

**DECISION OF THE KENAI PENINSULA BOROUGH
BOARD OF EQUALIZATION**

Appellant: Tesoro Alaska Petroleum Company

Hearing Date: July 7, 2004

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; 015-040-02; 015-040-17; 015-050-34 (Refinery and Related Lands)

Appeal No: 2004-301

Tax Year: 2004

Assessed Value Appealed: Real Property Total: \$133,283,300
Improvements: \$131,720,000
Land: \$1,563,300 (as adjusted at hearing)

Value Established by BOE: Real Property Total: \$94,915,300
Improvements: \$93,352,000
Land: \$1,563,300

PROCEDURAL BACKGROUND

1. The Board of Equalization of the Kenai Peninsula Borough ("Board") convened on July 7, 2004 at 9:00 a.m. to hear an appeal by Tesoro Alaska Petroleum Company ("Tesoro") regarding the 2004 assessed valuation of 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; 015-050-27; 015-040-02; 015-040-17; 015-050-34.

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

3. In its notice of appeal, Tesoro asserted that the assessed value of the Refinery was unreasonable, unequal, excessive, and improper and Tesoro therefore contended the proper valuation for the improvements on Parcel No. 014-150-02 should be \$50,006,900 rather than \$131,720,000 as assessed. With respect to the underlying and related parcels of property (noted in the introduction), Tesoro asserted that the valuations were unreasonable, excessive, contending that the value of the underlying property should be \$1,463,381 as opposed to the assessed valuation, and moreover that that value should be subsumed into the value of the Refinery. At the commencement of the hearing, Assessor Horan stated that, upon further review of the notices of assessed valuation, his determination respecting underlying properties (that is, the valuation not including improvements) should be reduced to \$1,563,300 on the basis that "fill" included as an element of value for the real property was more properly included within the assessed value of the Refinery. In presenting its appeal to the Board, Tesoro sought an overall valuation of \$50 million.

4. Prior to the taking of testimony, the Board heard arguments on three motions pending before it,¹ and decided as follows:

a. The Board increased the amount time for presentation of each party's case to three hours plus one-half hour each for closing arguments. The Board concluded that the complexity of the case justified the additional increase to the normal period of time allowed for a party's presentation under KPB 5.12.060(G).

b. 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 2003. The agenda prepared by the Borough Clerk reflected this process.

c. The Board incorporated the burden of proof as set forth in the Board's decision in 2003, 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.

¹ Chair Sprague ruled on motions filed prior to June 30, 2004. In response to a number of motions, including motions for reconsideration, the Chair increased the time for presentation of each party's case to two hours (an extension beyond the normal limit of 30 minutes provided by ordinance, but less than that stipulated to by the parties or requested by the parties) later adding 30 minutes for closing arguments to that amount; denied Tesoro's request to compel depositions; and granted Tesoro's request to present Dr. Hal Heaton's testimony by teleconference. Those orders should be considered a part of the decisional record in this matter.

d. In response to Tesoro's proposed introduction of documents to supplement documents which Tesoro alleged to be incomplete in the Assessor's presentation, the Board ordered that (a) Assessor's exhibit 28 (Assessor's exhibit pp 282-83)² would be appropriately supplemented by Tesoro's submission of a document called "Assessment and Valuation of Refineries and Processing Plants" by Kathy G. Brown-Spletter, Tesoro exhibit page 368-402³; (b) A Ex 41 would be admissible without supplementation; © A Ex 42 would not be considered because it is an incomplete document and Tesoro's proffered supplement, a partial transcript of the 2003 proceeding, would not be admitted or considered as a supplement because it was itself incomplete.

5. Tesoro presented as its witnesses Rod Cason; Dr. Hal Heaton (by teleconference); Kathy Spletter; Brent Calongne; Jim Wentworth; Tom Dunagan; and Dan Shantz. The Assessor presented as its witnesses Shane Horan; Dave Walters; and Michael Goodwin. 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 all rebuttals were completed. The record of the hearing included all written documents submitted by the parties except as noted above, and the testimony and arguments at the hearing.⁴ Counsel for the parties are commended for the excellence of their presentations.

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. Potential validity or invalidity of asserted errors in assessment shall have no bearing on the determination on whether the taxpayer was unable to timely file an appeal.

² This designation may be abbreviated as "A Ex 28; A Ex pp 282-83," and subsequent record citations will use the same format.

³ This designation may be abbreviated as "T Ex ___; T Ex pp 368-402," and subsequent record citations will use the same format.

⁴ Eight days after the hearing ended, Tesoro filed a "Motion to Clarify the Legal Standards," the Assessor filed an opposition brief, and Tesoro filed a reply brief. Neither filing nor acceptance of these post-hearing materials was consistent with procedures in this matter. These materials were not considered by the Board, and the Board does not consider them a part of the decisional record.

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 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 recent 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. In this matter, the Assessor as well as Tesoro reacted to this Board's conclusions in the appeal by Tesoro to its 2003 valuation. In 2003 this Board concluded that insufficient persuasive information had been provided by either the assessor or the taxpayer to support valuations under two of the three standard approaches to property valuation: the income approach and the comparable sales approach. As a consequence in 2003, this Board stated that the most credible evidence supported the use of the cost approach (the third of the triad of valuation approaches). The Board concluded that the

assessor's "percent good" factor applied to an acceptable replacement cost new was not supported by the evidence, and found that the evidence best supported a range between the "percent good" factor of 19.49% presented by Tesoro and the 28% "percent good" proposed by the assessor. See, A Ex 40.

4. For this year's valuation, the Assessor relied upon the cost approach, which formed the primary basis for the adjustment made by the Board last year. The Assessor's analysis rested primarily on that of its retained advisor DAPA. DAPA offered a team approach to its valuation assistance, but Tesoro criticized DAPA witnesses Goodwin and Walters for their lack of actual refinery appraisal training and/or experience. Michael Goodwin of DAPA testified that DAPA and the Assessor had considered the income and comparable sales approach but concluded that in each instance, for differing reasons, data was not available to permit credible valuations based on those approaches. This left, according to the Assessor and DAPA (through witnesses Goodwin and Walters), the Assessor with no recourse but to emphasize the cost approach. The Assessor did, however, through the testimony of DAPA's Goodwin and Walters, assert that information which they thought was reasonably applicable in the income approach would, if fully fleshed out, have yielded an ultimate valuation similar to that which the Assessor proposed. Further, the Assessor stated that Tesoro created unnecessary obstacles to the ability of the Assessor to obtain information which could have been used to develop a more solid income approach assessment and possibly as well a comparable sales approach. As will be noted later in these findings, the Board does not believe that the Assessor took all steps that it reasonably should have to acquire that information and that as a consequence the Assessor did not fully exhaust its authority to conduct an independent examination for valuation purposes.

5. Tesoro asserted that its preparation for 2004 was also premised on the Board's decision in 2003 which criticized the inability of the parties before it to present credible data under the income and comparable sales approaches, the approaches to which Tesoro this year gave greatest weight. Tesoro hired what it determined to be experts in the field, including Kathy Spletter of Stancil & Co., Tom Dunagan, an Anchorage appraiser, and Brent Calongne of Mustang Engineering, an engineering and construction valuation firm, who supplied data for replacement cost new calculations. While the credentials of the panel of witnesses presented by Tesoro are significant, even this panel admitted that it failed on occasion to make certain required adjustments and that its experience was not in all respects appropriate. For example, Dr. Hal Heaton, a professor on valuation, had never been an appraiser. Ms. Spletter conceded that a valuation assignment for a buyer might carry a different emphasis than one for a seller; Spletter also recognized some illogic in her capital assumptions in the income approach (although any such "error" would be in the range of only 2%).

6. Tesoro, in contrast to the Assessor, presented in this hearing a case based upon all three of the traditional approaches to property valuation with the conclusion that

valuations under each approach essentially confirmed a valuation level in the 50 million dollar range. Tesoro gave greatest weight to the income approach and least to the cost approach. The Assessor's failure to at least meaningfully consider the three valuation approaches for an assessment as complex as the Tesoro refinery in Nikiski was a serious error. The Assessor's failure to do so, constitutes, in this particular instance and in this particular tax year, a fundamental flaw in valuation which is not likely to represent the full and true value of real property recognized by a willing buyer and a willing seller knowledgeable in the area.

7. Comparing the Assessor's and Tesoro's Income Approach. Tesoro presented significant data on the income approach to support a valuation in the range of \$52 million. The Assessor justified a cursory attempt at the income approach by contending that it received sketchy details from Tesoro in such a fashion as precluded it from producing a detailed model. See A Ex p 97. Tesoro contended that virtually all of its data on the income approach was available in the public sector. While Tesoro presented significant and important arguments to validate the income approach, a significant dispute arose with respect to the proper discount rate necessary to reduce the future stream of income to present value. The rate of return necessary for discounting purposes advanced in a relatively more risky investment such as the Tesoro refinery is a plausible distinction from the discount rate that the Assessor contended was best appropriate in its direct testimony. However, the Board was not persuaded by Dr. Heaton's testimony, particularly when Mr. Goodwin pointed out that Heaton had elsewhere utilized a lower discount rate than Tesoro suggested here.

8. Comparing the Assessor's and Tesoro's Comparable Sales Approach. Tesoro presented a list of comparable (in its opinion) sales of refineries noting that very few refineries remained which were similar to the size and complexity of the Tesoro one. The Assessor critiqued the list used contending that most if not all of these sales were duress situations and that many of the very same sales cited by Tesoro in 2004 had been described as not relevant in 2003. Ms. Spletter for Tesoro described a proprietary "complexity" factor applied to her assessment which was intended to equalize comparisons between facilities; the "complexity" factor presentation lost some of its credibility given its proprietary derivation which could not be fully tested. Moreover, Tesoro contended that synergies within Tesoro (multiple facilities owned by the one company which uniquely created internal economies) added value which could not be replicated if a "willing buyer" sought to buy the Refinery. The Assessor contended that the complexity and synergies factors were not capable of being tested and were unreliable. The Board concluded that, while unquantifiable, some synergistic value exists. The Assessor also concluded that the April 2004 finalized sale of the Williams refinery in North Pole, Alaska was not a technically relevant sales event, because it had not been consummated as of the tax date of January 1, 2004. Tesoro maintained however that the data underlying that sale was on the street before January 1, 2004 and could be used. Tesoro contended that the Williams facility was a larger plant with greater access to feedstock from the TAPS, conditions which

rendered even its \$99 million value considerably more than a comparable figure for the Refinery. Tesoro effectively argued that the \$99 million sale value of that plant was in direct and compelling conflict with the Assessor's valuation of the Refinery in this instance. While the Board was not persuaded with the ultimate valuation yielded by Tesoro's comparable sales approach, the Board was persuaded that the failure of the Assessor to utilize much of this data to at least corroborate its analysis constituted a fundamental flaw, and that as such the range of values under the comparable sales approach would likely be above Tesoro's recommended valuation level of \$50 million but most significantly not at the \$131.7 million assessment set by the Assessor.

9. Comparing the Assessor's and Tesoro's Cost Approach. The Assessor and Tesoro each spent significant effort and, in the Assessor's case a virtually exclusive, focus on the cost approach. Key to the Assessor's presentation of the case were its summary documents at A Ex pp 97 and 101. In A Ex p 101 the Assessor applied deductions to yield a 28 "percent good" factor to apply (in A Ex p 97) against the replacement cost new (RCN). In A Ex p 101, the Assessor utilized an obsolescence figure of 19% applied against the physically deteriorated value of the facility. Mr. Goodwin was not able to describe where in the records before the Board this 19% had been calculated and whether or not it definitively included both economic and functional obsolescence. Tesoro's presentation of the case however does not compel the Board to accept that its ultimate assessment of an 11 "percent good" factor is appropriate. Tesoro had, for example, selected refineries for its comparable sale approach which in many instances had a percent good factor of 30% or more, even given that no new refineries have been built for the last 25 years. Mr. Dunagan testified (but did not present documentation regarding) recent sales of a Louisiana and an Aruba refinery in which the percent good factors were 12 and 15%. Tesoro's best percent good factor utilizing both economic and functional obsolescence considerations ranged from an 11 to 14 percent. The RCN figures used by the Assessor and Tesoro were remarkably close: \$470 million according to the Assessor, \$453 million according to Tesoro. Only \$17 million or 4% represented the difference between the respective RCN's. The Board believes that the Assessor's valuation was flawed in failing to fully or appropriately document its obsolescence factor calculations and, as such, there is a basis for an adjustment to the valuation under this approach. However, the Board believes that "functional obsolescence" was at least somewhat accounted for by the Assessor and that the Tesoro "economic obsolescence" was itself incomplete by failing to fairly consider balancing external factors that would contribute to increased economic value; indeed, even properties that have been depreciated (in an accounting sense) to zero may still have significant value. The Board however is persuaded that the best evidence reveals a range of scenarios of percent good framed by Tesoro (12.5% if the respective best estimates of Tesoro's opinions on percent good of 11 and 14% are averaged) and the 28% percent good utilized by the Assessor. Similarly the RCN range is close enough to support an appropriate midpoint of \$461 million.

10. The Board believes the Assessor directly or through its retained advisor DAPA could and should have more proactively sought information from Tesoro. First, the Assessor never formulated written inquiries which could have elicited data on Tesoro's income and possibly comparable sales assessments by Tesoro. Mr. Walters implied that it was insufficient for Tesoro to only respond to what the Assessor/DAPA requested. It is difficult to ascertain what else Tesoro could be reasonably expected to do, particularly in the absence of written questions. Second, a dynamic tension exists between the Assessor's office and any taxpayer and here that tension possibly created some friction. Notwithstanding that friction, the Assessor had investigation tools under AS 29.45.130(b) which it did not use.

11. The Board concludes that Tesoro met its burden of proof in establishing that the Assessor's valuation on Tesoro's property was excessive as a consequence of applying a fundamentally flawed valuation approach - - particularly the focus on but one approach which itself contained unsupported conclusions respecting the obsolescence factor. The Assessor placed an excessive valuation on Tesoro's Refinery, and the Board is authorized to adjust that valuation. Tesoro is entitled to an adjustment. While Tesoro contends that the valuation for the Refinery should be placed at \$50 million, the standard applied to a taxpayer does not require the taxpayer to prove a specific figure to meet its burden of proof. Tesoro may therefore meet its burden without establishing that \$50 million is the only correct result.

12. Having recognized an entitlement to an adjustment, the Board must set an appropriate adjustment. The evidence presented compels the Board to find that the proper, fair and full valuation of the Refinery consistent with the standard set out by law and code is derived by utilizing a range of figures from the most compelling evidence presented. Specifically the Board finds that the proximity of the parties' positions on replacement cost new justifies the utilization of the average of those two figures (that is, \$453 million and \$470 million), to yield an appropriate RCN of \$461 million. The Board believes that the percent good to be applied to the RCN would be a range between 12.5% (the average of the best representations of percent good presented by Tesoro) and the 28% advocated by the Assessor. The mid point of this range is 20.25%. Application of 20.25% to a replacement cost new of \$461 million yields \$93,352,000, and the Board concludes this to be a proper adjustment.

13. Tesoro criticized the Assessor's valuation of individual real property parcels, as distinct from the Refinery. Tesoro contended that economic units rather than individual parcels were the appropriate bases for valuation and, further, that the environmental clean up costs potentially outweighed any separate market value of the properties. The Board finds that the Assessor's choices of valuation were reasonable under the circumstances, particularly once the Assessor adjusted the valuation at the beginning of the hearing (the "fill" issue).

Decision

1. For the foregoing reasons, the Board concludes that Tesoro has met its burden of proof in establishing that the Assessor's valuation was excessive, and that the true and proper valuation for the improvements (that is, the Refinery) should be adjusted to \$93,352,000.

2. For the foregoing reasons, the Board concludes that the Assessor's valuation for the underlying real property adjusted at the beginning of the hearing by the Assessor to \$1,563,300, is fair and appropriate, and Tesoro has failed to meet its burden of proof of establishing unreasonableness by the Assessor and to an entitlement to an adjustment.

3. This written opinion sets forth the Board's decision adopted August 17, 2004, 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.

Dated: _____

Pete Sprague, Chair

Attest:

Linda Murphy, Borough Clerk, MMC

(Borough Seal)