Real Property Financial Management Policy

Approval by RPU Board on November 21, 2014

Revision #1 November 20, 2015
Next Review Date: November 2016

Revision #1 – 11-20-2015

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1. Introduction

The City of Riverside (the “City”), through its Public Utilities Department (“RPU”), holds significant real property interests in San Bernardino and Riverside Counties, possessing 776 and 854 acres in each respectively. Although the City is the record title owner, the property was acquired through rate-payer funds and is managed by RPU as a steward (such properties are referred to herein as “the RPU real property assets”). The vast majority of RPU real property assets—over 400 parcels—were acquired over fifty years ago at very low cost and much of it remains vacant. However, the acquisition and long-term retention of these properties, with their associated water rights, have proven to be an invaluable asset of RPU.

This Real Property Financial Management policy shall serve as a guide to the Board of Public Utilities to assist when carrying out their Charter prescribed duties. Here are the guiding principles;

- Maximization of ratepayer value guides all decisions
- Stewardship, which includes both acquisition, use, and disposition, shall be done in conformance with California law

Given the strategic value of real property and the significant financial value of the real property portfolio, having an effective framework and policy for managing (including acquiring, transferring, leasing, selling, valuing, etc.) real property is a necessity to RPU.

RPU’s mission statement: “Riverside Public Utilities is committed to the highest quality water and electric services at the lowest possible rates to benefit the community” underscores the need for an effective real property management policy. In consideration of its mission statement, RPU has prepared this Real Property Financial Management Policy (“the Policy”) with the intent of establishing guidelines for RPU’s stewardship of real property assets for the benefit of RPU’s ratepayers.

The Policy contains eight sections: Purpose, Powers and Duties of the Board of Public Utilities, Classification, Evaluation and Assessment, Financial Valuation, Portfolio Management, Legal Considerations and Examples.

2. Purpose

The purpose of the Policy is to assist the Board of Public Utilities in their decision-making by providing a framework and set of guidelines for the classification, assessment and evaluation, financial valuation and portfolio management of the RPU real property assets. The Policy is a financial policy that only addresses management and financial considerations for real property holdings as assets.

The Policy establishes a framework based upon the assumption that the following are important considerations for real property asset assessment:

- Different classifications of property merit different considerations
- Each property should be classified, evaluated, and valued individually
- Properties should be evaluated in the context of the Policy as well as other RPU plans and policies (e.g. Integrated Resource Plans, infrastructure upgrades, reliability enhancements, etc.)
- Valuations should include assessment market benchmarks
- Financial tools can help more accurately value properties
- Financial and credit profile considerations can impact the decision of whether to retain or dispose of property
- Prudent management of properties may involve third party assessors, managers, and brokers who are more capable of extracting value from assets

The application of these assumptions suggests that real property assets should be evaluated in four steps which match the following four sections of the Policy:

1. Classify properties into three broad categories: Required – In Use, Required - Future and Idle, some of which contain subcategories;
2. Assess and evaluate each individual property by classification sub-categorization;
3. Value properties using various economic and financial considerations; and
4. Implement portfolio management practices to derive maximum value from idle assets.

3. Board of Public Utilities Powers and Duties

Under the provisions of the California Constitution and Article XII of the City Charter, the City owns and operates both electric and water utilities for its citizens. The City's Public Utilities Department exercises jurisdiction over the electric and water utilities owned, controlled and operated by the City. The Department is under the management and control of the City Manager, subject to the powers and duties vested in the Board of Public Utilities and in the City Council, and is supervised by the Public Utilities General Manager who is responsible for design, construction, maintenance and operation of the electric and water utilities.

Section 1202 of the City Charter provides that the Board has the following powers and duties, among others:

> "Authorize the acquisition, construction, improvement, extension, enlargement, diminution or curtailment of all or any part of any public utility system when the amount exceeds $50,000. . . . No such purchase, acquisition, construction, improvement, extension, enlargement, diminution or curtailment may be made without such authorization."

Under this authorization, the Board of Public Utilities <u>must</u> approve the actual acquisition or disposition of real property, including the transfer of the property to another City department, so long as the cost exceeds $50,000. For other real estate transactions that are less than $50,000, by City practice the Board serves as an advisory body to the City Council.

Section 419 of the City Charter provides that the City Council is the final decision maker regarding all contracts for the disposition, lease, licensing or other use of the RPU real property assets. This means that the Board approves expenditures in excess of $50,000, but the City Council approves all contracts related to real property.

The City Manager, pursuant to his City Charter authority, has adopted Administrative Manual Section 08.003, entitled "Disposition and Sale of City Owned Real Property." The following is a summary of that process as it pertains to the RPU real property assets:

1. RPU, through its Board of Public Utilities, notifies the City's Real Property Services division of its desire to sell or otherwise dispose of real property and, if applicable, declares that property surplus to its needs.

2. The City's Real Property Services division determines if other City departments wish to acquire the property. If there is internal interest, the Board of Public Utilities would approve such disposition, including the transfer

value. If there is no internal interest, an initial offering price is determined. An appraisal may be obtained to determine such price.

3. If applicable, the City Council declares such property surplus. However, if the property is undevelopable, disposition does not require such surplus declaration. “Undevelopable” is limited in Administrative Manual Section 08.003 to very small properties to be sold to a contiguous owner. The sale would be subject to approval as listed in Section 7 below.

4. Prior to marketing the property and as required by Government Code section 54222 et seq., the City must contact other local agencies as to their interest in the property.

5. If no other public agencies express interest, the City then proceeds to market the property.

6. If the marketing does not generate sufficient interest in the property, the City (after discussion with RPU) has the discretion to do additional marketing or take the property off the market until better sales conditions exist.

7. The Purchase and Sale Agreement is submitted to both the Board of Public Utilities and the City Council for approval. If the amount is more than $50,000, under the City Charter, the Board must approve the transaction.

8. Sales proceeds revert to RPU.

4. Classification of Real Property

Real property is defined as any interest in land, together with structures, fixtures, appurtenances, and improvements. The RPU real property assets can be separated into three general categories: Required - in use, Required - Future and Idle.

Required – In Use

"Required - In Use" properties are necessary for the production and delivery of water and power by RPU and/or associated with the operations and administration of RPU.

Exclusive

"Exclusive" properties are those used exclusively in current RPU operations and are owned by the City. Exclusive use is critical to ensuring continued operations. Examples of exclusive properties include power plant sites, water treatment facility sites, vacant land used to replenish groundwater basins, etc.

Multi-use

"Multi-use" properties are those properties which are City–owned and necessary for RPU operations but whose use does not exclude other operations from taking place (e.g., vacant lots with wells). These properties can be placed under review for further development or other considerations. Multi-use properties may include land that has attached water rights (that in all cases will be retained by RPU).

Environmental

"Environmental" properties are those properties which serve as or have the potential to offer environmental mitigation for any adverse impacts that RPU operations have or may have on the local environment.

Required - Future

"Required - Future" properties consist of any and all properties that may one day be used in the operations required of RPU by its mandate as a water and electric service provider or utilized in the fulfillment of RPU's mission statement (e.g., properties with water rights or mineral rights). Required - Future properties may include properties that could become Required – In Use properties in the future. Required - Future properties may also be properties which have characteristics which may be valuable to RPU (e.g., prominent location) or that may have characteristics which are similar to other assets that RPU may wish to acquire.

Idle

"Idle" properties are all properties other than those characterized as Required - In Use or Required - Future. In general, Idle properties are properties that are not currently utilized in the core operations of RPU. Idle properties can be separated into two categories: income properties and miscellaneous properties.

Income

"Income" properties are properties that do not fall into one of the aforementioned categories but which deliver lease or rent payments to RPU.

Miscellaneous

"Miscellaneous" properties are all other properties. Such properties may have the potential to be reclassified as income properties if the land could be leased or rented with or without investment in structures, fixtures, appurtenances, or improvements or could be declared surplus and sold.

5. Evaluation and Assessment of Real Property

Required - In Use

Required - In Use properties are by definition critical to RPU operations and should not be sold and thus need not be valued using financial valuation methodologies. These properties include but are not limited to:

- Critical office space, control centers
- Well sites
- Pumping stations
- Power plant sites
- Transmission and distribution sites
- Substation sites
- Treatment plant sites
- Percolation sites
- Sites with water rights
- Sites having security benefits

If these properties allow for other activities to take place on site, they will be put under review for further consideration as multi-use Required - In Use properties. For instance, vacant lots with only wells on site can be under consideration for the installation of photovoltaic panels.

If a property is not currently related to the core functions of RPU with respect to RPU's mission statement, it should be considered Required - Future or Idle property.

Required - Future

Properties that fall into the Idle category but hold some strategic value in relation to the core functions of RPU should be considered Required - Future properties. Such properties have the potential to one day be considered Required - In Use properties or have the potential to provide strategic value of another kind. These properties include but are not limited to:

- All properties which if developed would be considered Required - In Use
- Strategically located sites for future resources
- Sites which offer a financial hedge against future real property needs
- Sites which protect the operations of future Required - In Use assets
- Sites which offer environmental benefits

Required - Future properties should most likely be retained for future use; however, such assets could be sold under the right circumstances or at the right price if the loss of the property could be mitigated.

Idle

The real property assets which are not Required - Future are hereafter referred to as Idle assets of which there are two sub-categories:

Income

Income properties should be evaluated for further disposition using financial valuation methodologies.

Miscellaneous

Miscellaneous properties need to be reviewed for further disposition using financial valuation methodologies.

6. Financial Valuation of Real Property

As of Fiscal Year End ("FYE") 2014, the 1,630 acres owned by RPU had a net book value of $29 million. This total net book value grossly underestimates the total market value of the properties as many of the properties were purchased over 50 years ago.

Book Valuation

The current book value of the City's real property assets is not an accurate assessment of the actual market value today. Although book value is important for accounting purposes, market value is necessary for effective and efficient real property asset management. In order to learn the true value, the techniques described below need to be employed.

Instead of using Book Valuation, RPU's real property assets should have financial valuations done by examining comparable properties and/or by applying a discounted cash flow methodology.

Comparable Property Valuation

The use of appraisals will provide the most accurate and relevant information necessary for real property asset valuation. Assets within the Idle category should be broken into subgroups, each with distinct characteristics. Samples of properties within each subgroup should be appraised and then used to generate estimates (by methods described below) for the rest of the assets in each subgroup.

Sales Comparison

The Sales Comparison approach uses evaluation of criteria relevant to sales comparables, adjusting the values of the sales comparables on differences in criteria and calculating an average value of the sales comparables to derive a price estimate. This is the best method for estimating properties for which sales comparables are relatively easy to identify.

Income Capitalization Method

The direct capitalization method uses a current market capitalization rate and projected net operating income (gross annual incomes less annual operating expenses of similar properties) to determine the approximate market value of an improved property. Essentially, a capitalization rate is a rate of return on investment which is set by a real estate investor as a benchmark for determining how much they should pay for a property. This is the best method for income properties with suspected differences in income and/or operating expenses per square foot.

Discounted Cash Flow Valuation

In general, discount rates should represent the opportunity cost of the cash flow being discounted. That is, discount rates should reflect the next best alternative use of either the property or cash flow under consideration, or the cost of the money borrowed if applicable. Various ranges of discount rates are justifiable depending upon the circumstances. Discount rates are critically important and have a significant impact on valuations. As such any discounted cash flow valuation should be done carefully with as much emphasis placed on the selection of an appropriate discount rate as the development of the proforma cash flow associated with the real property asset.

Short-term Rates
If property is sold and the proceeds held in cash, a justifiable discount rate might be the short-term cash reinvestment rate—currently about one to two percent. This rate represents the cost of borrowing an equivalent amount of money (in reference to the predicted cash flow) in the short term. Good proxies for such discount rates are 1-3 year Treasury rates.

Long-term Rates
The appropriate discount rate for properties under consideration for sale depends on the proposed use of sale proceeds. If the proposed use of sale proceeds is:

- To refund long term debt, the appropriate discount rate might be the long term cost of borrowing (currently 4-5%). Good proxies for such discount rates are 10-20 year AAA MMD GO index rates.
- To fund capital improvements or construction, the appropriate discount rate might be a proxy weighted average cost of capital for a utility enterprise (historically 7-12%). Good proxies for such discount rates are peer utility cost of capital estimates.

Historic Returns on Real Estate
Cash flow from future leases could be discounted at a rate equal to historical growth rate of real property assets, which for the United States has been between 3.5% and 4.5%. Appreciation rates have almost certainly been higher for San Bernardino and Riverside counties than similar appreciation rates in the United States. Any discount rate based upon historic appreciation rates would represent the expected appreciation in property value of the asset in question if left as is.

A combination of the above discount rates may be deemed appropriate based on the amount of time under consideration and the unique attributes of any given property.

7. Portfolio Management of Real Property

Portfolio Management

There are a variety of reasons for RPU to own real estate assets including but not limited to:

- Reasons associated with Required - In Use assets
- Reasons associated with Required - Future assets
- Strategic investment in retention of real property assets for future growth

Although there are a number of good reasons for RPU to hold real property assets, there are potential disadvantages to over-investing in real property.

Real returns to property values nationally have averaged between fifty and one hundred and fifty (50-150) basis points for the last one hundred years; which represent significantly lower real returns even in comparison to AAA rated securities over the same time frame. Further, these estimated returns fail to take under consideration the expenses required of maintaining property, which, even for vacant properties, will significantly reduce any realized returns. Real property returns for Riverside and San Bernardino counties have exceeded returns on a national level however the basic point is the same. Additionally, one of the more valuable characteristics of real property investment is the tax treatment and RPU is less likely to benefit from such tax preference than other holders would. City receives property tax for non-municipal owners.

It should further be acknowledged that although RPU is the ideal manager for Required - In Use and Required - Future real property, RPU may not be the ideal manager for all of the other real property holdings. To the extent that RPU determines that valuing, leasing or renting, selling, operating or administering a given real property asset might be better done by a third party whose core competency is doing just that, RPU should seriously consider using a third party manager or broker.

For Idle property, RPU has two feasible alternatives: selling Idle property or placing the property under a third party manager who would undertake all property related activities, including but not limited to managing leases and maintenance. Better management of real property assets will result in lower rates for customers, which is one of the long term strategic initiatives of RPU.

Commercial Operation of Mission Square Office Complex

On October 13, 2015, RPU closed escrow on the purchase of the Mission Square office building and parking structure (MS Complex). In developing the financial pro-forma for the purchase versus lease decision, staff relied on a number of assumptions regarding the continued commercial operation of the building.

RPU will continue to operate the MS Complex as a commercial operation, in line with the financial pro-forma developed during the Board/Council deliberative process. Office space leases for non-RPU use shall be at market rates. RPU shall use a commercial broker to the extent possible to represent its interest during lease negotiations. RPU shall use a full time property manager for commercial management and maintenance of the building. RPU shall set aside a sinking fund budget for maintenance and future major building upgrades, subject to Board and Council approval.

RPU shall continue to operate the parking structure to maximize the financial value of that asset for current and future ratepayers. Daily and monthly parking rates shall be set at market rates and reviewed not less than annually in connection with the budget process.

Hedging Future Real Property Needs

There may be a cause for holding idle real estate in the San Bernardino and Riverside counties or use it as a means to diversify the financial portfolio of RPU. In other words, retention of real estate may hold some strategic value that is financially based rather than operational. This reasoning could justify the holding of Idle property. This hedging strategy only applies to property currently owned by the City (and was acquired through ratepayer funds) and does not mean that RPU would acquire any property for non-utility purposes or for purely speculative reasons.

Balancing Utility Assets with Customer Rates

The purpose of holding, disposing, or acquiring real property assets is ultimately for the benefit of RPU ratepayers. Therefore, portfolio management decisions for the individual properties should consider what RPU might be able to do with the proceeds of a sale. Best practices normally outline proceeds from the sale of property should not be used for ongoing operation needs, but rather replacement of a long term asset for another.

As it relates to Idle properties, RPU should consider selling properties if the proceeds of a sale could be used to acquire valuable real property assets or capital investments which could provide a greater present value benefit to RPU’s ratepayers.

Criteria for Sale, Lease, Transfer and Acquisition

If the property falls into the income category, it should be considered for sale if the property’s potential sale value exceeds the net present value of the expected cash flow from the property.

If the property falls into the miscellaneous category, investment opportunities should be considered. If the property is able to be leased, the necessary comparison of potential sale value to the net present value of expected cash flow should be made. If leases are not an option, the property should be considered for sale.

For income or miscellaneous property, if the property is leased, a third party should be considered to manage the property.

Allocation of Idle property, including vacant land for private use; should take place in exchange for RPU obtaining land/property market value paid monetary or in-kind.

Allocation of Idle property, including vacant land, or build-up property for private uses or contribution of such land/properties in public-private projects should take place only through competitive procedures (e.g. open auctions or requests for proposals) to bidders offering the highest price or in-kind equivalent. However, if the land is not independently developable and is exempt from declaring as surplus property, City policy provides that the land may be sold to the adjacent property owner without going through this competitive procedure.

The acquisition of real property assets by RPU should primarily take place if the property in question can be classified as Required - In Use, or Required - Future per the descriptions above.

Approach to Disposition and Sale of Real Property

If an assessment of a real property asset suggests that a particular asset should be sold, RPU would follow the existing Administrative Manual section entitled “Disposition and Sale of City Owned Real Property” as amended from time to time. This Real Property Financial Management policy is not meant to overlap or supplant existing City policies for disposition of real property.

Real Property Classification Listing

Staff will maintain a list of all RPU Real Property Assets, categorized according to this policy. Staff will amend this list from time to time to reflect future changes in property classification without Board of Public Utilities approval. This listing will be available for viewing on RPU’s website.

8. Legal Considerations

Proposition 218

On November 5, 1996, California voters approved Proposition 218, the so-called "Right to Vote on Taxes Act." Proposition 218 added Articles XIIIC and XIIID to the State Constitution. Proposition 218 changed, among other things, the procedure for the imposition of any new or increased property-related "fee" or "charge," which is defined as "any levy other than an ad valorem tax, a special tax or an assessment, imposed by a (local government) upon a parcel or upon a person as an incident of property ownership, including user fees or charges for a property related service" (and referred to in this section as a "property-related fee or charge"). As of 2006, water rates are deemed to be a "property-related fee or charge" within the meaning of Prop. 218.

Under Article XIIID, revenues derived from a property-related fee or charge may not exceed the funds required to provide the "property-related service" and the entity may not use such fee or charge for any purpose other than that for which it imposed the fee or charge. The amount of a property-related fee or charge may not exceed the proportional cost of the service attributable to the parcel, and no property-related fee or charge may be imposed for a service unless that service is actually used by, or is immediately available to, the owner of the property in question.

Proposition 26

On November 2, 2010, the voters approved Proposition 26 and approved revising provisions of Articles XIIIA and XIIIC of the California Constitution. Proposition 26 re-categorizes many State and local fees as taxes and specifies approval requirements for those taxes. In its "Findings and Declarations of Purpose" section, Proposition 26 states: "Fees couched as 'regulatory' but which exceed the reasonable costs of actual regulation or are simply imposed to raise revenue for a new program and are not part of any licensing or permitting programs are actually taxes and should be subject to the limitations applicable to the imposition of taxes."

The City's water service charges are property-related fees or charges that must comply with both Proposition 218 and Proposition 26. The City's electric service charges are not subject to Prop. 218. In relation to the RPU real property assets, this means that the property cannot be disposed of or used for non-utility purposes unless RPU receives adequate compensation, either monetary or otherwise, for such use.

Further, when the City issues revenue bonds to finance water operations, certain representations are made to bondholders. One such covenant is that "No building or other real property of the Water System shall be furnished free to any such public agency or any private person or corporation but each of the foregoing shall pay the reasonable rental value of any property so used." (See City Council Resolution No. 17664, as amended from time to time.)

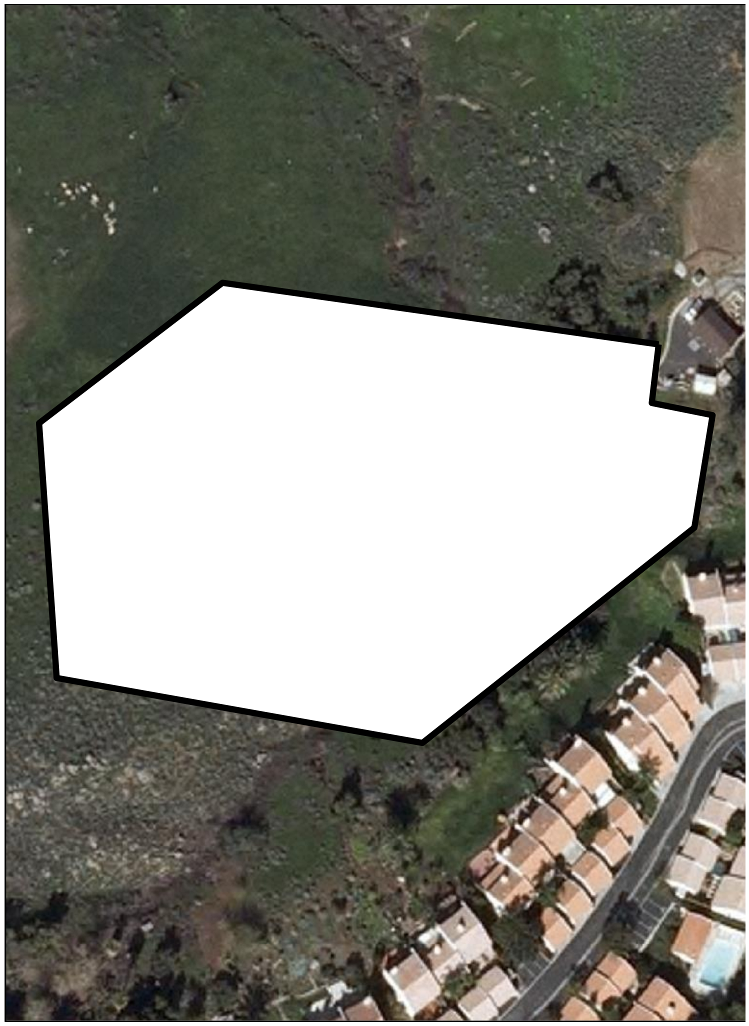
9. Examples

Example 1: John W. North WTP – Parcel No. 0275-191-56-0000

Step 1: Evaluation and Assessment
The John W. North WTP is directly involved in the delivery of water by RPU. Further, the nature of the structure itself precludes it from other uses. For example, it is not possible for RPU to access the treatment capabilities of the water treatment plant and lease it to some third party concurrently. Therefore, John W. North WTP is a Required - In Use exclusive asset.

Required - In Use exclusive assets are not under consideration for sale or lease. Once a property is given the distinction as a Required - In Use exclusive asset, the only objective which RPU has with respect to the property is to maximize operational efficiency, which is outside the scope of the Policy.

Example 2: Vacant Emtman Reservoir - Parcel No. 243-040-064



Step 1: Evaluation and Assessment

Parcel No. 243-040-064 has no existing structure built on it but it has been designated as a site for a proposed booster station or reservoir. Because Parcel No. 243-040-064 may one day be used in the operations required of RPU by its mandate as a water service provider or utilized in the fulfillment of RPU's mission statement, Parcel No. 243-040-064 is a Required - Future asset.

Required - Future assets are not under consideration for sale or lease (unless the term of the lease is short enough to allow RPU to regain control of the property prior to when necessary for RPU use). Once a property is given the distinction as a Required - Future asset, the only objective which RPU has with respect to the property is to maximize its Required - Future value and put the property to its highest and best use which is outside the scope of the Policy. As an undeveloped property it is possible that Parcel No. 243-040-064 may have multi-use potential (e.g. perhaps only part of the property is needed for the proposed booster station).

Example 3: Vacant Mt. Vernon Reservoir - Parcel No. 257-140-002

Step 1: Evaluation and Assessment

Parcel No. 257-140-002 has no existing structure built on it and has no water rights associated; therefore, it is not used in the core functions of RPU or the City and cannot be classified as a Required - In Use asset. The fact that this property has no Required - Future value associated with it and has no existing structures forces this property to be classified as Idle - Miscellaneous.

Step 2: Financial Evaluation

The only possible avenue to evaluate the financial value of a vacant, miscellaneous property is to have it appraised or use sales of recent comparable properties to provide an estimate of value. After the financial value is determined, the property should be put under consideration to determine if there is market demand to support leasing all or a portion of it.

After an open and competitive bidding process has been conducted for the lease of the property, the net present value of the highest lease amount offered will be compared to the previously determined financial value of the property. Because the property is currently vacant, the appropriate discount rate is the expected appreciation rate of the property, which historically has been approximately 4%.

Step 3: Portfolio Management

If the calculated net present value of lease payments exceeds the determined financial value of the property, the asset should be retained; however, a third party service should be utilized to manage property related activities such as the lease and maintenance. If the determined financial value exceeds the net present value of lease payments, the property should be put under consideration to be sold.

10. Conclusion

The Policy was first issued in November 2014. It is expected that the Policy will be updated every two years and the list and classification of real property assets will be updated more regularly.

11. Appendix I – Classification Chart