Town of Apple Valley

A Better Way of Life

June 26, 2015

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RE: TOWN OF APPLE VALLEY OFFER PER GOVERNMENT CODE SECTION 7267.2 TO PURCHASE APPLE VALLEY RANCHOS WATER COMPANY'S WATER SYSTEM

Dear Mr. Schilling:

Pursuant to Government Code section 7267.2(a)(2), the Town of Apple Valley ("Town") wishes to make an offer to acquire Apple Valley Ranchos Water Company's Water System ("Water System"). This system is the subject of California Public Utilities Commission filings by Apple Valley Ranchos Water Company and is described in more detail in the enclosures. The purpose of the proposed acquisition is for the public ownership, operation, and maintenance of the Water System to provide water service to the Town and its inhabitants.

The Town has determined the amount of just compensation for the Water System, using a date of value of June 1, 2015, to be $50,300,000.

The Town's offer is not less than what has been determined by the Town's valuation expert to be the fair market value of the Water System. The basis for that determination is explained in detail in the enclosed Appraisal Summary Statement. It is the Town's hope that this price is agreeable to you. This offer is, however, conditioned upon the Town's ratification of the offer by execution of a contract of acquisition and the adoption of a resolution of necessity authorizing eminent domain proceedings. In addition, because the Water System is the subject of a pending acquisition agreement, this offer is conditioned upon obtaining the approvals and consents of all necessary parties to that agreement.

We are obligated to provide you with certain additional information. Pursuant to Government Code section 7267.2(a)(2) enclosed is an informational pamphlet explaining the eminent domain process.

Please be advised that pursuant to Code of Civil Procedure section 1263.025, the owner is entitled to reimbursement from the Town for the reasonable costs, not to exceed $5,000.00, of obtaining an independent appraisal, should an appraiser be retained.

The "Description of the Apple Valley Ranchos Water System" accompanying this offer is included on a compact disk. A hard copy can be made available upon request.

We look forward to hearing from you. If this offer is not accepted in 30 days of the date of this letter, the Town will consider it rejected.

Very truly yours,

Frank Robinson
Town Manager

Enclosures

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.

$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:

$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:

Earnings Before Interest, and Income Taxes (EBIT)

Less:	*Cash Income Taxes*
Equals:	*Net Operating Profit Less Adjusted Taxes (NOPLAT)*
Plus:	*Depreciation and Amortization*
Equals:	*Gross Cash Flow*
Less:	*Gross Investment*
Equals:	*Operating Free Cash Flow (also called Free Cash Flow to the Firm)*

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**										

4. The following table summarizes the indicators of value developed for the subject property:

Apple Valley Ranchos Water Company Water System
Summary of Indicators of Value
As of June 1, 2015

Line	Approach	Description	Indicator of Value ($)
1	Cost		
2		Rate Base	48,086,807
3	Income		
4		Enterprise DCF	55,942,047
5		Economic Value Added	48,810,463
6		Capitalized Income (no growth)	61,187,050
7		Capitalized Income (growth)	69,929,259
8	Market		Not Relied Upon

The income approach reflects the going concern value of the AVR Water System as a whole, including all assets that are part of the System and used to provide water service to AVR's customers. The highest price for the AVR Water System that would be agreed to by a willing seller and willing buyer is equal to the value indicated by the income approach. If the prospective buyer were to pay an amount greater than the income value, the buyer would be unable to earn its desired return on invested capital.

From the indicators of value for the enterprise (DCF) model listed above, 10% was deducted as the result of a marketability/liquidity discount.

Based on the results of the analyses conducted in the appraisal report and the relative strengths and weaknesses of the indicators of value developed herein, the estimated fair market value of the AVR Water System is $55.9 million less $5.6 million or:

Estimated Fair Market Value as of June 1, 2015 $50,300,000

SEVERANCE DAMAGES

The AVR Waster System is a self-contained system. There are no identifiable severance damages or benefits.

TOTAL JUST COMPENSATION FOR ACQUISITION: $50,300,000

INFORMATIONAL PAMPHLET

OVERVIEW OF THE EMINENT DOMAIN PROCESS

AND DESCRIPTION OF PROPERTY OWNER RIGHTS

(Government Code Section 7267.2(a)(2))

Whenever a public agency makes a formal offer to purchase property under Section 7267.2 of the Government Code, it is required by law to provide a description of the eminent domain process. This pamphlet details the process of eminent domain and property owner rights under eminent domain law.

Public agencies acquire property for all types of public projects, such as schools, roads, water and sewer service, flood control, and fire protection. Sometimes public agencies may have to use eminent domain to acquire property for these projects. Eminent domain is the power to acquire property for a public use conditioned upon payment of just compensation.

The Appraisal Process

Before public agencies can use the power of eminent domain, they must follow certain procedures designed to protect the rights of property owners and the public.

If a public agency is potentially interested in acquiring property for a public project and makes an offer under Section 7267.2 of the Government Code, it is required to send to the owner notice of its decision to appraise the property. This notice will advise the owner that the agency has retained an appraiser to appraise the property. The notice may also provide background information on the acquisition process. It may advise that a business on the property potentially could have a claim for loss of business goodwill. It may also advise that occupants on the property may be entitled to relocation assistance, which can include relocation counseling and the payment for certain costs such as moving costs.

The fact that a public agency has sent a notice of decision to appraise does not mean that it has decided to acquire the property or to use eminent domain. It simply means that the public agency has decided to appraise the property.

The appraiser must also notify the owner that the appraiser is available to meet with the owner to discuss and view the property. After investigating the property and other similar properties, the appraiser will prepare an appraisal report and forward it to the agency.

The Offer of Just Compensation

Upon reviewing the appraisal, the public agency may decide to make an offer to acquire the property. This offer must be in writing. The offer cannot be less than the fair market value established by the approved appraisal. The offer must include certain information, including the public use for which the property is to be acquired and a detailed description of the basis for the conclusions of value. If the comparable sales approach is used, a description of the principal sales must be included. The appraisal report does not have to be provided unless an owner-occupant of residential property with four or fewer units requests to inspect the report.

The offer must be based upon fair market value. Fair market value is a technical legal phrase but generally it means the highest price that a seller and buyer would agree to on a particular date, with neither being under pressure to buy or sell, and with both being fully informed as to the uses available for the property. The proposed public project for which the property may be acquired is not to be considered for either decreasing or increasing the fair market value.

If only a portion of the property is being acquired, such as for a road widening or an underground sewer pipeline, the appraisal may also consider what are called severance damages. Generally, this refers to the reduction in fair market value to the remaining portion of the property that is not being acquired that results from the partial acquisition or the public project. Sometimes a proposed project will actually increase the value of the remaining property. These benefits can be considered in offsetting severance damages, if there any such damages. These benefits cannot be used to lower the value of the actual portion of the property that is being acquired.

A property may be improved and these improvements, if affixed to the realty, may be taken into consideration in the appraisal and the offer. Businesses may also have a claim for loss of business goodwill.

Just compensation is a concept that comes from the California and U. S. Constitutions. The written offer described above is intended to be an offer for just compensation.

The Negotiation Process

The public agency is required to negotiate in good faith upon making its offer of just compensation. It may not use threatening or coercive tactics. The offer process is a voluntary, negotiation process. The owner is under no obligation to agree to the offer.

In making the offer, the public agency must also offer up to $5,000 to the owner to retain an appraiser selected by the owner. The appraiser must be state licensed and other conditions may apply.

The owner and the public agency's representatives may negotiate. If the owner believes that certain information is wrong or incomplete, or if the owner has other information that the agency should know about, the owner may offer that information to the public agency. The owner may make a counter-offer, asking for more compensation or suggesting a change in the proposed acquisition. Or, if the owner does not wish to sell the property, the owner may simply reject the offer or not respond.

When property is occupied, the occupants may be entitled to what is called relocation assistance. These are benefits and services to be given to occupants if the proposed acquisition and public project will require an occupant to move. An occupant need not be an owner of the property to be entitled to such benefits. The nature and extent of the benefits can be technical and will depend upon the particular circumstances of the occupant. Laws and regulations set the amount and nature of applicable benefits. Businesses, homeowners, and renters may be eligible for relocation benefits. These benefits are protections offered by legislation and are different from and in addition to just compensation. When relocation is involved, the public agency will provide an explanation and itemization of the proposed relocation assistance benefits. What is required for relocation is subject to discussion and occupants can provide information they think is important in determining the amount and type of benefits.

Starting Eminent Domain

If the public agency's offer to purchase is not accepted, the public agency may then consider the use of eminent domain. Eminent domain involves the acquisition of property without the owner's consent for a public use conditioned upon payment of just compensation. A public agency may only use the power of eminent domain if it is granted that power by state statute.

The Requirement for a Public Hearing

Before a public agency can consider using eminent domain, it must conduct a public hearing. The public hearing is before the legislative body of the public agency. For example, if a city wishes to consider using eminent domain to build a road, the public hearing must be conducted by the city council. The owner, as identified by the latest tax rolls, is entitled to written notice of the hearing and has a right to speak before the legislative body. At the hearing the public agency considers the adoption of what is called a resolution of necessity. The hearing concerns whether the public interest and necessity require the project, whether the acquisition is most compatible with the greatest public good and the least private injury, whether the property is necessary for the project, and whether the written offer for just compensation has been made. The owner and the legislative body are to address these topics. The owner may be represented by someone at the hearing. This can be legal counsel but does not have to be. The owner must make a timely request to be heard. The notice for the hearing must explain this requirement.

Upon completing the hearing on these topics, the legislative body will determine whether findings on these topics properly can be made, and will consider adopting the resolution of necessity. The resolution can only be adopted if at least two thirds of the full legislative body votes to adopt the resolution.

The Court Process

If the resolution of necessity is adopted, the public agency is then authorized to bring an eminent domain action in state court. This action has to be filed in the county where the property is located. Those with an interest in the property will be named in the action. The action is a lawsuit that must be served on the named parties. The named parties have a right to respond by filing legal papers. In these papers the responding parties may raise legal issues regarding compensation or the public agency's right to use eminent domain.

Once an eminent domain action is filed, the public agency may ask the court for what is called prejudgment possession. This allows the agency to acquire possession of the property so it can begin work on its project without awaiting completion of the court action. The agency may have several actions in court regarding other properties and may not be able to wait until all those actions are resolved before proceeding with construction of its proposed project, such as a road, school, or water pipeline.

To obtain such possession, the public agency must first file and serve a motion on the affected parties. These parties have the right to object and have these objections heard in court. The public agency must also deposit with the court or the State Condemnation Fund the amount of probable just compensation for the property. This amount must be based upon a certified and detailed valuation statement. The owner has the right to challenge this deposit and can file a motion asking to increase the deposit. Those claiming an interest in the deposit may apply to the court to withdraw the deposit or a portion of it.

If the court finds that certain requirements are satisfied and that there are no valid objections to granting prejudgment possession, the court may grant the public agency's motion for possession. State law provides certain time periods to property owners and occupants before possession can take effect.

In many projects, such as road widenings or storm drains, relocation may not be involved at all. If relocation is involved, the public agency must provide relocation counseling and financial benefits to the affected parties. The specific requirements for such counseling and benefits are set by legislation and regulations. Relocation disagreements are subject to appeal to the public agency. Relocation claims may also be presented in court through a lawsuit brought by the claimant. These lawsuits are usually separate from the eminent domain action in court.

The eminent domain action may proceed to trial on the right to use eminent domain or on the amount of just compensation. Trials concerning the right to use eminent domain are conducted only before a judge, without a jury. The California Constitution gives the public agency and the property owner the right to a jury trial on the issue of just compensation. Trials on just compensation focus on the testimony of qualified valuation witnesses. The valuation positions of both sides are usually exchanged in writing on a scheduled date before the trial. These positions are then supported at trial by live testimony, which is subject to cross-examination. At trial, no side has the burden of proof on just compensation. A jury normally must reach a verdict within the range of the valuation opinions allowed into evidence by testimony. In other words, the jury generally cannot find less than the lowest valuation testified to in the trial nor more than the highest valuation.

Before trial either side can make a formal offer to settle. After the trial, if the trial judge finds that the public agency's offer to settle was unreasonable and the owner's offer to settle was reasonable, the public agency is required to pay the owner's reasonable litigation and expert expenses. The public agency cannot recover litigation expenses from the owner for contesting the amount of just compensation. Interest on the awarded just compensation is determined by the court.

During the eminent domain court proceedings, a public agency occasionally may decide that it does not wish to proceed with the acquisition. The owner is given the opportunity to object to the public agency abandoning the proceedings. If the public agency does abandon proceeding with the acquisition, it must pay the other side's reasonable litigation and expert expenses.

Either side may appeal an eminent domain judgment. The appeal process may involve going to the California Court of Appeal, to the California Supreme Court, and to the U. S. Supreme Court. The Court of Appeal must hear a timely appeal. Further review by the California Supreme Court and U. S. Supreme Court is generally within the discretion of those courts.

You Should Seek Professional Advice

This pamphlet is intended to give you an overview of the eminent domain process and property owner rights under state eminent domain law. A public agency does not and cannot represent you or give you legal advice. If you have questions or concerns at any time, you should consider consulting a professional, including an attorney. You always have the right to legal counsel.