TREADING ON WATER: PUBLIC UTILITIES, EMINENT DOMAIN, AND JUST COMPENSATION—VALUING THE PLANT

INTRODUCTION

Imagine that you are the owner of a business. You started the business from the ground up and have spent forty years of your life building its value—an asset base growing from $0 to $10,000,000, a customer base growing from twenty to over three thousand, and a brand that is well-trusted. Then, after forty years, you are informed that the government has filed a petition of eminent domain to take your business. Public utility company owners are common recipients of this nightmare. Municipalities, who do not want to endure the initial expense of providing the utilities, leave private owners to make the initial investment. Then, after there is profitability, up to ten, twenty, thirty, even forty plus years, they use eminent domain to take the utility company for public use. And, because utility companies are peculiar entities, municipalities are able to abuse the power to violate property owners' rights to just compensation under the Fifth Amendment.

Public utility companies are peculiar because (1) they are not frequently bought and sold on the open market, and (2) they not only possess tangible assets, such as the physical plant but also intangible assets, such as the government granted certificate, which gives the company the right to operate. Typically, a property is assigned one value based on the valuation method that is most suitable for that particular property. However, with a public utility company, no one valuation method can be used because of the unique makeup. The tangible plant has to be valued using the reconstruction cost approach, but this approach alone does not suffice because it fails to consider the value of the rights associated with the franchise. These rights are valued by using the income approach and added to the plant value to arrive at just compensation. Municipalities are able to take advantage of these complexities in order to lowball the value of the utility property leaving the property owner without just compensation.

The primary focus of this Comment is to identify how municipalities attempt to confuse the value of the tangible plant by using an unreliable approach under the reconstruction cost method of valuation. Some municipalities have attempted to leave

all consideration of the existing development costs out of their estimate of cost to reconstruct the plant. This Comment seeks to assist trial judges and practicing attorneys to achieve just results concerning just compensation for the tangible plant and avoid being reversed on appeal. This will minimize legal costs for public utility owners, giving them a standing chance to receive just compensation upon the condemnation of their livelihood.

Part I of this Comment discusses background law regarding just compensation as well as the generally accepted principles in economics and valuation methods used in valuing properties. Part II will discuss why the law requires the use of the reconstruction cost approach to value the plant. Part III demonstrates why and how both economic principles and the law requires consideration of development costs using the reconstruction cost approach in valuing the physical plant component of the utility property in order to ensure the constitutional guarantees to just compensation under the Fifth Amendment.

I. JUST COMPENSATION AND EMINENT DOMAIN

When property is taken for public use through the power of eminent domain, the Fifth Amendment requires that just compensation be made to the property owner.[1] It is well recognized that the limitations of this provision on eminent domain power were only applicable to the federal government at the time it was adopted.[2] However, the Fourteenth Amendment now grants federal assurance to property owners that states will not take their property without compensation.[3] All but two states also have a similar provision in their state constitutions, and the states generally pay just compensation according to the

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[1] U.S. CONST. amend. V ("[N]or shall private property be taken for public use, without just compensation.").

[2] 1 JULIUS SACKMAN, NICHOLS ON EMINENT DOMAIN § 1.3 (3d ed. 2012) ("[B]ut in that document [the Fifth Amendment] is a limitation on the powers of the United States only.") (citing Winous Point Shooting Club v. Casperson, 193 U.S. 189 (1904)).

[3] 1A SACKMAN, *supra* note 2, § 4.13[2] ("[I]t is a violation of the Fourteenth Amendment if a state court justice instructs the jury to adopt a measure of damages . . . which would not constitute just compensation in the constitutional sense."); *see also* Kelo v. City of New London, 545 U.S. 469 (2005) (applying the Fifth Amendment to a state eminent domain action).

interpretation of their constitution by their state courts.[4] And, state court decisions that are based on reasonable considerations of the property owner's rights are likely to stand.[5] However, the states must still meet the just compensation requirements of the Fifth Amendment.[6]

Regardless of what authority the taking stems from, just compensation is required.[7] Due to economic woes, all ranges of government, from the federal government to municipalities, have existed with "land-lust."[8] Thus, the Founding Fathers saw the need for lawmakers to develop the law of just compensation for condemned property as a necessity for the protection of property owners against this lust for land.[9] Even with the requirement of just compensation, property owners face an unwarranted risk of losing rightful value.[10] In order to ensure just compensation for the taking of public utilities, it is vital to understand the law,[11]

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[4] 1 SACKMAN, *supra* note 2, § 1.3 ("An eminent domain case brought under a state constitutional provision may require a different analysis and lead to different results where the language of a state constitution differs from that of the constitution of the United States."). North Carolina and New Hampshire are two lacking states. *Id.*

[5] *See* Chicago, Burlington & Quincy R.R. Co. v Chicago, 166 U.S. 226, 246 (1897) ("We are permitted only to inquire whether the trial court prescribed any rule of law for the guidance of the jury that was in absolute disregard of the company's right to just compensation."). The Court used the "absolute disregard" language to emphasize the point that the Fourteenth Amendment does not require the Court to review "every order or ruling of the state court." *Id. But see* United States v. Miller, 317 U.S. 369, 379-80 (1943) ("We need not determine what is the local law . . . . They do not, and could not, affect questions of substantive right—such as the measure of compensation—rounded upon the Constitution of the United States.").

[6] *See supra* note 3 and accompanying text.

[7] *See supra* notes 3-4 and accompanying text.

[8] CARLA T. MAIN, BULLDOZED: "KELO," EMINENT DOMAIN, AND THE AMERICAN LUST FOR LAND 106-07 (2007) ("[L]and seizures were not taking place on the sly. . . . Debates raged over how—indeed, whether—to pay the war debts, both in the national government and at the local level. In this climate, seizing Loyalist property became a sort of national sport.").

[9] *Id.* at 112 ("Madison witnessed the way American patriotic drive could flip like a switch to rapacious destructiveness. It would be up to future generations of lawmakers and community leaders to hold such darker, majoritarian instincts in check.").

[10] STEVEN GREENHUT, ABUSE OF POWER: HOW THE GOVERNMENT MISUSES EMINENT DOMAIN 9 (2004) ("The owner must simply wait until officials get their act together. Once the shoe drops, and the condemnation proceedings begin, owners often get thrown into a long and costly legal tangle. Cities often try to buy the land on the cheap, dragging out court proceedings for months or even years if the [property] owners don't like the deal they have been offered.").

[11] *See infra* Parts I.A.

the economic theory behind the standard appraisal techniques,[12] and how to apply these appraisal techniques according to the law.[13]

A. Measuring Just Compensation

While there may be some variation in state law applications of just compensation requirements, there is generally a common foundation of ideas. The implication of the term "compensation" is that the property owner should receive the "full and complete equivalent (usually monetary) for the loss sustained."[14] It is the value of the actual property taken, plus any damage to any remaining property caused by the taking.[15] In *United States v. 564.54 Acres of Land*, the Court stated the general premise that "the owner of condemned property [must be put] 'in as good a position pecuniarily as if his property had not been taken.'"[16] The Court went on to discuss three different ways to consider value under this premise—fair market value, value to the taker, and value to the owner. The Court described this as a "working rule."[17]

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[12] *See infra* Part I.B.

[13] *See infra* Part II.

[14] 3 SACKMAN, *supra* note 2, § 8.06[1]; United States v. Toronto, Hamilton & Buffalo Nav. Co., 338 U.S. 396, 402 (1949) ("[T]he balance between the public's need and the claimant's loss has been struck, in most cases, by awarding the claimant the *monetary 'market value'* of the property taken." (emphasis added)).

[15] 3 SACKMAN, *supra* note 2, § 8.06[1].

[16] 441 U.S. 506, 510 (1979) (citation omitted).

[17] *Id.* at 511. First, the Court discussed the idea of "fair-market value," which has become known as "'what a willing buyer would pay in cash to a willing seller' at the time of the taking." *Id.* Second, the Court mentions "the value to the owner," and third, "the value to the taker." *Id.* It is said that the "fair-market value" standard "has been chosen to strike a fair 'balance between the public's need and the claimant's loss' upon condemnation of property for a public purpose." *Id.* at 512 (citation omitted). However, there are situations, specifically "with respect to public facilities," when the "fair-market value" standard does necessarily constitute just compensation. *Id.* at 513. In these situations, the value to either the owner or the taker should be given special consideration. *See* LEWIS ORGEL, VALUATION UNDER THE LAW OF EMINENT DOMAIN 48 (James C. Bonbright ed., 1936) (discussing the three possible standards of value to include value to the taker, value to the owner, and market value).

1. "Fair-Market" Value

Fair-market value can generally be said to be "market price," which is "[t]he actual price of a good in the market."[18] The goal of considering fair-market value as a measure of just compensation is to determine a value that is not biased toward the buyer or the seller.[19] It is based on what is actually taking place in the market with comparable properties at the date of condemnation as opposed to any special values to either the buyer or seller.[20] The most modern definition of market value

> implies a completed sale under conditions in which:
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> 1. Buyer and seller are *typically* motivated.
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> 2. Both parties are well informed or well advised, and each acting in what he [she] considers his [her] own best interest.
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> 3. A reasonable time is allowed for exposure in the open market.
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> 4. Payment is made in cash or its equivalent.
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> 5. Financing, if any, is on terms generally available in the community at the specified date and typical for the property type in its locale.
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> 6. The price represents a normal consideration for the property sold unaffected by special financing amounts

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[18] WILLIAM M. SHENKEL, MODERN REAL ESTATE APPRAISAL 24 (1978).

[19] *See* ORGEL, *supra* note 17, at 62-65 (quoting cases from multiple jurisdictions that discuss the purpose of using the fair-market value approach as being the equal consideration to the buyer and seller without special consideration given to either).

[20] *See* Alfred Schimmel, *Market Value: Its Concept, Economics, and Foundation, in* A PRACTICAL GUIDE TO THE LEGAL AND APPRAISAL ASPECTS OF CONDEMNATION 21 (Sidney Z. Searles ed., 1969) (The definition of fair-market value includes "(1) exposure to sale in the open market; (2) exposure to sale for a reasonable time; (3) sale by a seller who is (a) fully informed, (b) not under abnormal pressure, (c) willing; and (4) a purchase by a buyer who (a) has knowledge of all the uses to which the property is adapted and for which it is capable of being used, (b) is not under abnormal pressure, (c) is willing."). The most recent definition of market value, as agreed upon by the American Institute of Real Estate Appraisers, and the Society of Real Estate Appraisers is "'the highest price in terms of money which a property will bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus.'" SHENKEL, *supra* note 18, at 31 (citation omitted).

> and/or terms, services, fees, costs, or credits incurred in the transaction.[21]

Although the legal use of the fair-market value approach is not without its problems,[22] it "is accepted by all American courts in most cases, and by some American courts in all cases, as the proper measure of compensation when property is taken by power of eminent domain."[23] However, there are "cases involving . . . factors of value to the taker and value to the owner [where] the increasing vagueness of the [fair-market value] standard [likely] destroy[s] its practical utility [in determining just compensation]."[24]

2. Value to the Taker

In some cases, a condemned property could have special value to the party taking the property based on any special uses that exist.[25] Generally speaking, "just compensation in the constitutional sense is what the owner has lost, not what the condemnor has gained."[26] Normally, the entity taking the property argues that any special value to the taker should not be considered, and in many cases, this argument wins.[27] In the typical public utility case, the municipality wants to argue that the value to the taker should be considered.[28] If this argument were to be accepted, the municipality would not have to consider value of the property owner's state granted franchises because of the fact that the municipality does not need the franchise to

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[21] SHENKEL, *supra* note 18, at 31-32.

[22] ORGEL, *supra* note 17, at 68-112 (discussing the potential problems with the legal use of the fair-market value approach as being classified in the following categories: "(a) problems arising from the time factor (time of negotiation, and exact date of sale); (b) problems arising from the choice of alternative uses for which the property might have a sale value; and (c) problems arising out of the influence on market value of the area of the property taken").

[23] *Id.* at 113.

[24] *Id.*

[25] *Id.* at 256-57.

[26] 4 SACKMAN, *supra* note 2, § 12.03.

[27] ORGEL, *supra* note 17, at 256-309 (discussing when "value to the taker" is generally considered and when it is not).

[28] *Id.* at 619.

operate the utility.[29] However, in cases involving government granted franchises, the general proposition that just compensation consists of what the property owner has lost wins against the "value to the taker" argument.[30] While this Comment does not reach to the issues in valuing the franchise, it is important to the idea that public utility companies have an "intrinsic value"[31] that requires consideration of "value to the owner" as opposed to the "value to the taker."[32]

3. Value to the Owner

In most cases, just compensation is determined by fair-market value, especially where fair-market value is ascertainable.[33] In these cases, any additional value to the property owner is usually considered as sentimental value, which is not allowed consideration.[34] However, "[w]ith many types of

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[29] *Id.* ("This reversal in position is explained by the fact that in the taking of a public utility, the condemning municipality seeks to avoid payment for franchises by contending that, while these rights may have great value to the company, they are without worth to the city since the latter needs no such sanction for the operation of a utility enterprise.").

[30] Monongahela Navigation Co. v. U.S., 148 U.S. 312, 343 (1893) ("*It is also suggested that the government does not take this franchise; that it does not need any authority from the state for the exaction of tolls*, if it desires to exact them; that it only appropriates the tangible property, and then either makes the use of it free to all, or exacts such tolls as it sees fit, or transfers the property to a new corporation of its own creation, with such a franchise to take tolls as it chooses to give. *But this franchise goes with the property; and the navigation company, which owned it, is deprived of it.* The government takes it away from the company, whatever use it may make of it; and the question of just compensation is not determined by the value to the government which takes, but the value to the individual from whom the property is taken; and when by the taking of the tangible property the owner is actually deprived of the franchise to collect tolls, *just compensation requires payment, not merely of the tangible property itself, but also of that of the franchise of which he is deprived.*" (emphasis added)).

[31] *See infra* notes 39-41 and accompanying text.

[32] *See infra* Part II.A (explaining further why public utilities are unique properties that require unique consideration).

[33] *See* United States v. 79.20 Acres of Land, 710 F.2d 1352, 1354-55 (8th Cir. 1983) ("Under the Fifth Amendment to the United States Constitution a landowner is entitled to just compensation *only* for the interest in land taken by eminent domain." (emphasis added)). "Condemnation proceedings are *in rem* and just compensation must be based upon the value of the rights taken, without regard to the personality of the owner or his personal relationship to the property taken." 4 SACKMAN, *supra* note 2, § 12.04[2].

[34] *Id.*

property . . . it is clear that there is not even a rough correspondence between the two kinds of value."[35] And, where this discrepancy exists, the fair-market value standard should be abandoned to the extent it does not provide just compensation to the property owner.[36] There are situations "where . . . economic forces have temporarily created abnormal market conditions, or where by reason of the character of the property it cannot by nature have a market value."[37]

This begs the question that if fair-market value is not sufficient, then how is the value determined in these cases? While the jurisdictions that do acknowledge this principle[38] use a variety of phrases to indicate the peculiar value of the property to the owner,[39] no jurisdiction implies that "*all* of the injuries which [the property owner] may have sustained" must be considered in

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[35] ORGEL, *supra* note 17, at 114. Orgel recognized that there are some

> [t]ypical examples of great discrepancy between the value of the property to its owner and sale value . . . in the following cases: First, with respect to structures, especially adapted to the use of their present owner—for example, churches, college buildings, club houses, unusually expensive residences and certain types of factories; second, with respect to land or structures so located that they form an integral part of the remainder of the owner's property; third, with respect to homesteads to which the owner has an unusual sentimental attachment; fourth, with respect to separate interests in real estate such as easements and life tenancies; *fifth, with respect to property that cannot be sold, or that can be sold only with great difficulty, because of legal restrictions such as those imposed by the terms of a will*.

Id. at 115 (emphasis added).

[36] *Id.*; United States v. Commodities Trading Corp., 339 U.S. 121, 123 (1950) ("This Court has never attempted to prescribe a rigid rule for determining what is 'just compensation' under all circumstances and in all cases. Fair market value has normally been accepted as a just standard. But when market value has been too difficult to find, or when its application would result in manifest injustice to owner or public, courts have fashioned and applied other standards.").

[37] 4 SACKMAN, *supra* note 2, § 12.04[2].

[38] It is important to note that not all jurisdictions acknowledge the peculiar value of the property to the owner even in cases where fair-market value falls short of just compensation. However, even in jurisdictions that have yet to apply these rules, a good persuasive argument can still be made to change the view of the jurisdiction in order to adapt to the requirements of the Fifth Amendment.

[39] Some courts have used the actual language "'value to the owner' . . . 'special value for the owner's uses' . . . [while] other courts have preferred colorless phrases like 'actual value', or 'intrinsic value', or just 'value' . . . . Sometimes the formula runs, 'value of the property in view of the use to which it is being put.'" ORGEL, *supra* note 17, at 121.

determining value (i.e., sentimental value).[40] While courts generally do not recognize sentimental value, they should recognize intrinsic value, which may not be considered by the normal applications of the standard appraisal methodologies.[41]

B. Understanding the Standard Valuation Methodologies

1. The Comparable Sales Approach[42]

Appraisers use the comparable sales approach to conclude a value on the given property by comparing it with "recent sales (or offering prices) of properties that are similar (i.e., comparable) to the subject property."[43] Where there are discrepancies between the subject property and the comparable properties, the appraiser will make adjustments in order to equate the value of the properties.[44] "The sales comparison approach is most reliable when there is an active market providing a sufficient number of sales of comparable property that can be independently verified through reliable sources."[45] This approach is most commonly

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[40] *Id.* at 121-22.

[41] *Id.* at 122 ("'Value' is thought of as something more or less inherent in the property; and this concept of an inherent or intrinsic value of property 'as such' remains to confuse the picture which the court paints, even when it is obliged to take cognizance of the peculiar value of the property to one particular owner. For the valuation theorist at least, the problem would be greatly simplified if the courts were ready to recognize value to the owner as a mere positive expression of the entire injury to the owner . . . and . . . *then* proceed[] to exclude from the measure of damages those particular 'consequential,' 'sentimental,' and 'remote' or unusual injuries, the exclusion of which is required by rules of evidence or by notions of public policy.").

[42] Discussion on the comparable sales and income approaches are kept limited for the purposes of this Comment, because the reconstruction cost approach is the relevant approach for valuing the plant, which is the main issue addressed.

[43] MACHINERY AND TECHNICAL SPECIALTIES COMMITTEE OF THE AMERICAN SOCIETY OF APPRAISERS, VALUING MACHINERY AND EQUIPMENT: THE FUNDAMENTALS OF APPRAISING MACHINERY AND TECHNICAL ASSETS 121 (2d ed. 2000) [hereinafter AMERICAN SOCIETY OF APPRAISERS]; AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS, THE APPRAISAL OF REAL ESTATE 309 (8th ed. 1983) ("The sales comparison approach is a method of estimating market value whereby a subject property is compared with comparable properties that have sold recently.").

[44] AMERICAN SOCIETY OF APPRAISERS, *supra* note 43, at 126-27 (discussing vintage and effective age, condition, capacity, features (accessories), location, manufacturer, motivation of parties, price, quality, and quantity as elements of comparability).

[45] *Id.* at 122; *see infra* Part II.A (discussing why the comparable sales approach is not sufficient as a matter of law to determine value for a public utility company).

associated with the market value standard of just compensation required by the Fifth Amendment. [46] The income and reconstruction cost approaches are generally reserved under Fifth Amendment compensation for unique properties when fair-market value cannot lead to just results.[47]

2. The Income Approach[48]

The income approach to valuation is based on the premise that the subject property is income producing and is being purchased for investment purposes. [49] In these situations, "[E]arning power is the critical element that affects the property's value."[50] This is best understood by realizing the time value of money, or "that a dollar received today is worth more than a dollar to be received in the future."[51] While there are two common ways to use the income approach, the discounted economic income method and the capitalized economic income method, the essence of both is the same.[52] The first step is to project the estimated

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[46] *See supra* notes 35-39 and accompanying text.

[47] *See supra* note 36 and accompanying text; *see also* Monongahela Navigation Co. v. United States, 148 U.S. 312 (1893) (holding that both the cost approach and income approaches were necessary—the first to value the physical bridge and the second to value the franchise held by the owner to collect tolls). As mentioned by the Court in the Fifth Amendment analysis:

> *[H]ence, to measure the damages by the mere cost of building the bridge would be to deprive the company of any compensation for the destruction of its franchises. The latter can no more be taken without compensation than can its tangible corporeal property.* Their value necessarily depends upon their productiveness. If they yield no money in return over expenditures, they would possess little, if any, present value.

Id. at 329 (emphasis added).

[48] *See supra* note 42.

[49] AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS, *supra* note 43, at 333.

[50] *Id.*

[51] AMERICAN SOCIETY OF APPRAISERS, *supra* note 43, at 161 ("[This is] because the dollar received today can be invested and earn interest or other benefits. Stated another way, a dollar is worth more today because it can be used to buy goods and services (i.e., it is liquid) and there is no risk associated with waiting.").

[52] SHANNON P. PRATT ET AL., VALUING SMALL BUSINESSES AND PROFESSIONAL PRACTICES 254 (3d ed. 1998) ("The capitalized economic income method actually is used more in the valuation of small businesses and professional practices than the discounted economic income method is. [However], once the analyst has a grasp of the discounted economic income method, the valuation theory that is applied in the capitalized income method can be grasped more easily."). Pratt also recognizes that

income of the business into the future.[53] The second step involves taking the future number calculated in step one and discounting (or capitalizing) it back to a net present value of the business.[54] Appraisers use the income approach to value both real estate and businesses.[55] However, when real estate is being transferred with the purchase of a business, it may require separate value.[56] While the income approach is certainly relevant to valuing a public utility's franchise, properly valuing the tangible property is the main premise of this Comment, which is where the reconstruction cost approach becomes relevant.[57]

3. The Reconstruction Cost Approach

The main premise of the reconstruction cost approach (or cost approach) is that the value of the subject property equals what it would cost the purchaser to reconstruct a similar property.[58] When valuing a house or other building using this approach, the appraiser estimates four items: (1) the land, (2) the costs of the building, (3) site improvements costs, and (4) the depreciation allowance.[59]

"the use of the discounted economic income method for valuing smaller businesses and professional practices is increasing." *Id.* at 236.

[53] *See id.* at 236 (discussing step one in the discounted economic income method). *But see id.* at 255-56 (discussing step one in the capitalized economic income method).

[54] *See id.* at 236 (discussing step two in the discounted economic income method). *But see id.* at 256 (discussing step two in the capitalized economic income method).

[55] *Id.* at 83-92 (discussing the differences between real estate and business practices).

[56] *Id.* at 84-85 ("Nonetheless, the valuation of a business integrates the total entity, including (1) all of the assets (i.e., financial assets, *real estate*, tangible personal property . . . and intangible real property interests), (2) all of the liabilities (i.e., current liabilities and long-term liabilities), and (3) all of the various classes of owners' equity. . . . In most cases, especially with respect to properties used by small businesses . . . the real estate is separable from the business. In such cases . . . the real estate may be appraised separately . . . ." (emphasis added)).

[57] *See supra* note 47 and accompanying text.

[58] AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS, *supra* note 43, at 442 ("[N]o prudent investor would pay more for a property than the amount . . . for which improvements that have equal desirability and utility can be constructed without undue delay.").

[59] SHENKEL, *supra* note 18, at 157. The following example summarizes how one would estimate the market value from these four factors:

Building cost (new)……..……$100,000

Land Improvements (land leveling, paving, and landscaping)..+10,000

In every valuation completed using this approach, appraisers use one of two methods, which are the replacement cost new or the reproduction cost new.[60] "[R]eproduction cost is the current cost of reproducing a new replica of the property being appraised using the same, or closely similar, materials."[61] On the other hand, "[r]eplacement cost is the current cost of a similar new property having the nearest equivalent utility as the property being replaced."[62] Replacement cost is used when "improved or more readily available materials would probably be substituted for the outdated or more costly materials used in the existing structure."[63]

Regardless which of these two methods are used under the cost approach, the appraiser must include two categories of costs, which are direct costs and indirect costs.[64] As stated by the American Institute of Real Estate Appraisers,

> Direct costs generally include
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> 1. Labor used to construct buildings
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> 2. Materials, products, and equipment
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> 3. Contractor's profit and overhead, including job supervision, workers' compensation, fire and liability insurance, and unemployment insurance

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	$110,000
Less building depreciation…….....	-30,000
	$80,000
Plus land value (estimated from comparable sales)……..	+15,000
Indicated market value, cost approach…..……..	$95,000

Id. at 157-58.

[60] AMERICAN SOCIETY OF APPRAISERS, *supra* note 43, at 44 ("It is essential that the appraiser understand the difference between *replacement cost new* and *reproduction cost new*."); SHENKEL, *supra* note 18, at 161 ("Appraisers take considerable care in selecting the type of cost used for valuation. Cost data may refer to (1) reproduction cost or (2) replacement cost. In either case, if the valuation is directed toward current market value, the appraiser must estimate how much it would cost to build a new building today.").

[61] AMERICAN SOCIETY OF APPRAISERS, *supra* note 43, at 44.

[62] *Id.*

[63] AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS, *supra* note 43, at 452.

[64] *Id.*

4. Performance bonds, surveys, and permits

5. Use of equipment

6. Watchmen

7. Contractor's shack and temporary fencing

8. Materials storage facilities

9. Power-line installation and utility costs

Indirect costs include

1. Demolition and removal costs

2. Architectural and engineering fees, including plans, plan checks, surveys to establish building lines and grades, and environmental and building permits

3. Appraisal, consulting, and legal fees

4. Permanent financing fees, as well as interest on construction loans, interest on land costs, and processing fees or service charges

5. Insurance and ad valorem taxes during construction

6. Lease-up costs

7. Administrative expenses of the owner

8. Title changes

9. Survey or feasibility studies[65]

Direct costs are the costs that are "normally and directly incurred in the purchase and installation of an asset, or group of assets, into functional use," and indirect costs are the costs "that are normally required to purchase and install a property but that are not usually included in the vendor invoice."[66] The appraiser must give accurate consideration to both of these types of costs "to

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[65] *Id.* at 453-54.

[66] AMERICAN SOCIETY OF APPRAISERS, *supra* note 43, at 50-51.

ensure a reliable value indication" of the property being valued by the cost approach.[67]

Once the construction cost has been established, the appraiser must estimate the deductible amount of physical depreciation.[68] When the replacement cost is used, the appraiser will also have to consider functional depreciation.[69] No matter which method is used to estimate the value using the cost approach, the logic is the same; it "is the principle of substitution: a prudent buyer will not pay more for a property than the cost of acquiring a substitute property of equivalent utility."[70]

II. APPLYING THE VALUATION METHODOLOGIES TO PUBLIC UTILITIES

A. Public Utilities Are Unique Properties Requiring Unique Considerations

A public utility company, at least a "for-profit" utility company,[71] is a unique property from a legal standpoint as

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[67] AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS, *supra* note 43, at 452.

[68] AMERICAN SOCIETY OF APPRAISERS, *supra* note 43, at 67 ("Physical deterioration is the loss in value or usefulness of a property due to the using up or expiration of its useful life caused by wear and tear, deterioration, exposure to various elements, physical stresses, the passage of time, and similar factors.").

[69] *Id*. at 87 ("Functional obsolescence has been previously defined as the loss in value or usefulness of a property caused by inefficiencies or inadequacies of the property itself, when compared to a more efficient or less costly replacement property that new technology has developed.").

[70] *Id*. at 43.

[71] City of Madison v. Bear Creek Water Ass'n, 816 F.2d 1057 (5th Cir. 1987). Bear Creek Water Association was found to be a non-profit organization that was indebted to the Farmers Home Administration. *Id.* at 1058. In this case, the City of Madison was prohibited from using its power of eminent domain to condemn the utility under the Consolidated Farm and Rural Development Act, 7 U.S.C. § 1926(b), which provides:

> "The service provided or made available through any such association shall not be curtailed or limited by the inclusion of the area within the boundaries of any municipal corporation or other public body, or by the granting of any private franchise for similar service within such area during the term of said [FmHA] loan; nor shall the happening of such event be the basis of requiring such association to secure any franchise, license or permit as a condition to continuing to serve the area served the association at the time of the occurrence of such event."

Id. at 1059. The court held that there could be no "loophole [for] . . . condemnation" if the purpose of the statute is to be fulfilled. *Id.* Thus, non-profit utility companies that

relevant to the issue of just compensation for several reasons. First, public utility companies are not frequently bought and sold on the open market.[72] The only frequent transactions involving the purchase of public utilities are eminent domain transactions, which are typically "held [as] inadmissible [evidence] as a matter of law." [73] Second, public utility companies are subject to valuations for a purpose other than determining purchase value.[74] It is important in determining just compensation not to confuse valuation for taking purposes with valuation for rate making purposes, because, in the latter circumstance, "[a]ssets not currently *used and useful* in the system and assets contributed to the utility by those other than the plant investor may be excluded."[75] And, just compensation requires value be given to *all* assets that are taken in the action. [76] Finally, public utility companies are unique because, in eminent domain, "the business and not merely the plant is taken."[77] These unique characteristics lie at the foundation for the unique considerations of value needed to ensure just compensation for public utility takings.[78]

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are indebted to the Farmers Home Administration may not be subject to eminent domain at all.

[72] Onondaga Cnty. Water Auth. v. N.Y. Water Serv. Corp., 285 A.D. 655, 661-62 (N.Y. App. Div. 1955) ("The valuation of utility properties in eminent domain presents unique problems. The absence of sales of similar property is one difficulty. . . . The usual method of fixing the value of property for taking is by ascertaining market value. But there is hardly a market, in the usual sense, for a public utility, particularly the regulated utility. We must, therefore, turn to other tests of value.").

[73] 8 SACKMAN, *supra* note 2, § G14A.06[1][c]; *see* Evans v. U.S., 326 F.2d 827, 829 (8th Cir. 1964) (holding that a deposit of estimated compensation by the government is not admissible evidence of value); *see also* State *ex rel.* Kansas City Power & Light Co. v. Salmark Home Builders, Inc., 350 S.W.2d 771, 772 (Mo. 1961) (holding that evidence of the compensation paid for a prior easement taken by eminent domain was not admissible as to the value of the easement being condemned in that case).

[74] ORGEL, *supra* note 17, at 610 ("The second reason lies in the possible repercussion of valuation for rate making on valuation for condemnation or purchase.").

[75] 8 SACKMAN, *supra* note 2, § G14A.06[1][b].

[76] *See* Dedeaux Util. Co. v. City of Gulfport, 938 So. 2d 838, 842 (Miss. 2006) (noting five jurisdictions that support the holding that valuations for eminent domain purposes must *include* all of the assets that are taken, specifically "contributions in aid of construction" made by developers to the utility company).

[77] ORGEL, *supra* note 17, at 631.

[78] 8 SACKMAN, *supra* note 2, § G14A.01 ("The valuation of a public utility for eminent domain purposes is fascinating and complex. The source of the complexity is the unique nature of the property.").

Valuing public utilities for eminent domain requires a unique application of the valuation methodologies as compared to valuing the majority of properties.[79] Normally, an appraiser values a property, as a whole, with all its components included, by giving a final professional opinion as to the value based on the results of one or more of the three methodologies.[80] Being based on market evidence and the type of property being valued and not a sum or average of the three methodologies, the appraiser's final opinion is the market value of the property.[81] However, because public utility companies are unique properties, market value does not fully encompass the value required by just compensation.[82]

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[79] SHENKEL, *supra* note 18, at 114 (discussing the reconciliation of the three appraisal methodologies as market value indicators).

[80] *Id.* ("After a careful review of each approach, the appraiser makes his or her final judgment on market value. Appraisers avoid taking an average of the three indicated market values; in fact these values are never averaged. While to some it may seem subjective, it is recommended practice to rely on the critical judgment of the appraiser, who depends on the approach that seems most strongly supported by market evidence."); *see supra* notes 56-57 and accompanying text.

[81] *Id.* ("Th[is] reconciliation allows the appraiser to emphasize, in his or her view, the best data: usually in the appraisal of a single-family dwelling it is the [comparable sales] approach; in the appraisal of a shopping center, the income approach; and in the appraisal of a school building, the cost approach. For some properties, such as a new shopping center, an office building, or an apartment building, sufficient data for all three approaches should be available."); AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS, *supra* note 43, at 526 ("Reconciliation of value indications should lead logically to an appraiser's statement of the final estimate of value.").

[82] *See* 8 SACKMAN, *supra* note 2, § G14A.03 ("The constitutional goal of valuation in eminent domain is just or full compensation . . . . It seeks to put the owner in as good a position financially as he or she would have been, but for the taking. This goal is often expressed in terms of 'fair market value.' In some circumstances, though, such as public utility valuation, market value may not be easily ascertained for lack of valid sales to indicate a traditional exchange market. Alternatively, unusual methods may be necessary to impute a market value. The goal, it should be remembered, is just or full compensation, not a rigid computation of fair market value."); Sidney Z. Searles, *The Legal and Appraisal Aspects of Specialty Properties, in* A PRACTICAL GUIDE TO THE LEGAL AND APPRAISAL ASPECTS OF CONDEMNATION 66 (Sidney Z. Searles ed., 1969) ("What becomes the proper measure of just compensation where property is unusual or unique or is not of a type commonly bought and sold in the open market, or where the standard of fair market value results in downright injustice? Suppose, for example, there are no recent sales of similar property and, hence, there is no market value in the ordinary sense of the term. Or suppose the property is not income producing and no one, except a similar operation, would purchase it. Where the result would be highly unjust either to a property owner or condemnor, the court applies other standards to determine 'just compensation.'").

First, the comparable sales approach cannot be used as a value indicator because of the lack of comparable sales of public utility companies.[83] Due to the lack of sufficient data available to the appraiser, this approach is typically prohibited from being considered altogether.[84]

Furthermore, when valuing a public utility company for eminent domain purposes, the appraiser should not use the income approach as a value indicator of the company as a whole.[85] The income generated by a public utility company is relevant to value the company has for both the property owner and the condemning authority.[86] However, the income approach cannot be used in its normal sense, as a value indicator of the company as a whole, because the rates of a public utility are set by guidelines that do not consider all of the assets owned by the company.[87] And, just compensation does not allow assets to be taken without their value being considered for the benefit of the property owner.[88]

This leaves the appraiser with the reconstruction cost approach to valuation of the utility company's tangible assets.[89] However, relying solely on the cost approach leads to a similar problem as relying solely on the income approach, because when a public utility company is taken, "the 'business' itself is considered condemned, and it must be valued and paid for along with the real

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[83] City of Phoenix v. Consolidated Water Co., 415 P.2d 866, 869 (Ariz. 1966).

[84] *Id.* at 868-69 ("In some instances it is impossible to determine what a willing buyer would pay and what a willing seller would accept simply because there are no sales of comparable property. In that event, resort *must* be had to other means of fixing market value. *Actions for the condemnation of utility properties usually fall within the exception to the rule since public utility properties are seldom bought and sold on the open market.*" (emphasis added) (citations omitted)).

[85] Dedeaux Util. Co. v. City of Gulfport, 938 So. 2d 838, 842 (Miss. 2006) ("We find that the trial court erred when it [failed] to strike [the expert's] testimony because his entire appraisal was based on data based on rates fixed by the Public Service Commission.").

[86] Bear Creek Water Ass'n v. Town of Madison, 416 So. 2d 399, 403 (Miss. 1982) ("We think it impractical to assume that a businessman interested in buying a going business would blind himself to past revenues . . . the likelihood of expansion and other business factors, including the likelihood of future revenues, because all are essential to its present market value.").

[87] *See supra* notes 75-76 and accompanying text.

[88] *See supra* notes 75-76 and accompanying text.

[89] *See* 8 SACKMAN, *supra* note 2, § G14A.06[2][a] ("The cost of reconstructing a public utility is generally held admissible in eminent domain because of the difficulties with the market approach and the speculative nature of the income approach.").

estate."[90] The additional value for the "business itself," the going concern value of the company's franchise, or intangible assets, is where the income approach comes into the equation. The tangible assets, the plant, and the intangible assets, the franchise, are two separate asset components of the utility property, and both must be assigned value.[91]

B. Just Compensation Requires Value Be Assigned to Each Component

1. Intangible Assets: Using the Income Approach to Value the Franchise

The franchise, also referred to as the utility company's certificate of public convenience, is the government granted document that gives the company its "right[s] to do business as a public utility."[92] Valuing the public utility's franchise is not the central issue of this Comment, but it is important to mention at this point to bring understanding as to how the income approach to valuation is used in addition to the cost approach.[93] The rights granted by the franchise include at least the rights to expand the plant to service more customers and the right to collect revenues

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[90] *Id.* § G14A.05[2]. As Sackman stated, "Going concern value is considered a part of fair market value, in excess of the value of the physical plant, because a reasonable buyer and seller would consider the whole system, assembled, in setting a purchase price." *Id.*; ORGEL, *supra* note 18, at 631-32 ("The absence of sales of similar property . . . have led [to the assumption] that the value of the whole property can be roughly approximated by estimating the separate 'values' of its component parts. They have accordingly proceeded to assign 'values' to what they conceive to be the separate parts of the whole. The California commission . . . expressed the procedure . . . as follows: '(a) + (b) + (c) + (d) = Just Compensation, where (a) represents valuation of physical property plus overhead on basis of reproduction cost less depreciation; (b) signifies franchise value; (c) going-concern including development cost; and (d) denotes severance damages.'" (citation omitted)).

[91] *See supra* notes 30, 47 (demonstrating the Fifth Amendment requirement of assigning value to both of these asset components). This approach also reflects the asset-based approach to valuing business; as stated by Pratt, "[T]he value of the company's equity is the value of the company's net tangible assets plus the value of the company's total intangible value, in the nature of goodwill." PRATT ET AL., *supra* note 52, at 369.

[92] ORGEL, *supra* note 17, at 669.

[93] *See supra* notes 89-90 and accompanying text.

from the customers for the provided utilities.[94] The calculated future value of *these benefits* represents the amount that the appraiser discounts back to a net present value to determine just compensation for the franchise.[95] However, the appraiser must still determine the value of the tangible assets, which should be added to this franchise value in order to achieve just compensation for the company as a whole.[96]

2. Tangible Assets: Using the Reconstruction Cost Approach to Value the Plant

When valuing the tangible assets of a public utility company for eminent domain, the law narrows the appraiser's options to the reconstruction cost approach.[97] While it is true that public utility properties are unique in the eyes of eminent domain law, the theory of the reconstruction cost approach does not change when used to value the tangible assets of the company.[98] However, in order to properly use the reconstruction cost approach to value a utility company, the theory behind the approach leads the appraiser to different considerations from those used to value a house or other types of buildings.[99] While the general direct and indirect costs involved in reconstructing a utility plant may be nearly identical to those of reconstructing a house or other building,[100] the physical asset lists, as well as costs to install such, are considerably different.[101]

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[94] 8 SACKMAN, *supra* note 2, § G14A.05[3] ("The following issues warrant examination because they may affect the value of the going concern significantly. . . . Can the service area logically and reasonably be expanded to include more customers? If more utility customers, either within or outside the present area, are probable, then what utility infrastructure is necessary to bring them on-line, and when can that occur?").

[95] *Id.* § G14A.06[3][d] ("Under the income approach, the value of the utility system is derived from the accounting formula V=I/R, when I is net income; R is the capitalization or discount rate; and V is the value of the going concern. There are two major components to the income approach: (1) forecasting the stream of income (future benefit) of continued operation of the business, and (2) discounting those benefits at a capitalization or discount rate suitable for the business at hand.").

[96] *See supra* note 90 and accompanying text.

[97] *See supra* notes 83-89 and accompanying text.

[98] *See supra* note 58 and accompanying text.

[99] *See infra* notes 100-01 and accompanying text.

[100] *Compare supra* note 65 and accompanying text (noting the direct and indirect costs associated with reconstructing a building), *with* 8 SACKMAN, *supra* note 2,

For example, in a water and sewer utility, the valuation may include:

a. Land.

b. Easements.

c. Buildings

d. Transmission/distribution mains.

e. Fire hydrants.

f. Gravity Mains.

g. Manholes.

h. Lift stations.

i. Water plant equipment and pump stations.

j. Wastewater treatment and effluent disposal plant and equipment.

k. Construction work in progress.

l. Water meters.

m. Governmental permits.

n. Wells for water.

o. Wells for effluent disposal.

p. Developer/utility agreements

q. Engineering studies and system drawings.

r. Time and cost of building the business.

s. Establishment of routes and customer lists.

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§ G14A.06[2][b] (noting a similar list of direct and indirect costs associated with reconstructing a utility plant).

[101] *Compare* AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS, *supra* note 43, at 468 (giving an example asset list involved in reconstructing a building including items like masonry, flooring, insulation, etc.), *with infra* note 102 and accompanying text (giving an example asset list involved in reconstructing a utility plant).

t. Managerial skill and efficiency of trained work force.

u. Accounts receivable and records of profitability.

v. Franchise or certificate of necessity.[102]

Utility plants are also "far more physically and economically complex than most condemned property" because of other notable characteristics including the need for a source of water and a spread out and expanding customer service area.[103]

Municipalities may abuse the eminent domain power by taking advantage of these complexities involved in using the cost approach to value utility plants.[104] Being considered a unique property with peculiar circumstances, utility company valuations must consider multiple components taken together as a whole in order to provide just compensation. In the broadest sense, value must be given to both the tangible assets and the intangible assets of the company. In a more detailed sense, the intangible assets generally include the government-granted property right in the certificate or license to operate the utility, which holds going-concern value. The tangible assets should include the physical plant as well as land, easements, and other tangible property as needed to operate the company.

There are a number of legal issues regarding each of these components of value that are worthy of comment. As the first part of a series of comments on eminent domain of public utility companies, this Comment focuses on how to use the reconstruction cost method to value the plant. One of the ways municipalities attempt to take advantage of public utility owners is by conducting the cost approach without considering the cost of overcoming existing constraints as a part of installation cost.[105] The language "existing constraints" is used in field of public utility valuations to describe the development that exists in the customer service area such as the existing streets, curb, gutter, sidewalks, driveways, and other existing utility lines.[106] The courts have

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[102] 8 SACKMAN, *supra* note 2, § G14A.04.

[103] *Id*.

[104] *See infra* note 105 and accompanying text.

[105] *See* Dedeaux Util. Co. v. City of Gulfport, 63 So. 3d 514, 525-28 (Miss. 2011); *see also* City of Phoenix v. Consolidated Water Co., 415 P.2d 866, 870 (Ariz. 1966).

[106] *See Dedeaux Util Co*., 63 So. 3d at 525.

responded to this approach taken by municipalities in two opposing ways, which will be further explained by looking at cases from New York, Arizona, and Mississippi.

C. Jurisdictional Split Concerning the Consideration of the Cost of Overcoming Existing Constraints in the Cost Approach as a Matter of Law

When applying the reconstruction cost approach, appraisers determine value by estimating what it would cost new to reconstruct the property with a similar function.[107] While the existing development would have to be considered in reconstruction costs in order to result in a property with similar function, municipalities have attempted to instruct their appraisers to calculate reconstruction costs as if the existing development did not exist. Should the costs of overcoming the existing development be considered when using the reconstruction cost approach to value public utilities for eminent domain? Some jurisdictions, such as New York and Arizona, have said these costs should be considered as a matter of law. On the other hand, the Mississippi Supreme Court has decided that this issue is a matter of discretion for the trial court.

1. The New York and Arizona Approach

In *Onondaga County Water District v. Board of Assessors*, the New York Supreme Court dealt with a case regarding the value of a utility company for tax assessment purposes.[108] After the court rejected the use of the income approach in determining the value of the tangible assets, the water company[109] unsuccessfully proceeded to argue that the value of the easements as well as the costs of overcoming existing constraints should be excluded.[110] The

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[107] *See supra* note 70 and accompanying text.

[108] 324 N.Y.S.2d 857, 858 (N.Y. Sup. Ct. 1971).

[109] In eminent domain proceedings, it is the municipality trying to keep these costs out of the value in order to keep the just compensation payment as low as possible. However, in this case, the water company argued to keep these costs out of the value in order to keep the property assessment as low as possible for tax purposes. *Id.* at 862.

[110] *Id.* The water company argued that easement costs should be kept out of the value because the easements were not taxable. *Id.* The water company further argued

court then rejected the existing constraints argument by holding that "[w]hile . . . [the costs of overcoming the existing constraints] are not a tangible part of the water system as it now exists and hence 'confer no value on it as such', where the approach to market value lies in assembling construction costs, they must be included."[111]

In *City of Phoenix v. Consolidated Water Co.*, the Arizona Supreme Court dealt with an eminent domain suit brought by the City of Phoenix.[112] In the trial proceedings, the city's expert proposed a value of $2,457,080, which was substantially lower than the value proposed by the water company's expert.[113] As mentioned in the opinion, "[T]he principle difference between the expert for the City . . . and the expert for Consolidated was the exclusion from valuations of all costs of cutting and relaying pavement built after the installation of water mains and other conduits. It was stipulated that this item could run as high as $492,000."[114] The court held that "[t]his exclusion was improper."[115] The court went on to say:

> The trial judge could have concluded . . . 'that in computing the reproduction costs of a public utility property, cost of paving is properly included, even though the work was done by others subsequent to the laying of the mains. Consequently [they should be] given . . . consideration in arriving at the reproduction cost . . . in determining the ultimate question of value.'[116]

Thus, both the New York and Arizona courts have acknowledged that the cost approach must include these costs to overcome existing constraints when valuing a public utility property

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that the cost of overcoming existing constraints should be excluded because they "are not a tangible part of the water system as it now exists." *Id.*

[111] *Id*. (citation omitted).

[112] 415 P.2d 866, 867 (Ariz. 1966).

[113] *See id*. at 869-70. If the city, in this case, would have considered the costs of overcoming the existing constraints, it would have added approximately twenty percent of the city's value to the total appraisal, which is substantial.

[114] *Id.* at 870.

[115] *Id*.

[116] *Id.* (citation omitted).

because they are real costs that could not be avoided in reconstructing the plant.

2. The Mississippi Approach

In *Dedeaux Utility Co. v. City of Gulfport*, the Mississippi Supreme Court dealt with an eminent domain case.[117] In this case, one of the primary differences in the valuations done by the opposing experts was identical to the differences in valuations described in *City of Phoenix*.[118] As stated in the opinion, "The debate pertains to the 'foundational facts' applied by those experts (i.e., the assumption of raw land or existing constraints) in their cost approach calculations."[119] Despite citing both *City of Phoenix* and *Onondaga*, the Mississippi court decided that these costs to overcome existing constraints should not be included as a matter of law for three primary reasons.[120]

First, the Mississippi court reasoned that although the Arizona court held that the costs of overcoming existing constraints must be considered as a matter of law, the Arizona court acknowledged that the rule seemed to be against the weight of authority.[121] Second, the Mississippi court reasoned that while Sackman acknowledged actual construction costs should be considered, Sackman also has stated that items that may be utterly idle to reproduce should not be considered.[122] Finally, the Mississippi court accepted the city's argument that no authorities supported the fact that value should be determined by what it would cost the city to rebuild the system.[123] They accepted the reasoning that cost to rebuild should be considered only if the system was of such low quality that the city would actually have to rebuild the system, which they said was a matter of the trial court's discretion.[124] Based on these three lines of reasoning, the Mississippi court held that the consideration of costs to overcome

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[117] 63 So. 3d 514, 518 (Miss. 2011).
[118] *See supra* notes 112-13 and accompanying text.
[119] *Dedeaux Util. Co.*, 63 So. 3d at 527.
[120] *See infra* notes 121-24 and accompanying text.
[121] *Dedeaux Util. Co.*, 63 So. 3d at 527.
[122] *Id*.
[123] *Id*. at 526.
[124] *Id*. at 527.

existing constraints was a matter for the trial court's discretion as opposed to being a matter of law.[125]

3. The Implications of These Different Rules

The application of these different rules would produce substantially different results depending on which rule is applied. Mississippi's rule allows the municipality to introduce evidence of a value that leaves out the cost of overcoming the existing development. Following this rule, the municipality can then attempt to persuade the jury that these costs are irrelevant to the true value of the plant using the reconstruction cost approach. On the other hand, the New York and Arizona rule mandates that any valuation of a utility plant submitted to the jury must consider these costs. It is important to understand the basis for each of these rules because of the substantial difference in value that may result depending on which rule is followed. This Comment will demonstrate that both the economic theory of the reconstruction cost approach, as well as the legal precedent concerning just compensation, best supports the rule set forth by New York and Arizona.

III. PROPERLY USING THE RECONSTRUCTION COST METHOD TO VALUE THE PLANT

A. Roadmap for the Argument

The rule set forth by New York and Arizona mandates as a matter of law that the cost to overcome existing constraints be considered as a part of the installations costs when using the cost approach to value the utility plant. Subsection B demonstrates how the economic principles behind the cost approach best support this rule. Subsection C aims to rebut the argument that considering the costs of installing the plant in the existing development is double consideration of the value of the existing customers, which is also indirectly considered in valuing the franchise of the utility company. Subsection D explains why the

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[125] *Id.*

New York and Arizona rule should be accepted, and why the Mississippi rule should be rejected as a matter of law.

B. The Value of the Existing Plant Must Consider the Vital Components that Provide Equivalent Utility

The economic theory behind the cost approach best supports the rule suggested by New York and Arizona that the cost of overcoming existing constraints must be considered as a matter of law when using the cost approach to value the utility plant. First, this Section will describe how a utility property has different vital components than a property with a house or other building. Second, it will demonstrate that when valuing a utility plant, the cost approach must be applied differently than when valuing the typical property, by considering the costs to overcome existing constraints as a part of installation cost.

1. The Utility Property Is Different than a Home or Other Building

A developed utility plant is comprised of components that are unique as compared to a typical property with a building.[126] A functioning plant includes water tanks, as the source of water, as well as pipes extending from the tanks to distribute the water and meters to measure the distribution. In order to function, the utility must also include land on which the tanks exist, easements, which grant the utility owner the right to access and maintain the pipes, as well as the developed subdivisions which provide the customers for whom the utilities are provided. A utility plant cannot function unless it has all of these components working together.[127]

In the typical property valuation scenario using the reconstruction cost approach, the appraiser is dealing with a piece of land and the infrastructure that is constructed on the land.[128] In this situation, the appraiser will consider each of these components because they are the necessary components to

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[126] *See supra* notes 101-02 and accompanying text.

[127] *See supra* notes 102-03 and accompanying text.

[128] *See supra* note 101 and accompanying text (noting the types of materials involved in constructing the typical property with a house or other building).

reconstruct the property with a similar function. Like the typical scenario, the utility plant has infrastructure—the tanks, pipes, meters, etc. However, the land element of a utility plant is the component that is unique when compared to the typical property. While the typical property can usually be reconstructed on a piece of vacant land in order to put the property owner in as good a position as before the condemnation, a utility plant cannot be reconstructed on vacant land, because it would leave the utility owner without the developed subdivisions and customers.[129] So, how is the reconstruction cost approach properly applied for a utility plant valuation?

2. Existing Land, Easements, Infrastructure and Development Are the Vital Components of a Utility Plant

In order to give proper consideration to the existing location of the plant, the appraiser must give value based on all of the rights and components necessary for the plant to operate as it exists.[130] The first of these rights are the land and easements on which the water tanks and pipes exist.[131] Second, the appraiser

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[129] Kennebec Water Dist. v. City of Waterville, 54 A. 6, 18-19 (Me. 1902) ("Nor would the mere cost of reproducing the waterworks plant be a fair test, because that does not take into account the value which flows from the established connections between the pipes and the buildings of the city. It is obvious that the mere cost of purchasing the land, constructing the buildings, putting in the machinery, and laying the pipes in the streets,-in other words, the cost of reproduction,-does not give the value of the property as it is to-day. A completed system of waterworks, such as the company has, without a single connection between the pipes in the streets and the buildings of the city, would be a property of much less value than that system connected, as it is, with so many buildings . . . .").

[130] *See supra* note 58 and accompanying text (noting that equivalent function of the existing property is required when estimating value based on construction cost of a new, similar property).

[131] In order to construct the water tanks that provide the source of the water for the plant, the municipality would have to acquire rights to the land on which they exist. Furthermore, in order to construct and maintain the pipes and water meters, the municipality would have to acquire easement rights to the land under which these structures are built. This Comment does not extend to the issues involved in appraising these land and easement components, which both require separate valuation techniques. However, they are noted at this point because they are vital components to the plant, and the land the tanks are on, as well as the pipeline easements, fits into the "land" element of the reconstruction cost approach. Thus, they must be given value in order to ensure that the utility owner receives the just

must consider the cost to reconstruct the plant in the area as it exists, which includes the existence of houses, streets, curbs, sidewalks, driveways, and other utilities to the extent they exist in the service area of the utility property being taken.[132]

a. Infrastructure, Development, and the Meaning of "Cost New" as Used in the Reconstruction Cost Approach

In addition to the costs of purchasing the existing land and easement rights necessary to operate the plant, the appraiser must consider the cost to reconstruct the plant's infrastructure, as it exists at the relevant date of valuation.[133] One of the main issues involved in using the reconstruction cost method to value public utilities for eminent domain revolves around the interpretation of "new" as used in the definitions of replacement cost and reproduction cost. Because typical property valuations consider vacant, similarly situated land, the term "new" can be deceptive. It may be suggested that "new" is relevant to the condition of the land being "new" or undeveloped. However, simply because the appraisal of a house involves valuing a new, or undeveloped, piece of land, does not mean that "cost new" means undeveloped land.[134]

While appropriate to identify and give value to vacant, similarly situated land in determining the reconstruction value of a house, an appraiser cannot apply the reconstruction cost approach in the same manner when valuing a utility plant.[135]

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compensation required by the Fifth Amendment. The primary focus of this Comment is how to determine the cost of reconstructing the infrastructure of the plant.

[132] *See supra* notes 68-69 and accompanying text (noting that depreciation will also have to be considered based on the age of the system and the useful life of the plant).

[133] *See supra* notes 47, 89 and accompanying text (suggesting the cost approach as the proper way to value the tangible infrastructure of unique properties not frequently bought and sold on the open market).

[134] *See supra* note 60 and accompanying text (suggesting that the term "new" refers to the cost of construction at the date of valuation as opposed to the condition of the land).

[135] PRATT ET AL., *supra* note 52, at 104 ("An asset's replacement cost is *sometimes* quantified using a 'green field' approach. That is, the replacement cost of a subject asset or property is the cost to build a redesigned and reengineered ideal replacement from scratch—on a virgin 'green field." (emphasis added)). Pratt's use of the word "sometimes" implies that new, undeveloped land is not always an appropriate consideration, and the main premise of the reconstruction cost method gives clear indication that public utilities are a clear exception to the "green field" approach due to

First, the cost to purchase similarly situated land "new" would require the purchase of hundreds of acres at a minimum. And, the cost to condition that property for the installation of a water and sewer plant would be astronomical. In addition, assuming this could be affordable, once the land is prepped and the utilities installed, you still end up with square miles of installed utilities with no customers to serve.[136] Thus, in order to put the property owner in as good a position as before the condemnation took place, using the cost approach in this manner, the municipality would also have to pay the utility owner the cost of new houses to be constructed, and lost income for the time of reconstruction would have to be provided. Even if the municipality were to pay this amount, it would take years for the houses to be occupied. Thus, the cost approach to value cannot be applied to a utility plant in the same manner that it is applied to a house or other building. Therefore, "new" is most concretely interpreted to refer to the date of valuation as opposed to the condition of the land when the utility plant is initially installed.[137]

b. The Cost of Overcoming Existing Constraints Must Be Considered

The fact that the municipality does not have to consider the cost to redevelop all of the existing homes and businesses on new, undeveloped land does not mean that the municipality can

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the existing development being necessary to the plant's function. *See supra* note 58 and accompanying text (stating that the main premise of the cost approach is to estimate value based on the cost of reconstructing a similar new property with *equivalent function to the existing property*).

[136] Kennebec Water Dist. v. City of Waterville, 54 A. 6, 19 (Me. 1902) ("[T]he method of fixing present value by ascertaining cost of replacement is not applicable to property of this character, because, *chiefly, the construction and development of waterworks is a matter of growth*. At the outset the company owning them is a pioneer. . . . The works must be constructed, and usually *no reward can be realized by the constructors until some time has elapsed*. . . . But we think that, at the most, these considerations suggest only that other elements are also taken into account in fixing present value." (emphasis added)).

[137] This does not mean that the land element of the cost approach is not considered; it is considered in the land and easements where the utility's current infrastructure exists. *See supra* note 131 and accompanying text; *see also* 8 SACKMAN *supra* note 2, § G14A.06[2][c] (noting that "original cost" of construction is not relevant to value for just compensation purposes) (citing United States v. Toronto, Hamilton & Buffalo Navigation Co., 338 U.S. 396 (1949)).

determine the value based on the nonexistence of such development. The only feasible way to consider the existing development using the cost approach to value a utility plant is to consider the cost to install the plant "new" in the existing development. It is true that the utility owner paid for the plant to be installed as the development took place, which is undoubtedly less expensive than having to replace it in existing constraints. For example, it is less expensive to install ten feet of pipe in dirt than it is to tear up a street or driveway, install the pipe, and replace the street or driveway. However, if the municipality wants the benefit of having the utility plant with the existing development, it should have to pay the reconstruction costs based on reconstructing the plant, as it exists with all of the development—driveways, etc. It is well established that where fair-market value falls short of just compensation, special value to the owner must be considered based on the "intrinsic value" of the property. [138] And, the existing development is certainly of special value to a utility plant owner because without it, there would be nobody to provide the utility services.

It may be argued that because the utility owner faced a less expensive means of installing the plant as the development took place, it would be inequitable for the municipality to have to pay the more expensive cost of tearing out the existing streets, etc., to install the pipes and replace them after installation. However, original cost of construction is not relevant to the reconstruction cost approach, which is based on the date of valuation. [139] Furthermore, in many cases, the owner has spent decades of placing sweat equity into the growth of a company for which the municipality gets to come in and take over the day payment is made.[140] If the municipality were able to come, in a day, and reap the benefits of hundreds of customers developed over several decades, it would confer a benefit of the owner on the municipality without compensation where it is reasonably expected. By

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[138] *See supra* notes 35-39 and accompanying text (explaining how the Fifth Amendment requires intrinsic value to be considered for properties not frequently bought and sold on the open market); *see also* Monongahela Navigation Co. v. U.S., 148 U.S. 312, 328 (1893) ("The value of property, generally speaking, is determined by its productiveness . . . .").

[139] *See supra* note 137 and accompanying text.

[140] *See supra* note 138 and accompanying text.

definition, this is unjust enrichment, which in theory of equitable principles directly opposes the idea of just compensation.[141]

If the municipality's argument were to be accepted on this point, the benefit that would be conferred by the property owner to the municipality without compensation is the development, including the development, homes and businesses, which exist in the service area of the utility plant. It allows the municipality to construct the plant without paying for new development or paying to overcome the existing constraints in the utility company's certificated area. If the municipality were to invest in new land and subdivision development to reconstruct the system, it would have to wait decades for the plant to have the same function as the plant being taken. On the other hand, if the municipality wants to reconstruct its own system where the development and customers already exists, it would have to deal with the existing development or constraints—streets, driveways, etc.

It could be argued that leaving these costs out of the value is one of the measures to be taken with the idea that public utilities are unique. However, as a matter of law, equity, and economic principles of valuation, every component necessary for similar function of the existing property being taken must be considered in determining value.[142] It would be inequitable to allow the municipality to reap the benefits of all of the development and homes by being able to pretend they did not exist. Thus, since new, undeveloped land similarly situated cannot be considered to reproduce the plant in a manner comparable to the existing plant, it is essential to consider the cost of overcoming constraints as existing in the area of the condemned plant in valuation.

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[141] BLACK'S LAW DICTIONARY 1678 (9th ed. 2009) ("[U]njust enrichment. 1. The retention of a benefit conferred by another, without offering compensation, in circumstances where compensation is reasonably expected."). As a matter of public policy, unjust enrichment should be said to apply to eminent domain suits. *See* United States v. Commodities Trading Corp., 339 U.S. 121, 124 (1950) ("The word 'just' in the Fifth Amendment evokes ideas of 'fairness' and 'equity' . . . ."). While unjust enrichment is generally a doctrine of equity applied to damages, "compensation" and "damages" are generally considered synonymous. *See* 3 SACKMAN, *supra* note 2, §§ 8.01-8.06.

[142] *See supra* note 58 and accompanying text.

C. Considering the Cost to Overcome Existing Constraints Is Not Double-Consideration of the Customer Value

Considering the cost to overcome existing constraints is not double consideration of customer value. Generally, a property owner may not recover business losses as a part of just compensation in eminent domain cases. However, in a public utility condemnation, "the business itself is considered condemned, and it must be valued and paid for along with [the plant]."[143] This value is found as "going-concern" value in the company's intangible assets, which include its "franchise [or] certificate of convenience and necessity."[144] One of the key things considered in valuing the intangibles of the utility company is the income generated by the plant. This is based on the idea that the company's certificate to operate guarantees the company its future earnings, which "a reasonable buyer and seller would consider [as a part of] the whole system . . . in setting a purchase price."[145] It is true that the appraiser must consider the customer base in determining the present value of future earnings. Thus, it could be argued that the current development, including existing houses, should not be considered in valuing the tangible plant because the customers are properly considered in valuing the intangible property. However, this argument is without merit for two primary reasons.

1. Intangible Value Considers Existing Income While the Reconstruction Costs of the Tangible Plant Considers Existing Development

In valuing the intangible assets, the appraiser does not consider the development but merely the income collectable by the utility company. The customer base considered in valuing the intangible property is not necessarily reflective of all of the development that exists in the plant's certificated area. The present value of future revenues is based on past records of paying customers, which means that the appraiser does not consider houses that may have been empty in the years used to determine

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143 8 SACKMAN, *supra* note 2, § G14A.05[2]

144 *Id*.

145 *Id*.

future revenues.[146] For example, the utility company may only average sixty percent occupancy in the relevant years, which means that only the sixty percent generating income to the company are considered in the intangible value. However, for purposes of determining the reconstruction cost of the plant, just compensation should not allow the appraiser to pretend this development did not exist simply because the houses were not generating income in the relevant years.

2. The Tangible Plant and Intangible Franchise Rights Are Two Separate Components of the Utility Requiring Separate Valuation Methodologies

The tangible plant and the intangible franchise rights are two separate components of the company, and each of them require separate, established valuation methods.[147] The idea behind the reconstruction cost method reaches beyond the premise that the customers are not considered. If this were the case, then the consideration of the customer base in valuing the intangibles might void the need to consider the existing development in valuing the tangible plant. However, the reconstruction cost approach is premised on the fact that the buyer must pay what it would cost to reconstruct a plant with similar function.[148]

The idea is that the buyer should pay the same cost (less depreciation) that he would incur if he decided to reconstruct a similar property rather than buying the existing property. Now, let us say that the municipality in this case was to take over the franchised area while deciding to reconstruct the plant rather than buying the existing plant from the property owner. The municipality would have to pay to have the pipes installed with the existing development in place.[149] Thus, these costs should be directly indicative of the tangible plant's value under the reconstruction cost method separate from the calculation of income used in determining the value of the franchise.

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[146] *See supra* note 95 and accompanying text.
[147] *See supra* note 47 and accompanying text.
[148] *See supra* note 58 and accompanying text.
[149] *See supra* Part III.B.ii.b.

D. New York and Arizona Are Right: The Cost to Overcome Existing Constraints Should Be Required as a Matter of Law

In addition to the support of economic principles behind the New York and Arizona rule, the legal precedent concerning just compensation also indicates that that this rule should be accepted and the Mississippi rule should be rejected. First, Mississippi could not properly cite any authority to support its rule, and thus it is without authority. Furthermore, in order to ensure just compensation, the jury should not be vulnerable to a decision that the value of the utility plant could be accurate without considering every vital component that existed with plant at the relevant date of valuation. The subdivision development in the customer service area is a vital component of the utility plant being valued; thus, the jury should only be exposed to evidence of value that considers this existing development.

1. Mississippi Could Not Properly Cite Any Authorities to Support Its Rule

Both the Arizona and New York courts have held that the cost of overcoming existing constraints should be considered as a matter of law.[150] On the other hand, the Mississippi court appears to have decided that the cost of overcoming constraints, as they exist in a developed utility company's area, should not be included as a matter of law.[151] However, the Mississippi court (1) erroneously relied upon *City of Phoenix*, (2) misapplied Sackman, and (3) erroneously held that a utility owner would have to prove that the municipality would have to actually rebuild the system due to the system's low quality in order to strike testimony excluding the costs of overcoming existing constraints. Because Mississippi could not properly cite any supporting authority for its rule, the Arizona and New York approach is the proper approach under the Fifth Amendment.

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[150] *See supra* notes 111-16 and accompanying text.

[151] *See supra* notes 119-20 and accompanying text.

a. Mississippi Erroneously Relied upon City of Phoenix

First, in coming to the opposite conclusion from *City of Phoenix*, the Mississippi court arbitrarily relied on the language from the Arizona case, saying, "[T]he weight of authority seems to be against [this] position."[152] The case cited by Arizona following this statement was a Kansas case in which it was the lower court that ruled against this position.[153] On appeal, however, the federal district court actually reversed on the grounds that this position stems from a case involving the setting of rates, which requires actual cost, rather than the issue of establishing fair market value, which requires reconstruction cost.[154] The Kansas case was not in opposition to the Arizona rule, nor did Arizona actually cite any authorities that were in opposition to their holding. Thus, although Arizona stated, "[T]he weight of authority seems to be against this position," there are actually no cited authorities opposing the rule that the costs of overcoming existing constraints should be included as a matter of law.[155]

b. Mississippi Misapplied Sackman

Second, the Mississippi Court arbitrarily relied on Julius Sackman's treatise on eminent domain quoting, "[W]hy talk about the reproduction costs of that which it would be utterly idle to reproduce." [156] However, the case Sackman was referring to involved a navy yard taking property from a utility company for the purpose of expanding its naval facilities.[157] It would have been "utterly idle" to consider the costs of replacing the utilities in that case because the navy yard was not seeking to continue the

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[152] City of Phoenix v. Consolidated Water Co., 415 P.2d 866, 870 (Ariz. 1966).

[153] Wichita Water Co. v. City of Wichita, 271 F. 973 (D. Kan. 1921), *rev'd on other grounds*, 280 F. 770 (8th Cir. 1922).

[154] *Id*. at 976 (distinguishing value for eminent domain purposes from value for rate-making purposes). This case is an example of a federal court interpreting Fifth Amendment compensation to include the cost of overcoming existing development under the cost approach to valuing public utility companies for eminent domain. *Id*.

[155] The only cited case that did not accept consideration of these costs was a rate-making case, *Des Moines Gas Co. v. Des Moines*, 238 U.S. 153 (1915), which uses an "original cost" approach as opposed to the "reconstruction cost" approach. *Id*. at 166-68.

[156] Dedeaux Util. Co. v. City of Gulfport, 63 So. 3d 514, 527 (Miss. 2011).

[157] *See* 4A SACKMAN, *supra* note 2, § 15.09[2].

operation of the utility.[158] In that case the preferred fair-market value standard was applicable because the condemned property was a piece of land that happened to have utility infrastructure installed.[159] However, when the utility company is what is being taken for its continued operation, the value to the owner standard is applied by using the cost method to value the tangible plant.[160]

c. The Lack of Dispute Over the Quality of the Plant Is Irrelevant

Finally, the City of Gulfport erroneously argued that the trial court did not abuse its discretion in allowing testimony that excluded the cost overcoming existing constraints.[161] Gulfport reasoned that there is no modern day authority to support the idea that "'the correct valuation methodology is to compute the cost to rebuild the Dedeaux system in place.'"[162] The court accepted this argument by holding that "[a]s this Court finds . . . the parties do not dispute that the . . . system was of high quality on the date of taking, this Court concludes that the trial court did not abuse its discretion in admitting all such expert testimony and leaving resolution of the evidence presented to the jury."[163]

The court was somehow implying that the utility owner would have to prove that the municipality would actually have to rebuild the system due to low quality of the system. However, the main premise of the reconstruction cost approach to value is "that no prudent investor would pay more for a property than the amount . . . for which improvements that have equal desirability and utility can be constructed with undue delay."[164] The whole idea is that the value is based on no more or less than what it *would* cost the buyer to rebuild the system as its exists if he was going to build a new property rather than purchase the existing system. And, the quality of the existing system is then considered

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[158] *Id*. (citing United States v. 25.4 Acres of Land, 65 F. Supp. 333 (E.D.N.Y. 1946)).
[159] *See supra* notes 19-24 and accompanying text.
[160] *See supra* notes 36-39 and accompanying text.
[161] *Dedeaux Util. Co.*, 63 So. 3d at 526.
[162] *Id*. (citation omitted).
[163] *Id*. at 527.
[164] *See supra* note 58 and accompanying text.

through the depreciation function of the cost approach.[165] Thus, the fact that the municipality would or would not have to actually rebuild the system depending on the present quality of the system contradicts the very essence of the reconstruction cost approach to value. Mississippi again cited no authority that indicates the reconstruction cost approach allows the appraiser to take out some of the reconstruction costs involved due to the fact that a buyer would not actually have to rebuild the system because of its high quality.

d. Mississippi's Rule Is Without Authority of Law

Mississippi's rule is without authority of law. The court improperly relied upon *City of Phoenix*. The Arizona court held that the cost of overcoming existing constraints must be considered as a matter of law, and then mentioned the rule might be against the weight of authority. Mississippi relied on this statement although neither the Arizona court nor the Mississippi court could actually cite any authority on point suggesting that these costs should not be considered.

Mississippi also misapplied Sackman's idea that whatever would be idle to reproduce should not be considered. However, Sackman was suggesting that the costs of rebuilding utilities would be utterly idle when the condemning authority was actually taking the property for ordinary purposes—building government facilities. Thus, Sackman's language does not apply to the unique purpose of taking a public utility company to continue operation of the plant.

Furthermore, Mississippi seemed to rely on the idea that the municipality should have to consider every cost in reconstructing the system if they would actually have to reconstruct the system because it was high quality. This completely contradicts the reconstruction cost approach to value, which determines the value based on what the municipality *would* have to pay *if* they were to build a new property instead of buy the existing property. Mississippi does not have one line of reasoning that is properly supported by an authoritative source. Thus, the New York and

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[165] *See supra* notes 68-69 and accompanying text.

Arizona approach is the proper approach under the Fifth Amendment.

2. The Fifth Amendment Should Require Costs to Overcome Existing Constraints as a Matter of Law

In order to ensure just compensation, the costs of overcoming existing constraints should be considered as a matter of law. Rather than accepting the Arizona and New York authorities,[166] the Mississippi Supreme Court proceeded to instruct the trial court to form a "'reasonably accurate basis' . . . of 'foundational facts' concerning the physical condition of the property (e.g., *identifying developed versus undeveloped land*) at the relevant date for determining fair market value."[167] If the trial court forms a reasonably accurate basis of facts concerning the condition of the property at the relevant date, it will find that houses, streets, curb, sidewalks, driveways, and other utilities existed, at least to some extent. This is why the appropriate rule should include the language "existing constraints." This would only allow consideration of the constraints that exist in the relevant property area while prohibiting evidence that constraints did not exist in the area at the relevant date for determining fair market value, as a matter of law.

By making existing constraints an issue of trial court discretion, the issue only has room for possible confusion. Trial courts could interpret this ruling to mean that the issue should be one of fact for the jury to decide. In this case, the jury would hear testimony from one side establishing a value that excludes these costs. The jury should not be allowed to hear testimony of a value that leaves out essential costs in the first place. If a house with an elite kitchen were being taken, the Fifth Amendment would not allow testimony that indicates value of the house without a kitchen. It may allow opposing testimony on how to value the kitchen, which would leave the jury to decide which value of the kitchen is most reasonable. But, if the kitchen is being taken, it must be given compensation. In the same way, if just compensation is to be ensured, the jury should not hear any

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[166] *See supra* Part II.C.

[167] *Dedeaux Util. Co.*, 63 So. 3d at 527-28 (emphasis added).

evidence of value depicting the reconstruction of a plant that does not have equivalent utility to the property being taken.[168] Thus, the costs to overcome existing constraints should be required as a matter of law to ensure the just compensation guaranteed by the Fifth Amendment of the U.S. Constitution.

CONCLUSION

When a municipality takes a public utility company, the owners are deprived of the certificate, which gives them the right to provide the utilities, as well as the tangible plant, which is used to transport the utilities to the customers. Appraisers must use the reconstruction cost approach to value the plant. The cost approach sets the value based on the idea that the purchaser should pay for the existing property what it would cost to reconstruct the property with equivalent function. The vital components of a functioning utility plant include land and easements for the tanks and pipelines, the infrastructure, and the developed subdivisions where the customers dwell. Any value arrived at without considering all of these components would reflect an inaccurate value of the property being taken because it would be based on a cost to rebuild a property that has less than equivalent function of the existing property. Furthermore, no legal authority exists to support the idea that the appraiser can leave out a vital component of an existing property when determining the cost of reconstructing a new property with equivalent function. Thus, the costs of overcoming these development constraints existing in the taken property should be considered in the reconstruction cost approach to value as a matter of law in order to ensure just compensation as required by the Fifth Amendment of the Constitution.

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[168] *See* Monongahela Navigation Co. v. United States, 148 U.S. 312, 325 (1893) ("It is the duty of courts to be watchful for the constitutional rights of the citizen, and against any stealthy encroachments thereon. Their motto should be obsta principiis." (citation omitted)).

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