

DECISION OF THE KENAI PENINSULA BOROUGH BOARD OF EQUALIZATION

Appellant: Tesoro Alaska Petroleum Company

Hearing Date: June 16, 2005

Parcel Nos: 014-020-14; 014-150-02; 014-150-03; 014-150-05;
014-150-07; 014-150-32; 014-150-40; 014-150-43;
015-050-27 (Refinery and land)

Appeal No: 2005-401

Tax Year: 2005

Assessed Value Appealed: Real Property Total: \$124,869,700
Refinery: \$124,000,000 (Assessor's Revised Value)
Land: \$869,700

Value Established by BOE: Real Property Total: \$124,869,700
Refinery: \$124,000,000
Land: \$869,700

PROCEDURAL BACKGROUND

1. The Board of Equalization of the Kenai Peninsula Borough ("Board") convened on June 16, 2005 at 9:00 a.m. to hear an appeal by Tesoro Alaska Petroleum Company ("Tesoro") regarding the 2005 assessed valuation of land and improvements described on Assessor's Parcel No. 014-150-02 -- the Tesoro Refinery in Nikiski, Alaska (the "Refinery") -- and the underlying and related real property described as Assessor's Parcel Nos. 014-020-14; 014-150-02; 014-150-03; 014-150-05; 014-150-07; 014-150-32; 014-150-40; 014-150-43; and 015-050-27.

2. Chair Gary Superman, and Board Members Dan Chay, Betty Glick, Grace Merkes, Milli Martin, Chris Moss and Pete Sprague were present, constituting a quorum. Members Ron Long and Paul Fischer were absent and excused. Appellant Tesoro was represented by counsel Robin Brena of Brena, Bell & Clarkson. Kenai Peninsula Borough Assessor Shane Horan and counsel Louisiana Cutler of Preston, Gates & Ellis presented the position of the Assessor.

Decision - Tesoro

Page 1

Date of Hearing: June 16, 2005

S:\WPWIN\DATA\BOE\2005\June 16, 2005 Tesoro\Decision - Tesoro.wpd

3. In its notice of appeal, Tesoro asserted that the assessed value of the Refinery was unreasonable, unequal, excessive, and improper and should be \$60,000,000 rather than \$130,000,000 as originally assessed. The Assessor recommended a revised valuation of \$124,000,000 to reflect a deduction of \$6,000,000 in personal property (A 00154), noting that this is the first year such property has been included on the personal property tax rolls. With respect to the underlying and related lands (noted in the introduction), Tesoro asserted that the valuations were unreasonable and excessive, contending that the value of the land should be \$0 as opposed to the assessed valuation of \$869,700, and that value should be subsumed into the value of the Refinery. At the hearing, Tesoro also noted the ongoing litigation related to its appeal of the Board's 2004 assessed valuation, and said Tesoro would accept the Board's 2004 valuation (\$93,352,000) as an appropriate assessed value for 2005, withdraw their 2004 appeal and would appeal anything higher.

4. Prior to the taking of testimony, the Board heard arguments on a motion from Tesoro to strike from the record the Assessor's Opening Brief dated June 14, 2005 and granted Tesoro's motion.

5. Chair Superman ruled on motions filed prior to June 9, 2005. In response to a number of motions the Chair increased the time for presentation of each party's case to 4.5 hours (an extension beyond the normal limit of 30 minutes provided by ordinance) to include presentation, rebuttal and closing statements; denied Tesoro's request to have a witness participate telephonically; denied the Assessor's request to compel certain discovery; and denied Tesoro's request for confidential treatment of the Johnson report. Those orders are considered a part of the decisional record in this matter.

6. The Board reaffirmed that the order of presentation by the parties in the course of the hearing would be the same as in the analogous hearing in 2004. The agenda prepared by the Borough Clerk reflected this process.

7. Tesoro presented the following witnesses:

Kathy G. Spletter, Vice President
Stancil & Co.

Richard Marchitelli, MAI, CRE, Managing Director
Cushman & Wakefield, Inc.

Hal B. Heaton, Ph.D., Professor of Finance
Brigham Young University

John Moore, Tax Manager and Assistant Secretary
Tesoro Corporation

8. The Assessor presented the following witnesses:

Shane Horan, Kenai Peninsula Borough Assessor

Dudley A. Platt, Petroleum Engineer

Dennis Deegear, Vice President
Capital Appraisal Group, Inc.

Sebastian Rodrigano, Appraiser and Chemical Engineer
Capital Appraisal Group, Inc.

Brent Eyre, Appraiser

Jeffry Johnson, CPA

9. Pursuant to procedures set by ordinance and the agenda, cross examination of witnesses occurred during the parties' respective rebuttals and questions from the Board occurred after each party's direct cases and after rebuttals. The record of the hearing includes all written documents submitted by the parties except as noted above, and the testimony and arguments at the hearing.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

1. The authority of the Board to approve, reject or adjust valuations of property made by the Assessor is set forth in KPB 5.12.050 with procedures for an appeal by a taxpayer set in KPB 5.12.045 through 5.12.060. As provided in KPB 5.12.050(E),

The grounds for appeal are: unequal, excessive, improper or under valuation of the property not adjusted by the assessor to the property owner's satisfaction, or an error in ownership or classification of the property.

In ascertaining whether a valuation is "unequal, excessive, [or] improper" within the meaning of KPB 5.12.050(E), the provisions of AS 29.45.110(a) apply:

The assessor shall assess property at its full and true value as of January 1 of the assessment year, except as provided in this

Decision - Tesoro

Page 3

Date of Hearing: June 16, 2005

S:\WP\WIN\DATA\BOE\2005\June 16, 2005 Tesoro\Decision - Tesoro.wpd

section, AS 29.45.060, and AS 29.45.230. The full and true value is the estimated price that the property would bring in an open market and under the then prevailing market conditions in a sale between a willing seller and a willing buyer both conversant with the property and with prevailing general price levels.

2. The interpretation and application of the provisions set forth in paragraph 1 above have been the subject of litigation. It is insufficient for a taxpayer to simply establish that a better or more detailed method of valuation could be substituted for that of the assessor. Rather the courts have required, given the deference to the assessor and presumptively to a board's findings, that the appellant/taxpayer affirmatively show that the valuation failed to meet the standard set forth in AS 29.45.110(a) or that the assessor's valuation is fundamentally flawed. A decision by the Alaska Supreme Court holds:

The Alaska Constitution requires that the law prescribe appraisal standards, and the implementing law mandates that property be assessed "at its full and true value," in other words, "the estimated price that the property would bring in an open market." The relevant inquiry is whether or not a valuation method selected by the assessor provides some reasonable estimate of the market value of the interest to be taxed, not whether the appraisal method has received the imprimatur of acceptance from the appraisal community. If the assessor has a reasonable basis for the valuation method, we will approve that method "so long as there was no fraud or clear adoption of a fundamentally wrong principle of valuation."

Fairbanks North Star Borough Assessor's Office v. Golden Heart Utilities, Inc., 13 P.3d 263, 268 (Alaska 2000).

3. The Board incorporated the burden of proof as set forth in the Board's decision in 2004, specifically that:

The burden of proof lay with the taxpayer to provide sufficient evidence to prove an excessive, unequal, improper or under valuation of the property. The taxpayer does not have to offer the correct amount, range, or method of valuation. Once the burden of proof is met, the burden shifts to the taxing authority to introduce credible evidence which substantiates the assessment.

Decision - Tesoro

Page 4

Date of Hearing: June 16, 2005

S:\WPWIN\DATA\BOE\2005\June 16, 2005 Tesoro\Decision - Tesoro.wpd

4. Both parties provided evidence and testimony to value the property using all three of the traditional approaches to property valuation – the comparable sales approach, the cost approach, and the income approach. Neither party relied heavily on the cost approach, and used both the cost approach and comparable sales primarily as means to test the reasonableness of the income approach.

5. The Assessor's analysis rested primarily on an appraisal report prepared by Capital Appraisal Group, Inc. ("CAGI"). This year, Tesoro provided the Assessor with sufficient information to value the property using the income approach, so all three methods were discussed. Tesoro criticized CAGI witnesses Deegear and Rodrigano for their lack of refinery appraisal experience on behalf of buyers and sellers, as opposed to CAGI's extensive experience in appraising refineries for tax assessment purposes. Tesoro questioned Mr. Rodrigano's age. The Board declines to impose age requirements on appraisers or witnesses. Tesoro also criticized CAGI's reliance on refinery sales information from Purvin & Gertz, Inc. However, the Assessor noted that, up until recently when Tesoro hired Stancil & Co., Tesoro had relied on Purvin & Gertz, Inc. which is in the same line of business as Stancil.

6. Tesoro raised several specific assertions that criticized the income approach valuation developed by CAGI. Tesoro asserted that the gross margin calculation failed to include 547,728 barrels of cutterstock (TES 00229), resulting in excess value of \$25.5 million (TES 0463). CAGI calculated the gross margin using production results data from Tesoro for the period 2000 through 2004 (TES 2096, 2111, 2123, 2140, and 2154) to obtain a five-year average gross margin of \$6.28 per barrel (A 00197). The parties agreed with the gross margin calculated for each year except 2004. Tesoro accounted for the cutterstock as a negative product in 2004, which had not been done in the past. The Assessor, through Mr. Rodrigano, showed that CAGI used consistent methodology and calculated the gross margin correctly.

7. Tesoro disagreed with CAGI's use of five-year average operating costs with regard to salaries and utilities, asserting that future costs will be higher and that averaging lower costs from the past to calculate future costs resulted in an improperly increased overall value. Tesoro entered into a new contract for natural gas that became effective January 1, 2005, increasing the cost from \$2.30 per Mcf to \$4.00 per Mcf. (TES 0073). Tesoro argued the reduction in value from averaging utility costs, as opposed to using 2004 numbers only, should be \$33.4 million (TES 0463). Tesoro argued the reduction in value from averaging salaries and benefits, as opposed to using 2004 numbers only, should be \$10.8 million. (TES 0463). The Assessor used five year averages for all operating costs, included a factor of 1.8% increase compounded each year, and included proposed special projects within the next ten years. The Assessor also used a five-year average for all revenues and argued that consistency requires treating costs and revenues in the same manner, to properly reflect the

Decision - Tesoro

Page 5

Date of Hearing: June 16, 2005

S:\WPWIN\DATA\BOE\2005\June 16, 2005 Tesoro\Decision - Tesoro.wpd

cyclical nature of refineries. The Board notes that the Stancil report states, "nominal operating costs have tended to be fairly flat" (TES 0080). Employee costs have increased slightly each year since 2000, but "supplies, utilities and fuel" have generally decreased over the five year period, and gross sales revenues was substantially higher in 2004 than in prior years. (A 00207). Tesoro's approach would anticipate higher costs, but ignore higher revenues. The Assessor's methodology is consistent and reasonable.

8. Tesoro argued that CAGI should have used a higher discount rate of 12.7% instead of 10.9%, and a higher capitalization rate of 15.7% instead of 11.3%. (TES 0450) Tesoro asserted, through testimony of Hal Heaton and other evidence, that CAGI did not use discount rates reflected by actual refinery sales, underestimated the cost of capital by measuring against a weighted average cost of capital used for integrated oil companies, should have used a model based on cash returns to investors instead of company earnings, and should have considered the Refinery to be much more risky than other refineries. In response to questions from the Board, it was determined that an "integrated" facility is involved in at least two, and usually three, of the following activities: production, refining, transportation, and marketing. Using this definition, the Refinery is an "integrated" facility because it is involved with production, transportation, and marketing. Mr. Platt testified that most, if not all, buyers of refineries are integrated companies. The Stancil report estimated a reasonable discount rate to be in the range of 12 to 15% (TES 0081) and states that "the correct capitalization rate to use based on the character of CAGI's cash flow projection is 12.0 percent" (TES 0095). The Board acknowledges that certain assumptions are made by appraisers (see TES 0094), and Tesoro has not shown CAGI's discount rate or capitalization rate to be unreasonable.

9. Use of the comparable market sales data supports the Assessor's conclusion of \$124,000,000 resulting from the income method. CAGI showed the North Pole refinery sale confirmed the Assessor's estimate, appropriately adjusted for complexity and other differences. As the only other refinery in Alaska, it was reasonable to use the North Pole refinery as a comparison. Both process North Slope crude ("ANS") (and the Refinery in Kenai also has access to Cook Inlet oil). Both share similar markets. Differences in location, and the need for expensive upgrades to the North Pole refinery were considered. The criteria used by the Assessor (A 00109) to select comparable properties were appropriate, and analysis of similarities and differences were reasonable. The Board disagrees with Tesoro's value (in the range of \$9.8 to \$60 million) and its reliance on the allocation for accounting purposes of total purchase prices to the refinery prices for the Bakersfield, CA, Denver, CO, Kapolei, HI refineries (TES 0101) and the Tyler refinery sale in Texas that closed in March 2005. Tesoro correctly noted that asphalt plants used by CAGI for comparison are different, and the Board finds that CAGI adjusted the values and complexities accordingly (A 00140).

Decision - Tesoro

Page 6

Date of Hearing: June 16, 2005

S:\WP\WIN\DATA\BOE\2005\June 16, 2005 Tesoro\Decision - Tesoro.wpd

10. Tesoro argued the Assessor should decrease the Refinery assessment to reflect the decline in Cook Inlet crude. The Assessor was not concerned about the source of crude, noting that the Refinery has access to ANS crude as well, and noting the 2004 charges were highest with the highest product yield from ANS (T 00443).

Decision

1. For the foregoing reasons, the Board concludes that Tesoro has not met its burden of proof in establishing that the Assessor's valuation was excessive or improper, and the Assessor's revised valuation for the Refinery (Parcel No. 014-150-02) is upheld at \$124,000,000.

2. For the foregoing reasons, the Board concludes that the Assessor's valuation for the underlying real property, revised to \$869,700 by the Assessor to reflect environmental contamination, is upheld as being fair and appropriate, and Tesoro has failed to meet its burden of proof of establishing an excessive or improper valuation by the Assessor. These values are identified for each parcel as follows:

Parcel No.	Assessed Value
014-020-14	\$1,400
014-150-03	\$96,000
014-150-05	\$98,100
014-150-07	\$195,000
014-150-32	\$204,300
014-150-40	\$191,700
014-150-43	\$5,500
015-050-27	\$77,700

3. This written opinion sets forth the Board's decision adopted August 2, 2005, and constitutes the final administrative decision for purposes of any appeal to the superior court. Pursuant to KPB 5.12.060(S) and Alaska Rule of Appellate Procedure 602(a)(2), a party desiring to appeal this decision must file its appeal with the superior court in Kenai within 30 days from the date of distribution of this decision.

Decision - Tesoro

Page 7

Date of Hearing: June 16, 2005

S:\WPWIN\DATA\BOEV\2005\June 16, 2005 Tesoro\Decision - Tesoro.wpd

AUG-04-2005 THU 08:50 AM KENAI PENN BOROUGH CLERK

FAX NO. 907 262 8815

P. 09

Dated:

8.2.05

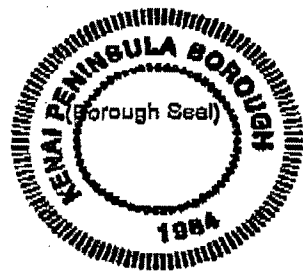
[Handwritten Signature]

Gary Superman, Chair

Attest:

[Handwritten Signature]

Sherry Biggs, Borough Clerk



Decision - Tesoro

Page 8

Date of Hearing: June 16, 2005

S:\WPWIN\DATA\BOE\2005\June 16, 2005 Tesoro\Decision - Tesoro.wpd