

Executive Summary

The purpose of this report is to document the findings of a preliminary valuation assessment and cost of service evaluation completed to support the Monterey Peninsula Water Management District (“MPWMD” or “District”) in evaluating the feasibility of securing and maintaining public ownership of the Monterey Water System. The preliminary valuation assessment consisted of completion of a preliminary desktop valuation assessment of the Monterey Water System to estimate the cost required to be incurred to acquire the Monterey Water System. The cost of service analysis was completed to compare the cost of public ownership, operation, and maintenance of the Monterey Water System (i.e. the public ownership scenario) with a status quo scenario, which is the anticipated cost of continued ownership, operation, and maintenance of the system by California American Water (“CAW”). The cost of service analysis was compared in terms of the annual Monterey Water System revenue requirements and typical residential customer bill impacts associated with the various scenarios that were developed.

CAW currently provides water service to approximately 41,000 customer connections and a population of approximately 99,794 in its Monterey County District. The “Main” system within the Monterey County District serves approximately 38,325 customers and includes customers within the incorporated cities of Carmel-by-the-Sea, Del Rey Oaks, Monterey, Pacific Grove, Sand City, Seaside, and the unincorporated areas of Carmel Highlands, Carmel Valley and Pebble Beach. The Main system is generally located within the MPWMD boundaries. The Monterey County District also includes the areas of Bishop, serving approximately 385 customers, Hidden Hills, serving approximately 454 customers, and Ryan Ranch, serving approximately 212 customers, which are areas that are also within the MPWMD boundaries.¹ The Central Satellite areas include the areas of Ambler, Ralph Lane, Chualar, Toro, and Garrapata, which are located outside of MPWMD boundaries and serve a total of approximately 1,086 customers. The subject of the preliminary valuation and cost of service analysis is the portion of the water system located within the boundaries of the District.

Preliminary Valuation Assessment

The valuation of the Monterey Water System was prepared for acquisition feasibility purposes considering three methods of valuation: the Income Approach, the Sales Comparison Approach, and the Cost Approach. The definition of value used in the valuation assessment was fair market value as the term is defined in California’s Eminent Domain Law (Code of Civil procedure Section 1263.320), and the date of the valuation estimate was January 1, 2020.

¹Approximately 33 residential connections within CAW’s Main System are currently located just outside the District’s boundaries in the Yankee Point area. In addition, approximately 10 residential connections in CAW’s Hidden Hills System extend beyond the District’s boundary. These portions of the Main and Hidden Hills Systems are physically and functionally connected to the much larger portion of the systems located within the District’s boundary and cannot practicably be served and operated independently. For the purposes of this report, we have assumed that if the District determines to acquire the portions of CAW’s Monterey Water System currently located within its boundary, it will take whatever steps necessary to either annex these 43 “extra-territorial” connections into its boundary or otherwise comply with such legal requirements that may need to be satisfied in order to enable the District to serve those properties (see, e.g., California Government Code Section 56133). Through the balance of this report, it was assumed that these connections are within the District and not part of the Central Satellite areas.

The income approach is based on the premise that the value of a property is the present value of the future economic benefits of owning the property. The underlying principle in this approach is that buyers invest in assets with the expectation of receiving the anticipated future net benefits. This approach is relevant when the property being valued generates or is anticipated to generate net income, profits, or free cash flows. The value estimate of the Monterey Water System calculated using the income approach ranged \$222 million to \$255 million. An 80% weighting was placed on the results of this valuation method.

The Market Approach is a general way of determining an indication of value of an enterprise by comparing the subject to similar businesses that have been sold. The valuation estimate under the market approach was prepared using the Guideline Transactions Method, which is a method whereby pricing multiples are derived from transactions involving companies engaged in the same or similar lines of business. Certain factors, such as the location, date of sale, physical characteristics, and technical and economic factors relating to sales transactions were analyzed for their comparability to CAW's Monterey Water System. Based on this analysis, the average value of the Monterey Water System under the market approach was estimated to be approximately \$272 million. A 20% weighting was placed on the results of this valuation method.

Under the Cost Approach, the value of the assets is typically derived by subtracting the amount of depreciation from the replacement or reproduction cost of the assets. The value under this approach is estimated by the sum of the parts of the system, i.e. physical asset components, land, water rights, etc. Depreciation in this context represents the loss in value caused by physical deterioration, functional obsolescence, and economic obsolescence. The reproduction cost new less depreciation ("RCNLD") amount was calculated and estimated to be approximately \$464 million. No weighting was placed on the results of this valuation approach because it tends to place an absolute ceiling on the market price, which most frequently is not approached in actual market negotiations associated with regulated public utilities.

Combining these three valuation methods with their weightings, the base estimated value of the Monterey Water System (portion located within MPWMD jurisdictional boundaries) as of the valuation date (January 1, 2020) was estimated to be approximately \$245 million. This estimate is a preliminary estimate of value that was prepared based on a desktop analysis described above for feasibility purposes and information available as of the date of this report. This value estimate may be higher or lower than the conclusion of value that may result from the completion of a formal appraisal.

This base estimate excludes the value of asset additions, such as construction-work-in-progress, 30% of the Monterey Pipeline and Pump Station value deemed by the California Public Utilities Commission ("CPUC") not to be "used and useful" in conjunction with CAW's Monterey Water System, the value of the desalination plant currently under development, and the value of non "used and useful" land parcels. The value of the Monterey Water System, including the base value and the identified asset additions, was estimated to be approximately \$359 million.

CAW has incurred other expenses that CPUC has approved for recovery through Monterey District water rates over time. It is possible that MPWMD may be required to compensate CAW for these unrecouped expenses as part of a potential taking of the Monterey Water System. These expense items and their potential amounts include unrecouped portions of tank painting expenses, San Clemente Dam removal costs, the portion of the "acquisition premium" allocable to the Monterey Water System that was approved by the CPUC in 2001 in connection with CAW's acquisition of the California assets of Citizens Water Company, the portion of the "acquisition premiums" allocable to the Monterey Water

System associated with the acquisition of the Bellflower Municipal Water System, the Rio Plaza Water Company, Fruitridge Vista Water Company, and Hillview Water Company that are proposed under CAW's Special Request No. 11 in its 2019 General Rate Case Application to the CPUC, plus the unrecovered portions of various balancing accounts. These net expenses were estimated to total approximately \$155 million as of the valuation date, and adding these net expenses to the value estimate of the "base" water system results in a total value estimate, plus adjustments, of approximately \$513 million. A summary of the valuation and adjustments is provided in Table ES-1.

Table ES-1: Estimated Value of the Monterey Water System with MPWMD Boundaries

Valuation Estimate Approach	Estimated Value	x	Weighting	=	Weighted Value
Base Water System (Including 70% of Monterey Pipeline and PS)					
Income Approach					
Discounted Net Cash Flow Method	\$ 222,346		40%		\$ 88,938
Direct Capitalization Method	254,499		40%		101,800
Sales Comparison Approach					
Market Transaction Method (Price/Eq Connection) ¹	185,214		5%		9,261
Market Transaction Method (Price/Earnings)	279,480		5%		13,974
Adjusted Net Asset Value Method (Price/NBV)	250,066		5%		12,503
Adjusted Net Asset Value Method (Price/Rate Base)	371,981		5%		18,599
Cost Approach					
RCNLD Method	463,686		0%		-
OCLD x 1.3x	288,119		0%		
Estimated Value of the Base System					\$ 245,075
Asset Additions:					
Construction Work in Progress (Reported 2019 value)					\$ 2,199
Portion of Monterey Pipeline and PS Not Included Above (30%)					16,865
Desal Plant (Excl SRF, Surcharge, and Public Agency Funded Portions)					92,749
Land - Not "Used and Useful"					1,977
Other Non-Regulated Assets (e.g., contributions-in-aid-of-construction, plant, equipment)					TBD
Estimated Value with Asset Additions					\$ 358,866
Potential Additional Items:					
Tank Painting (PV Amount)					\$ 4,459
Citizens Acquisition (PV Amount)					9,458
San Clemente Dam (PV Amount)					63,509
New UPAA (PV Amount)					6,508
Other Balancing Account Items (Net under-collection as of 5/31/19)					70,585
Severance					TBD
Estimated Total Including Potential Additional Items					\$ 513,384

¹Includes sales comparison value for base system, plus value of Monterey Pipeline and PS.

Values shown in \$1,000s

Base System	\$ 145,862
Monterey Pipeline & PS (70% portion)	<u>39,352</u>
Total	\$ 185,214

This value estimate, with adjustments, does not include the potential value of other assets that are not currently included in CAW's rate base, except for the value of land which has been considered. These assets either have not been deemed to be "used and useful" for the provision of water service or were developer contributed and are not allowed by CPUC to be included in rate base. It is possible that some of the non "used and useful" assets may become "used and useful," and recoverable in water rates in the future. However, the value of these assets is not likely to be substantial. CAW reports a value of \$20.2 million of "contributions-in-aid-of-construction" and "advances-in-aid-of-construction", which are contributions of money or property contributed by developers pertaining to the expansion, improvement, or replacement of water system assets. However, since CAW is not allowed to include the value of these assets in rate base, they have been excluded from consideration in the value of the Monterey Water System.

MPWMD may also be required to pay severance damages to CAW for acquiring the Monterey Water System. These damages may relate to not taking the satellite water systems owned and operated by CAW within their Monterey District, but outside of MPWMD's jurisdictional boundaries. Severance damages in this instance would consist of increased inefficiencies in CAW's provision of service to these smaller pockets of customers and potentially higher costs per customer to do so. It is somewhat difficult to evaluate and quantify such severance damages, which would involve better understanding CAW's current service model, how CAW could most effectively modify its service model in the post-District acquisition scenario, and how much of the work formerly performed by local CAW staff could effectively be transferred to other nearby CAW field offices or centralized locations. In addition, given that CAW would likely be entitled to include reasonable increased marginal operating costs in its next rate filing(s) to the CPUC with respect to the "remainder" of its Monterey District, it is questionable whether CAW would suffer any net profitability losses at all. Given these uncertainties, and the likelihood that CAW could mitigate some or all of its severance damages through the CPUC ratemaking process, our tentative conclusion is that CAW is likely to suffer minimal, if any, severance damages, and any severance damages it does suffer would not be so significant as to materially affect the conclusions of the District's feasibility analysis. If the District does proceed to prepare a formal appraisal of just compensation for the acquisition of the Monterey Water system, however, it is recommended that the severance damages issue be further reviewed at that time.

Cost of Service Evaluation

The cost of service evaluation consisted of preparing a 20-year financial projection of CAW continuing to own and operate the Monterey Water System (status quo), analyzing and identifying the incremental cost differences associated with MPWMD owning and operating the Monterey Water System in comparison to the status quo, preparing an annual cash flow projection of two district ownership scenarios, and estimating customer bills under both the CAW status quo and District ownership scenarios. The following cost of service scenarios were prepared:

- A. Status Quo – CAW ownership
- B. MPWMD Ownership with District staff operations
- C. MPWMD Ownership with contract operations

The cost of service modeling results indicate that significant annual reductions in revenue requirements and projected monthly water bills can be realized by MPWMD acquiring and operating the Monterey

Water System. The estimated revenue requirement in 2022 under the MPWMD ownership scenario with District operations (Scenario B) was projected to be approximately \$13.6 million or 11.9% lower than the status quo CAW ownership scenario (Scenario A). Scenario B is estimated to have a net present value savings from 2021 to 2040 of approximately \$267 million. The estimated revenue requirement in 2022 under MPWMD ownership and contract operations (Scenario C) was projected to be approximately \$10.2 million or 8.9% lower than the status quo CAW ownership scenario (Scenario A). Scenario C is estimated to have a net present value of savings from 2021 to 2040 of approximately \$213 million. These net present value savings estimates include the debt service costs associated with the District paying fair market value for CAW's Monterey Water System. These cost of service modeling results are summarized in Table ES-2.

The projected reductions in revenue requirements are a result of the following differences between CAW and MPWMD ownership and operation:

1. Lower corporate and administrative overhead costs. An estimated \$7.2 million in CAW corporate administrative overhead would be avoided under MPWMD and replaced with approximately \$1.8 million in District operations and administrative costs.
2. Operating cost differences. The District's ability to utilize existing administrative staff and eliminate redundant positions, net of higher pension and benefit costs under public ownership.
3. Cost of public financing (4.0% interest rate) vs. rate of return and CAW profit (7.61%). The tax-exempt annual debt interest rate for MPMWD is lower than taxable corporate debt and CAW's allowable rate of return. The public financing interest rate was reviewed by Barclays and was deemed to be reasonable.
4. Reduction in revenue requirements of an estimated \$10.1 million per year (2021 estimate) under public ownership due to avoidance of property and income taxes.
5. Elimination of rate regulatory expenses estimated at \$330,000 per year (2021 estimate).

Based on the information and estimates summarized in this report, which are reasonable considering the currently available information, the acquisition of the Monterey Water System by MPWMD appears to be economically feasible. Economic feasibility was assessed by comparing the estimated revenue requirements of the water system under MPWMD ownership versus CAW ownership and indicated that significant revenue requirement savings could be achieved under the MPWMD ownership scenarios that were evaluated.

**Table ES-2: Summary Cost of Service Evaluation Results
(Annual Revenue Requirement Projection for Each Scenario)**

Year	A Status Quo CAW Ownership w/ Desal Plant	B MPWMD Ownership w/District Ops	C MPWMD Ownership w/ Contract Ops	B-A	C-A
2020	\$63,284	\$63,284	\$63,284	\$0	\$0
2021	\$105,583	\$93,018	\$96,309	(\$12,565)	(\$9,275)
2022	\$113,862	\$100,286	\$103,682	(\$13,575)	(\$10,180)
2023	\$114,880	\$98,486	\$101,959	(\$16,394)	(\$12,921)
2024	\$116,793	\$100,242	\$103,793	(\$16,551)	(\$13,000)
2025	\$118,756	\$101,622	\$105,253	(\$17,133)	(\$13,503)
2026	\$120,767	\$103,037	\$106,748	(\$17,730)	(\$14,018)
2027	\$122,826	\$104,489	\$108,283	(\$18,338)	(\$14,543)
2028	\$124,936	\$105,978	\$109,857	(\$18,958)	(\$15,079)
2029	\$127,098	\$107,507	\$111,473	(\$19,592)	(\$15,625)
2030	\$129,313	\$109,075	\$113,130	(\$20,238)	(\$16,183)
2031	\$131,582	\$110,685	\$114,831	(\$20,897)	(\$16,751)
2032	\$133,963	\$112,419	\$116,659	(\$21,544)	(\$17,305)
2033	\$136,403	\$114,172	\$118,506	(\$22,232)	(\$17,897)
2034	\$138,903	\$115,969	\$120,401	(\$22,934)	(\$18,502)
2035	\$141,465	\$117,814	\$122,346	(\$23,651)	(\$19,119)
2036	\$144,090	\$119,706	\$124,340	(\$24,383)	(\$19,750)
2037	\$146,779	\$121,648	\$126,386	(\$25,131)	(\$20,393)
2038	\$149,535	\$123,640	\$128,485	(\$25,894)	(\$21,050)
2039	\$152,359	\$125,684	\$130,638	(\$26,675)	(\$21,721)
2040	\$155,268	\$127,780	\$132,846	(\$27,488)	(\$22,423)
Total	\$2,688,446	\$2,276,543	\$2,359,208	(\$411,903)	(\$329,238)
PV (@4.0%)	\$1,805,484	\$1,538,143	\$1,592,710	(\$267,341)	(\$212,773)
PV (@6.0%)	\$1,517,276	\$1,296,636	\$1,342,061	(\$220,640)	(\$175,215)

Values shown in \$1,000s.