Davis Wright Tremaine LLP

SAN FRANCISCO OFFICE

MEMORANDUM

TO: Peter Brundage

CC: Nancy C. Miller

FROM: Steven F. Greenwald
Salle E. Yoo

DATE: March 29, 2006

RE: Assessment of PG&E and SMUD Proposals Regarding Valuation Methodologies Applicable to the Condemnation of Public Utility Facilities

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We have been asked to provide an analysis of the submissions by the Sacramento Municipal Utility District ("SMUD") and Pacific Gas and Electric Company ("PG&E") regarding the valuation methodology that a California court or the California Public Utilities Commission ("CPUC") will apply to determine the "just compensation" amount to be paid by SMUD to PG&E for facilities acquired by condemnation.

We have not been requested to, and we are not providing, an assessment of the actual dollar amount that the fact finder would determine as "just compensation." Thus, while the submissions the parties provided do reference certain dollar amounts associated with various valuation theories and facilities, we have not assessed nor considered those dollar amounts for purposes of this memorandum.[1]

We conclude that in determining the just and equitable compensation SMUD would be obligated to pay PG&E for the condemned facilities, the fact finder will most likely consider various valuation methodologies, assuming the evidence supporting the valuation methodology is otherwise competent and admissible. Further, while the case law often expresses that Replacement Cost New Less Depreciation methodology ("RCNLD") establishes the ceiling and Original Cost Less Depreciation ("OCLD") often sets the floor for any valuation, the courts and the CPUC have purposely not established an absolute one-size-fits-all preference applicable in all instances for the utilization of a particular methodology for the valuation of utility facilities. Rather, in each case, the fact finder has been vested with the authority to accord differing weight to various valuations, based on the specifics of the condemned facilities and to exercise its judgment in determining the compensation amount.

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[1] We are similarly not addressing PG&E's assertions regarding, and quantifications of, the relative profitability of the property to-be-condemned in Yolo County or PG&E's comparative costs to serve the departing customers. *See* Appendix 3 of submission from PG&E to Peter Brundage, dated February 1, 2006 at 14.

If SMUD decides to initiate a condemnation action to set the appropriate purchase price, California law provides SMUD the option of pursuing its case in either superior court or the CPUC.[2] SMUD's decision to initiate any such condemnation proceeding in court or at the CPUC should not have any impact on the ultimate determination of compensation. The CPUC has held that "the same 'market value' measure of compensation set forth in the [court decisions] and codified in [California Code of Civil Procedure] Section 1263.320 is applied in [CPUC proceedings to determine just compensation]."[3]

For purposes of preparing this memorandum, we have reviewed the submissions made by the parties in response to the Sacramento Local Agency Formation Commission's ("LAFCO") February 13, 2006, request for legal authority to support their respective positions regarding the valuation methodology applicable to the to-be-condemned PG&E property; specifically, SMUD's letters dated December 2, 2005 ("SMUD December Letter") and March 1, 2006 ("SMUD March Letter") and Appendix 3 of PG&E's submission, dated February 1, 2006 ("PG&E Letter").[4] Additionally, we have reviewed the relevant authorities and case law cited by the parties.

A summary of our relevant experience in the area of energy law and eminent domain issues is attached hereto as Exhibit A.

I. CALIFORNIA LAW REQUIRES THE PAYMENT OF "JUST COMPENSATION"

"The constitutional goal of valuation in eminent domain is just or full compensation, a 'practical attempt to make the owner whole.'"[5] The measure of just compensation "is the fair market value of the property taken."[6] PG&E and SMUD agree with these basic principles.[7]

A witness testifying to the value for the condemned property may rely on matters "that is of a type that reasonably may be relied upon by an expert in forming an opinion as to the value of property."[8] Thus, evidence of comparable sales, leases, comparable leases, reproduction cost

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[2] Code of Civ. Proc. §§ 1250.110; 1230.060, LAW REV. COMM'N COMMENT 1975; Pub. Util. Code § 1401 *et seq.*

[3] *Vandenberg Village Community*, D. 87-07-080, 25 CPUC 2d 20, 30 (1987).

[4] In response to the LAFCO February 13, 2006 request, SMUD submitted its letter dated March 1, 2006, attaching thereto its December 2, 2005 letter. PG&E's response to the LAFCO February 2006 request was its resubmission of Appendix 3, originally submitted on February 1, 2006.

[5] NICHOLS ON EMINENT DOMAIN (3rd ed.) at §14A.03.

[6] Code of Civ. Proc.§ 1263.310.

[7] PG&E explains that California law provides that "[t]o acquire PG&E's facilities by eminent domain, SMUD must pay fair market value." PG&E Letter at 1. SMUD agrees, asserting that "[u]nder eminent domain law, PG&E is entitled to receive 'just compensation;' the measure of just compensation is fair market value." SMUD December Letter at 5.

[8] Evid. Code § 814.

and conditions in the general vicinity of the property, that are otherwise admissible, are permitted for consideration by the fact finder.[9]

The "usual method of fixing a value of property taken in condemnation is by ascertaining market value,"[10] which in the more typical context is set by an assessment of recent sales of comparable properties. Thus, "[i]f exchanges of similar property have been frequent, the inference is strong that the equivalent arrived at by the haggling of the market would probably have been offered and accepted . . . ."[11] However, with respect to utility properties, courts and the CPUC have recognized the absence of a "market" for the sale of publicly regulated utility property and thus, have acknowledged, "[w]hat we use is largely a matter of judgment and circumstance."[12]

The California Legislature has responded to this lack of comparable sales in the area of utility facilities by authorizing the fact finder in instances in which "there is no relevant market" to determine fair market value by "any method of valuation that is just and equitable."[13] The point of divergence between PG&E and SMUD is on the particular methodology the fact finder would be obligated, or most likely, to use to calculate "fair market value", given the assumed absence of substantial evidence on comparative sales.

A. The Determination of Fair Market Value Requires More than the Selection of the "Highest Price" Among the Valuations Presented

PG&E states fair market value is "the 'highest' price the property would sell for."[14] To the extent that PG&E is advocating that if presented 10 different prices California law dictates that the fact finder select the "highest price" as the fair market value, PG&E's statement is incorrect. The statutory directive that the condemnee be compensated with fair market value equal to the "highest price" does not deprive the fact finder of the right to set fair market value at a lesser price based on the exercise of judgment, and in light of the evidence presented.

The California Legislature has defined fair market value as follows:

> the highest price on the date of valuation that would be agreed to by a seller, being willing to sell but under no particular or urgent necessity for so doing, not obliged to sell, and a buyer, being

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[9] Evid. Code §§ 816-821.

[10] NICHOLS, at § 14A.06.

[11] *South Bay Irr. Dist. v. California-American Water Co*., 61 Cal.App.3d 944, 971 (1976).

[12] *Onondaga Cty Water Authority v. NY Water Service Corp.,* 285 A.D. 655, 662 (N.Y.App. Div. 1955); *Sacramento Municipal Water District*, D.35985, 44 CRC 467, 474 (1942).

[13] Code of Civ. Proc. § 1263.320(b).

[14] PG&E Letter at 1.

> ready, willing, and able to buy but under no particular necessity for so doing . . . .[15]

In brief, fair market value is not simply the highest price that one party may place on the property to be condemned, but rather, the highest price the fact finder determines that two parties, engaged in an open-market, arms' length transaction, would agree to pay.[16]

B. Evidence of RCNLD Valuation is Admissible, But is Not Necessarily Controlling Nor the Preferred Methodology

The primary issue on which PG&E and SMUD differ is the relative importance that the fact finder would place on two recognized valuation methodologies: RCNLD and OCLD. PG&E recognizes that its preferred RCNLD methodology is not the "only possible method to value the Yolo facilities"[17] but advocates that RCNLD represents "the best and most likely method to be used here."[18] SMUD acknowledges that evidence of RCNLD is admissible, but maintains that RCNLD would not be the most appropriate indicator of the value of PG&E's assets in a condemnation action.[19]

RCNLD estimates the reproduction cost new, depreciated, of physical facilities plus land and intangible assets.[20] In short, it is a valuation method that attempts to measure the potential costs avoided by a condemnor who obtains utility facilities by eminent domain, rather than being required to construct similar facilities.

While RCNLD is generally admissible, because of the difficulties inherent with the market approach, *i.e.,* the absence of comparable sales and the somewhat speculative nature of the capitalization of income approach, it is not controlling or even the preferred method of valuing utility property. The California Court of Appeals has held that "[r]eproduction-cost-new-less-depreciation, and its alternative . . . are acceptable bases for or approaches to an opinion or determination of the market value of property taken in an eminent domain action."[21]

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[15] Code of Civil Proc. § 1263.320(a). The seminal California case interpreting this provision is *Sacramento So. R.R. Co. v. Heilbron*, 156 Cal. 408, 409 (1909):

> the measure of this damages is the market value; that is to say, the highest price estimated in terms of money which the land would bring if exposed for sale in the open market, with reasonable time allowed in which to find a purchaser, buying with knowledge of all of the uses and purposes to which it was adapted and for which it was capable.

[16] *United States v. 55.22 Acres of Land*, 411 F.2d 432, 434 (9th Cir. 1969); Judicial Council of California, Civil Jury Instruction No. 3501 ("'Fair Market Value' Explained").

[17] PG&E Letter at 3.

[18] *Id.*

[19] SMUD December Letter at 9.

[20] *City of Riverside,* D.80480, 74 CPUC 193, 232 (1972).

[21] *South Bay Irr. Dist*., 61 Cal.App.3d at 975.

Further, the Evidence Code specifically permits the consideration of "reproduction cost" in the assessment of fair market value.[22]

However, we have been presented no case that holds that as a matter of law or policy, RCNLD is necessarily the preferred, or even the controlling methodology applicable to the valuation of utility property. Rather, the role of RCNLD is more generally appropriately described as one of several possible aids to a determination of market value.[23] Moreover, some courts have found in assessing the various valuations presented that RCNLD is a less useful determinant of fair market value: "Reproduction cost is not considered the best evidence of fair market value if other evidence is available."[24]

PG&E cites to the CPUC's decision on rehearing in the *City of Riverside*, 74 CPUC 563, 565 (1973), for support of its proposition that the fact finder would afford exclusive or the most predominant weight to RCNLD. Specifically, in the rehearing of the *City of Riverside* decision, the Commission expressed that "[t]he use of reproduction cost (less accrued depreciation) as a major or sole criterion in determining value is solidly based on precedent."[25] In support of this proposition, the Commission cited three cases: *PG&E v. Devlin*, 188 Cal. 33 (1922); *Sacramento Municipal Utility District*, D.35985, 44 CRC 467 (1942) and *City of Redding*, D.26890, 39 CRC 193 (1934). A close look at these cases raises the question whether the language that PG&E quotes from the *City of Riverside* decision accurately construes these precedents.

In *PG&E v. Devlin*, the California Supreme Court affirmed a Railroad Commission decision fixing the amount of compensation to be paid PG&E by the City of Auburn for a water plant. Significantly, it appears that RCNLD was the primary valuation evidence presented by both parties and thus, the Court and the Railroad Commission did not address its benefits and disadvantages relative to other valuation techniques. In approving the lower RCNLD-based amount advocated by Auburn and challenged on appeal by PG&E, the Court found satisfactory that the Railroad Commission considered "[a]ll factors relating to the condition of the properties in question … in arriving at an estimate of reproduction cost less depreciation."[26]

In *Sacramento Municipal Utility District*, SMUD petitioned the CPUC to determine just compensation to be paid for certain property to be acquired from PG&E. The Railroad Commission noted that while both parties presented estimates of reproduction costs "neither of the parties attached any great weight thereto, although differing somewhat in opinion as to the relative importance thereof."[27] Rather, for both parties "'earning power' or productiveness of the property [is] the principal or dominant element bearing upon the question of value."[28] The

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[22] Evid. Code § 820.

[23] *South Bay Irr. Dist.*, 61 Cal.App.3d at 975.

[24] *Id.* at 976, *citing United States v. 55.22 Acres of Land,* 411 F.2d at 435.

[25] *City of Riverside*, 74 CPUC 563, 565 (1973).

[26] *PG&E v. Devlin,* 188 Cal. at 36.

[27] *Sacramento Municipal Water District*, 44 CRC at 469.

[28] *Id.* at 477.

Railroad Commission found that "present and prospective [earning power] is not merely a factor, but a factor of very pronounced weight, for consideration in conjunction with various other items, including the reproduction cost, new and depreciated, of the plant when seeking to determine the fair market value of the property."[29] Moreover, in determining the value for the properties and property rights to be acquired by SMUD, exclusive of severance value, the Railroad Commission specifically noted that it was not attaching any one factor "a definite weight expressed in terms of value."[30]

In *City of Redding*, the City of Redding petitioned the Railroad Commission to determine the compensation to be paid to PG&E for certain facilities. The Railroad Commission considered "testimony regarding reproduction cost new, historical cost and cost to the owner of this property, as well as, earnings upon the same . . . .These are all elements entering into a final determination of value and will be considered and reflected according to their relative worth in the final figure. The most important item from a physical property standpoint in this group is reproduction cost new and the one upon which specific attention was devoted during the hearings."[31] In reaching its final determination of just compensation, the Commission noted that it took into "consideration all of the factors presented in this record and [gave] consideration to them in accordance with their relative weight and in consonance with the findings in the preceding opinion."[32]

Thus, the CPUC's quotation from its rehearing of the *City of Riverside* upon which PG&E greatly relies in advocating RCNLD, is somewhat out of context and an overstatement of the role of RCNLD in the cases cited. Rather, *Devlin, SMUD* and the *City of Redding* are consistent with a more recent expression by the CPUC that "RCNLD is not conclusive proof of value in a hypothetical market . . . [but that] certainly it is of assistance in determining just compensation."[33] However, as stated above, "generally speaking, RCNLD is not considered the best evidence of fair market value if other evidence is available."[34] Rather, RCNLD is "usually reflective of the marketplace ceiling."[35]

Therefore, while case law authorizes the fact finder to consider RCNLD in determining fair market value, in most cases it represents the upper limit of any compensation owed by the condemnor to the condemnee. Further, assuming other admissible and competent evidence is presented, there is no basis for LAFCO to make a present determination that the condemnation fact finder would necessarily rely solely, or predominantly, on a RCNLD valuation methodology of fair market value and exclude from its consideration all other evidence of value in determining the just compensation to be paid by SMUD to PG&E.

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[29] *Sacramento Municipal Water District*, 44 CRC at 477.

[30] *Id.* at 478.

[31] *City of Redding,* D. 26890, 39 CRC 193, 194 (1934).

[32] *Id.* at 197.

[33] *Vandenberg Village Community*, D. 87-07-080, 25 CPUC 2d 20, 34 (1987).

[34] *Id.* at 41-42; *citing South Bay Irr. Dist.*, 61 Cal.App.3d 944 (1976).

[35] *Vandenberg Village Community*, 25 CPUC 2d at 35.

C. Evidence of Original Cost Less Depreciation Methodology is Also Admissible, but Not Necessarily Dispositive

SMUD describes OCLD as using "the original cost of the property when it was first put into service, less accrued depreciation."[36] SMUD concedes that "while OCLD will be considered as a valuation factor, it, like RCNLD, will not be a determinative factor."[37] However, SMUD advocates that OCLD "may be given more weight as a factor than RCNLD in cases where, as here, older utility property is under consideration and the value of utility property is included in the rate base on which the utility is authorized to receive a rate of return."[38]

The primary case in support of SMUD's claim that OCLD would be an appropriate basis for the fact finder to include in its fair market value assessment, is *Vandenberg Village Community*.[39] In *Vandenberg*, the CPUC established the compensation to be paid by Vandenberg Village Community Service District to condemn the lands, property and rights of the Park Water Company. The CPUC stated in its valuation determination that "the least weight was given RCNLD."[40] Rather, "the only conclusion to be drawn is that if District wishes to take the Vandenberg package, it must pay that fair market value, affording no windfall to the seller and being no fire sale or bargain basement acquisition for the buyer. . . ."[41] Further, "any determination of fair market value must always take into consideration original cost."[42] But, "[j]ust as sales at RCNLD are usually reflective of the marketplace ceiling, sales at or below original cost are usually reflective of the marketplace floor."[43]

PG&E is correct in stating "[t]here is no law that requires OCLD to be used, or that allows SMUD to pay only OCLD if the trier of fact determines that OCLD understates fair market value."[44] However, any effort by PG&E to expand this most narrow statement into a broad and absolute legal standard that a fact finder is somehow barred from relying heavily on OCLD if warranted by the facts and evidence presented, would misstate the applicable law.

One shortcoming recognized of OCLD is its inability to reflect inflation. "Depending on its age, the original cost of the utility system is generally admissible …[but where some time has passed since the facilities were constructed,] [o]riginal cost is therefore usually unsatisfactory as

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[36] SMUD December Letter at 6.

[37] *Id.* at 11.

[38] *Id.*

[39] SMUD also appears to rely in part on *South Bay Irrig. Dist.* SMUD December Letter at 11 at note 48. In *South Bay Irrig. Dist.,* the Court of Appeals affirmed the trial court's valuation, which relied more on the "capitalization-of-income approach but also relied on other approaches." *South Bay Irrig. Dist.,* 61 Cal.App.3d at 1004. *See infra,* at §I.D.

[40] *Vandenberg Village Community*, 25 CPUC 2d at 23.

[41] *Id.* at 23.

[42] *Id.* at 34.

[43] *Id.* at 35.

[44] PG&E Letter at 7.

a measure of value in eminent domain."[45] We would anticipate that in any condemnation action PG&E and SMUD would each present evidence regarding the age of the condemned facilities and the somewhat competing impacts of physical degradation, obsolescence, and inflation on the fair market value.

Thus, OCLD may be considered in determining fair market value. However, there is no basis for a conclusion that the fact finder, in determining the just compensation to be paid by SMUD to PG&E, would necessarily rely exclusively on a OCLD valuation methodology, and correspondingly reject all other valuations based on differing methodologies.

D. Evidence of Income Capitalization Methodology is Also Admissible in Determining the Value of Public Utility Property

PG&E criticizes any consideration of the income capitalization methodology on the basis that "[t]he CPUC has also rejected the capitalized earnings approach on the ground it is too uncertain – and the RCNLD approach is preferable for that reason too. . ."[46] SMUD responds that "LAFC[O] can and should consider the income approach analysis included in SMUD's Application."[47]

The income capitalization methodology determines the value from the perspective of the amount the facilities "brings in way of earnings to its owner."[48] The premise of the income capitalization approach is that a potential buyer will pay a price for an asset that reflects the income stream to the seller. As previously stated, it is a "well settled rule that it is the owner's loss, not the taker's gain, which is the measure of the value of the property taken."[49]

In the context of the condemnation of property owned by regulated public utilities, evidence of income capitalization methodology may also be admissible and applicable to the determination of just compensation. A public utility is unique in that its income stream is regulated via the establishment of a rate of return on a utility's rate base. Because a public utility is constrained in the amount that it can earn on utility property and facilities, the income capitalization approach may more accurately reflect the "value" of the to-be-condemned property to the owner of the utility property being condemned.

Moreover, the California Court of Appeals has affirmed the valuation of public utility property that was based primarily on the capitalization of income approach.[50]

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[45] NICHOLS, at §14A.06[2]C.

[46] PG&E Letter at 8.

[47] SMUD March Letter at 8.

[48] NICHOLS, at 14A.06[3] (citation omitted).

[49] *State of California v. United States,* 395 F.2d 261 (9th Cir. 1968).

[50] *South Bay Irrig. Dist.,* 61 Cal.App.3d at 1004.

E. What is the Likely Methodology that a Court Would Utilize in Determining Fair Market Value?

While the cases do not instruct that one particular valuation methodology must be applied to calculate fair market value, the following four general principles appear to be well-established:

- in a proceeding in which no or limited evidence of comparable sales is presented, the fact finder retains broad discretion to consider "any method of valuation that is just and equitable," including any combination or partial adoption of competing valuation methodologies;

- "the proper valuation method or methods for any given case are inextricably bound up with the particular circumstances of the case."[51] Thus, the ultimate determination of just compensation is contingent on the fact finder's exercise of judgment and experience;

- "just compensation is the goal and if rigid application of a rule tends to produce an injustice, the court must deviate from that rule";[52]

- "the question of just compensation is [determined] by . . . the value to the individual from which the property is taken."[53]

In the *City of Riverside* decision, upon which PG&E heavily relies, the CPUC captured these tenets as follows:

> [w]e also recognize that there is no precise formula for determination of just compensation. The Commission, in previous just compensation cases, has considered a number of value criteria with varying emphasis, in the performance of its duty to reach an independent judgment on just compensation based on resolution of conflicting testimony and other conflicting data in records before it.[54]

Further, the CPUC noted that:

> [I]t is not surprising, in a case as long and vigorously contested as this one has been, that the proponents of various valuation criteria and estimates should assert that their methods and results are superior to those of their opponents. Although we are bound to reach an independent judgment on market value based on what the record discloses, we are not required, in so doing to adhere to any particular theory, assumption, technique, or opinion espoused by the witnesses employed by

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[51] *Dade County v. General Waterworks Corp.,* 267 So. 2d 633, 639 (Fla. 1972).

[52] *Dept. of Transp. v. So. Pac. Transp.*, 84 Cal.App.3d 315, 325 (1978), *citing Napa Union High School Dist. v. Lewis,* 158 Cal.App.2d 69, 73 (1958).

[53] *Onondaga Cty Water Authority*, 285 A.D. at 663; *State of California v. United States*, 395 F.2d 261 (citations omitted).

[54] *City of Riverside,* D.80480, 74 CPUC 193, 202 (1972) (emphasis added).

the several parties, with regard to either the tangible or intangible properties here being valued.[55]

Therefore, the CPUC and the courts have considered RCNLD, OCLD, income capitalization and evidence of comparable sales where available,[56] often in the same proceeding. For example, in determining compensation for PG&E in a condemnation by the City of Redding, the Railroad Commission was presented with "testimony regarding reproduction cost new, historical cost and cost to the owner of this property, as well, as earning upon the same [and proceeded on the basis that] [t]hese are all elements entering into a final determination of value and will be considered and reflected according to their relative worth in the final figure."[57]

Thus, rather than directing the use of one particular methodology to be exclusively used in all circumstances, or adopting a rule automatically favoring one valuation method over another, the California courts and the CPUC vest the fact finder with the discretion to consider all relevant valuation methodologies presented by the parties and from the totality of the evidence, determine the just compensation owed by the condemnor to the condemnee.

II. OTHER ISSUES RAISED BY THE PARTIES

A. Going Concern

Going concern is a valuation of the intangible assets of an ongoing business such as the organization of the utility[58] and it may warrant that the condemnee be paid some incremental amount over the value of the physical facilities. It appears that PG&E proposes that the "going concern" value in this case increase the payment by an amount equal to 25 percent of RCNLD.[59]

The only grounds that have been presented in support of PG&E's apparent claim for a 25 percent going concern adder are its answer to Question 12 in the PG&E Letter. The answer references some prior material presented by a PG&E consultant and includes block quotes to two non-California cases and several similar lengthy quotations from the *Nichols* treatise on eminent domain law.

SMUD does not dispute that "under certain circumstances owners of public utilities are constitutionally entitled to recover business losses, or going concern."[60] However, SMUD contends that PG&E has failed to demonstrate "any basis for *adding* going concern value to its already inflated and unsupported RCNLD value."[61]

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[55] *City of Riverside,* 74 CPUC at 209-210.

[56] *United States v. 55.22 Acres of Land,* 411 F.2d at 434.

[57] *City of Redding*, 39 CRC at 194; see also, *South Bay Irr. Dist.,* 61 Cal.App.3d 944.

[58] *See* PG&E Letter at 17; SMUD December Letter at 13.

[59] *See* SMUD December Letter at 12.

[60] SMUD March Letter at 11.

[61] SMUD December Letter at 13 (emphasis in original).

As an initial matter, the *Nichols* treatise explains that "[a]ccording to most court decisions, the going-concern-increment factor only applies when the reconstruction cost approach is used."[62] Further, "[t]he method of quantifying going concern or assembled unit value is imprecise and a difficult, perhaps arbitrary, task."[63] "[T]he fundamental difficulty with the attempt to set a definite sum as the measure of going value is that it is an attempt to divide a thing which is in its nature practically indivisible. The value of the plant and business is an indivisible gross amount."[64]

Given the nature of PG&E's proof, we must agree with SMUD that while the final award may include some component for "going concern" value, PG&E has thus far failed to present any evidentiary grounds to support such a claim and no cognizable basis to sustain a 25 percent adder.[65] Moreover, to the extent that PG&E's claim does, as SMUD suggests, include going concern compensation based on good will, it is unlikely that a fact finder would include any such good will component.[66]

B. Depreciation Methodology

According to SMUD, PG&E stated in a September 16, 2005 submission to LAFCO that SMUD erred by using straight line depreciation and that the fact finder would necessarily use a "present worth depreciation method" for purposes of any SMUD condemnation proceeding.[67] PG&E did not include in the PG&E Letter any discussion relating to its possible claim that straight line depreciation is not a valid method for use in either RCNLD or OCLD calculations and thus, our comments on this issue are necessarily limited.

However, to the extent PG&E is suggesting that straight line depreciation may not be used for purposes of calculating a RCNLD or OCLD amount, it is mistaken. In *Devlin*, the California Supreme Court rejected PG&E's challenge to the use of straight line depreciation, affirming its use by the Railroad Commission to set the compensation to be paid PG&E.[68]

We also do recognize that the *Nichols* treatise provides that while "straight line method is an acceptable starting point for determination of physical depreciation . . . [i]t is still a mechanical calculation requiring inspection and adjustment for maintenance, repair, replacement

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[62] NICHOLS at § 14A.05.

[63] NICHOLS at § 14A.05[3] (citation omitted).

[64] *Appleton Water Works Co. v. Railroad Comm'n of Wisconsin,* 142 N.W. 476, 484 (Wis. 1913).

[65] The "fact" that a court in some other case, based on the evidence presented in that matter, may have awarded a 25 percent going concern adder does not constitute "evidence" relevant to whether and how much the fact finder may award PG&E for going concern in any possible condemnation action by SMUD.

[66] In responding to PG&E's possible claims for a going concern adder, SMUD references the *Re City of Fresno,* D.86-02-040, 20 CPUC 2d 502, 535 (1986) ("Due to the monopoly nature of public utility service where customers continue regardless of good will, no value should attach to this part of going concern.") SMUD December Letter at note 70.

[67] SMUD December Letter at 3.

[68] *PG&E v. Devlin*, 188 Cal. at 44-45.

of parts, environmental and usage conditions."[69] The concern is that straight line depreciation may not accurately reflect the value of the assets acquired by condemnation because the methodology does not reflect actual wear and tear or actual functional or economic obsolescence.[70]

Thus, the choice of depreciation protocol or methodologies to be used by the fact finder will depend upon the actual facts and arguments presented at the evidentiary hearing. The fact finder would certainly have the authority to decide to use straight line depreciation if such method is consistent with its view of the evidence and arguments presented.

C. Lack of Relevance of CPUC Decisions Authorizing PG&E to Sell Utility Property

PG&E identifies 13 CPUC decisions and suggests that these decisions "support its claim that it will receive RCLND."[71] None of these cases support PG&E's assertion, and none is likely to even be relevant to the fact finder's decision as to how to determine fair market value.

In each of the cited CPUC decisions, the CPUC did not actually adjudicate the value of the condemned properties; rather in each instance the parties had previously agreed to a sale price and the CPUC's role was strictly limited to making a separate and independent regulatory determination that the "proposed transfer would not be adverse to the public interest and that the public convenience and necessity no longer require electric service by PG&E in the area herein considered."[72] In fact, and directly contrary to PG&E's assertions, in most of the cases the CPUC specifically noted that "[t]he action taken herein shall not be construed as a finding of the value of the property authorized to be transferred."[73]

Given the fact that in these decisions, the CPUC's scope of inquiry was generally restricted to preserving the quality of service for PG&E's remaining ratepayers and did not involve the exercise of its fair market value setting adjudicatory jurisdiction, it is likely that a civil court would reject evidence relating to such decisions. Moreover, to the extent that PG&E would seek to introduce the underlying settlement between the parties, as a general rule, evidence of settlement is generally excluded in civil court proceedings to prove a party's

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[69] NICHOLS at § 14A.06[2]f[ii].

[70] *See* NICHOLS at § 14A.06[2]f.

[71] PG&E Letter at 5.

[72] *City of Redding*, D.80356, mimeo at 1 (1972). Although not specifically referenced in the CPUC decisions, it appears that in approving PG&E's sale of its facilities in these proceedings, the CPUC was exercising its jurisdiction under Section 851 of the Public Utilities Code. The purpose of Section 851 is to insure that service to ratepayers is not prejudiced by the utility's sale, assignment, encumbrancing or other disposition of property heretofore used to provide utility service. In other words, in these proceedings the CPUC was not asked to, and did not, exercise its jurisdiction under section 1404 of the Public Utilities Code (or its predecessor, Pub. Util. Code § 27(b)) to "fix and determine the just compensation" to be paid to the condemned utility.

[73] *See e.g., PG&E (Cal-Pacific)* D. 76228, mimeo at 2 (1969).

liability.[74] PG&E accordingly recognizes that it is unlikely that the evidence of the valuation techniques the parties used to reach the settlements in the condemnation actions referenced in the CPUC decisions would be permitted in civil court.[75]

Additionally, given the fact that the primary and overriding commercial term that PG&E and the municipal purchaser in the underlying valuation settlements were negotiating was the sale price, PG&E's characterization of the "method" used to arrive at the sales price ultimately negotiated would provide no meaningful guidance. Once the purchase price was agreed to by the parties, it is reasonable to assume that PG&E's characterization of the settlement methodology was of no consequence, economic or otherwise, to the purchaser.

[74] Evid. Code § 1152.

[75] PG&E Letter at 2.

EXHIBIT A

Davis Wright Tremaine LLP ("DWT") is a full service business and litigation law firm, with more than 400 attorneys in its nine offices located throughout the Pacific Northwest, and in Anchorage, Los Angeles, San Francisco, New York, Washington D.C., and Shanghai, China.

DWT has an integrated national energy law practice comprising of more than 20 full time practicing lawyers representing some of America's leading energy companies in California, the Pacific Northwest and on Capitol Hill. We assist clients, including public utilities, energy producers and suppliers, project developers, energy consumers and energy industry investors to best understand markets and regulatory structures, and to take advantage of opportunities arising from this complex landscape. The firm is also currently representing the South San Joaquin Irrigation District ("SSJID") on several matters, including SSJID's plan to acquire certain PG&E facilities for purposes of providing retail electric service.

Our San Francisco office has been selected by Chambers USA as one of the top energy law firms in the state of California. Steven Greenwald and Edward O'Neill in our San Francisco office have been identified by Chambers as among the "leading" individual energy lawyers within California and also designated as "Super Lawyers" in the energy area by Law & Politics, a division of Key Professional Media, Inc.

Steve Greenwald chairs the firm's national energy practice. His experience includes representing independent power producers and marketers in State and Federal regulatory proceedings, including utility rate proceedings, proceedings related to the divestiture of utility power plants and market-based rate authority. Steve has been practicing law in San Francisco since 1975. In 1980, Steve joined the Law Department at Pacific Gas and Electric Company and, since that time, his practice has been entirely devoted to energy and public utility law. During his tenure at PG&E (through 1989), Steve, among other responsibilities, participated in business transactions and regulatory proceedings related to PG&E's sale of its Utah coal properties and certain municipal street light systems. He is experienced in contractual negotiations and litigation involving disputes between power producers and public utilities. Steve has represented a number of municipal utility districts regarding issues pertinent to the acquisition of public utility facilities and the provision of service to customers previously served by investor-owned public utilities.

Salle Yoo's representative experience includes extensive transactional and regulatory work including counsel to independent power projects, investment banks and private equity clients regarding California energy regulatory issues and the application of energy regulations and public utility law to the development of electric generation facilities in California. Salle regularly advises project developers and lenders regarding the California Environmental Quality Act requirements and eminent domain issues in regulatory proceedings as well as represents clients in energy matters before the California Public Utilities Commission and the Federal Energy Regulatory Commission.