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Via Federal Express and Registered Mail
Dawn G. Abrahamson
City Clerk, City of Vallejo
555 Santa Clara Street
Vallejo, CA 94590

Re: Objections to Lakes Water System Appraisal

Dear Ms. Abrahamson:

This firm represents the Green Valley Landowners' Association, a California mutual benefit corporation (the "GVLA").[1] We are in receipt of the *Appraisal of the Lakes Water System – Final Report*, dated March 2013 and prepared by FCS Group (FCS).

In the appraisal, FCS opines that the value of the Lakes Water System (LWS) is $9,077,000. This opinion of value is deeply flawed. As explained below, the flaws relate to incorrect facts and faulty assumptions provided to FCS by Vallejo (or in some instances, not provided to FCS by Vallejo). In addition, the appraisal ignores the fact the LWS comes with no vested water rights and inexplicably omits the substantial real property associated with the LWS from its scope.

Problems with FCS's Valuation of the LWS

FCS assessed the value of the LWS at $9,077,000. This amount allegedly equals Vallejo's rate base – *i.e.*, Vallejo's original cost, less accumulated depreciation. We agree with FCS's opinion that the most a utility will pay is Vallejo's rate base. However, for the reasons set forth below, the rate basis is *significantly* less than $9,077,000. In fact, it is likely that Vallejo's rate basis is *negative*.

- ***Failure to Deduct CIAC from Rate Base***. The rate base admittedly does not include capital contributions, also known as, capital in aid of construction (CIAC). Although

[1] Simultaneously with this letter, this firm, on behalf of the GVLA, has served the City of Vallejo (the "City") with a claim under the Government Claims Act (Cal. Gov. Code §§900, *et seq.*) as well as a demand letter setting forth the legal and factual grounds for the GVLA's claim.

FCS deducted roughly $12.8 million (replacement cost value) or $520,616 after depreciation on account of CIAC (Appendix 1, pp. 33-34), it failed to include the following CIAC:

- Lakes Water System Surcharge. The appraisal also failed to exclude CIAC in the form of the LWS "surcharge" put into effect in 1995 (Ord. 1334 N.C. (2d) §5, 1995). As set forth in the Vallejo Municipal Code, "*The surcharge is assessed to generate sufficient revenue to construct improvements in the Lakes Water System; primarily, water treatment facilities improvements and requirements* that will comply with the new surface water treatment required by the U.S. Environmental Protection Agency and the State of California, Department of Health Services, and associated debt service. The moneys received shall be deposited into a dedicated account, and shall be expended and/or withdrawn from said account only for the purposes herein indicated" (Vallejo Code §11.48.181). The LWS surcharge is "in addition to any and all taxes, fees, or charges of any nature whatsoever relative to a supply of water, water service or water service connection" (*id.* §11.48.180). As of 2012, the time basis for the appraisal, the amount of these depreciated assets was $4,216,661 (Appendix 1, Asset Nos. 50019 and 50024). Of this amount, about **$3,289,000** in principal, paid by the LWS customers through the surcharge, is CIAC and should be excluded. FCS was apparently not informed of the LWS surcharge which is contributed capital and must be excluded.

- User Capital Connection Charges. The appraisal also failed to exclude CIAC in the form of water connection fees charged to new customers by the City of Vallejo. Residential water connection fees within the LWS are currently $19,330.00. According to the Vallejo Code, "The purpose of the water facilities connection ordinance codified in this chapter is to create revenue to assist in *providing for capital costs of additions and improvements to the municipal water system.* To accomplish this objective, all moneys received under Sections 11.16.020 through 11.16.030 *shall be deposited in the capital reserve account of the municipal water system fund* as the same is established and designated by Ordinance No. 47 N.C.(2d). That money shall be used, after approval of the city council, to pay for acquisition, installation, or construction of components (including easements, rights-of-way and/or land) of the municipal water system" (Vallejo Code §11.16.021). Again, FCS was apparently not told that significant capital was collected. We do not know how much capital has been raised from the LWS in connection fees, but we estimate the amount is likely in the millions, and should likewise be excluded from the rate base.

- Solano Transportation Authority CIAC. The appraisal also should have deducted an additional **$1,907,286** for CIAC attributable to the Solano Transportation Authority (STA). In 2010, the STA replaced a portion of the original Gordon Line to facilitate construction of new highway projects around the Interstate 80, Interstate 680 and State 12 interchange area. The STA paid for the installation of a new 12-inch water main along Rockville Road from Suisun Valley Road to a point of connection in Green Valley (Assets Nos. 20018-40024) as well as a pressure regulator on Rockville Road (Asset No. 50025). FCS was apparently unaware of this capital contribution even though it occurred just two years before the effective date of the appraisal.

- Cordelia CIAC. The appraisal should have deducted an additional **$415,068** for CIAC contributed by developers in Cordelia in 2004 (Assets No. 20501, 20601, 20208, 20201, 10201, 20200, 20205, 20206, 20202, 20203). FCS was also apparently unaware of this capital contribution.

- ***Failure to Maintain Historical Cost Records***. The rate base is determined by looking at the original cost of an asset, less depreciation. Where the original cost is not available, the *replacement cost* adjusted for inflation may be substituted. Vallejo failed to maintain its historical cost records for the vast majority of LWS assets, inexplicably, even for assets built within the last few years.[2] As a result, FCS was forced to rely on replacement cost values. However, based on an apples-to-apples comparison of actual costs versus replacement costs, it is evident that the replacement costs vastly exceed the original costs, resulting in a significant overstating of the value of the system.

  - For example, Vallejo installed 14,704 feet of 12" PVC pipe for a documented cost (June 2012 cost basis) of approximately $109/foot (Asset Nos. 40021-40024). However, for identical 12" PVC pipe *simultaneously installed as part of the same project* in 2010, there is no historical cost record. As a result, the appraisal relied on the estimated replacement value of the same pipe. The

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[2] In some instances, we believe that Vallejo does have historical costs information which was not provided to FCS. For example, Vallejo represented in its permit application that the estimated cost of constructing 14.5 miles of the Gordon pipe line would be $300,000. However, because FCS did not use the actual historical cost of $300,000, it used a replacement cost of $839,023, which results in an increase in value of $529,023. Although this error is a moot point because the asset has been fully depreciated, it is indicative, we believe, of the problem – the substitution of inflated "replacement cost" values for the actual historical cost which Vallejo has or should have access to.

replacement value (June 2012 cost basis) of identical pipe installed in the same location (Asset Nos. 40018-40020) was estimated to be $174 per foot, *or 60% higher than the actual cost of the same 12" PVC pipe installed as part of the same project.*

- To take another example, in 2004, Vallejo installed 3170 feet of 8" PVC pipe (Asset Nos. 20501, 20601, 20207). After accounting for inflation to June 2012, the replacement cost of this pipe is estimated to be $144 per foot. However, this amount is $35 per foot higher than *the actual cost for larger 12" pipe* installed in 2010 (Asset Nos. 40021-40024), even after adjusting for inflation.

- Based on Vallejo's inexplicable failure to maintain records and the vast discrepancies between the actual cost and the estimated replacement cost of certain assets, we have strong reason to believe that Vallejo's failure to maintain records has had the perverse effect of artificially inflating the value of the entire system by at least 60%. This number may be even higher. Discounting the estimated replacement value by 60% on the assets for which there is no historical cost data, and adjusting for inflation, the rate base should be reduced by an additional **$885,667**.

- ***Oversized Pipes***. FCS should have, but did not, exclude from the rate base the cost of infrastructure which was overbuilt in excess of existing consumer needs. In *Application of Hesperia Water Co.* (1961) 58 Cal. PUC 766, the PUC held that to set a rate base reflecting the cost of overbuilt assets would be "unreasonable, unjust and discriminatory." Asset No. 20016 is 10,200 feet of 14" iron pipe built in 1995 with a replacement value of $2,752,377. FCS notes that this pipe is oversized and if replaced with proper 12" PVC pipe, would have a replacement cost of just $1,929,675. After accounting for inflation and depreciation, the cost of this pipe, and thus the rate base, should be reduced by **$559,259**.

- ***Assets Beyond Useful Life***. Assets beyond their useful life are not included in the rate base, even at a salvage cost basis (*Bay Cities Transit Co.* (1947) 47 Cal. PUC 621). However, for the many assets which have been fully depreciated, FCS improperly attributed an additional five years of useful depreciable life, thereby artificially adding value attributable to fully depreciated assets. In addition, the remaining useful life of Assets No. 50024 and 50013 was adjusted to be greater than the actual remaining useful life. When this improper treatment is corrected, the rate base should be reduced by **$165,147**.

After accounting for these adjustments, the proper rate base (and therefore value) of the LWS is just **$1,855,573**. However, this figure does <u>not</u> include the LWS connection fees discussed above. If the CIAC collected in the form of connection fees averages more than $2,294 per connection (or just 23% of the current residential connection fee), the true rate base will be *negative*. In other words, the LWS (exclusive of Vallejo's existing debt relating to the LWS, the need for capital improvements and the other problems explained below) is a ***liability*, not an asset**.

The LWS Has No Water Rights

In addition to the valuation problems discussed above, the appraisal specifically excludes from the scope of a proposed transfer Lakes Frey and Madigan and *any* water rights. We fail to see how a system without any water rights can have any value other than as the scrap value of the existing infrastructure.

FCS does not explain how a water system can have value independent of its right to water. Rater, FCS glosses over this inconvenience and simply assumes without any factual basis (i) that Vallejo will have water rights to sell, (ii) that such rights would be sufficient in amount to meet the needs of the LWS, (iii) that such a sale would be on a market basis and (iv) that the infrastructure currently exists which would physically allow for such a transfer. Needless to say, in the unlikely event a potential buyer is willing to assume the risk of these contingencies, they would, at the very least, demand a significant discount off the already diminished (or nonexistent) rate base.

The Appraisal Excludes All Watershed and Non-Watershed Land Owned by Vallejo

Most egregiously, the appraisal also excludes all land, watershed and non-watershed, owned by Vallejo. Because Vallejo's original cost for the real estate is so low ($14,000), Vallejo apparently believes it could earn a bigger profit ($2,873,473, or significantly more) by excluding the land from a potential transfer of the LWS (Appendix 1, p. 34).[3] In addition, Vallejo apparently believes it can further leverage its position by "selling" water and/or water rights from Lakes Frey and Madigan to the LWS.

Vallejo's self-dealing is a breach of its fiduciary and contractual duties to the LWS consumers, as explained in the accompanying demand letter. In addition, this self-dealing also runs afoul of established State policy. Specifically, given the State-wide need to fund capital improvements to water systems, water corporations are both (i) encouraged to sell land which is

[3] We note that the real estate referenced in Appendix 1, page 34, does not include Lake Curry or its watershed. If the 19 square miles of Lake Curry land is worth the same $2,000 per acre as the Lakes Frey and Madigan land, this additional potential value is *$24 million*. Vallejo recently represented to its bondholders that Lake Curry was a part of the LWS. Within the last 10 years, Vallejo represented to the federal and state governments that Lake Curry was "critical" to Vallejo's own municipal water supply. Lake Curry is undoubtedly a part of the LWS.

no longer useful to the provision of the water system, and (ii) *required* to invest the proceeds of such sales in new capital improvements (Cal. Pub. Util. Code §§789.1(d), (e)[4], 790).

Although Vallejo is not a water corporation, it is a fiduciary of the LWS customers, and we fail to see how a fiduciary would not be held to the same standard as a private utility. Vallejo's self-dealing is especially outrageous given that after failing to replace assets *decades* beyond their useful lives and then dumping the dilapidated system on the LWS consumers, it now seeks to pocket the proceeds from the sale of land which would otherwise provide significant capital for improvements within the LWS.

To put this in perspective, even after accounting for the oversized pipes, the replacement cost of assets which are already ***decades*** beyond their useful lives is **<u>$24.1 million</u>**. This is the legacy Vallejo leaves to the LWS – an immediate capital shortfall of over $24 million.[5] At the same time, Vallejo (in violation of State policy and its fiduciary duty) is seeking to "keep" for itself real estate with a potential value of over $26 million.

We therefore have no reason to doubt that if Vallejo attempts to sell the LWS without the watershed and non-watershed land around Lakes Frey, Madigan and Curry, that the LWS consumers could obtain a court order to (i) enjoin the sale, (ii) compel Vallejo to include the land in the purchase (at its *original cost*), or (iii) require Vallejo to put aside all proceeds from a future sale of the land into a capital improvement fund for the benefit of the LWS.

The *De Facto* "Loan" to the LWS

There is no basis for LWS to recover $2,967,000 in alleged "subsidizes" it provided or "loaned" to the LWS prior to the 2009 rate increases. In fact, as explained in the accompanying demand letter, the flow of money undoubtedly flows in the other direction. Even if there were a basis to enforce this so-called "loan", the statute of limitations has long since expired. We do not believe that any further comment is warranted with regard to the alleged "loan."

Conclusion

FCS's opinion of value is tied directly to the rate base. As demonstrated above, the rate base is $1,855,573, *less* the amount of CIAC attributable to LWS connection fees. We believe this will result in a negative number, meaning that LWS has no value (or a negative value).

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[4] Section 789.1(e) provides that "It is the policy of the state that any net proceeds from the sale by a water corporation of real property that was at any time, but is no longer, necessary or useful in the provision of public utility service, <u>shall be invested</u> by a water corporation in infrastructure, plant, facilities, and properties that are necessary or useful in the performance of its duties to the public . . . ."

[5] Within the next decade, an additional $6 million of assets will be fully depreciated and in need of immediate replacement.

Further, to the extent there is any value in the LWS, a prudent buyer will demand a significant discount off the rate base to account for the fact the LWS comes with no vested water rights or the proven ability to physically transfer such water from a willing seller.

Finally, we believe Vallejo's attempt to sell the LWS without the watershed and non-watershed land is itself a breach of fiduciary duty and a breach of contract. It is also in violation of official State policy. If such a sale is proposed, the LWS will either seek to enjoin the sale, to compel Vallejo to either include the land (and associated water rights) in the sale price at its original cost, or to apply the net proceeds of any sale of land to a capital improvement fund for the benefit of the LWS.

Very truly yours,

Stephen M. Flynn

cc. Osby Davis, Mayor (via U.S. Mail)
Claudia Quintana, City Attorney (via U.S. Mail)
Daniel E. Keen, City Manager (via U.S. Mail)
David Kleinschmidt, Public Works Director (via U.S. Mail)
Franz Nestlerode, Water Superintendent (via U.S. Mail)