

APPRAISAL SUMMARY STATEMENT
Town of Apple Valley, California
APPLE VALLEY RANCHOS WATER COMPANY

BASIS OF VALUATION:

The fair market value for the property proposed to be acquired is based upon an appraisal prepared in accordance with generally accepted appraisal principles and methodologies.

Code of Civil Procedure section 1263.320 defines Fair Market Value as follows:

- a) The fair market value of the property taken is the highest price on the date of valuation that would be agreed to by a seller, being willing to sell but under no particular or urgent necessity for so doing, nor obliged to sell, and a buyer, being ready, willing, and able to buy but under no particular necessity for so doing, each dealing with the other with full knowledge of all the uses and purposes for which the property is reasonably adaptable and available.
- b) The fair market value of property taken for which there is no relevant, comparable market is its value on the date of valuation as determined by any method of valuation that is just and equitable.

Section 1263.330 provides that the fair market value shall not include an increase or decrease in value attributable to the project for which the property is to be acquired.

DATE OF VALUATION: The fair market value of the property was estimated as of June 1, 2015.

BASIC PROPERTY DATA:

Public use for which the property is to be acquired: To provide water service to the public, including the Town of Apple Valley and its inhabitants, within the Apple Valley Ranchos Water Company (“AVR”) Service Area.

Location and extent of property to be acquired: The Apple Valley Ranchos Water Company Water System is located in San Bernardino County, California and serves the majority of the Town of Apple Valley and portions of the surrounding area. See “Description of the Apple Valley Ranchos Water System” accompanying this Appraisal Summary Statement.

Interest to be acquired: All tangible and intangible assets (i.e., operating assets) used to provide water services within AVR’s service area (i.e., the AVR Water System). For a more detailed description, see “Description of the Apple Valley Ranchos Water System” accompanying this Appraisal Summary Statement.

Zoning: Not relevant to extent the property is subject to CPUC jurisdiction. For zoning designations for particular properties see “Description of the Apple Valley Ranchos Water System” accompanying this Appraisal Summary Statement.

Present use: Public water utility.

Highest and best use: Highest and best use is the most reasonably probable and legal use of a property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value. The highest and best use of the AVR Water System is its current use—to provide water utility service.

VALUATION:

FAIR MARKET VALUE ANALYSIS: In a business valuation, two frameworks could be used—accounting and economic. The accounting framework uses financial data found in a water utility’s financial statements. In contrast, the economic framework analyzes a utility’s value added (or lost) as the result of earning profits above (or below) its weighted average cost of capital (WACC). Both frameworks were used in the valuation analysis and they provided relatively mutually supporting results.

There are three generally accepted approaches to estimating the value of property: (a) the cost (asset) approach, (b) the income approach, and (c) the market approach. Under the cost approach, the value of the property is based on the premise that an informed buyer would pay no more than the cost of producing a substitute property with the same utility as the subject property. Under the income approach, the value of the property is estimated by capitalizing or determining the present worth of the prospective economic benefits from the property. The market approach assesses value based on: (a) recent fair market sales of similar facilities under similar circumstances (i.e., merger and acquisition method), or (b) the capital market method (i.e., market prices of similar publicly-traded water utilities).

All three approaches—cost, income, and market—were considered in performing the appraisal.

THE FOLLOWING INFORMATION IS BASED ON THE ENTIRE PROPERTY:

1. The sales comparison, or market, approach is based on the consideration of comparable land and improved sales. In this approach, given the wide disparity in: (a) location of water utilities, (b) terms included in the sales (e.g., debt and equity financing), (c) size of the utilities, and (d) when the transactions occurred, the market approach was not relied upon.
2. The cost approach is based on the premise that an informed buyer would pay no more than the cost of producing a substitute property with the same function or utility as the subject property. When valuing public utility assets, five frequently used methods under the cost approach are considered. These are: (a) reproduction cost new less depreciation (RCNLD), (b) replacement cost new less depreciation, (c) original cost

less depreciation (OCLD), (d) asset accumulation, and (e) rate base (i.e., the utility’s operating assets and liabilities recognized by the California Public Utilities Commission as being “used and useful” and “prudent” in providing service to AVR’s customers).

The RCNLD method provides the estimated cost to reproduce existing properties in their current form and capability at current cost levels, less depreciation. OCLD is defined as the original cost of the property when it was first put into service as a public utility, less accumulated depreciation. The replacement cost new less depreciation method provides an estimate of the cost to replace the existing facilities (either as currently structured or as redesigned to embrace new technology) with facilities that will perform the same functions. The reproduction and replacement cost new less depreciation methods were not used because they are both costly to implement and controversial.

The OCLD value is an estimate of the net book value of the property, which is used to determine the rate base value of public utility property for ratemaking purposes. The rate base method is being considered for purposes of evaluating fair market value and is estimated as follows:

**Apple Valley Ranchos Water Company Water System
Estimated Rate Base
as of June 1, 2015**

Line	Description	\$
1	Plant in service including construction work in progress (CWIP)	125,853,634
2	Accumulated Depreciation	-34,088,752
3	Net plant in service	91,764,882
4	Cash working capital	2,154,020
5	Materials and Supplies	342,898
5	Contributions in aid of construction (CIAC)	-2,197,933
6	Customer advances	-28,746,796
7	Deferred income taxes	-15,143,073
8	Deferred Investment Tax Credits (ITC)	-87,191
9	Total rate base	48,086,807

3. Typically, the income approach estimates the value of the operating assets by: (a) capitalizing economic benefits derived from the assets (possibly with or without a growth factor); and/or (b) using the enterprise discounted cash flow (DCF) method; and/or (c) using the economic value added (EVA) model.

(a) Capitalized Economic Benefits

This method—often referred to as capitalized income—may be utilized either with or without a growth factor. The no-growth version is derived by dividing the normalized 2014 net income (profit) of \$4,649,656 by AVR’s estimated weighted average cost of capital (WACC) of .0760.

$$\mathbf{\$4,649,656/.0760 = \$61,187,050}$$

Adding a growth factor of .0095 (based on the projected long-run population growth rate of Apple Valley, California) yields:

$$\mathbf{\$4,649,656/ (.0760-.0095) = \$69,929,259}$$

(b) Enterprise Discounted Cash Flow (DCF) Method

This method is widely used in practice and reflects capital provided by both debt and equity owners. In this method, a discount rate (WACC) is used for a discrete period (e.g., 10 years) and a terminal period (i.e., years 11 to infinity). The discount rate represents the risk associated with the future flows of economic benefits.

Under the enterprise DCF method, the direct economic benefits derived from continued ownership of the system are expressed in terms of free cash flow, which represents the total cash flow generated by the going concern that is available to the providers of both debt and equity capital.

The enterprise DCF model used to estimate the value of the AVR Water System is essentially an after-tax free cash flow model over a ten-year period beginning with fiscal year 2015 and ending with fiscal year 2024; and a terminal value. The calculation of free cash flow is illustrated as follows:

	<i>Earnings Before Interest, and Income Taxes (EBIT)</i>
<i>Less:</i>	<i>Cash Income Taxes</i>
<i>Equals:</i>	<i>Net Operating Profit Less Adjusted Taxes (NOPLAT)</i>
<i>Plus:</i>	<i>Depreciation and Amortization</i>
<i>Equals:</i>	<i>Gross Cash Flow</i>
<i>Less:</i>	<i>Gross Investment</i>
<i>Equals:</i>	<i>Operating Free Cash Flow (also called Free Cash Flow to the Firm)</i>

The next table shows the calculation of the income value for the AVR Water System using the enterprise DCF method. EBIT, cash income taxes, depreciation, amortization, and gross investment were projected based on data from a variety of reliable sources including revenue changes necessary for AVR to achieve its average earned rate of return on rate base of 8.9% for the six-year period (2009-2014).

**Apple Valley Ranchos Water Company Water System
Enterprise DCF
Valuation Summary (\$000, rounded)**

Line	Description		2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	
1	EBIT		5,854	6,344	6,877	7,454	7,978	8,552	9,179	9,780	10,400	10,701	
2	Cash Inc. Tax		1,252	1,217	1,184	1,151	1,120	1,089	1,060	1,031	1,003	976	
3	NOPLAT		4,602	5,127	5,693	6,303	6,859	7,463	8,119	8,749	9,397	9,725	
4	Gross cash flow		7,631	8,068	8,549	9,077	9,553	10,080	10,661	11,219	11,796	12,056	
5	Gross investment		7,665	7,826	7,877	7,936	8,004	8,085	8,180	8,294	8,431	8,599	
6	Free cash flow		-34	243	673	1,141	1,548	1,995	2,481	2,925	3,365	3,456	
7	Terminal value												45,485
8	Present value factor		.929	.864	.803	.746	.693	.644	.599	.557	.517	.481	
9	Value of operations		-32	210	540	851	1,074	1,286	1,486	1,628	1,740	1,662	
10	Prorated for 2015	--13											
11	Total Entity Value	55,942											

(c) Economic Value Added (EVA) Model

The EVA model uses an economic framework as described previously. The following table shows how this model was used in estimating the value of AVR.

**Apple Valley Ranchos Water Company Water System
Economic Value Added
Valuation Summary (\$000, rounded)**

Line	Description	'14	'15	'16	'17	'18	'19	'20	'21	'22	'23	'24
1	Invested Capital	48.1	53.7	56.8	60.0	63.3	66.7	70.3	73.9	77.7	81.5	84.0
2	Return on Rate Base		.089	.089	.089	.089	.089	.089	.089	.089	.089	.089
3	After-tax WACC		.076	.076	.076	.076	.076	.076	.076	.076	.076	.076
4	Spread		.013	.013	.013	.013	.013	.013	.013	.013	.013	.013
5	Incremental Investment		7.7	7.8	7.9	7.9	8.0	8.1	8.2	8.3	8.4	8.6
6	EVA		.102	.102	.103	.106	.105	.106	.110	.111	.113	.108
7	Discount Factor		.929	.864	.803	.746	.693	.644	.599	.557	.517	.481
8	PV of EVA		.094	.088	.083	.079	.073	.068	.066	.062	.059	.052
9	Sum of P.V. EVA	.724										
10	Value of Operations	48.8										
11	Value of Non-operating Investment	0										
12	Total Value	48.8										

