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ORIGINAL

Decision No. 68135

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Petition of the Monterey Peninsula Municipal Water District to have fixed the just compensation to be paid for the water system of California Water and Telephone Company existing within and adjacent to the boundaries of said District.	Application No. 41463

Myron B. Haas, Martin McDonough, and C. T. Mess, for Monterey Peninsula Municipal Water District, petitioner.
Bacigalupi, Elkus & Salinger, by Claude N. Rosenberg and William G. Fleckles, for California Water & Telephone Company, respondent.
J. T. Phelps, William R. Roche, Walter J. Cavagnaro, and Martin Abramson, for the Commission staff.

OPINION

On September 2, 1959, petitioner Monterey Peninsula Municipal Water District, hereinafter sometimes called District, filed its petition of the second class setting forth the District's intention to institute such proceedings as may be required to submit to its voters a proposition to acquire the water system of California Water & Telephone Company, hereinafter sometimes called Company, on Monterey Peninsula within the District's boundaries under eminent domain proceedings, and requested the Commission to fix the just compensation to be paid in such proceedings.

By Decision No. 59145, dated October 13, 1959, the District was authorized to amend its petition to name Bank of America, N.T.&S.A., as trustee under the Company's bond indenture.

The hearing on the Order to Show Cause why the Commission should not proceed to hear the petition and fix the just compensation, issued October 6, 1959, was held in Carmel on November 19, 1959. On December 21, 1959, the Commission issued its Decision No. 59436 noting that the Company had presented no objection to the Commission proceeding to hear the petition and ordering that further hearings be held in the matter.

The further hearings commenced on October 25, 1961, and the taking of evidence was concluded on March 20, 1963, after 83 days of hearing during which 135 exhibits were received in evidence.

Briefs were filed, oral argument was held before the Commission en banc on October 30, 1963, and the matter was taken under submission subject to the filing of an amendment to the petition to conform the description of the property to the proof. The reporter's transcript of the hearing consists of 84 volumes including 9,619 pages.

The Second Application for Leave to Amend Petition was filed November 14, 1963, the response of the Company was filed on December 9, 1963, and the stipulation relative to the Second Application for Leave to Amend was filed on February 7, 1964. By Decision No. 67258, issued May 26, 1964, the Commission authorized the further Amendment of the Application pursuant to the Second Application for Leave to Amend, as amended by said stipulation. Said stipulation provides that (1) the Company shall not in any proceeding contend that the inclusion of the flowage easements in the amended petition impairs the force or effect of the finding on just compensation to be made by the Commission in this proceeding, (2) the District agrees that both the Company and the District in any supplemental just compensation proceeding before this Commission may present evidence relative to such flowage easements, and (3) any increase in just compensation which might have been awarded in this proceeding on account of such claimed flowage easements may in lieu thereof be awarded in such supplemental proceeding.

The District urges that the just compensation to be fixed by the Commission not exceed $10,800,000, and the Company urges that the evidence establishes a value for the properties in question of $24,000,000. The Company estimate of $24,000,000 is based upon a summation of the following Company estimates:

Reproduction Cost New Less Accrued Depreciation	$17,586,252
Lands and Rights of Way	2,015,185
Water Rights	3,500,000
Organization Expense	107,000
Going Concern Value	1,000,000
Total	$24,208,437

The issues presented in this proceeding for Commission determination are as follows:

1. What is the proper measure of just compensation in this case? Is it the summation of reproduction costs and intangible values, as contended by the Company, or is it fair market value, determined predominantly by earning power, as urged by the District?

2. To the extent that reproduction cost new less accrued depreciation of physical works is a factor in just compensation:

(a) Is the higher reproduction cost new before general overheads figure produced by the witness for the Company, or the lower figure of the Commission staff engineers, to be used in this proceeding?

(b) Should the general overhead allowances estimated by the District's witness be used in place of the higher allowances of the staff and Company witnesses?

(c) Is the most appropriate method of depreciating reproduction cost new the sinking fund-present worth-equal annual cost method employed by the witness for the Company, or the straight-line method as employed by the Commission staff witness?

(d) Should such an estimate include cost of paving over mains where historically no such paving occurred?

3. To the extent that market value of land and land rights is a factor in just compensation, should the Commission use the higher figures of the witness for the Company, or the lower figures of the witnesses for the District?

4. To the extent that value of water rights can be dealt with separately, and as such is a factor in just compensation, is it more appropriate to use the cost of developing a substitute supply from outside the basin, developed by the witness for the Company as its absolute value, or the cost of developing a substitute supply from alternate works within the basin, used by the witness for the District, to modify the estimate of reproduction cost new, including land?

5. To what extent, if any, is it appropriate to determine an allowance for organization expense and going concern value as an additive to the summation of physical costs and water rights, and to that extent, what credit should be given to the testimony of the overall valuation witness for the Company?

Both the District and the staff agree that this Commission in determining the just compensation to be paid for the properties of the Company may consider market value, original cost, rate base, capitalization of earnings, and reproduction cost. The Company urges that just compensation is the summation of (1) reproduction cost new less depreciation for physical properties other than lands and rights-of-way, (2) the market value of lands, easements, and rights-of-way, (3) the market value of water rights, (4) organization costs, and (5) going concern value.

The closing brief for the District defines market value as "the price which would be paid by an informed and agreeable purchaser to an informed and agreeable seller, neither being under any unusual pressures as to time or circumstances."

The definition of market value which appeared in City of North Sacramento, 56 C.P.U.C. 554 at 561 reads as follows:

> "In determining just compensation the Commission should consider those matters which would be considered by a willing seller and by a willing buyer each of whom has knowledge of all the uses and purposes to which the property is best adapted and for which it is capable of being used."

We conclude that market value as so defined under these definitions is the proper measure of just compensation in this proceeding.

Knowledgeable sellers and purchasers of utility properties, of course, realize that such properties have been dedicated to public use and that the use of such properties is thereby limited to such use.

This Commission will take official notice of the following facts and finds that an informed purchaser and an informed seller would be aware of such facts:

1. The Company has dedicated the properties involved in this just compensation proceeding to the public use and is lawfully operating such properties as a public utility water corporation on the Monterey Peninsula.

2. Properties dedicated to the public use must continue to be so used until lawfully abandoned to the public or until some other use is authorized by this Commission.

3. No other private entity may operate as a public utility water corporation within the service area of the Company on the Monterey Peninsula unless it obtains a certificate of public convenience and necessity from this Commission, and this Commission can grant such a certificate only after making a finding that public convenience and necessity require or will require the construction of the system needed for such operation.

4. The District may parallel the lines of the Company and operate a competing water system on the Monterey Peninsula without authorization from this Commission.

5. The rates which this Commission has presently authorized the Company to charge for its service are rates which this Commission has found will allow the Company an opportunity to earn a reasonable return on the original cost of its properties plus an allowance for working capital less the depreciation reserve and deducting advances for construction and contributions in aid of construction.

Other facts to be considered in determining just compensation are original cost less depreciation, rate base, comparable sales, capitalization of earnings, and present day cost, i.e., the sum of (1) reproduction cost new less depreciation of physical properties other than lands and rights-of-way, (2) the market value of lands, easements and rights-of-way, (3) the market value of water rights, and (4) organization costs and going concern value.

With respect to the first issue raised by the District we further conclude that a willing purchaser and a willing seller would undoubtedly consider both the present and potential earning power of the properties and the present day cost as factors affecting market value. The willing purchaser would expect to be able to earn a reasonable return on his investment in the properties and he would be unwilling to pay much in excess of the present day cost of the properties in view of the possibility of the water system being paralleled or condemned by a public agency. A willing purchaser and a willing seller would also consider the fact that public agencies as well as private concerns are in the market for utility properties.

We shall next consider the evidence introduced in this proceeding pertaining to just compensation.

There is no dispute as to the original cost of the properties depreciated and the rate base. We find that the original cost of the properties and the rate base components, as of September 2, 1959, are as set forth in Exhibit No. 25 as follows:

Original cost of utility plant, exclusive of intangibles, land, land rights and water rights		$9,935,107
Less Depreciation Reserve		1,863,958
Subtotal		$8,071,149
Intangibles		45,302
Original Cost of Land and Land Rights		315,587
Original Cost of Water Rights		89,594
Total Original Cost of Properties Depreciated		$8,521,632
Less:		
Advances for Construction	$350,655	
Contributions in Aid of Construction	563,381	
Other Modifications	13,995	928,031
Original Cost Rate Base Components		$7,593,601

Exhibit No. 140 is a tabulation of sales of water systems and ratios of sales price to depreciated plant, as follows:

SALES OF WATER SYSTEMS
RATIO OF SALES PRICE TO DEPRECIATED PLANT COST

Approx. Date	Orig. Owner	Purchaser	Sales Price	Depreciated Plant Cost	Ratio Sales Price to D.P. Cost
Sept.1956	Ben Ali Water Co.	Arcade C.W. Dist.	$1,787,000	$1,490,000	120%
Jan. 1958	Calif. W. Serv. Co.	Hanford	1,837,300	1,109,000	164%
Mar. 1959	P.G.&E.	Vacaville	1,700,071	1,486,245	123%
Apr. 1959	Lakewood W.& Power Co.	Lakewood	4,465,000	3,398,000	130%
Sept.1959	Cal.Water Serv.	Petaluma	2,425,000	1,697,000	156%
June 1956	Cal.Water Serv.	San Ramon C.W.D.	1,764,000	1,778,259	99%
Feb. 1961	Cal.Water Serv.	C.C.C. W. Dist.	13,350,000	10,819,500	124%
Mar. 1963	Western Water Co.	West Kern C. W. Dist.	1,425,000	901,000	158%
Jan. 1962	P.G.&E.	Cal. Water Serv.	4,250,000	4,037,000	105%
1954-1958	29 small Systems	Various (from Contra Costa Report)		av.	107%
8/1/62	Pacific Water Co.	So. Calif. Water	1,863,510	1,883,510	99%

This exhibit was introduced not for the purpose of establishing comparable sales prices of water properties, but for the purpose of establishing the range of the ratios of sales prices to the depreciated plant costs of comparable properties, i.e., public utility water systems operating under the jurisdiction of this Commission. We find that the information set forth in said Exhibit No. 140 is representative of the range of the ratios of sales prices to the depreciated plant costs of water systems as of September 2, 1959.

The District's municipal financing consultant witness testified that he "viewed earning power, or the productiveness of the property, as the principal, dominant element bearing on the question of fair market value."

In arriving at his conclusion that the fair market value of the system as of September 2, 1959 was $10,800,000, which is approximately 142 percent of the original cost rate base components and approximately 127 percent of the depreciated plant cost, this witness took into account the following: "the property to be valued in this proceeding had, on September 2, 1959, been in operation under the jurisdiction of this Commission for a long time, as an important and prosperous enterprise; that it has consistently earned an adequate return on the investment, and may be expected to continue to do so. The water supply in the area is adequate for the foreseeable future, and the area served will continue to grow in an orderly, consistent, well-planned fashion." He also considered the past earnings of the property as reported in the annual reports of the Company on file with this Commission, prospective future earnings, interest rates on borrowed capital, and income, property and capital gains taxes. In addition he "examined certain other actual transfers of water properties to determine the relationship of the sale or condemnation price to the depreciated plant book cost. The ratios ranged from about 99 percent to a high of 164 percent of depreciated plant book cost with about 70 percent of the transfers taking place at less than 140 percent of depreciated plant book cost." A tabulation of these transfers is set forth in Exhibit No. 140, as shown above.

The District's municipal financing witness did not give adequate consideration to the effect of the exclusion of the advances for construction and the contributions in aid of construction from the rate base on which this Commission allows a return, and we are of the opinion that this witness was too conservative in his estimate of the market value of the properties involved in this proceeding based principally upon the earning power of such properties.

We find that as of September 2, 1959, the value of the properties involved in this proceeding based principally on the capitalization of earnings, or the productiveness of the property, and a consideration of the transfers of other utility properties set forth in Exhibit No. 140 was $12,500,000, which is approximately 147 percent of the depreciated plant cost and approximately 165 percent of the rate base.

We shall next consider the evidence pertaining to present day cost and the issues pertaining thereto.

Since a public entity could theoretically parallel the water system, whereas a private entity could not except in special circumstances which have not been shown to exist in this proceeding, we conclude that the reproduction cost estimate to be used in this proceeding should be that for a public rather than a private entity.

If a public agency were to parallel the water system involved in this proceeding it would have to cut and replace nonhistorical rather than historical paving.[1/] Therefore, we conclude that the estimate of reproduction cost should include the cost of cutting and repaving over mains wherever paving existed as of September 2, 1959.

The following is a table of the comparative results of the reproduction cost new studies of the staff and the Company, including the general overheads estimates of the District:

1/ Historical paving is paving which was in place at the time the mains were actually installed. Nonhistorical paving is paving which was in place on September 2, 1959, the date of the filing of the petition herein.

	Staff RCN	District RCN	Company RCN
Direct Materials	$ 7,636,000		$ 7,553,000
Material Indirects	525,000		333,000
Direct Labor	3,301,000		3,812,000
Labor Indirects	399,000		427,000
Equipment Costs	2,537,000		2,711,000
In Place Costs	803,000		970,000
Field Engineering	947,000		880,000
Contractor's Overhead and Profit	500,000		2,269,000
	$16,648,000	$16,648,000	$18,955,000
General Overheads			
Construction by Private Entity	2,066,000	1,839,000	2,643,000
Construction by Public Entity	1,769,000	1,456,000	-
RCN - Private Entity	$18,714,000	$18,487,000	$21,598,000
RCN - Public Entity	$18,417,000	$18,104,000	$ -

The principal differences in the reproduction cost estimates of the parties occur in the item Contractor's Overhead and Profit and the item General Overheads.

As the Company estimate of $2,269,000 for contractor's overhead and profit includes certain costs included elsewhere in the staff's estimate for this item, the staff's estimate of $500,000 has been increased to $783,670 to place the estimates on a more comparable basis. The difference between the Company estimate and the adjusted staff estimate for this item therefore amounts to $1,485,330.

The staff witness testified that in making his estimate for contractor's overhead and profit he applied a judgment percentage of 8 percent to both labor and equipment costs which is equivalent to a percentage of 13-1/2 percent applied to a direct and indirect labor base. In arriving at this judgment percentage the staff witness considered "cost plus" type contracts under which contractors perform work for water utilities. The staff witness considered that E. P. Heple did work for San Jose Water Works at a charge of 8 percent of the direct and indirect labor costs to compensate for overhead costs, supervision, management and profit and that E. T. Haas had an agreement with California Water Service Company which provided 9 percent of the direct and indirect labor costs for contractor's overhead and profit. The staff counsel in his brief argues that a reproduction cost new estimate should be based on a "cost plus" type contract rather than a bid type contract, because the historical data available for use in the preparation of such an estimate reduces to a minimum the risk attendant by reason of the unforeseen elements which are present in estimates of future construction costs.

The staff reproduction cost new estimate was based on the assumption that the construction agency rather than the contractor would purchase and supply the materials. This was done to eliminate contractor's overhead and profit on materials and to provide the benefits of quantity purchases by an established utility. The record shows that this assumption is consistent with the actual practice of East Bay Municipal Utility District, the City of San Francisco, San Jose Water Works, California Water Service Company, and California Water & Telephone Company.

The staff witness testified that the administrative organization of the contractor necessary for the project, exclusive of the two dams, was one superintendent, one project engineer, and two timekeepers. A similar type of organization would be provided for each of the dams. The staff witness recognized that contractor's overhead and profit would also include the field and office overhead costs that the contractor would incur as well as an allowance for profit.

The Company's rounded estimate of $2,269,000 for contractor's overhead and profit may be broken down as follows:

Overhead	$1,184,845
Margin	1,128,600
Bond Costs	63,000
	$2,376,445
Less Corrections per Exhibit No. 75	106,960
	$2,269,485

The Company's estimate included the amount of $4,239,332 for direct and indirect labor costs. Relating the $2,269,000 for contractor's overhead and profit to this labor base produces a ratio of 53.5 percent. This may be compared to the ratio of 13.5 percent derived from the staff's estimates.

The Company's estimate for overhead is allocated as follows:

Los Padres Dam	$ 154,000
San Clemente Dam	56,000
Remainder of System	975,000
Total	$1,185,000

The above sum of $975,000 is composed of two items, $676,000 for salaries and payroll taxes for the 32 administrative employees and $299,000 for overhead costs other than payroll.

In direct labor costs the Company has provided for 14 foremen to supervise the working personnel. Among the 32 administrative personnel provided for in contractor's overhead of $975,000 are a project manager, a general superintendent, an administrative manager, a project engineer, six field superintendents and three office engineers. These are in addition to the supervisory and administrative personnel associated with the two dams.

The amount of $110,000 for surveying is included in the Company's previously mentioned sum of $676,000 for salaries and payroll taxes. Under field engineering the Company has also included the sum of $114,000 for surveying. Clearly one of these amounts should be eliminated for the reproduction cost estimate of the Company.

In addition to contractor's overhead the Company estimate includes $1,129,000 for contractor's margin. The amount was derived by applying a 25 percent factor to the labor costs in the two dams and a 27 percent factor to the labor costs on the remainder of the system. These factors are factors which would be appropriate for a very high risk undertaking rather than for a reproduction cost estimate based on historical data and plant which can be inspected in place.

We find that the staff's estimate for contractor's overhead and profit is the more reasonable and should be adopted in this proceeding.

The other item in the reproduction cost new estimates where there is a large difference is general overheads. The Company estimate is that for a private entity and uses a 36-month construction period and a 6½ percent rate for interest during construction. We have previously concluded that the reproduction cost new estimate to be adopted in this proceeding should be that for a public entity.

The District estimate for general overheads for a public entity is based on a 33-month construction period and uses an interest rate of 2.83 percent for interest during construction. The staff estimate is based on a 36-month construction period and uses an interest rate for a public entity of 4.5 percent. We find that the 36-month construction period and the 4.5 percent interest rate as used by the staff in computing its estimate for general overheads are appropriate in this proceeding.

The voluminous evidence pertaining to the reproduction cost new estimates is much more thoroughly discussed by the parties in their extensive briefs. We have considered the qualifications of the witnesses, the thoroughness of the respective studies and the testimony of the witnesses regarding the reproduction cost new estimates. We find that the staff estimate of $18,417,000 is reasonable and should be adopted in this proceeding.

In the evaluation of present day cost, accrued depreciation is deducted from reproduction cost new because it represents the dollar loss in service value not restored by current maintenance and occasioned by physical and functional causes. The staff based its estimate of accrued depreciation upon the principle of the straight-line method, whereas the Company employed the sinking fund-present worth-equal annual cost method. The following sets out the estimates of accrued depreciation:

Accrued Depreciation

	Staff		Company		Company Over Staff
Item	Amount	Percent of RCN	Amount	Percent of RCN	Amount
Public Entity	$6,077,000	33.0%	$ -	-%	$ -*
Private Entity	6,174,000	33.0%	4,012,000	18.6%	(2,162,000)

(Red Figure)

* Company made no reproduction cost new estimate for a public entity.

The method of depreciation used in developing the estimates of accrued depreciation was the primary reason for the difference between the staff and company estimates of percent accrued depreciation. The sinking fund-present worth-equal annual cost method produced considerably lower amounts for accrued depreciation than the straight-line method used by the staff. We are in this proceeding concerned with an attempt to measure the dollar loss in service value as related to a reproduction cost new study. While an interest factor may be appropriate in certain types of economic studies, in a proceeding of this type it has to be considered in relation to the type of appraisal involved. Accrued depreciation is the end result of a considerable number of physical and functional elements of depreciation and we conclude that straight-line depreciation produces a reasonable result to be used in conjunction with the reproduction cost new appraisal prepared by the staff. We adopt the staff's accrued depreciation estimate for a public entity of $6,077,000 as reasonable, and find that the reproduction cost new less accrued depreciation of physical properties of $12,340,000 is reasonable.

The following is a tabulation of appraisals of land and land rights by the District and the Company:

	District	Company
Land	$1,039,000	$1,846,775
Land Rights	103,970	168,410
Total	$1,142,970	$2,015,185

We have considered the qualifications of the witnesses, the care with which the appraisals were made, and the evidence submitted by the parties regarding the value of land and land rights free from the restrictions imposed on them by reason of the dedication to public use and we are of the opinion that the District's total estimate is too low and the Company's total estimate is too high. We believe that the District's estimate, although too low, is more nearly accurate than the Company's estimate. We find that the reasonable value of the land and land rights without consideration of the restrictions imposed by reason of the dedication to public use is $1,475,000.

The Company through its witness introduced evidence to show that the value of the water rights is $3,500,000. This appraisal was in part based upon the estimate of the Company's witness of the cost of obtaining a comparable alternate supply of water through the Pacheco Aqueduct of the Santa Clara-Alameda-San Benito Water Authority which is usually referred to as the Tri-County Water Authority. One of the plans of the Tri-County Authority is to take water which has been brought from the Feather River Development to the San Luis Reservoir near Los Banos and to carry that water in a tunnel through the Pacheco Pass to serve Santa Clara, Santa Cruz and San Benito Counties. This witness concluded that the most reasonable and economic way to obtain a substitute supply of water for the Monterey Peninsula area would be to transport water from this proposed Pacheco Aqueduct. This witness also considered comparable sales and the difference in the value of the lands in the area with water and the value of the same lands without water. This appraisal was based on the assumption that the Company has a first and prior right to all the surface and underground water in the Carmel River which amounts to at least 44,000 acre-feet annually.

The first witness for the District who testified regarding the value of the water rights appraised them at $117,000. This estimate was based in part on an estimate by another of the District's witnesses that the cost of reproducing the Company's existing rights as of September 2, 1959 would be $21,000.

The second witness for the District testified that an alternate water supply plant with water rights could be constructed at a present cost which is $1,239,093 less than the depreciated reproduction cost shown for the existing water supply system in the Commission staff appraisal. The costs used by this witness were those for the construction of an alternate system to bring water to Forest Lake reservoir using ground water capacity, not used by the Company to develop its possible future yield of 18,000 acre-feet.

The appraisals of the District witnesses were based on the assumption that the present water rights of the Company when fully exercised can provide a safe yield of not more than 18,000 acre-feet annually, but they were also based on a review of all the documents through which the present water rights of the Company were acquired.

After reviewing the qualifications of the witnesses and evidence pertaining to the value of the water rights we find that the present day cost of the water rights of the Company which the Company has dedicated to public use, as of September 2, 1959, is reasonably $117,000. This amount is a proper addition to the present day cost of land and improvements.

The only evidence in the record pertaining to organization expense is the $107,000 estimate of the Company's witness. We find that the amount of organization expense to be included in our finding of present day cost is reasonably $107,000.

The witness for the Company also testified that $1,000,000 should be allowed for going concern value. Counsel for the District contends that this evidence should be given no weight because (a) development costs are inconsistent with a reproduction cost new theory and (b) increases in value because they comprise a going concern must relate to the earning power of the properties. In the absence of earning power which would justify a valuation in excess of reproduction cost new less depreciation he would allow nothing for going concern value. These contentions relate to good will rather than going concern value. The conditions which justify a going concern value as an element of present day cost exist in this proceeding. The Company's estimate of $1,000,000 is too high, however. We find that $300,000 reasonably should be added for going concern value in computing total present day cost.

We find from the foregoing evidence that the present day reasonable cost of the Company's properties involved in this proceeding as of September 2, 1959, is $14,339,000, which is the sum of the following amounts:

RCN Depreciated	$12,340,000
Land and Land Rights	1,475,000
Water Rights	117,000
Organization Expense	107,000
Going Concern Value	300,000
Total	$14,339,000

The following is a tabulation of the preliminary findings upon which the ultimate finding of just compensation is based:

Original Cost	$ 8,522,000
Rate Base	7,594,000
Capitalization of Earnings and Transfers of Other Utility Properties	12,500,000
Present Day Cost	14,339,000

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ULTIMATE FINDING AND ORDER

The Commission finds that the total just compensation to be paid by the Monterey Peninsula Municipal Water District for the taking of the lands, properties and rights described in the District's petition, as amended, is the sum of $12,720,000.

The Secretary is directed to cause certified copies of this order to be served upon the parties, including Bank of America N.T.&S.A., and the effective date of this order, as to any party, shall be twenty days after service upon such party.

Dated at San Francisco, California, this 27th day of OCTOBER, 1964.

President

Commissioners

We dissent. The people of the Monterey area are being required to pay an excessive amount for property already dedicated to their use. We will file a full explanation of our reasons.

George G. Grover
Frederick B. Holoboff

DCF

Decision No. 68135

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Petition of the Monterey Peninsula Municipal Water District to have fixed the just compensation to be paid for the water system of California Water and Telephone Company existing within and adjacent to the boundaries of said District.	Application No. 41463

DISSENTING OPINION

I dissent. Capitalization of earnings is the proper measure of just compensation in this case; judged by that standard, the District's proposal of $10,800,000 is adequate.

I

This case goes to the very heart of the public utility concept. Not only is there a substantial amount of money directly at stake, there is much more money involved indirectly in the many sales and condemnations which will be influenced by this award. The proceeding has been before us for over five years, it was thoroughly and ably presented on both sides, and it has attracted widespread interest as a test of current condemnation principles. Whether intentionally or not, the majority commissioners have shown in their decision what they truly think of public utility regulation. My view of regulation is quite different.

Public utility condemnation is merely the other side of the mirror. On the rate regulation side, we struggle to do justice to the utilities and to the public by fixing the charges of these monopolies at a reasonable level. The California Commission has a good record and there are a number of our policies over the years which have served in this direction: original cost rate base, remaining life depreciation, alter ego adjustments, flow-through taxes, lead-lag working cash, interim relief, and many more. All of these painstaking efforts are brought to nought, however, by the majority decision in this case. The essence of that decision is that the public, in condemnation, must now pay <u>more</u> than the equivalent of the rates which we have found to be reasonable.

Condemnation should not make such a difference. It should not make <u>any</u> difference. The properties we are appraising are already "dedicated" to this very same public: the people of the Monterey area. These properties cannot lawfully be used for any other purpose, and the present owner is even obligated to maintain, improve, and extend them in accordance with reasonable public demand within the service area. No one other than a public agency will pay for the system any significant amount above rate base, and no public agency other than this condemnor is interested. (Even if the city or the county or some other district were interested, it would merely be the same public acting through a different agency.) As Mr. Justice Shenk observed more than a quarter-century ago (speaking for the California Supreme Court in Southern California Edison Co. v. Railroad Commission [1936] 6 Cal.2d 737, 754):

> ". . . We are here dealing with a problem in the condemnation of a specific unit of the property of a public utility corporation. That property is already impressed with a public use. It is possessed by the company subject to the right of the city to acquire it pursuant to the Constitution which insures to the owner just compensation for the property taken and likewise pursuant to other laws of the state which prescribe the rules under which the amount shall be ascertained for the taking of that and similar property. This is not like the property of a strictly private corporation, as to which the productiveness in excess of a reasonable return might be controlling. Here the public has already acquired an interest in the property in the sense that it may insist upon service faithfully and impartially and at no more than reasonable rates. . . ." (Emphasis added.)

Almost any property is available on a voluntary basis "at a price". The essence of eminent domain is that the public may not be held up for this extra price. The whole idea is that the price should be the same as the value of the property in the absence of public acquisition. In the absence of public acquisition, dedicated public utility property has only one value: rate base x rate of return - in a word, earnings. Moreover, it is earnings at a reasonable level, as determined by this Commission. The reasonable earning value of this property constitutes "just" compensation for the simple reason that it is the only compensation in the absence of condemnation. To award on condemnation anything more than such earning value is to award a premium, a premium which is repugnant to the very concept of eminent domain. It constitutes a special burden upon the public through an extra charge for public acquisition. How ironic that this Commission should be blind to that burden!

It is settled that value to the condemnee, not value to the condemnor, is the real test of just compensation. Thus, in United States v. Cors, 337 U.S. 325, 333, 93 L.ed. 1392, 1399 (1949), the United States Supreme Court said:

> "It is not fair that the government be required to pay the enhanced price which its demand alone has created. That enhancement reflects elements of the value that was created by the urgency of its need for the article. It does not reflect what 'a willing buyer would pay in cash to a willing seller' . . . in a fair market. . . . That is a hold-up value, not a fair market value. That is a value which the government itself created and hence in fairness should not be required to pay."

The Cors case involved a tugboat; the principle is even more applicable to utility property, which is already dedicated to the public.

It is sometimes pointed out that public agencies are in a position to pay more for a public utility system than private buyers are, for a public agency is not subject to most of the taxes which a private operator must pay. But this is merely a special value to the condemnor, not a circumstance which would bear on ordinary sales of such property. To increase the award on that basis would be to grant to the private owners, indirectly, a tax advantage which Congress and the Legislature have most emphatically withheld from them. Moreover, any loss of tax revenue resulting from public acquisition must be compensated through additional taxes upon the public in some other way, or else there must result a corresponding reduction in governmental services to the public; in either case, the public really does pay after all for any tax benefit gained in acquiring the system. The fact that a different segment of the public may be called upon to make up for the loss in tax revenue occasioned by the transfer from private to public ownership is a matter for legislative consideration in planning the spread of taxes; it is not a factor to be weighed in determining the just compensation due the private utility. Especially is this true in the case of a water system condemnation; with over 80% of California's water users already receiving a tax exemption through public or mutual ownership, the people of the Monterey area will not be gaining a tax advantage as much as they will be overcoming a long-standing tax disadvantage.

These tax considerations also completely invalidate the effort to judge this transaction on the basis of other sales of water utility systems. In virtually every such sale to private purchasers, original cost rate base or its substantial equivalent has been the purchase price. Only the tax-exempt, unregulated public agencies will pay more, for under our regulations the rate base (that is, the earning potential) for a private purchaser will be the same as that for the seller. Another factor which bears on these "voluntary" sales is that many of them have been negotiated in contemplation of condemnation; they have been influenced, therefore, by three unfortunate factors for which this Commission bears at least some responsibility: (a) our condemnation procedures take a long time (in this case more than five years); (b) our condemnation procedures are costly (in this case the

District's expenses to date are reported to be close to $700,000); and (c) our condemnation awards in the past, in their unjustified preoccupation with reproduction cost, have often exceeded just compensation, so that prospective condemnors have felt compelled to settle for more than a reasonable amount.

Reproduction cost (or reconstruction cost) can be an appropriate test for just compensation in certain unusual cases, but it is not sound when capitalization of earnings provides a reasonable approach. The very idea of reproducing a water system is contrary to public utility philosophy. Utility regulation in the United States has developed in large part because of our concern about duplication of such large capital expenditures; the American solution has been to legalize private monopoly, with rate regulation as a necessary adjunct. Reproduction is also repugnant to the principles of condemnation; it is to avoid building its own system that a condemnor takes over the existing one - pursuant to its lawful right to do so. If the condemnee is given the system's earning value, he receives the equivalent of what he has lost and is thereby fairly compensated. Reproduction value, in contrast, is a grotesque substitute for the realities of the transaction.

An exceptional situation in which reproduction cost might properly be used would be presented by facts suggesting that reproduction cost is below depreciated original cost and below the capitalized equivalent of earnings. Under such facts, the public would have the practical option of duplicating the system at less than these other measures of compensation, and no doubt the condemning agency would do so unless it could obtain the existing system for the price of reproduction. Accordingly, in furtherance of the social policy against system duplication, the Commission would be justified in limiting the condemnee's compensation to the reproduction cost. The alternative of a higher award would merely prompt the condemnor to build its own system.[1/]

1/ In passing, it should be observed that this view of reproduction cost would call for no deduction on account of depreciation, for of course the condemnor, in resorting to such an alternative to condemnation, would have to pay the full present cost of reproducing the system.

I do not propose original cost rate base as a measure of just compensation. A strong argument can be made for such a rule (see 54 Columbia Law Review 916), and it derives considerable support from the fact that private purchases of public utility property are usually at or near rate base. But where, as here, utility common stock is publicly traded, and where it can be shown that investors are willing to pay substantially more for it than its book value, I am persuaded that it would be unrealistic and unjust to ignore the premium which the marketplace has thus bestowed upon the property.

II

It will not always be possible to appraise business property on the basis of capitalized earnings. If the necessary records are lacking, or if earnings are erratic or affected by temporary or irrelevant influences, it may be difficult to say just what the true earnings are. At times it may also be difficult to determine with reasonable accuracy what the capitalization rate should be. Such problems may be especially troublesome in non-utility condemnations. In proceedings before a jury, they may be further intensified by the fact that the capitalization method calls for a certain amount of expert judgment; courts have sometimes thought it safer to rely on the relatively less complex method of comparing prior sales of similar property.

None of these considerations are appropriate here - indeed they will seldom be present in any major utility condemnation tried before this Commission. In the first place, the alternative of comparing other sales is, as has been seen, illogical and unfair - even if we assume that it is ever reasonably possible to compare one utility system with another. Moreover, capitalization of earnings is ideally suited to the public utility situation. As a result of the Commission's Uniform System of Accounts, the necessary records will almost always be available. The very fact of regulation also tends toward long-range stabilization of earnings, for whenever earnings become too high or too low, either the utility or the Commission is likely to initiate corrective proceedings. Certainly there is no difficulty involved with respect to the particular water system being appraised in this case; the detailed annual reports of the company, duly filed with the Commission, show that the 1959 earnings were both representative and reasonable - in fact they were somewhat better than in the years immediately before and after. Determination of a reasonable capitalization rate is likewise not a significant problem; an extensive and current literature on utility earnings is available, and this Commission and its staff (in connection with the almost identical process of determining reasonable rates of return) have developed expertise as to capitalization factors and are experienced in applying them. Whatever might be said of nonutility enterprises (or even certain other utilities, such as very small water or telephone companies), the 1959 capitalized earnings of this utility system are capable of reasonable calculation. Possible difficulties in other cases provide no basis for refusing to rely on capitalized earnings here.

The same is true of the suggestion that capitalization of earnings in certain cases might lead to unreasonable results. That is not this case. The fact that a utility is not entitled to capitalization of excessive earnings (Southern California Edison Co. v. Railroad Comm., supra) does not mean that capitalization of reasonable earnings is inappropriate.[2/] Original cost rate base is not rejected as a general standard for rates merely because, in some cases, utilities have made unreasonable investments in plant; the solution has been to modify the general standard to fit such exceptional facts or, if necessary, to apply some other standard.

The earnings of this system in 1959 were reasonable. Capitalization of earnings is therefore an appropriate standard for this case and for most utility condemnations. The time to consider exceptions is when exceptional facts are presented.

Still another criticism of capitalization of earnings is that, in a given case, there may be special values in the property which are not reflected in utility earnings. Thus, if a utility reservoir is located on oil-bearing lands which have not yet been developed for oil, the contribution of those lands to utility earnings might be slight compared to their value for oil production. Again, however, it is only necessary to adjust general principles to allow for this special case. If the oil can be produced without interfering with utility operation of the dedicated reservoir

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2/ Capitalization of low earnings could also be unfair, as when a utility is condemned during its developmental period, before customer density is sufficient to generate adequate revenues.

(or if a comparable reservoir can be developed elsewhere without the complication of potential oil production), then the condemning agency can adjust the scope of its taking accordingly; otherwise it should reasonably expect to pay extra for taking the oil. The appropriateness of capitalized earnings as a general standard for the condemnation is not affected.

All these various criticisms of capitalization of earnings amount to no more than a recitation of exceptional situations in which it may not be possible to apply it or in which its application might call for reasonable modification. No regulatory technique can be uncritically imposed upon all situations; even the most firmly established principles must occasionally be modified to fit the reasonable requirements of exceptional circumstances.[3/] It is enough to say that in this case, as in the case of most major utility condemnations before the Commission, capitalization of earnings is an available, reliable, and sufficient standard for determining just compensation, a standard superior to any other which has been suggested.

III

A precise figure for the capitalized earnings of this water system as of September 2, 1959 need not be set forth here. The Commission has refused to adopt capitalized earnings as the standard for valuation, and no purpose would be served in my presenting a detailed calculation. Even without such detail, however, this much can be said: the capitalized earnings for 1959 are close to the $9,631,000 estimated by the District's financial witness and are no more than the District's proposed award of $10,800,000. In awarding $12,720,000, the majority Commissioners have allowed approximately two million dollars more than the public should pay.

In essence, the method employed by the District witness for capitalization of earnings was to allow book value of the portion of the

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3/ In connection with depreciated original cost rate base, for example, the Commission often applies a "saturation" factor during the initial development of a system; a utility thus may not earn anything at all (notwithstanding a substantial investment) until reasonable customer density is obtained. At the other extreme, a utility is usually allowed to earn on property which is "fully depreciated"; this refinement merely brings out the distinction between depreciation (return "of" investment) and profit (return "on" investment). There are many such refinements of the original cost rate base principle.

system which is represented by debt, preferred stock, advances, and contributions,[4/] and to allow a premium value for the portion represented by common equity. This premium value was calculated primarily from a price-earnings ratio of 14, based on quotations for the company's common stock for the period in question and a comparison with similar stocks. The result was to recognize a higher value for common equity than its book value - a higher value commensurate with the esteem in which investors generally then held the company's common shares.[5/] All the indications confirm that the selection of a price-earnings ratio of 14 for 1959 was sound. A similar calculation, using the same general approach but based on the detailed information contained in the company's annual reports for the period in question, yields a comparable figure: slightly below $10,000,000. Another approach would be to determine this common equity "premium" value by substituting for the book value of common equity the value given by investors in 1959 to the company's common shares. On the basis of a price

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4/ The claim in the majority opinion that he did not consider advances and contributions is simply not true. His calculation of capitalized earnings utilized depreciated original cost of $8,521,632 (which includes advances and contributions) rather than rate base of approximately $7,600,000 (which excludes advances and contributions). (See Reporter's Transcript, page 9336.) That he also considered advances and contributions in his comparison with transfers of other water systems is apparent from a reading of pages 9344-9347 of the transcript.

Beyond the fact of this misstatement in the majority opinion, I take issue with the view that contributions should be included in the award. Essentially they represent exactions from customers and land developers as a condition of water service; although the utility holds title to the resulting plant, the Commission, in fixing reasonable rates, properly disallows any return on such contributions. The public should not be required to pay for this property again merely because title is being transferred to a public agency. To allow compensation for contributions is to grant the company a condemnation windfall.

Advances for construction present a closer question because they may eventually have to be refunded. A reliable estimate of the portion of advances which is likely to be refunded can sometimes be made, and in such a case the Commission would be justified in allowing for advances only the amount of such estimate. (See my dissenting opinion in Camino Water Co., 61 Cal.P.U.C. 605, 610.)

5/ The witness assumed that the Monterey water system was about 10% of the company's properties; the annual reports of the company indicate that this assumption was, if anything, favorable to the condemnee. At least as against the condemnee, it is also fair to assume that this water system had relatively the same value as the company's other properties, which were largely telephone systems.

per share of $27,[6] capitalization ratios computed from the annual reports, and (again) 100% credit for the book value of related debt, preferred stock, advances, and contributions, the result would still be below $10,000,000. No fair effort to calculate the capitalized earnings of this system for 1959 has yielded more than $10,800,000.[7]

At this point I wish to protest the refusal of the majority Commissioners to make a finding on capitalization of earnings. Although paying lip service to capitalization of earnings by lumping it under a finding that "the value of the properties involved in this proceeding based principally on the capitalization of earnings, or the productiveness of the property, and a consideration of the transfers of other utility properties set forth in Exhibit No. 140 was $12,500,000," the majority opinion in fact ignores capitalized earnings. The refusal to state a finding based on capitalized earnings separately from one based on transfers of other water systems is indefensible; it merely obscures the fact that the composite figure of $12,500,000 gives negligible weight to capitalized earnings and total weight to the comparison with sales of other systems.

If a separate finding were to be made for capitalized earnings, it would have to be at or near the $9,631,000 estimated by the District's financial witness, for the record would not support any substantially higher figure. The composite figure given in the majority opinion for a combination of capitalized earnings and comparison with transfers of other systems is $12,500,000. Therefore, any finding as to the comparison with other transfers would have to be higher than $12,500,000. For example, if the two methods are to be given equal weight, then the majority finding for transfers of other systems would have to be as much above $12,500,000 as $9,631,000 is below $12,500,000. The result would be $15,369,000, which is 180% of depreciated original cost - far above the highest percentage of

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6/ This was the average for 1959. It was also the asking price for September 2, 1959; on that day $25.50 was offered.

7/ The willingness of the District's witness to propose an ultimate valuation of $10,800,000 (as opposed to the $9,631,000 he had computed for capitalized earnings) appears to have been due to his erroneous assumption that he should give weight to prices at which <u>public</u> agencies have purchased other water systems. (See Reporter's Transcript, pages 9342-9343.) That error is discussed in Part I of this opinion.

any transfer listed in Exhibit 140! It is apparent what little weight the majority have given to capitalized earnings in arriving at the composite finding of $12,500,000.

Even if the figure of $12,500,000 is viewed as wholly dependent on the transfers shown in Exhibit 140 (divorced from any consideration of capitalization of earnings), it is still excessive. As conceded in the majority opinion, it amounts to 147% of depreciated original cost, which is higher than 7 of the 10 major transfers listed; significantly, the listed average of the 29 smaller transfers shown in the exhibit is 107%. Wholly aside from the fact that purchases by public agencies do not provide a logical or fair basis for condemnation awards(see Part I of this opinion), the majority decision evidences a regrettable preference for high-priced transactions.

Although the majority Commissioners have refused to say what they believe the capitalized earnings of this system are, it is clear that any fair finding on that issue would be at or below the $10,800,000 at which the District has valued the system.

IV

Wholly aside from the uncertainty of the Commission's composite "finding" of $12,500,000, the ultimate award of $12,720,000 constitutes uncertainty in spades. After adopting a list of various valuations (the rate base, the depreciated original cost, the composite of earnings and other transfers, the depreciated reproduction cost, and finally the so-called "present day cost"), the majority opinion then arbitrarily selects an in-between figure and solemnly declares that this precise amount - supported by none of the theories advanced - is just compensation for the system. Not a word of explanation is offered; no suggestion is made as to the relative weighting (if any) of the various standards recited; there is not the slightest hint of the reasoning behind this ultimate award. The idea seems to be that, with several conflicting theories in the record, the Commission is free to follow no theory at all.

The majority have failed to answer even the question which their own opinion recites as the initial issue in the proceeding:

> "What is the proper measure of just compensation in this case? Is it the summation of reproduction costs and intangible values, as contended by the Company, or is it fair market value, determined predominantly by earning power, as urged by the District?"

The award sheds no light on which of these two approaches is proper after all.

It is unfair not to tell the parties how the Commission has arrived at its decision. If the decision is right, it will withstand the light of examination; only if there is uncertainty about rationale need there be concern about reversal. This vague, unexplained award may even be unlawful. Although the California Supreme Court has accepted such an approach in past condemnation cases, the new requirement that we make findings of fact on all material issues (Pub. Util. Code §1705), especially in view of the Court's opinion in California Motor Transport v. Public Utilities Commission, 59 Cal.2d 270 (1963), suggests that the Commission may not continue to get by with a figure pulled out of the air.

The failure to explain is also illogical and unnecessary; neither rate base nor depreciated original cost nor comparison with other sales nor reproduction cost have any logical value in this case when weighed against the ideal relevance of the company's earnings on this property. We should not compromise with these other measures of value, for they lead away from an accurate determination of just compensation. Alone of all the methods presented, capitalization of earnings leaves the company where the condemnation found it.

Finally, an unexplained award will wholly frustrate the high hopes which have attended this case in its diligent and costly trial over the past five years. Throughout the state, countless interested utilities and public agencies have come to look upon it as a vehicle for clarification of condemnation principles. It is demoralizing to announce, as the majority decision in effect does, that some arbitrary amount "in the middle" is the standard by which future condemnation awards are to be determined. We owe it to the industry and to the public - we owe it to the Constitution - to produce a better method than a jury's educated guess. Over thirty years ago this Commission rejected the hopeless complexity, uncertainty, and delay involved in the so-called fair value method for computing rate base. It is not too much to ask that we now do the same for our condemnation awards.

George G. Grover

George G. Grover
Commissioner

I concur in the opinion of
Commissioner Grover.

Frederick B. Holoboff

Frederick B. Holoboff
Commissioner

San Francisco, California

November 2, 1964