.) The Board "legitimately took into account the value added by the ERCs," to the plant in determining assessed value "because without the presence of the deployed ERCs, the power plant cannot operate and function as intended." (Opinion, 6.) To consider the value added by ERCs to the plant is not the same as separately assessing the intangible ERCs. Here, the only *value* estimated by the Board was for the tangible plant as a unit, calculated in part by using a standard *replacement cost* methodology that summed all estimated *costs* to replace the plant, including necessary building and special use permits and other "soft" costs such as engineering fees necessary for the property's construction and operation. (II CT 351-352, III CT 652-654.)

For the income approach used in 2006, 2007, and 2008, in estimating capitalized earning ability, Elk Hills' assertion that the Board failed to apply its own methodology to exclude income attributable to ERCs from its income approach valuation is wrong. (AOB 12, 40, 41.) No deduction from unitary value was required due to added plant productivity from the deployed ERCs. (See *Los Angeles SMSA Ltd. Partnership v. State Board of Equalization* (*Los Angeles SMSA*) (1992) 11 Cal.App.4th 768, 777.)

F. The Board's Assessment of Elk Hills is Consistent with Judicial Precedent Stretching Back Over 60 Years.

Elk Hills repeatedly contends that the Court of Appeal's decision presents a "new test" that violates the California Constitution by permitting the property taxation of intangible assets or rights deemed "necessary" for the beneficial and productive use of tangible real or personal property. (See AOB 3-4, 13, 22, 31.) Nowhere, however, does the Court of Appeal say that it is permissible to directly or separately tax intangibles, nor has the Board advocated such. There is no "new" test. The Court of Appeal merely interpreted and applied section 110 in a fashion consistent with the California Constitution, the plain language of the section, the legislative history, and over 60 years of judicial precedent holding that intangible values may properly be reflected in the valuation of taxable tangible property.

More than 60 years ago, this Court explained in *Roehm v. County of Orange* (*Roehm*) (1948) 32 Cal.2d 280 that, even though the value of intangible property cannot be separately taxed, it may permissibly be reflected (or assumed) in valuing taxible property. Although the *Roehm* case held that a liquor license was not taxable property, it distinguished between taxing intangibles separately as property, and taking them into consideration in taxing tangible property:

> Intangible values, however, that cannot be separately taxed as property may be reflected in the valuation of taxable property. Thus, in determining the value of property, assessing authorities may take into consideration earnings derived therefrom, which may depend upon the possession of intangible rights and privileges that are not themselves regarded as a separate class of taxable property.

(*Id.* at pp. 285-286.)

Roehm established the critical distinction -- missed by Elk Hills in its erroneous reliance on the case -- between direct taxation of an "intangible"

and consideration of intangible property use rights necessary for the beneficial and productive use of taxable tangible property. (See also *American Sheds v. County of Los Angeles, supra,* 66 Cal.App.4th 384 at pp. 389, 392-395.) *Roehm* held that the proper valuation of property allows assessing authorities to consider the "earnings derived" from such intangibles, precisely as the Board did here. (*Roehm, supra*, 32 Cal.2d 280, 285.)

Elk Hills criticizes *Roehm's* explanation as being dicta (AOB 21), but its roadmap on intangibles has been followed for over 50 years. (See e.g., *Michael Todd v. County of Los Angeles* (*Michael Todd*) (1962) 57 Cal.2d 684, 690-691 [copyright added value to the property]; *American Sheds, supra*, 66 Cal.App.4th at p. 392 [land use and waste permits]; *LA SMSA, supra*, 11 Cal.App.4th 768, 775 [FCC permits added value]; *Western Title Guaranty Co. v. County of Stanislaus* (1974) 41 Cal.App.3d 733, 739-741 [title plant added value].)

Moreover, even if *Roehm's* guidance on intangibles was dicta when first written, to say dicta is not controlling does not mean it is to be ignored; on the contrary, dicta is often followed, especially dicta in which the courts have long acquiesced. (9 Witkin, Cal. Proc. Appeal, § 511.) A statement that does not possess the force of a square holding may nevertheless be considered highly persuasive, particularly when made by an able court after careful consideration, or in the course of an elaborate review of the authorities, or when it has been long followed. (*Ibid.*) A dictum in a Supreme Court opinion is even more persuasive when it squares the opinion's holding with a constitutional mandate. That is the case here, where the California Constitution mandates that property be taxed based on its full value.

In the next important case, this Court held in *Michael Todd, supra,* 57 Cal.2d 684, that the valuation methodology used to determine the

assessment value of film negatives of a copyrighted motion picture was proper because the law requires that property be assessed at fair market value, and not scrap value. The Court noted that "'[m]arket value' for assessment purposes is the value of property when put to beneficial or productive use." (*Id.* at p. 696.) In *Michael Todd*, "[t]here was *no actual market* for the subject negatives without plaintiff's copyright therein. The sole *beneficial or productive use* of the negative film of a motion picture is for making prints thereof for exhibition, whether such prints be sold or leased." (*Ibid*, italics added.) Consequently, the Court concluded that the assessor could take the copyright into consideration and use the production costs of the film "Around the World in 80 Days" to value the master film negative at fair market value for property tax purposes. This concept, "beneficial or productive use" of the property, was subsequently incorporated in several cases and eventually codified in section 110, subdivision (e) and section 212, subdivision (c).

Then, in *Western Title Guaranty Co. v. County of Stanislaus* (1974) 41 Cal.App.3d 733, the Court of Appeal upheld an assessor's valuation of the title plant's physical records above "mere scratch" by using a cost approach to value the intangible information compiled and indexed in such records. "The propriety of including nontaxable intangible values in the valuation of otherwise taxable property has been asserted by the courts in a variety of contexts, and market value for assessment purposes is the value of property when put to beneficial or productive use." (*Id.* at p. 741.)

In *County of Stanislaus v. County of Stanislaus Assessment Appeals Board* (1989) 213 Cal.App.3d 1445, the court addressed the proper assessment of a cable television operator's municipal franchise, holding that "in valuing the possessory interest for assessment purposes, the assessor may take into consideration the presence of the intangible assets necessary to put the possessory interest to beneficial or productive use in

the operation of the cable television system." (*Id.* at p. 1449.) In making that determination, the court looked to *Roehm* and the cases following it, and explained:

> Our conclusion that the intangible right to do business is not assessable for ad valorem tax purposes, however, does not mean the value of Post-Newsweek's intangible rights may not be considered in assessing the value of the possessory interests. As explained in *Roehm* [citations] 'Intangible values . . . *that cannot be separately taxed as property may be reflected in the valuation of taxable property*.' Thus, in determining the value of [taxable] property, assessing authorities may take into consideration earnings derived therefrom, which may depend upon the possession of intangible rights and privileges that are not themselves regarded as a separate class of taxable property.

(*Id.* at pp. 1455-1456, italics in original.)

In *LA SMSA, supra*, 11 Cal.App.4th 768, 776, the taxpayer made an argument similar to the one made here by Elk Hills, except that the assessee was a cellular telephone company, the assessed property was a cellular telephone facility, and the "intangible asset" was the Federal Communications Commission (FCC) permit or station authorization necessary to build and operate the facility. (*Id.* at p. 772.) The court held that, although the FCC permit itself constituted nontaxable intangible personal property, the Board's unitary valuation of the state-assessed public utility property properly considered the value added by such permit to the tangible, taxable property operating as a unit at its highest and best use. The court explained that:

> The crux of the problem in the present case and what PacTel fails to appreciate is that although 'intangible property is exempted from property taxation, such property may enhance the value of taxable tangible property.'

(*Ibid.*, citing *ITT World Communications, Inc. v. County of Santa Clara* (1980) 101 Cal.App.3d 246, 254.)

For property tax purposes, the ERCs surrendered by Elk Hills are equivalent to the FCC permit discussed in *LA SMSA*, *supra*. The ERCs are an intangible that must be considered by the Board when determining the unitary value of the power plant at its "highest and best use" because, without the deployed ERCs and the permits whose issuance they authorized, the power plant could not have been built or operated. Yet another case applying the same principle is *Freeport-McMoran Resource Partners v. County of Lake* (1993) 12 Cal.App.4th 634, which involved the assessment of a geothermal power plant. The intangible asset at issue was the existence of long-term contracts guaranteeing a sales price for power produced at the plant. Like the deployed ERCs in this case, the supply contracts in *Freeport* ("SO4 contracts") were theoretically separable from the taxable property, but in reality the taxable property could not and would not be sold without the contracts. The court in *Freeport* concluded it was proper to include value contributed by the intangible contracts in assessing the power plant because they increased the value of the plant. (*Id.* at p. 644.) The *Freeport* court rejected the same argument made by Elk Hills here:

> We are not persuaded by appellant's argument that consideration of the SO4 contract income impermissibly taxes nontaxable intangible property. Only tangible personal property is subject to taxation. [Cites omitted.] But "'[i]ntangible values . . . that cannot be separately taxed as property *may be reflected in the valuation of taxable property*. Thus, in determining the value of [taxable] property, assessing authorities may take into consideration earnings derived therefrom, which may depend upon the possession of intangible rights and privileges that are not themselves regarded as a separate class of taxable property.' [Cites omitted.]

(*Freeport-McMoran Resource Partners v. County of Lake*, *supra*, at pp. 645-646, italics in original.)

Similarly, in *American Sheds v. County of Los Angeles*, *supra*, 66 Cal.App.4th at p. 384, the court concluded that the "board permissibly considered government permits" that authorized landfill operation on the property, including an operating permit issued by the county's department of health service and waste discharge requirements issued by the regional water quality board, "in appraising the [taxable] property at beneficial and productive use." (*Id.* at p. 396.) And in *Watson Cogeneration*, *supra*, 98 Cal.App.4th 1066, the court held that the assessor properly considered the income stream related to favorable government-facilitated intangible purchase agreements in valuing the property because such contracts enhanced the facility's value. (*Id.* at pp. 1075-1076.)

Elk Hills tries to minimize the significance of the cases summarized above, yet they show that the Board's interpretation of law with respect to intangibles was established long ago, and that courts have uniformly held the same view. On the other hand, the cases Elk Hills does rely on are easily distinguishable.

For example, Elk Hills mistakenly relies on *Shubat v. Sutter County Assessment Appeals Board* (1993) 13 Cal.App.4th 794. *Shubat* distinguished between intangibles such as zoning, which are related to property, and business "enterprise value," which results from such things as a valuable trade name or the superior business skills of the owner and is not related to the right to use the property at highest and best value.[7] Elk Hills' reliance on *Shubat* only highlights its dependence on both a factual mischaracterization of the ERCs here, and a mischaracterization of the facts

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[7] In valuing operating properties such as power plants, telephone systems, and similar public utilities on a going concern basis for state assessment purposes, the Board must assume "prudent management" in determining unitary value. (Board of Equalization Property Tax Rules, Rule 8(e), at Cal. Code Regs., tit. 18, § 8.)

and holding in *Shubat*. Unlike "enterprise value," intangibles that have been held not to relate to taxable property, such as exceptional management skills, superior work force or a franchise "right to do business," the deployed ERCs are a requisite part of the authorization for the construction and operation of the tangible power plant itself.

Elk Hills also mistakenly relies on *GTE Sprint v. County of Orange* (1994) 26 Cal.App.4th 992, *Service America Corp. v. San Diego County* (1993) 15 Cal.App.4th 1232, and *County of Orange v. Orange County Assessment Appeals Bd.* (1993) 13 Cal.App.4th 524. These cases also involved business enterprise intangibles unrelated to the use or value of taxable tangible property. As summarized by the court in *Watson*, "[t]he intangibles in those cases included such assets as franchise rights, concession rights, cable licenses, liquor licenses, and other assets attributable to the enterprise value of the business." (*Watson, supra,* 98 Cal.App.4th 1066, 1075.) None of these business intangibles authorize or enhance the use of tangible property, and the reviewing courts always are careful to distinguish intangibles that authorize the use, construction, and operation of tangible property. (*Ibid.*, see also *LA SMSA*, *supra*, 11 Cal.App.4th 768, 776, and *American Sheds, supra,* 66 Cal.App.4th 384, 393.)

In *GTE Sprint*, the court remanded the matter to the Board for further action. Notably, *GTE Sprint* reiterated the same opinion expressed by this Court in *Roehm* and *Michael Todd*, as well as their progeny that:

> [A]lthough intangible property is exempted from direct property taxation, the courts in this state have repeatedly held that the value of such intangible property may be included in the valuation of otherwise taxable tangible property. [Citations.]

(*GTE Sprint, supra*, 26 Cal.App.4th 992, 1002.)

And as the Court of Appeal here noted: "Unlike in *GTE Sprint*, [citation], this record does not show a refusal by the Board to address the

taxpayer's evidence of separate values of intangible assets. Instead, the board made site-specific adjustments for the ERCs, based on its formula, and the record does not demonstrate why those adjustments were improper." (Opinion 37-38.)

In summary, the cases following *Roehm* distinguish between those intangible rights and assets that are necessary for the beneficial and productive use of real property under section 110, subdivision (e), and intangible rights that are "attributable to the enterprise value of the business," and therefore fall under section 110, subdivision (d). (*Watson, supra*, 98 Cal.App.4th 1066, 1075.) ERCs, once deployed to specific taxable property to permit its highest and best use, are clearly within subdivision (e).

G. Elk Hills Mischaracterizes the Nature of the Emissions Reduction Credits it Purchased.

Elk Hills attempts to avoid the reach of section 110, subdivision (e), by mischaracterizing the nature of the ERCs it purchased. It alternatively argues that its deployed ERCs are like government permits that convey the right to do business, or are like liquor licenses. The deployed ERCs here are far different, though, because they provide the legal right to build and use real property as a power plant, and once deployed, they are identical in kind and effect to the many other types and varieties of governmental property use authorizations necessary to build and operate improvements to real property.

1. ERCs are similar to other government real property use authorizations such as building and operational permits, and are not government franchises.

As this Court stated in *California Portland Cement Co. v. State Bd. of Equalization* (1967) 67 Cal.2d 578, 584, "[I]ncome derived in large part from the enterprise activity may not be ascribed to the property being

appraised; instead, it is the earnings from the [taxable] property itself or from the beneficial use thereof which are to be considered." (Citing *Michael Todd, supra*, 57 Cal.2d 684, 696.)

Elk Hills claims that deployed ERCs are "like other government permits" that "convey the 'right to do business,' an intangible right the Board has repeatedly acknowledged is not subject to California property tax." (AOB 40.) Elk Hills also argues, "If the [Court of Appeal's] Decision is left intact, business taxpayers throughout the State of California are at risk of having their intangible rights – including franchises, concession rights, licenses and other intangibles granting the "right to do business" - assessed for property tax purposes." (AOB 49.) But these claims are legally unfounded and factually unsupported.

Elk Hills claims that under *County of Stanislaus v. Assessment Appeals Board, supra*, 213 Cal.App.3d 1445, the value of the ERCs must be deducted from the assessed value of its power plant. Contrary to Elk Hills' claim, though, *Stanislaus* reaffirms the general rule that although intangible assets are not separately taxable, the value they contribute to taxable property must be taken into consideration for assessment purposes. (*Id.* at p. 1455.) Although the *Stanislaus* court did require the assessor to disregard such income as might be attributable to "enterprise activity," that is inconsequential to Elk Hills' case because *Stanislaus* dealt with a cable television franchise that authorizes a company to engage in a certain business in a specified location in return for an annual franchise fee. (*Ibid.*; see also Gov. Code, § 53066.) ERCs, on the other hand, provide property use rights because they are necessary to obtain the building and operational permits for the tangible plant itself, and are clearly not related to an "enterprise activity," such as superior management skills or a valuable trade name, which add value to a business enterprise rather than to tangible property, The ERCs simply allow construction and use of a power plant

that is built with the capacity for a higher level of productivity and emissions. (Cal. Code of Regs., tit. 18, § 8) In addition, here there is no franchise and no franchise fee, and thus no provision of a "right to do business."

Moreover, *Stanislaus* actually undermines Elk Hills' position because it held that, although a "right to do business" was not taxable, the value contributed to taxable property by such an asset should nonetheless be considered in assessing the value of that taxable property. (*County of Stanislaus*, *supra*, 213 Cal.App.3d at pp. 1455-56.) Indeed, the *Stanislaus* court actually directed the assessor in that case on remand to *include* any income attributable to the "right to do business" as opposed to "enterprise activity." (*Id.* at p. 1456.)

The Board's position is also supported by *GTE Sprint*, *supra.* In *GTE Sprint*, the court held that although intangibles cannot be separately taxed, the market value concept required that certain intangible values be reflected in the valuation of taxable property. (*GTE Sprint v. County of Orange, supra,* 26 Cal.App.4th at pp. 1002-1003.) The intangibles at issue in *GTE Sprint*, however, included such business-related items as trade name, customer base, and assembled workforce, which are unrelated to property use. (*Id.* at p. 999.)

It is true, as this Court stated in *California Portland Cement Co. v. State Bd. of Equalization* (1967) 67 Cal.2d 578, 584, "[I]ncome derived in large part from the enterprise activity may not be ascribed to the property being appraised; instead, it is the earnings from the [taxable] property itself or from the beneficial use thereof which are to be considered." (Citing *Michael Todd, supra*, 57 Cal.2d 684, 696.) However, Elk Hills' attempt to categorize ERCs as a "right to do business" is factually flawed. The ERCs did not provide Elk Hills a franchise right to engage in the business of

power production, but instead, enabled the construction and operation of a power plant with the capacity to produce more power than it otherwise could produce given the technology it chose to use. Furthermore, there are many requirements before a power plant can be built and operated; the deploying of ERCs are just one such requirement.

The deployed ERCs, like other governmental property use authorizations, enabled Elk Hills to obtain the necessary building and operating permits for a power plant at a higher power production level without adding cleaner and more expensive pollution control equipment. (II CT 273-274.) Cleaner plants can operate with fewer or no ERCs. Thus, the deployed ERCs cannot be said to have been necessary to engage in the business; they were only required to obtain the necessary building and operating permits to build a cheaper, more polluting power plant without investing in more expensive clean equipment.

2. ERCs are not similar to liquor licenses.

Throughout this litigation, Elk Hills has incorrectly attempted to draw a comparison between liquor licenses and ERCs (and supposedly thus make them deductible from taxable value under *Roehm*). (AOB 20.) This position is odd in light of *Roehm's* holding that while a liquor license, as an intangible asset, cannot be separately taxed, the value added by intangibles to taxable property can be reflected in an assessment of that property. (*Roehm v. County of Orange, supra,* 32 Cal.2d 280, 285-86.) However, even if we were to accept Elk Hills' premise that a key holding of *Roehm* and its progeny can be disregarded, a liquor license differs from the ERCs here in very significant respects. The ERCs were necessary to obtain the permits to build and operate a power plant, which is real property. (II CT 274.) In contrast, a liquor license is not necessary to build real property, but only to sell alcohol at a specific location under the government's police

power. (Bus. & Prof. Code, § 23396.) As such, the legal rights provided by liquor licenses are different from the property rights provided by deployed ERCs in this case.

For example, selling alcohol without a license is a crime, but one can sell the real property upon which a licensed business operates without restriction and without also transferring the license. And, if an owner loses a liquor license, improvements to the property can still be occupied and used for another purpose, such as a grocery store. On the other hand, as Elk Hills has admitted, it cannot operate its power plant at the permitted emissions level or even sell its plant without the deployed ERCs. (AOB 9-10; II CT 274; II CT 348.)

Moreover, a retail structure may be built without a liquor license despite the fact that it is intended for use as a liquor store. On the other hand, construction of the power plant here could not have commenced prior to deploying the necessary ERCs. (II CT 274.)

II. REVENUE AND TAXATION CODE SECTION 110, SUBDIVISION (F), ALSO SUPPORTS THE JUDGMENT.

The trial court granted summary judgment for the Board under section 110, subdivision (f). Although the appellate court did not address the arguments regarding subdivision (f), the Board submits that it provides an alternative ground for affirming the decision of the Court of Appeal. (*Davey v. Southern Pacific Co.* (1897) 116 Cal. 325, 329 [Court of Appeal decision must be upheld if valid upon any legal theory].)

Section 110, subdivision (f), provides:

> For purposes of determining the 'full cash value' or 'fair market value' of real property, intangible attributes of real property shall be reflected in the value of the real property. These intangible attributes of real property include zoning, location, and other attributes that relate directly to the real property involved.

The trial court specifically found that the ERCs were necessary "to construct the power plant" and to "lawfully operate the power plant in accordance with state emissions requirements," and therefore that the ERCs were intangible attributes that "relate directly to the power plant real property." (Opinion, 13; IV CT 841-42.)

Elk Hills claims section 110, subdivision (f) is inapplicable here because "ERCs are not an 'attribute' of real property like zoning, location, architecture and view." (AOB 26.) Again, Elk Hills builds its argument by confusing one concept with another, equating an "attribute" of real property with inseparability from real property. But there is no support in the statute or in relevant cases under the statute for such a narrow interpretation.

Elk Hills mixes apples and oranges when it equates its concept of permanent attachment to a land parcel with the law's test of direct relation to property. Statutory construction begins with the language of the statute, affording the words their "ordinary and usual meaning and viewing them in their statutory context." (*Hassan v. Mercy American River Hospital* (2003) 31 Cal.4th 709, 715.) The statute's language is "relate directly," not "permanently attached;" thus, once again, the issue can be resolved by reference to the statutory language.

As of the assessment dates, the ERCs remained in direct relationship with the operating power plants being valued. As long as the ERCs are still applied to the power plant and its operating permits, and the power plant remains in operation, it cannot be seriously contended they do not directly relate to such power plant. As admitted by appellant and factually found by the courts below, Elk Hills could not have obtained a building permit, commenced construction, or operated the plant without deploying the ERCs. (II CT 273-274.) In fact, Elk Hills' attorney stated to the trial court, "I don't believe any buyer would pay [for the plant] what they would pay without those [ERCs], without having those included...." (I RT 24.) If and

when the plant is dismantled or replaced so as to disassociate the ERCs from the taxable property, the property would of course then be assessed without continuing to assume the presence of the ERCs. Until then, as long as ERCs are applied to an operating power plant, they relate directly to it.

Under the holding of *American Sheds, supra*, 66 Cal.App.4th 384, section 110, subdivision (f) provides an independent basis for assuming the presence of the ERCs in the assessment of Elk Hills' plant. The *American Sheds* court rejected a characterization of the facts remarkably similar to the one proffered here by Elk Hills. In *American Sheds*, the plaintiff alleged, similarly to Elk Hills, that intangible permits are not site specific within the meaning of section 110, subdivision (f), and that it was therefore erroneous to include the value added by those permits to the assessment of land on which they were used. (*American Sheds v. County of Los Angeles, supra* at p. 395.) The *American Sheds* court found, although the permits were held by the operators of the facility in question and did not legally attach to the land, there was a "practical connection between the permits and the property" bringing the permits under the ambit of section 110, subdivision (f). (*Ibid.*)

As in *American Sheds*, the permit in question here was used on a specific piece of property and thereby increased the productivity and value of such property. To say that such an asset "does not relate directly" to the property involved, whose use and operation it authorizes, is to give no meaning to the words of the statute. To accept Elk Hills' position in this appeal would, in effect, require a judicial repeal or amendment of section 110, subdivision (f).

Mitsui Fudosan v. County of L.A. (1990) 219 Cal.App.3d 525, also indicates that transferrable rights, once applied to specific real property, relate to and constitute an interest in that real property. In *Mitsui Fudosan*, Elk Hills encounters yet another obstacle to having its property assessed by

assuming the absence, rather than the presence, of those intangible rights necessary to use real property, such as those found in a permit to build and operate a power plant.

In *Mitsui Fudosan*, the taxpayer sued for a refund after being assessed for the value of transferable development rights (TDRs). The court dealt with a somewhat different question in *Mitsui Fudosan* – whether the sale of TDRs constituted a taxable event within the meaning of Proposition 13. In holding for the assessor, *Mitsui Fudosan* found that such sale of the TDRs was indeed a taxable event, because the TDRs themselves constituted an interest in real property. (*Mitsui Fudosan*, *supra*, 219 Cal.App.3d at p. 530.)

The relevance of *Mitsui Fudosan* lies in the fact that ERCs operate in a similar manner as TDRs to allow a "higher and better use" of the specific property on which they are deployed. Just as TDRs relate to a specific property when they are deployed to increase the allowed density on that property, ERCs relate to a specific property when they are deployed to build and operate a more polluting, more valuable power plant. The trial court in this case found *Mitsui Fudosan* to be relevant because it is not possible to reconcile *Mitsui Fudosan's* holding with Elk Hills' contention that ERCs are unrelated to property.

III. THE TAX BREAK SOUGHT BY ELK HILLS CONTRAVENES PUBLIC ENVIRONMENTAL POLICY.

Deducting the value of ERCs from property tax assessments will act as a counter incentive to pollution control technological innovation. If ERCs are deducted from the assessed value of a power plant, a tax incentive will be created favoring offset credits over the use of pollution control technology, thereby adversely affecting air quality.

According to the California Air Resources Board, the purpose of ERCs is to mitigate the air emission impact of new industrial growth.

Districts use the credits "as an alternative means to comply with district [air quality control] rules." (California Environmental Protection Agency Air Resources Board Initial Statement of Reasons for Rulemaking, Public Hearing to Consider Statewide Regulation That Provides a Methodology to Calculate the Value of Interchangeable Emission Reduction Credits, April 4, 1997, at 1.)

ERCs are intended, as a market-based mechanism, to achieve emission reductions "that would have occurred through compliance with certain district technology or performance-based regulatory requirements." (*Ibid.*) Excluding the value of ERCs in property taxation will distort the intended market mechanism and artificially incentivize their use in place of actual pollution reduction technologies; thus, defeating the intent of maximizing the efficient reduction of pollution in contravention of state policy.

The incentive to use ERCs *instead* of actual pollution reduction would be compounded by the comparative tax or economic disadvantage to which less-polluting competitors would be put under the new rule advocated by Elk Hills. Under the new rule that Elk Hills is asking this Court to propound, if there were two power plants, one which actually pollutes less by investing in environmentally superior technology and the other which instead uses ERCs to "offset" its pollution, only the less-polluting plant will be taxed at full value while the more-polluting plant will effectively receive a tax break unavailable to its less-polluting competitor. Such a result not only violates the Constitutional requirement to tax property at full value, it also undermines public environmental policy – the very policy ERCs were intended to promote. As the Court of Appeal aptly pointed out in this case:

> As a policy matter, we find it most unlikely the Legislature intended by its creation of the ERCs' statutory scheme, or by amending the statutes regarding the treatment of intangibles, essentially to provide a unitary tax deduction or tax credit for

> those power plant operators that cannot operate a plant at state accepted levels of admissions, but that instead must obtain ERCs through purchase or trade, to enable them to commence and continue operations at a higher level of emissions.

(Opinion, 39.)

With the recent adoption by our State of a "cap and trade" system for the control of pollution – a system that operates in a manner similar to the ERCs in this case – it is especially imperative that environmental policy not be undermined. The use of a market-based mechanism to control pollution presumes a level playing field, not a tax advantage for those who choose offset over those who reduce pollution.

CONCLUSION

The Board correctly assessed Elk Hills' taxable power plant property at fair market or full cash unitary value. The decision of the Court of Appeal should be affirmed.

Dated: February 17, 2012

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

I certify that the attached **RESPONDENTS BRIEF** uses a 13 point Times New Roman font and contains 11,126 words.

Dated: February 17, 2012

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California State Board of Equalization

DECLARATION OF SERVICE BY U.S. MAIL

Case Name: **Elk Hills Power v. CA State Board of Equalization, et al.**

No.: **S194121**

I declare:

I am employed in the Office of the Attorney General, which is the office of a member of the California State Bar, at which member's direction this service is made. I am 18 years of age or older and not a party to this matter. I am familiar with the business practice at the Office of the Attorney General for collection and processing of correspondence for mailing with the United States Postal Service. In accordance with that practice, correspondence placed in the internal mail collection system at the Office of the Attorney General is deposited with the United States Postal Service with postage thereon fully prepaid that same day in the ordinary course of business.

On February 17, 2012, I served the attached **ANSWER BRIEF ON THE MERITS** by placing a true copy thereof enclosed in a sealed envelope in the internal mail collection system at the Office of the Attorney General at 110 West A Street, Suite 1100, P.O. Box 85266, San Diego, CA 92186-5266, addressed as follows:

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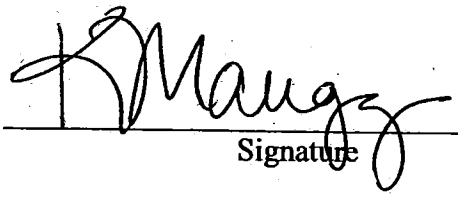
I declare under penalty of perjury under the laws of the State of California the foregoing is true and correct and that this declaration was executed on February 17, 2012, at San Diego, California.

K. Marugg
Declarant



Signature

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