



THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

Office of the General Manager

Date: April 12, 2016
To: Board of Directors
From: Marcia Scully, General Counsel
Gary Breaux, Assistant General Manager/Chief Financial Officer
Subject: Response to SDCWA Reports on “San Diego County Water Authority Metropolitan Water District Cost of Service Rate Review” and “Metropolitan Water District of Southern California Water Supply Assessment and Use Among its 26 Member Agency Customers”

At the Finance & Insurance Committee meeting on April 11, 2016, the San Diego County Water Authority (SDCWA) provided two reports to Metropolitan Board Executive Secretary, Dawn Chin: 1) “San Diego County Water Authority Metropolitan Water District Cost of Service Rate Review” (MFSG Report), and 2) “Metropolitan Water District of Southern California Water Supply Assessment and Use Among its 26 Member Agency Customers” (Stratecon Report). The reports purport to undertake a review of the proposed rates and charges for calendar years 2017 and 2018 the Metropolitan Board is set to consider on April 12, 2016.

The reports contain a number of factual and legal misrepresentations which are too numerous to evaluate and report on within a 24-hour timeframe. Thus, we identify in this letter only some of the most egregious misrepresentations and fundamental misunderstandings. Moreover, we note that the reports do not provide any of the qualifications or experience of the authors or firms and their ability to opine on the topics each presents. In fact, the MFSG Report fails to identify *any* author. The MFSG Report simply states it was “developed by” the Municipal & Financial Service Group, which is located in Annapolis, Maryland. However, it fails to establish any knowledge or experience related to the legal requirements specific to California and those relating specifically to wholesale water agencies. Indeed, the *lack* of knowledge, or at least the misguided application, of those legal requirements is demonstrated throughout the MFSG Report. Lack of knowledge of applicable legal requirements is also evident in the Stratecon Report. Its author, Rodney Smith, has no relevant expertise concerning wholesale water rate-setting based on the information on his company website (see attached).

The MFSG Report Inappropriately Applies Retail Concepts from the M1 Manual to Metropolitan, Resulting in Application of the Wrong “Industry Standards”

One of the major flaws underlying the MFSG Report’s erroneous conclusions is its failure, and the unknown author’s apparent refusal, to distinguish between retail water utilities and wholesale water utilities when it purports to apply the American Water Works Association’s (AWWA) M1 manual, Principles of Water Rates, Fees and Charges, Sixth Edition (the M1 Manual).

Metropolitan's Cost of Service Report follows the guidelines and principles of the M1 Manual. As Metropolitan noted in its Cost of Service Report, "[T]he majority of the M1 Sixth Edition is written for utilities providing retail service or combined retail and wholesale service. The distinction in practices for wholesale-only utilities is indirect; care must be taken to be attuned to these distinctions such that the guidelines are not incorrectly applied or misrepresented."

As explained by Rick Giardina, current Chair of the American Water Works Association (AWWA) Rates and Charges Committee, in a separate letter, the MFSG Report does not account for the significant distinctions between the services provided by Metropolitan, as a wholesaler, and the services a water retailer provides to parcels of property. The Report claims to apply an "Industry Standard Cost-of-service-Methodology," but the industry it focuses on is the retail water industry.

The Reports are Based on a Fundamental Misunderstanding and Misapplication of California Law

The MFSG Report states that Proposition 26 requires three things of a public agency in rate-setting. (MFSG Report, p. 13.) It states that Proposition 26 provides that:

1. Revenues cannot exceed the costs required to provide the service.
2. Revenues cannot be used for any other purpose than to recover the costs related to the service provided.
3. Amount of any fee cannot exceed the proportional cost of the service attributable to a customer.

The first problem with MFSG's representation is that it states the requirements of Proposition 218 – not Proposition 26. The requirements of Proposition 218 summarized by MFSG are found at Article XIII D of the California Constitution and apply to property-related fees, charges, and assessments, such as retail water rates imposed on parcels of property – not wholesale water service rates. Article XIII D, Section 6(b), added by Proposition 218, provides that:

- (1) Revenues derived from the fee or charge shall not exceed the funds required to provide the property related service.
- (2) Revenues derived from the fee or charge shall not be used for any purpose other than that for which the fee or charge was imposed.
- (3) The amount of a fee or charge imposed upon any parcel or person as an incident of property ownership shall not exceed the proportional cost of the service attributable to the parcel.

(Cal. Const., art. XIII D, §6, subd. (b)(1)-(3).)

The provisions Proposition 26 added to the California Constitution, on the other hand, are found at Article XIII C, section (1)(e). There, the voters added a new definition of special taxes, which makes "any levy, charge, or exaction of any kind imposed by a local government" a "tax," unless exempted. (Cal. Const., art. XIII C, §1, subd. (e).) Whether Proposition 26 applies to Metropolitan's rates and charges is an issue in the pending appeal in the *SDCWA v. Metropolitan*

litigation. Metropolitan contends Proposition 26 does not apply to its rates and charges and, even if it did, the rates and charges would be exempt as user fees or charges pursuant to each of the following exemptions:

- (e)(1) A charge imposed for a specific benefit conferred or privilege granted directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the local government of conferring the benefit or granting the privilege.
- (e)(2) A charge imposed for a specific government service or product provided directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the local government of providing the service or product.
- (e)(4) A charge imposed for entrance to or use of local government property, or the purchase, rental, or lease of local government property.

(Cal. Const., art. XIII C, §1, subd. (e)(1), (2), and (4).)

As the language of each exemption demonstrates, user fees for government services or benefits are subject only to a reasonableness standard, and charges for use, purchase, rental, or lease of local government property are not limited by any such standard. (*Id.*) “Reasonableness ... is the beginning and end of the judicial inquiry” and courts will not overturn a water rate if there is a reasonable basis such as the “cost of service or some other reasonable basis.” (*Hansen v. City of San Buenaventura*, 42 Cal. 3d 1172, 1180-81 (1986).) The California Supreme Court has clearly held that whether the agency’s costs to provide a government service or benefit is reasonable is measured on a collective basis – not based on the extremely segmented and particularized classes proposed by either MFSG or Stratecon. (*See California Farm Bureau Fed’n v. State Water Res. Control Bd.*, 51 Cal. 4th 421 (2011).) That was the measure of reasonableness for user fees before Proposition 26 and remains the measure of reasonableness today.

In *Rincon Del Diablo Mun. Water Dist. v. SDCWA*, for example, the California Court of Appeal held that SDCWA’s transportation rates did not exceed the estimated reasonable cost of providing the service, because they did not exceed SDCWA’s collective transportation costs, and the Court further rejected the argument that charges must be based “on the costs attributable to [each agency’s] specific burden on the system.” (*Rincon Del Diablo*, *supra*, 121 Cal. App. 4th 813 (2004).) The Court in *Rincon* evaluated language that is identical to the user fees exemptions in Proposition 26 at (e)(1) and (e)(2). (*Id.* [evaluating Cal. Gov. Code § 66013, stating fees or charges “shall not exceed the estimated reasonable cost of providing the service for which the fee or charge is imposed.”]; *see also Schmeer v. Cnty. of Los Angeles*, 213 Cal. App. 4th 1310, 1316 (2013) [Proposition 26 exempts regulatory fees based on language “nearly verbatim” to the test applied before its adoption].) Thus, just as the SDCWA rates were subject to a collective reasonableness test, so too are Metropolitan’s rates and charges.

The Stratecon Report is similarly flawed based on its unsupported assumption that Metropolitan’s rates and charges are subject to a “proportional” allocation requirement and that such requirement mandates multiple classes of customers. (Stratecon Report, p. 12.)

Proportionality is a requirement only in Proposition 218 for parcel-specific charges, which might explain MSFG's misrepresentation that the Proposition 218 requirements are in fact those of Proposition 26. They are not. There is no language in the provisions of Proposition 26 or case law that requires proportionality for rates or charges subject to Proposition 26.

The Stratecon Report's reference to the "*San Juan Capistrano*" decision, as it is interpreted in an article, is irrelevant as that case analyzes only Proposition 218 in the retail rates context – not Proposition 26 in the wholesale rates context. (See Stratecon Report, p. 12; see also *Capistrano Taxpayers Ass'n v. City of San Juan Capistrano*, 235 Cal. App. 4th 1493 (2000).) Notably, even in the Proposition 218 analysis found in *San Juan Capistrano*, the Court refused to break down a water service into segmented parts to determine whether a cost of one project was proportional to a parcel. Indeed, Proposition 218 case law establishes that even in that context – the "proportionality" requirement context – courts must consider a public agency's holistic costs when reviewing that agency's cost of service determinations. (See *San Juan Capistrano*, supra, 235 Cal. App. 4th at 1502; see also *Morgan v. Imperial Irrigation Dist.*, 223 Cal. App. 4th 892, 918 (2014); and see *Moore v. City of Lemon Grove*, 237 Cal. App. 4th 363 (2015).)

The MFSG Report Misstates and Mischaracterizes Metropolitan's Costs for the State Water Project as Purchased Water Costs

As Metropolitan's Cost of Service Report clearly explains at pages 11-13 and 50-53, and throughout the Report, none of Metropolitan's State Water Contract obligations and use of the State Water Project (SWP) to transport water are characteristic of a "purchased water cost." The MFSG Report contradicts Metropolitan's analysis and conclusions based solely on its fundamental misunderstanding of the State Water Contract, as well as the charges pursuant to that Contract.

The MFSG Report erroneously concludes that the "cost of moving water through the SWP for delivery to MWD is included in the SWP supply costs." (MFSG Report, p. 10.) They are not. DWR invoices Metropolitan for, and Metropolitan pays DWR, the transportation-related costs separately from the supply costs. The power required to move water through the SWP for delivery to Metropolitan also is not included in the SWP supply costs; it is included separately through the Transportation Variable and the OAPF charges. Knowledge of the basic concepts of Metropolitan's participation in the State Water Project system is necessary to review Metropolitan's SWP costs and the MFSG Report fails to establish such knowledge.

The MFSG Report Mischaracterizes the Ad Valorem Tax Revenues as a Cost-of-Service Issue

The MFSG Report attempts to suggest that the determination to suspend Section 124.5 of the Metropolitan Water District Act is a cost-of-service issue. The suspension of the tax rate limit in Section 124.5 has no effect on the level or functionalization of Metropolitan's costs, as projected costs and revenue offsets are handled separately in the cost-of-service analysis. Ad Valorem Tax revenues can only be used for two purposes: to pay Metropolitan's General Obligation debt service and to pay State Water Contract capital costs.

The MFSG Report Mischaracterizes Metropolitan's Budgeting and Financial Reporting Obligations

The MFSG Report suggests that Metropolitan's budget document should conform to its financial statements. (MFSG Report, p. 5.) However, consistent with the M1 Manual and the general practice of government-owned utilities, Metropolitan uses a "forward looking" or prospective rate period as the test year for rate-setting, as a prospective period accommodates the impact of rapidly increasing and changing costs on rates. Metropolitan follows this practice by incorporating budget information for the proposed biennial budget expenditures in its revenue requirement. This ensures that Metropolitan's budget and its rates and charges are supported by the same information.

Metropolitan's financial statements are prepared in accordance with Generally Accepted Accounting Principles, which do not dictate governmental budgeting or rate-setting. Metropolitan's financial statements report information that has already occurred, based on accrual accounting, which may or may not be relevant to the prospective budget and rate-setting period in question.

Further, the MFSG Report suggests that Metropolitan is required to maintain balancing accounts or "true-ups" at the end of revenue periods. It points to the State Water Contract and the California Public Utilities Code as examples. Neither places such a requirement on Metropolitan. As in other places, the MFSG Report mischaracterizes the State Water Contract. The State Water Contract is a take-or-pay cost recovery agreement; Metropolitan must pay its allocated share of State Water Contract costs whether Metropolitan receives any water at all. The State Water Contract can recover only those costs attributable to Metropolitan and not costs attributable to other Contractors or the State of California General Fund.

Similarly, the MFSG report misunderstands the relationship between public agencies and the California Public Utilities Commission. Metropolitan is not regulated by the California Public Utilities Commission or Code. The MFSG Report suggests that "industry best practices" dictate that Metropolitan "true-up" its costs at the end of the budget cycle similar to regulated private utilities. (MFSG Report, p. 15.) However, there is no such "industry best practice." True-ups are not a common governmental utility practice and not widely used by wholesale utilities.



Marcia Scully
General Counsel



Gary Breaux
Assistant General Manager/
Chief Financial Officer

cc: Jeffrey Kightlinger

Attachment

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Stratecon Inc. has partnered with World Water Institute (“WWI”) to provide support for curriculum development and student and faculty research that seeks to find solutions to the world’s most pressing

water challenges. Stratecon President and WWI Board Member Rodney T. Smith said, “With WWI’s focus on using market mechanisms to solve water resource management problems, [...]

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About Us

Stratecon Inc. is a strategic planning and economics consulting firm specializing in water. We provide advisory services in the acquisition of water rights throughout the western United States and in the sale and leasing of water rights and water supplies to public and private sector water users, as well as provide proprietary research services, and expert testimony. Stratecon brings together the disciplines of economics, finance, natural resource management and law to develop innovative solutions to commercial and public water policy issues.

Stratecon also produces Journal of Water, Hydrowonk Blog and Stratecon Water Policy Marketplace:

Journal of Water is a paid subscription journal reporting on the important, path-breaking and innovative developments in water resources in the Colorado River Basin, Texas and elsewhere in the Southwest.

Hydrowonk Blog is an open intellectual marketplace for the water industry... a forum to exchange information and perspectives. Stratecon invites you to join in the conversation at Hydrowonk.com and click on Hydrowonk Blog.

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[Contact us](#)

Our Team

▼ [Rodney T. Smith, Ph.D.](#)

Rodney T. Smith is President of Stratecon Inc., an economics and strategic planning consulting firm specializing in the economics, finance, law, and politics of water resources. He was also manager of a water rights fund in 2005 for DB Zwirn, lead a water rights and infrastructure project for investors

through Southwest Texas Water Resources, L.P. and currently serves as President of Baja Norte Water Resources LLC and an affiliated Mexican entity involving the marketing of desalinated Mexican seawater in the United States. Rod is also currently involved in the early stage, start-up of a water company in Texas.

Rod is involved as an advisor in the acquisition of water rights throughout the western United States and in the sale and leasing of water rights and water supplies to public and private sector water users. He has consulted extensively for public and private sector clients, including high net worth investors, on business and public policy issues concerning water resources. Recently, Rod served as a consultant to a major new water transfer study by the Western Governors' Association and the Western States Water Council.

Rod received his Ph.D. in Economics from the University of Chicago and a Bachelor of Arts in Economics from the University of California at Los Angeles.

[▶ Michael D. Smith, Vice-President, Finance](#)

[▶ Marta L. Weismann, Director of Research](#)

[▶ Kelly Dietz, Project Coordinator](#)

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