No. S194121

IN THE

SUPREME COURT OF CALIFORNIA

ELK HILLS POWER, LLC,
Plaintiff and Appellant,

v.

CALIFORNIA STATE BOARD OF EQUALIZATION AND COUNTY OF KERN,
Defendants and Respondents.

After A Decision By The Court of Appeal
Fourth Appellate District, Division One, Case No. D056943,
San Diego Superior Court Case No. 37-2008-00097074-CU-MC-CTL

APPELLANT'S REPLY BRIEF ON THE MERITS

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

TABLE OF AUTHORITIES (cont'd)

Constitution and Statutes

Other Authorities

INTRODUCTION

Under California law, all intangible assets and rights are exempt from property taxation, regardless of whether they are necessary to the beneficial and productive use of taxable property. (Cal. Const. art. XIII, §2; Rev. and Tax. Code §§110 and §212.)[1] This Court has consistently upheld that constitutional exemption. (See *Roehm v. County of Orange ("Roehm")* (1948) 32 Cal.2d 280, 290; *Michael Todd v. County of Los Angeles ("Michael Todd")* (1962) 57 Cal.2d 684, 693; *De Luz Homes, Inc. v. County of San Diego ("De Luz Homes")* (1955) 45 Cal.2d 546, 565-66.) Curiously, while citing neighboring provisions of Article XIII of the Constitution, the Answer Brief on the Merits ("Answer Brief") of Defendant/Respondent California State Board of Equalization ("Board") never once cites Article XIII §2, the key constitutional provision at issue in this case, which prevents the taxation of intangible assets and rights for **property** tax purposes. It is this constitutional provision that precludes the Board from expressly including the value of intangible ERCs in its assessment of Plaintiff/Appellant Elk Hills Power, LLC's ("EHP") electric generation plant ("Plant").

Section 110 of the Revenue and Taxation Code explains how to determine "full cash value" for property tax purposes. Subdivision

[1] Undesignated statutory references are to the Revenue and Taxation Code.

110(d)(2) specifically mandates removing intangible value in cases of "unit valuation" where land, improvements and personal property are assessed together as a unit. In this case, which involves the unit valuation of EHP's Plant, the Board fails to analyze or even discuss this subdivision. Instead, the Board summarily dismisses Subdivision 110(d)(2), claiming it is "overridden" by Subdivision 110(e).

The court of appeal's (and Board's) fundamental error lies in their misinterpretation of three words found in Subdivision 110(e) – "assume the presence." "Assume the presence" means simply that the Board may assume the existence or "consider" the presence of intangible ERCs in valuing EHP's Plant at its "beneficial and productive use." (§110(e).) Pursuant to Subdivision 110(e), EHP's Plant should be valued as a functioning power plant, rather than at salvage or scrap value. Subdivision 110(e) is thus a codification of this Court's decision in *Michael Todd*, where this Court held that productive property should be valued at its beneficial and productive use.[2] (*Michael Todd,* 57 Cal.2d at p.696.)

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[2] In its brief, the Board misstates the facts and holding from *Michael Todd,* alleging that the copyright "**added value to the property**," *i.e.*, the motion picture film negative. (Answer Brief, p.19) To the contrary, the Los Angeles County Assessor "considered" the copyright, but did not add a value component for it. In fact, the Assessor "stipulated at the trial that '[plaintiff's] interest in the property by reason of having the copyright was considered in determining the value of the property that was assessed'; and that if plaintiff had had no copyright the negatives would have had a 'salvage value' of $1,000." (*Michael Todd,* 57 Cal.2d at pp.688-89.)

The court of appeal misinterpreted the words "assume the presence" to mean "add the value." But the word "assume" is not synonymous with "add" and the word "presence" is not synonymous with "value." These words and phrases have different meanings and cannot be interchanged. As the Board succinctly states in its own publication, *Assessors' Handbook* 502 (Advanced Appraisal), "[a]lthough the presence of the intangible assets are assumed in the valuation of the tangible property, this does not mean that their values are included in that valuation." (1 CT 153, emphasis added.) Contrary to the Board's argument and the court of appeal's opinion, Subdivision 110(e) does not permit the Board to add the value of intangible ERCs into the assessment of EHP's tangible property.[3]

The Board sidesteps the core issue in this case by devoting much of its Answer Brief to the presentation of an argument that EHP does not dispute, repeatedly stating that a taxing authority may "consider" intangible assets and rights in valuing taxable tangible property. EHP agrees. The

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[3] The Board attempts to limit the reach of the court of appeal's opinion in this case in a way not supported by Section 110, arguing that what it calls "business enterprise intangibles" – which include franchises, concession rights, cable licenses, and liquor licenses – are "unrelated to the use or value of taxable tangible property," and that Subdivision 110(e) does not apply to these assets. (Answer Brief, pp.24-25.) However, these so-called "business enterprise intangibles" are necessary to the beneficial and productive use of tangible property just as ERCs. Therefore, their presence may be assumed under Subdivision 110(e), but their value must still be excluded from assessment under Subdivision 110(d).

Board may consider ERCs in valuing EHP's Plant. The problem with the Board's position is that the undisputed facts of this case prove that it did not merely "consider" (or "assume the presence") of intangible ERCs. Instead, the Board expressly added the replacement cost of the ERCs into the unit valuation of EHP's Plant for each tax year at issue.

Finally, the Board argues that its actions in expressly adding the replacement cost of ERCs to the valuation of EHP's Plant are consistent with "judicial precedent stretching back over 60 years." (Answer Brief, p.18.) The opposite is true. Prior to the court of appeal's decision in this case, there has never been a California appellate decision in which a taxing authority has identified the value of a specific intangible asset and expressly added that value to the assessment of tangible property. The cases relied upon by the Board do permit "consideration" of intangible assets, but none of them authorize "adding" the value of intangible assets to the assessment of taxable property as happened here. Hence, contrary to the Board's characterization, the issue in this case is not whether intangible ERCs can be "considered" in assessing the Plant. Instead, the issue is whether the value of the ERCs themselves – their replacement cost – can be added to the Plant's assessment. The answer under both the Constitution and Section 110 is a resounding "NO."

ARGUMENT

I. THE COURT OF APPEAL'S DECISION IGNORES THE CONSTITUTION AND SUBDIVISION 110(d)(2).

As this Court has repeatedly held, statutes should be interpreted in a manner that is consistent with the Constitution. (*In re Howard* (2005) 35 Cal.4th 117, 132; *Estate of Hofferber* (1980) 28 Cal.3d 161, 175.)

> If a statute is susceptible of two constructions, one of which will render it constitutional and the other unconstitutional in whole or in part, or raise serious and doubtful constitutional questions, the court will adopt the construction which, without doing violence to the reasonable meaning of the language used, will render it valid in its entirety, or free from doubt as to its constitutionality, even though the other construction is equally reasonable. The basis of this rule is the presumption that the Legislature intended not to violate the Constitution, but to enact a valid statute within the scope of its constitutional powers.

(*Conservatorship of Wendland* (2001) 26 Cal.4th 519, 548 [citations omitted].)

Therefore, the basic premise from which this Court should begin its application of Section 110 is the broad exemption from property taxation for intangible property rights set forth in the Constitution. (Cal. Const. art. XIII, §2.) Pursuant to Article XIII, §2, the Legislature is granted authority to tax tangible property, but it is not granted the right to tax intangible assets and rights other than those specifically enumerated in Article XIII, §2. As this Court stated many years ago in *Roehm*, Article XIII, §14 (now codified as Article XIII, §2) "is a grant of power to the Legislature to

provide for the assessment, levy, and collection of taxes, but it does not grant power to provide for the taxation of intangible assets other than those listed [in Article XIII, §14]." (*Roehm*, 32 Cal.2d at p.285.)

In its own publication, *Assessors' Handbook* 502 (Advanced Appraisal), the Board describes the exemption for intangible assets and rights as follows:

> Under article XIII, section 2 of the California Constitution, only the specific items of intangible personal property listed in that section may be subject to property tax. The Legislature may provide for the property taxation of these items of intangible personal property, which include notes, debentures, shares of capital stock, bonds, solvent credits, deeds of trust, mortgages, and any legal or equitable interest therein. **The Legislature may not provide for the property taxation of any other type of intangible personal property**.

(1 CT 151, emphasis added.)[4]

Significantly, the Board does not once cite to the above-quoted section entitled: "Treatment of Intangible Assets and Rights." (1 CT 151-66, *Assessors' Handbook* 502, Advanced Appraisal, Chapter 6, pages 150–165.) In fact, the position taken by the Board in that chapter expressly contradicts the Board's position here. (*Ibid.*) While the Board ignores this

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[4] "Assessors' handbooks have been relied upon by courts and been accorded great weight in the interpretation of valuation questions." (*Watson Cogeneration Co. v. County of Los Angeles ("Watson Cogeneration")* (2002) 98 Cal.App.4th 1066, 1070, fn.2 [*citing CAT Partnership v. County of Santa Cruz* (1998) 63 Cal.App.4th 1071, 1085, fn.12; *Prudential Ins. Co. v. City and County of San Francisco* (1987) 191 Cal.App.3d 1142, 1155].)

key section from its own Handbook, the Board does cite to its other publications to explain general appraisal concepts. (Answer Brief, pp.4-5 [citing the *State Assessment Manual* to explain the cost and income approaches to value]; Answer Brief, p.8 [citing *Assessors' Handbook* 501 to define "highest and best use"].) The Board's selectivity in disregarding its own official positions, which directly contradict arguments in the Answer Brief, is telling.[5]

The Board also ignores Article XIII, §2 of the Constitution in its brief, but it repeatedly cites Article XIII, §§1 and §19, which require that property be assessed at fair market value. The Board argues that "[t]hese rules are clarified and implemented by section 110." (Answer Brief, p.8.) EHP agrees that its taxable, tangible property should be assessed at fair market value. Nevertheless, EHP's unitary assessment must still exclude the value of nontaxable, intangible assets and rights.

Just as Section 110 "clarifies and implements" Article XIII, §§1 and 19 of the Constitution, it also clarifies and implements Article XIII, §2. Specifically, it explains how to remove value associated with intangible

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[5] The Board also disregards the legal analysis of its current Executive Director, Kristine Cazadd, who warned that: "The current staff policy of treating ERCs as *intangible attributes* and including them in the taxable value of any property (including electric generation facilities) violates the Constitution and statutory law." (1 CT 209, emphasis added.)

assets and rights when determining the fair market value of tangible property. (§110(d).) While the Board's brief cites frequently to Subdivisions 110(e) and 110(f), it fails altogether to address the application of Subdivision 110(d)(2), the key provision mandating the removal of intangible value from unit valuation. That provision unambiguously requires that the value of intangible assets or rights "shall" be excluded:

> 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(d)(2), emphasis added.)

In its brief, the Board repeatedly points out that Article XIII, §19 of the Constitution requires it to value EHP's plant on a unitary basis. (Answer Brief, pp.1, 8-9.) EHP has never disputed that point. Indeed, the fact that EHP's property is subject to unit valuation renders Subdivision 110(d)(2) directly applicable to the resolution of this case. It is this statutory subdivision – Subdivision 110(d)(2) – which this Court should focus upon in deciding this case.

A. The Board Admits Facts Evidencing Its Failure To Comply With Subdivision 110(d)(2).

In its brief, the Board admits two key facts, both of which establish that it ignored the mandate of Subdivision 110(d)(2) to remove intangible

value from the unit valuation of EHP's Plant. First, the Board admits that in determining the value of EHP's Plant using the cost approach, it "included standard estimated replacement costs for the deployed ERCs." (Answer Brief, p.17.) Thus, the Board deliberately added the replacement cost of intangible ERCs to its assessments of the Plant. The following table illustrates the dollar value for ERCs the Board expressly added to its calculation of the replacement cost of EHP's Plant in each tax year.

Tax Year	2004	2005	2006	2007	2008
ERC Cost*	$2,943,000	$2,825,280	$2,736,990	$9,262,426	$8,973,425

*These figures represent the cost of the ERCs after applying depreciation. (3 CT 516.)

Second, the Board acknowledges that "[w]ith respect to the CEA approach, it 'calculated the income indicator without any deduction for applied ERCs."[6] (Answer Brief, p.5, emphasis added.) In doing so, the Board ignored its own prescribed methodology for removing the value of intangibles when valuing unitary property using the income approach. This methodology was developed in the wake of the 1995 amendments to Section 110 and it is set forth in the Board's publication, "Unitary Valuation Methods." (3 CT 530-33.)

Notwithstanding these two key factual admissions, the Board asserts:

[6] CEA stands for "capitalized earning ability," which is a recognized approach used to value property based on its ability to produce income.

> 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 (sic) [cost] valuation approach, the Board properly included standard estimated replacement costs for the deployed ERCs . . . .

(Answer Brief, p.16-17.) This argument is specious. "Replacement cost" is the method of valuation selected by the Board.[7]

Under the replacement cost method, all real and personal property associated with EHP's Plant (excluding land) was valued at what the Board determined it would cost to "replace" those assets as of each date of valuation. None of the Plant property – including ERCs – was valued at its actual cost. If valuing property at its "replacement cost" does not equate to assessment or taxation of property as the Board asserts in its brief, then none of EHP's property, whether tangible or intangible, was assessed. Of course, this is not the case. The replacement cost methodology is a widely-used and generally-accepted appraisal technique. It is one of several ways to estimate or measure value. Its use by the Board in this case neither invalidates the assessment of EHP's tangible property nor justifies its assessment of EHP's intangible ERCs.

The Board admits it added a line-item for the "replacement cost" of intangible ERCs to its cost approach. The fact that ERCs were valued at

[7] Replacement cost is one of several methods for valuing property using a cost approach, which can also be calculated using other starting points, such as original cost, book cost, historic cost, or reproduction cost.

their "replacement cost" rather than "actual cost" is irrelevant. The express addition of ERC replacement costs to EHP's tax valuations constitutes the assessment of nontaxable, intangible property, in contravention of California law.

B. The Exemption For Intangible Assets And Rights Arises Under The Constitution, Not Section 110.

It is the Constitution – not Section 110 – that exempts intangible assets and rights from property taxation. In its brief, the Board argues that Section 110 is an "exemption statute," and, therefore, the statute should be strictly construed against the taxpayer. (Answer Brief, pp.12-13.) Contrary to what the Board now argues, Section 110 is a taxing statute. As such, the applicable canon of construction is that any ambiguity the Court perceives in Section 110 should be resolved in favor of the taxpayer. (*California Motor Transp. Co. v. State Board of Equalization* (1948) 31 Cal.2d 217, 223-24 ["In case of doubt, construction is to favor the taxpayer rather than the government."].)

Unquestionably, Section 110 is not an exemption statute.[8] Rather, Section 110 explains how to determine the "full cash value" for property tax purposes. Specifically, Subdivisions 110(d), (e) and (f) implement the pre-existing constitutional exemption for intangible assets and rights, in

[8] In fact, the Board conceded below that Section 110 is not an exemption statute: "While the Board does not agree that section 110 of the Revenue and Taxation Code involves a tax exemption . . . ." (4 CT 851:15-16.)

accordance with this Court's holdings in *Roehm* and *Michael Todd*, by explaining how to determine "full cash value" when associated intangible assets and rights are present.[9]

C. Public Policy Supports The Constitutional Exemption For Intangible Assets and Rights.

In *Roehm*, this Court based its decision, in part, on recognizing the fundamental distinction between "income" tax, which is intended to capture value attributable to intangible rights, and "property" tax, which is intended to capture value attributable to tangible property. (See *Roehm,* 32 Cal.2d at p.289.) As this Court explained, the value of intangible assets and rights is properly taxed through the **income** tax system. (*Ibid.*)

Indeed, the income of a *business* is often dependent upon possession of intangible assets and rights. A cable television company's income is dependent upon its intangible franchise agreement. An airport concession company's income is dependent upon its intangible concession agreement. Likewise, EHP's income is dependent upon its ownership of ERCs, which permit the Plant to operate at optimum levels. That income is taxed through the income tax system.

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[9] In the last section of its brief, the Board also argues that EHP is seeking a "tax break." (Answer Brief, p.32.) This is a complete mischaracterization of EHP's position. EHP is not asking this Court to create a "tax break." To the contrary, EHP is asking this Court to uphold and enforce the longstanding constitutional exemption from property taxation for intangible rights, as implemented by the plain language of Section 110(d).

Moreover, as this Court explained in *Roehm*, the taxation of intangible assets and rights through the property tax system would create significant administrative problems. (See *id.* at pp.288-89.) In *Roehm,* this Court quoted and relied upon a report authored by the California Tax Commission:

> The Commission is convinced that the taxation of such property [intangible assets and rights] at full valuation and at the full rate is an **administrative impossibility and an ethical monstrosity**. To extend special treatment to such property is, in its opinion, a **practical necessity**.

(*Id.* at p.288, emphasis added.)

As this Court recognized in *Roehm*, property taxation of intangibles raises the specter of double-taxation (*i.e.*, taxing a business' intangibles via the income tax and then taxing those same intangibles again via the property tax). In turn, this could impose significant burdens on those charged with administering laws that are focused solely on the taxation of tangible property. Indeed, the property taxation of intangible assets and rights would – as it has here – lead to numerous disputes before administrative tribunals and in the courts, with the attendant uncertainty that surrounds litigation. Hence, sound public policy is at the core of this Court's recognition in *Roehm* of the practical reasons for upholding the constitutional exemption in Article XIII, §2.

II. THE COURT OF APPEAL MISCONSTRUED SECTION 110.

A. The Decision Misinterprets "Assume The Presence" In Subdivision 110(e) To Mean "Add The Value."

The key phrase relied upon by the court of appeal and defended by the Board in its brief – "assume the presence" – is found in Subdivision 110(e). (Decision, p.40.) These words emanate from *Michael Todd*, in which this Court recognized that, for property tax purposes, productive property (ownership of a film and associated copyrights) should be differentiated from unproductive property (ownership of a film without an associated copyright), holding that (1) productive property should be valued based on its beneficial and productive use; and (2) unproductive property should be assessed at salvage value. (*Michael Todd*, 57 Cal.2d at p.696-98.) This Court wrote, "'market value' for assessment purposes is the value of property when put to beneficial or productive use; it is not merely whatever residual value may remain after the property is demolished, melted down, or otherwise reduced to its constituent elements." (*Id.* at p.696.)

Subdivision 110(e) thus codifies this Court's holding in *Michael Todd*, permitting "consideration" of intangible rights in order to value property at its beneficial and productive use. The legislative history of the 1995 amendments to Section 110 also sheds light on the meaning of "assume the presence." These amendments post-date the vast majority of

cases addressing the property tax treatment of intangible assets and rights. As the Board acknowledges in its brief, the Legislature intended the 1995 amendments "to reflect preexisting law." (Answer Brief, p.13.)

Senator Maddy, the author of these amendments, explained the meaning of Subdivision 110(e) as follows:

> The bill provides that the intangible assets and rights relating to the going concern (such as goodwill and trade names) are not to be reflected in the value of property. However, **under subdivision (e) of Section 110** of the Revenue and Taxation Code as added by the bill, property may be valued **assuming the existence** of intangible assets necessary to put the property to productive use. **This subdivision makes it clear that property need not be valued at salvage value but at its value when put to beneficial or productive use.** For example, under the terms of the bill, an assessor could not use a liquor license to enhance the value of taxable property. However, the assessor may assume the presence of a license so that a bar's taxable property may be taxed as a bar and not at salvage value (i.e., as a warehouse).

(2 CT 450, emphasis added.)

In assessing EHP's Plant, the Board failed to apply this correct interpretation of Subdivision 110(e). There is a stark difference between "assuming the presence" of intangible rights for purposes of valuing property at its beneficial and productive use – which Subdivision 110(e) permits – and "adding the value" of those same intangible rights – which contravenes settled California law.

In *County of Los Angeles v. Southern California Edison Co.* (2003) 112 Cal.App.4th 1108, a case that post-dates the 1995 amendments and

involved the valuation of a locally-assessed electric generation facility, the Second District explained the distinction between these two concepts:

> County contends the real property value should **include the value** of operating permits and intangible assets essential to the operation of a plant and the going concern value of the plants as businesses. County cites no authority for these arguments.
>
> . . . . **Property is valued for purposes of property tax by assuming the presence of intangible assets necessary to put the property to productive use, but excluding the value of those intangible assets,** and also excluding the value of intangible assets relating to the going concern value of a business (Rev.&Tax. Code §§110, subds. (d), (e), 212, subd. (c).)

(*Id.* at p.1122, emphasis added.)[10]

Likewise, *Assessors' Handbook* 502 (Advanced Appraisal), interpreting the 1995 amendments to Section 110, articulates the difference between "assume the presence" and "include the value":

> **Sections 110(e) and 212(c) do not authorize adding an increment to** the value of taxable property to reflect the value of intangible assets and rights necessary to put the taxable property to beneficial or productive use. Instead, these sections indicate that, in valuing taxable property, it is appropriate to **assume the presence** of the intangible assets and rights which are necessary to put taxable property to beneficial or productive use. For example, a business which owns taxable property may need . . . intangible assets in order to productively use its tangible property. **Although the presence of the intangible assets are assumed** in the

[10] Although *Southern California Edison* involved valuation for documentary transfer tax purposes (rather than property tax), its reasoning, which was expressly based on Section 110, is relevant and applicable here.

> valuation of the tangible property, **this does not mean that their values are included in that valuation.**

(1 CT 153, emphasis added.)

Applying these principles, it is entirely proper for the Board to value EHP's unitary property at its beneficial and productive use – as an independent electric generation facility – and to "assume the presence" of ERCs, just as subdivision 110(e) allows. However, the Board cannot expressly add the replacement cost of ERCs to its assessment of EHP's Plant. The Board's actions here in adding the value of ERCs to the unit assessment of the Plant violates Article XIII, §2 of the Constitution and Section 110.[11]

B. The Court of Appeal's Interpretation Of Subdivision 110(e) Violates Rules Of Statutory Construction.

This Court has articulated a key tenet of statutory construction:

> It is a settled principle of statutory construction, that courts should "strive to give meaning to every word in a statute and to avoid constructions that render words, phrases or clauses superfluous." . . . **We harmonize statutory provisions, if possible, giving each provision full effect**.

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[11] The Board relies upon *ITT World Communications, Inc. v. City and County of San Francisco* (1985) 37 Cal.3d 859, to argue that when valuing unitary property of a public utility, the Board is permitted to include the value of intangible assets and rights. (Answer Brief, pp.1, 9.) However, *ITT* pre-dates the 1995 amendments to Section 110 at issue herein. Moreover, the language relied upon by the Board from *ITT* is pure dicta. The only dispositive issue in *ITT* was whether Proposition 13 applied to unit taxation. (See *id.* at p.862.) Accordingly, *ITT* was not a case that dealt with the taxation of intangible rights as the Board implies.

(*In re C.H.* (2011) 53 Cal.4th 94, 103, citations omitted, emphasis added.) EHP's interpretation of Section 110 harmonizes the key subdivisions at issue here, just as the canons of statutory construction require.[12]

To summarize EHP's position, Subdivision 110(e) first provides that the presence of the intangible ERCs may be "assumed" in valuing the property at its beneficial and productive use, *i.e.* as a functioning electric generation plant. (§110(e).) Then, notwithstanding the "consideration" of intangibles allowed by Subdivision 110(e), the value of intangible ERCs must still be removed from the assessment of EHP's unitary property, as required by Subdivision 110(d)(2). (§110(d)(2).) Finally, ERCs do not fall

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[12] The relevant subdivisions of Section 110 provide:

(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**:

. . .

(2) If the principle of **unit valuation** is used to value properties that are operated as a unit and the unit includes intangible assets and rights, then the fair market value of the taxable property contained within the unit **shall be determined by removing from the value of the unit the fair market value of the intangible assets and rights contained within the unit**.

. . .

(e) Taxable property may be assessed and valued by **assuming the presence of** intangible assets or rights necessary to put the taxable property to beneficial or productive use.

(f) 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**.

(§110(d),(e) and (f), emphasis added.)

under Subdivision 110(f) because they are not "attributes of real property" like zoning and location. (§110(f).) So construed, these three subdivisions of the same statute coexist in perfect harmony.

Applying this interpretation to ERCs, under Subdivision 110(e), the ERCs are first "considered" in valuing the Plant at its beneficial and productive use. Nevertheless, under Subdivision 110(d)(2), the identified value of the intangible ERCs must then be removed from the unit valuation of the Plant. Lastly, Subdivision 110(f) does not apply to ERCs because they are not intrinsic to real property (like "location"), and they do not run with the land (like "zoning").[13]

Conversely, the court of appeal's interpretation of Section 110, which the Board defends in its brief, completely fails to give meaning to Subdivision 110(d), the key provision that implements the constitutional exemption for intangibles. This violates the rules of statutory construction. Indeed, under the court of appeal's interpretation, Subdivision 110(e)'s "assume the presence" language would ***always*** override Subdivision 110(d)

[13] Moreover, even if ERCs could be considered an "intangible attribute" of real property, they could only be "reflected" in the value of property. (§110(f).) Interestingly, one pertinent dictionary definition of "reflect" is: "to consider." (See http://www.merriam-webster.com/dictionary/reflect.) That meaning is also consistent with the meaning of the phrase "assume the presence" in Subdivision 110(e), thus fully harmonizing these provisions with the removal of intangibles mandated by Subdivision 110(d).

whenever an intangible was deemed "necessary" to the productive use of property. This would render Subdivision 110(d) meaningless.[14]

Specifically, the court of appeal misconstrues the introductory clause of Subdivision 110(d) – **"[e]xcept as provided in subdivision (e)**" in such a way as to promote Subdivision 110(e) to mean more than its instruction that all property must be valued at its beneficial and productive use. That interpretation negates Subdivision 110(d) – the provision that implements the constitutional exemption of intangible assets and rights from property taxation. Clearly, the introductory phrase in Subdivision 110(d) merely preserves the overriding proviso that when intangibles are necessary for the beneficial and productive use of tangible property, the *presence* of those intangibles may be *assumed* in assessing such property.

For example, it is *assumed* that a business selling alcohol will obtain a liquor license. Similarly, it is *assumed* that a motion picture is copyrighted. It is also *assumed* that a cable television company possesses a franchise. Likewise, it is *assumed* that a power plant will obtain ERCs. Notwithstanding these *assumptions*, the intangible rights must still be excluded when assessing the tangible property per Subdivision 110(d).

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[14] The Board argues alternatively for the application of Subdivision 110(f), but its overbroad interpretation of what constitutes an "attribute of real property" would also effectively nullify Subdivision 110(d) here.

This Court must construe Section 110 as a whole, giving meaning to all its subdivisions, and it must do so in a way that is consistent with Article XIII, §2 of the Constitution. EHP submits that Section 110 can only be harmonized by "assuming the presence" of ERCs to assess the property at its beneficial and productive use as a power plant, and then excluding the value of ERCs from the Board's unit valuation of the Plant.

C. The Board Concedes That "Some" Intangibles Are Exempt Under Subdivision 110(d) – Just Not ERCs.

Subdivision 110(d)(2) codified the First District's decision in *GTE Sprint Communications Corp. v. County of Alameda* ("*GTE Sprint*") (1994) 26 Cal.App.4th 992, a case which involved the unit valuation of a state-assessee, and which pre-dated the 1995 amendments by one year. In *GTE Sprint,* the Board ignored evidence presented by the taxpayer identifying and valuing its intangible assets. (See *id.* at p.999.) The First District found the Board's actions were improper, and concluded that "the Board's appraisers are required by law to **identify** and **value** intangible assets, if any, and **exclude** these values from the appraisal of the taxpayer's property." (*Ibid,* emphasis added.)

The Board attempts to distinguish the present case from *GTE Sprint,* as well as from *Service America Corp. v. County of San Diego County* (*"Service America"*) (1993) 15 Cal.App.4th 1232, and *County of Orange v. Orange County Assessment Appeals Bd.* (*"County of Orange"*) (1993) 13

Cal.App.4th 524, by arguing that those cases involved what the Board now calls "business enterprise intangibles," and claiming that such intangible rights are "unrelated to the use or value of taxable tangible property." (Answer Brief, p.24.) According to the Board's reasoning, "business enterprise intangibles" fall only under Subdivision 110(d) and Subdivision 110(e) does not apply to them. (See *id.* at p.25.)

The Board's analysis is seriously flawed. Under the Board's interpretation of Section 110, some intangible assets and rights can be excluded from property tax assessment under Subdivision 110(d), but not ERCs. Ostensibly, ERCs are subject to Subdivision 110(e), but that subdivision does not apply to "business enterprise intangibles." (*Ibid.*) By implication, the Board thus incorrectly argues that the court of appeal's decision does not apply to "business enterprise intangibles."

What the Board terms "business enterprise intangibles," including franchises, concession rights, cable licenses, and liquor licenses, are all equally "necessary to the beneficial and productive use" of the tangible property they are associated with, just as ERCs are to the Plant. Subdivision 110(e)'s requirement that all intangible rights necessary to the beneficial and productive use of taxable property may be "considered" in valuing tangible real or personal property, clearly extends to all property in California, not just ERCs. (E.g., *Michael Todd*, 57 Cal.2d p.696.)

Indeed, Senator Maddy used a liquor license (a classic "business enterprise intangible") as his example of an intangible asset the "presence" of which may be "assumed" under Subdivision 110(e). (2 CT 450 ["For example, under the terms of the bill, an assessor could not use a liquor license to enhance the value of taxable property. However, the assessor may assume the presence of a license so that a bar's taxable property may be taxed as a bar and not at salvage value (i.e., as a warehouse)."].) A series of precedents make it clear that the same is true of franchises, concession rights and other types of licenses that allow a taxpayer to operate its business.

Contrary to the Board's argument, so-called "business enterprise intangibles" are unquestionably necessary to the beneficial and productive use of taxable property. As such, Subdivision 110(e) extends to these intangible assets and rights just as it applies to all California property, which must be valued at its beneficial and productive use. For example, a franchise is necessary to the beneficial and productive use of a cable television company's tangible property and its presence may be "assumed" in the valuation of such property. (See, e.g., *County of Orange,* 13 Cal.App.4th at p.533-34.) Likewise, a concession agreement is necessary to the beneficial and productive use of a stadium food and beverage franchisee's taxable tangible property, and its presence may be "assumed"

in valuing the tangible property. (See, e.g., *Service America*, 15 Cal.App.4th at p.1242.) Similarly, it would be difficult to operate a wireless phone company without a license from the FCC. (See, e.g., *Los Angeles SMSA Ltd. Partnership v. State Board of Equalization ("Los Angeles SMSA")* (1992) 11 Cal.App.4th 768, 777.) Therefore, these "business enterprise intangibles" may also be assumed under Subdivision 110(e), but their value must nevertheless be removed under Subdivision 110(d). As discussed in Section III below, the same is true of ERCs.

The Constitution and Section 110 do not draw the distinction argued by the Board between "business enterprise intangibles" and ERCs. Under California law, the presence of all intangibles "necessary to the beneficial and productive use" of tangible property may be assumed under Subdivision 110(e), but the value of those intangibles must still be removed under Subdivision 110(d). In this case, the court of appeal's erroneous holding arguably extends to so-called "business enterprise intangibles," rendering them subject to property tax assessment for the first time. Indeed, it is the widespread recognition that the court of appeal's decision could result in assessment of a broad spectrum of intangible assets and

rights that prompted so many business taxpayers to support review of that decision by this Court.[15]

III. ERCS ARE NOT ANALOGOUS TO BUILDING PERMITS.

In its brief, the Board argues that ERCs are analogous to building permits and from this premise it asserts that ERCs are subsumed into EHP's tangible taxable property. (Answer Brief, pp.25-26.) The Board is wrong.

Whereas building permits are a pre-condition of construction, ERCs are not. In fact, while some of the ERCs issued by the San Joaquin Valley Air Pollution Control District for this Plant were issued prior to the commencement of operations, other ERCs were not issued until after commencement of operations. (2 CT 289-93.) Clearly, ERCs were not required for construction, as the Board implies.[16]

In making this argument, the Board repeatedly and improperly conflates "construction" and "operation." (Answering Brief, pp.25-28.) It is clear that constructing a power plant and operating a power plant are distinct activities. ERCs are analogous to operating permits, not building

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[15] There were twelve separate *amicus curiae* letters submitted in support of EHP's Petition for Review in this case.

[16] The Los Angeles County Assessor has already filed an *amicus curiae* brief, arguing that ERCs are a "direct or indirect cost of construction," and asserting that the Plant "came on line on July 23, 2003." (Amicus Brief, at p.2.) EHP will respond to that *amicus* brief in due course. For now, EHP emphatically asserts that ERCs are not a cost of construction.

permits. Operating permits are a cost of doing business, not a cost of construction.

According to statute, ERCs are a fungible and interchangeable form of currency that permit a plant operator to emit specified levels of emissions into the atmosphere during the course of operating the plant. (Health and Safety Code §§40709(a), 40711(a), §40711(b) ["Approved emission reductions may be transferred in whole or in part by written conveyance or by operation of law from one person to another."].) ERCs thus relate to emissions resulting from plant operation, not plant construction.

The Board recently filed a motion asking this Court to take "judicial notice" of the California Environmental Protection Agency Air Resources Board's April 4, 1997 document proposing a statewide regulation to provide a methodology to calculate the value of "Interchangeable Emission Reduction Credits." EHP did not object to the Board's request, in part because this document clearly describes ERCs as a form of "**uniform currency**" that can be "used by the generator, **traded** for use by another source, or **retained in the bank** for future use." (Motion for Judicial Notice, Exhibit A, p.6, emphasis added.)

This document goes on to explain that the transfer of credits among operators "may stimulate the development of a **credit market** based on the

expected demand for credits to comply with district requirements . . . ." (*Id.* at p.14, emphasis added.) Indeed, that is exactly what has happened. A credit market for ERCs has emerged and ERCs can now be bought, sold and traded on the credit market. Not surprisingly, no such market exists for selling building permits.[17]

Likewise, in this case, if technology was to improve, resulting in reduced emissions, or if EHP's Plant was shut-down, the ERCs at issue could be "re-banked" and "sold" to an unrelated third party. (2 CT 340, San Joaquin Valley Air Pollution Control District Rule 2301, §4.3.) In contrast, the cost of a building permit can never be recovered; it is a "sunk cost" of construction.

In addition, EHP could choose to lease or temporarily transfer its ERCs to another party. (2 CT 344, San Joaquin Valley Air Pollution Control District Rule 2301, §7.3 ["Nothing in this rule prevents the lease or temporary transfer, in whole or in part of, ERCs represented by ERC certificates."].) Conversely, a building permit cannot be "leased" or

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[17] To illustrate that ERCs are "banked" and "sold" in the market, at oral argument in the trial court, counsel for EHP raised the example of a company known as Flying J, Inc., which operated an oil refinery in Bakersfield. (4 CT 793.) As a result of improved technology at that refinery, Flying J was able to lower its emissions and "bank" a large number of ERCs. (*Ibid.*) Those banked ERCs were sold years later to another energy company operating a different plant for more than twelve million dollars. (*Ibid.*) The sale, which followed submission of bids from multiple companies, was approved by the U.S. Bankruptcy Court. (*Ibid.*)

"temporarily transferred" to another party. It is appurtenant to a specific piece of real property. Once the building is constructed, the building permit loses its identity as a separate intangible asset and becomes subsumed into and part of the real property. In contrast, ERCs never lose their identity as a separate intangible asset and are not subsumed into real property.

In summary, building permits are a cost of construction because they relate to a specific parcel of real property and they are appurtenant to and "run with" the land. Building permits do not have an identity or a value separate from the real property itself. They cannot be banked, traded or sold, and there is no "credit market" for building permits. Hence, ERCs are nothing like building permits. They are neither a direct nor an indirect cost of construction. Rather, ERCs confer the right to **operate** an electric generation plant. As such, they are comparable to liquor licenses, franchises and concession rights that grant the "right to do business."[18]

[18] Contrary to the Board's characterization of EHP as a "polluter" (Answer Brief, p.28), EHP's Plant, which burns natural gas utilizing "combined-cycle" technology, is one of the cleanest and most efficient sources of electric power-generation in the world, fully complying with all California emission standards. Moreover, the Board's allegation that EHP chose to purchase ERCs rather than investing in the very best technology to build the Plant is false. (*Ibid.*) It is undisputed that EHP "had to" **both** install **all** the "Best Available Control Technology" ("BACT"), **and also** purchase ERCs in order to operate the Plant at its present capacity. (3 CT 601.)

IV. THE BOARD MISCONSTRUES EXISTING CASE LAW.

A. The Board Misrepresents The Facts And Holding From *Michael Todd.*

Three times, during the past sixty-plus years, this Court has upheld the constitutional exemption for intangible assets and rights. (See *Roehm*, 32 Cal.2d at p.290 [upholding the property tax exemption for an intangible liquor license]; *Michael Todd,* 57 Cal.2d at p.693 [upholding the property tax exemption for an intangible copyright]; *De Luz Homes,* 45 Cal.2d at pp.565-66 [upholding the property tax exemption for intangible business enterprise value].) Despite the Board's suggestion to the contrary, neither *Roehm* nor *Michael Todd* can be interpreted to permit a taxing authority to add intangible value to the assessment of tangible taxable property. (Answer Brief, pp.19-20.)

In *Michael Todd*, the Los Angeles County Assessor used a cost approach to value the motion picture "Around the World in 80 Days." (*Michael Todd*, 57 Cal.2d at p.697.) The cost approach was based on the production cost of the film negatives, minus depreciation, exclusive of intangibles, most notably, exclusive of the value of the intangible copyright. (See *id.* at p.689.) In *Michael Todd*, the County Assessor expressly stipulated that the underlying "assessment **did not include as such any of the intangible copyright interests which plaintiff had with respect to said motion picture**." (*Ibid.,* emphasis added.) Clearly, in

Michael Todd, the Assessor did not add the replacement cost of the intangible copyright to its cost approach. Rather, the Assessor knowingly excluded such value.

In this case, the Board knowingly included intangible value in its assessment. But *Michael Todd* establishes that intangible value must be excluded:

> [P]laintiff's copyright in the motion picture and the negatives may not be subjected to ad valorem property taxation under the present constitutional and statutory law of this state. Indeed, copyrights are among the intangible rights and privileges which, as we observed in *Roehm* (p.283 of 32 Cal.2d), 'have never been taxed as property in this state during its entire existence . . . .'

(*Id.* at p.691.)

The Board also cites *Roehm* as purportedly upholding consideration of intangible assets and rights in valuing tangible property. (Answer Brief, pp.18-19.) The holding in *Roehm* is not based on consideration of intangible rights, because *Roehm* did not address the assessment of tangible property (land or improvements). Rather, *Roehm* focused solely on the treatment of an intangible liquor license, holding that the license was not taxable. (See *Roehm* 32 Cal.2d at p.290.) Significantly, in *Michael Todd*, this Court expressly stated that its holding did not in any respect "circumscribe" *Roehm*. (See *Michael Todd*, 57 Cal.2d at p.694.)

More than half a century after this Court decided *Roehm* and *Michael Todd*, the constitutional and statutory law still prohibits the taxation of intangible rights – including ERCs – for property tax purposes. This Court should apply the reasoning it articulated in *Roehm* and *Michael Todd* to hold that the value of intangible ERCs must be excluded from the assessment of EHP's Plant.

B. *Mitsui Fudosan* Does Not Support The Board's Position Because ERCs Are Not "Attributes" Of Real Property.

In its brief, the Board relies upon the Second District's decision in *Mitsui Fudosan v. County of Los Angeles ("Mitsui")* (1990) 219 Cal.App.3d 525, to support its alternative argument for taxing ERCs under Subdivision 110(f). (Answer Brief, pp.31-32.)[19] In *Mitsui*, which predates the 1995 amendments to Section 110, the Second District found that transferable development rights ("TDRs") are real property interests that can be assessed upon transfer. (See *Mitsui,* 219 Cal.App.3d at p.529.)

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[19] The Board alleges: "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." (Answer Brief, p.32.) This misrepresents the trial court's ruling and it misstates EHP's position. The trial judge, focusing solely on Subdivision 110(f), stated: "The closest case is *Mitsui Fudosan v. County of L.A.*" (4 CT 842:5-8.) Contrary to the Board's assertion, *Mitsui* can be reconciled with EHP's position in this case. TDRs arise from and run with ownership of land. As such, they are "intangible attributes" of real property like the examples of location and zoning listed in Subdivision 110(f). In contrast, ERCs do not "arise from" or "run with" ownership of land.

In reaching its conclusion, the *Mitsui* court made important observations that explain how TDRs are distinguishable from ERCs:

> [TDRs] are appropriately viewed as one of the fractional interests in the complex bundle of rights **arising from the ownership of land**. . . . The transactions in the instant case bear all the hallmarks of a transfer of real property. . . . [I]n conjunction with the conveyances, escrows were opened, escrow instructions and purchase and sale agreements were executed, title reports and insurance issued, [and] property surveys were obtained. . . . The agreements memorializing these dealings variously stated that the TDRs "shall be **appurtenant to** and used for the benefit of the real property owned by [Mitsui] and that they "**shall run with the land**. . . ."

(*Id.* at pp.528-29, emphasis added.)

TDRs arise from ownership of land, they are appurtenant to land, and they run with the land.[20] (*Ibid.*) Conversely, ERCs do not arise from ownership of land, they are not appurtenant to land, and they do not run with the land. If emission requirements of an air quality control district change; or if emissions of a power plant are reduced; or if a plant ceases operation, ERCs retain their separate identity and would be "refunded" to the power plant owner, who could "bank" them for future use, or sell them to another source. (See Health and Safety Code §§40709, 40711; 1 CT:126:5-10; 127:3-7; 143:16-18.) Therefore, ERCs are not "intangible

[20] Appurtenant is defined as "pertaining to something that attaches. In real property law this describes any right or restriction which goes with that property, such as an easement to gain access across the neighbor's parcel, or a covenant (agreement) against blocking the neighbor's view." (http://legal-dictionary.thefreedictionary.com/appurtenant.)

attributes" like location and zoning that are intrinsic to the real property. Instead, they are severable intangible rights relating to the operation of an electric generation plant.

C. No Prior Case Supports The Express Addition Of Intangible Value In Assessing Tangible Property.

The Board cannot cite a single case in which the replacement cost or other measure of value for an intangible asset or right was added to the assessment of tangible property, because there are none. Rather, the Board cites cases addressing the "consideration" of intangible assets and rights. (Answer Brief, pp.19-23 [citing multiple cases permitting the "consideration" of intangible assets and rights including a power purchase agreement (*Watson Cogeneration*), operating permits (*American Sheds v. County of Los Angeles ("American Sheds")* (1998) 66 Cal.App.4th 384), an SO4 contract (*Freeport-McMoran Resource Partners v. County of Lake* (1993) 12 Cal.App.4th 634), and a cable television franchise (*County of Stanislaus v. Assessment App. Bd.* (1989) 213 Cal.App.3d 1445)].) As discussed above, EHP agrees that "consideration" of intangible rights is consistent with Subdivision 110(e) and this Court's prior holdings in *Roehm* and *Michael Todd*.

In its brief, the Board relies heavily on *Los Angeles SMSA*, which involved unit valuation of a cellular telephone company and pre-dates the 1995 amendments to Section 110. (Answer Brief pp.17, 21-22.) In *Los*

Angeles SMSA, as here, the Board utilized the cost approach as one method of determining value. (*Los Angeles SMSA,* 11 Cal.App.4th at p.778.) Although the Board "considered" the value of the FCC permit in assessing the taxpayer's property, it did not **add** the replacement cost of the FCC permit to the unit assessment. Rather, as the Second District noted, "the Board **did not assess any single itemized asset**, whether tangible or intangible, and **never specifically assessed or even addressed PacTel's FCC authorization**." (*Id.* at p.777, emphasis added.)

The Board also relies upon *American Sheds,* a case which involved operating permits. (Answer Brief, pp.19, 23.) In *American Sheds*, the assessor did not add a separate value component for those permits. Rather, the assessor employed a royalty valuation method, which purposefully **excluded** income associated with those operating permits, as required by Subdivision 110(d):

> The [assessment appeals] board permissibly **considered** the permits in appraising the property at beneficial and productive use. The board conducted that appraisal by capitalizing the income attributable to the property by means of the royalty method, **to avoid including income that represented the fruits of the intangibles alone** rather than the property itself.

(*American Sheds*, 68 Cal.App.4th at p.396, emphasis added.)

In summary, there is no legal precedent supporting the court of appeal's decision to permit the express addition of value associated with

identifiable intangible assets to the assessment of tangible property. Hence, its opinion in this case violates the Constitution and Section 110(d), and it represents a radical departure from more than sixty years of settled jurisprudence.

CONCLUSION

In its Answer Brief, the Board disregards Article XIII, §2 of the Constitution and Subdivision 110(d)(2) of the Revenue and Taxation Code. Obviously, the Board cannot reconcile those provisions with its actions in assessing EHP's property. ERCs are not assessable because they are intangible rights that are exempt from property taxation under Article XIII, §2 of the Constitution. The Legislature codified this constitutional exemption, mandating that the value of intangible ERCs be removed from the unit valuation of property such as EHP's Plant. (§110(d)(2).) The Board expressly added the replacement cost of ERCs to its assessment of the Plant. Accordingly, this Court should reverse.

RESPECTFULLY SUBMITTED this 30th day of April, 2012.

LAW OFFICE of PETER MICHAELS
and
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and
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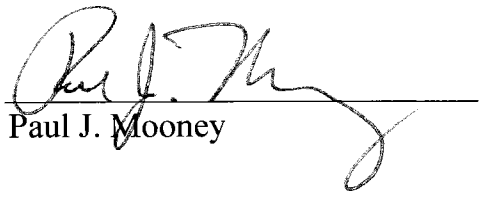
CERTIFICATE OF WORD COUNT

Pursuant to Rule 8.520(c) of the California Rules of Court, I hereby certify that this brief contains 8,396 words, including footnotes, but excluding the Table of Contents, Table of Authorities, Certificate of Service, this Certificate of Compliance, and any attachments. I have relied on the word count of the computer program used to prepare this Certificate.

RESPECTFULLY SUBMITTED: April 30, 2011.



Paul J. Mooney

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Court of Appeal No. D056943

Superior Court Case No. 37-2008-00097074-CU-MC-CTL

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Appellant's Reply Brief on the Merits

in envelopes and deposited the sealed envelopes with the U.S. Postal Service, with the postage full prepaid.

4. The envelopes were addressed as follows:

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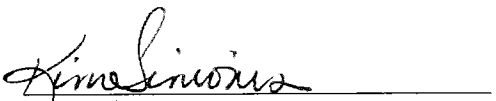
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