



STATE BOARD OF EQUALIZATION  
450 N STREET, SACRAMENTO, CALIFORNIA  
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082  
TELEPHONE (916) 445-5580  
FAX (916) 323-3387  
[www.boe.ca.gov](http://www.boe.ca.gov)

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Executive Director

September 30, 2002

Principal Property Assessment Specialist  
County of Los Angeles, Office of the Assessor  
500 West Temple Street  
Los Angeles, CA 90012-2770

**RE: *Revenue and Taxation Code Section 69.4 – New Construction Exclusion for Environmentally Contaminated Water District Property***

Dear Mr. \_\_\_\_\_,

This is in response to your letter of June 20, 2002 in which you request a legal opinion concerning the application of section 69.4 of the Revenue and Taxation Code for new construction of improvements at water plants owned by a regulated public utility water company in Los Angeles county. The improvements were necessary and required by the U.S. Environmental Protection Agency for decontamination of a major water supply source for the facility as described in the Interim Record of Decision and Record of Decision that were provided. The water company filed a claim requesting exclusion from new construction for the improvements pursuant to section 69.4 and an application for assessment appeal in the event that the claim was denied. For the reasons set forth below, it appears that the claim and the application should be denied because the subject properties are not “qualified contaminated property” as defined by the constitutional and statutory provisions and the construction of those improvements does not constitute repair or replacement excluded as new construction under those provisions. However, the value of the new construction may not be reflected in the assessment of the water plant appraisal unit if the water decontamination property is not included in the water company’s rate base and, therefore, the company is not allowed to earn a return on the property.

**Facts Presented**

San Gabriel Valley Water Company (“San Gabriel”) is a public utility water company regulated by the California Public Utilities Commission (CPUC) that provides water service, through its Los Angeles County division, to approximately 46,000 customers in Los Angeles county. The Los Angeles County division relies on three water production facilities, Plants B4, B5 and B6, to supply water in the eastern portion of its service area and on the facilities at Plant 8 to supply water in the western portion of its service area. In 1997, it was determined that water from the reservoir at Plant B4 and from wells 8B, 8C, and 8D exceeded the federal and state drinking water standards for contamination. Plant B4 was taken out of service due to water contamination until a treatment facility could be constructed. The company immediately started

drilling a new water production well at Plant 8 and also constructing a new water treatment facility.

At that time, Plants B4 and 8 consisted of land, ground water wells, buildings housing booster pumps and electrical supply equipment, a building used for disinfection treatment of water entering the system and aboveground reservoirs.

In 1998, contamination was discovered in one of the groundwater wells supplying Plant B6 and it was also removed from service. The single remaining plant in service, Plant B5, was not sufficient to provide the necessary reliability required of a public water supply. For that reason, San Gabriel applied for and was granted approval to construct a water treatment facility at Plant B4 which enabled San Gabriel to resume operations at that plant. The existence of the contamination was not known to San Gabriel or to a related individual or entity at the time the real property was acquired or constructed.

### **Law and Analysis**

Proposition 1 of 1998 added subdivision (i) to Article XIII A, section 2 of the California Constitution to require the Legislature to provide for the transfer of the base year value of “qualified contaminated property” to replacement property and to exclude as new construction any repairs to or replacement of property necessary to remediate environmental problems on qualified contaminated property. Paragraph (1)(B) of subdivision (i), provides that

In the case in which the remediation of the environmental problems on the qualified contaminated property requires the destruction of, or results in substantial damage to, a structure located on that property, the term “new construction” does not include the repair of a substantially damaged structure, or the construction of a structure replacing a destroyed structure on the qualified contaminated property, performed after the remediation of the environmental problems on that property, provided that the repaired or replacement structure is similar in size, utility, and function to the original structure.

Paragraph (2) of subdivision (i) then sets forth the definition of “qualified contaminated property” for purposes of that subdivision.

The Legislature adopted Revenue and Taxation Code section 69.4 to interpret and implement section 2, subdivision (i). That section provides, in relevant part, that “if the remediation of the contamination requires the repair or replacement of contaminated property, that repair or replacement shall not be considered ‘new construction,’” pursuant to paragraph (1), subparagraph (B) of subdivision (i). Section 69.4 incorporates the provisions of paragraph (1), subparagraph (B) which specifically apply only to “qualified contaminated property”, and, thus, a property must meet the definition of a “qualified contaminated property” in order to qualify for relief pursuant to section 69.4. The criteria for a “qualified contaminated property” are set forth in paragraph (2), subparagraphs (A) through (D), of section 2, subdivision (i).

With respect to nonresidential real property, such as the property in issue here, paragraph (2), subparagraph (A) provides that it must be “rendered unusable, as the result of either environmental problems, in the nature of and including, but not limited to, the presence of toxic or hazardous materials, or the remediation of those environmental problems.” That paragraph further specifies that “nonresidential real property is ‘unusable’ if that property, as a result of health hazards caused by or associated with the environmental problems, is unhealthy and unsuitable for occupancy.”

It appears that Plants B4 and 8 were “unusable” within the meaning of subparagraph (A). The water contamination constituted an environmental problem that put Plants B4 and 8 out of service because state and federal regulations prohibited the delivery of the water to customers. Furthermore, although the facts presented do not so indicate, we assume that the presence of the contamination posed health risks to employees and, therefore, the plants were unsuitable working environments.

Secondly, subparagraph (B) requires that the property be “[l]ocated on a site that has been designated as a toxic or environmental hazard or as an environmental cleanup site by an agency of the State of California or the federal government.” The documents that you have provided, the Interim Record of Decision and the Record of Decision, indicate that the water source for Plants B4 and 8 is within the San Gabriel Valley Area 2 Superfund Site. The decisions both state in the assessment of the site that actual or threatened releases of hazardous substances from this site may endanger the public health and welfare or the environment. Thus, it appears that the site has been designated as an environmental hazard by the United States Environmental Protection Agency, an agency of the federal government, within the meaning of subparagraph (B).

While the plants may meet the two criteria described above, they do not appear to meet the criterion of subparagraph (C) which reads as follows: “Real property contains a structure or structures thereon prior to the completion of environmental cleanup activities, and that structure or structures are substantially damaged or destroyed as a result of those environmental cleanup activities.” Under the facts presented, the existing structures on the real property were not substantially damaged or destroyed in the cleanup process. In its statement accompanying its applications for relief, San Gabriel states only that the property located at the plants was “unusable due to toxic contamination of the groundwater.” The statements further indicate that the plants resumed operation as soon as the construction of the water treatment facilities was completed and the facilities became operational. Thus, the existing structures were rendered unusable by the water contamination but were not “substantially damaged or destroyed” as a result of the environmental cleanup, i.e., the construction and operation of the water treatment facility, as required by subparagraph (C).

Moreover, even if the plants constituted “qualified contaminated property” the newly constructed water treatment facilities would not appear to qualify for exclusion under the general provision of paragraph (1)(B). Paragraph (1)(B) excludes as new construction “the repair of a substantially damaged structure or the construction of a structure replacing a destroyed structure

on the qualified contaminated property, performed after the remediation of the environmental problems on that property . . .” As stated above, none of the structures located at the plant sites was substantially damaged or destroyed. Thus, the water treatment facilities were presumably not constructed for the purpose of repairing or replacing structures which would thereby qualify them as new construction subject to exclusion.

Although the relief under section 69.4 is not available, we note that the water contamination rendered the existing property unusable for a period of time and, thus, diminished its value during that period. The diminution in value should have been reflected in the assessment of the property as required by section 51, subdivision (a) which provides that the taxable value of real property shall be the lesser of the factored base year value or

- (2) Its full cash value, as defined in Section 110, as of the lien date, taking into account reductions in value due to damage, destruction, depreciation, obsolescence, removal of property, or other factors causing a decline in value.

We assume that the subject properties depreciated in value due to functional obsolescence caused by the water contamination. If the depreciation resulted in full cash values of the properties which were less than the factored base year value, the assessor was required to enroll the lesser full cash values of the properties pursuant to section 51, subdivision (a).

With respect to valuation of the property after the completion of construction of the water decontamination facility, it is possible that under the methodology used to appraise San Gabriel’s property the value of the new construction would not be reflected in the value of the appraisal unit, notwithstanding the inapplicability of section 69.4. In a recent conversation with Robert Barone of your office, he informed me that, as a public utility company regulated by the CPUC, San Gabriel’s property is valued using the historical cost less depreciation (HCLD) approach. The use of HCLD for valuing such properties is consistent with the advice provided by the State Board of Equalization in Assessors’ Handbook Section 542, *Assessment of Water Companies and Water Rights*, which explains that HCLD is appropriate because the market value of regulated properties generally approximates HCLD. Because the market value generally approximates HCLD, the market value of this type of property is generally less than the factored base year value.

The HCLD approach relies upon the rate base established by the CPUC and from which the CPUC determines the rates a public utility may charge its customers. The rate base generally includes the value of the property for which the CPUC allows the company to earn a return on its investment. If a CPUC-regulated company is not allowed to earn a return on property, then that property generally has a zero value for property tax assessment purposes because a prospective purchaser would not pay for such property. AH 542, p. 15. Thus, if San Gabriel is only allowed to earn a return *of*, and not a return *on*, the investment in the water decontamination facilities, then the value of those facilities should *not* be reflected in the assessments of water plants.

The views expressed in this letter are only advisory in nature; they represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity.

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Very truly yours,

*/s/ Lou Ambrose*

Lou Ambrose  
Supervising Tax Counsel

LA:tr

prop/prec/newcons/02/03lou

cc: Mr. David Gau, MIC:63  
Mr. Dean Kinnee, MIC:64  
Mr. Charles Knudsen, MIC:62  
Ms. Jennifer Willis, MIC:70