Our Region's Trusted Water Leader
San Diego County Water Authority

September 2, 2021

VIA EMAIL

Dr. Michael Hanemann
San Diego County LAFCO
2550 Fifth Avenue, Suite 725
San Diego, CA 92103
(hanemann@berkeley.edu)

RE: Potential Exit Fees

Dear Dr. Hanemann:

Thank you for your asking the parties to submit information on proposed exit fees for any potential detachment of Fallbrook and/or Rainbow. The Water Authority appreciates the opportunity to provide its information. We ask that this letter be provided to the Advisory Committee and all LAFCO Commissioners (it is copied to Keene Simonds and Adam Wilson, so we ask that they do so).

In 2020, the Water Authority Board of Directors passed Resolution 2020-06, a copy of which is attached to this letter. In that Resolution, our Board stated that it would oppose detachment unless four conditions were met:

a. It can be determined by what means Rainbow and Fallbrook can guarantee that all obligations as promised to their own ratepayers are met;

b. It can be demonstrated that detachment will not adversely affect other Water Authority member agencies and San Diego County as a region financially or environmentally;

c. It can be demonstrated that detachment and then annexation into Riverside County's Eastern Municipal Water District will not increase reliance on the Bay-Delta; and

d. It can be demonstrated that detachment will not result in a diminution of the Water Authority's voting power at MWD to represent the interests of all San Diego County ratepayers and property owners.

The "exit fee" issue you have asked about goes to issue "b" above, i.e. financial impacts of detachment, and we address it here in the context of the direction our Board set.

However, it is important to state at the outset that the applicants have failed to demonstrate during this process that any of the above conditions are likely to be met. Further, our providing this information in no way should be construed as agreement by the Water Authority with any detachment even if an exit fee were paid, but simply responds to your request.

1. "Exit Fee" Legal Context and Policy

Before delving into the particulars of any potential exit fee, it is important to first address some of the relevant legal and policy considerations for such a fee. Though we realize you are not an attorney and are not providing legal analysis or opinions, we provide below the applicable and relevant laws to understand the Legislature's goals and intent.[1]

Two main sets of laws apply: the County Water Authority Act, and the LAFCO statutes (all emphases below are added).

Section 45-11(a)(2) of the County Water Authority Act states as to exclusion (detachment):

> [T]he corporate area of the public agency shall be excluded from the county water authority and shall no longer be a part thereof; provided, that the taxable property within the excluded area shall continue to be taxable by the county water authority *<u>for the purpose of paying the bonded and other indebtedness of the county water authority outstanding or contracted for at the time of the exclusion</u>* and until the bonded or other indebtedness has been satisfied … .

Government Code section 56886(c) allows LAFCO to set conditions for payment of outstanding "bonds, including revenue bonds, or other contracts or obligations" and taxes by "imposition, exemption, transfer, division, or apportionment." The specific LAFCO statute governing the financial effects of detachment is found at Government Code section 57354 and requires that the detaching areas:

> continue to be liable for the payment of principal, interest, and any other amounts which become due on account of *<u>any bonds, including revenue bonds, or other contracts or obligations of the district and any improvement district within which the detached territory has been situated, as are outstanding on the effective date of detachment</u>*.

The above statutes are very similar, and the legislative goal is clear: upon detachment, the exiting parties are responsible for their share of agency obligations incurred – here, primarily to meet the conservation adjusted base load water demand of the exiting public agencies.[2]

[1] A much fuller discussion of these issues is found in the Water Authority's September 2020 Response filed with LAFCO, at pages 152 *et seq*.

[2] *See* the Water Authority's September 2020 Response at pp.10 *et seq*. where the Water Authority's regional planning history is discussed, and at pp. 65-67 where the important differences between detachment and reduced water purchases resulting from local water supply development are explained.

2. What Is An Appropriate "Exit Fee"?

In our 2020 Response to LAFCO we stated, "The Water Authority has about $21.1 billion in bonded and other indebtedness and certain water supply contracts . . . ."[3] Of the $21.1 billion total existing at that time, about $19.1 billion was for long-term "take or pay" water supply contracts, and the remainder was for various forms of debt, such as bonds, CalPERS obligations, etc. *See* Water Authority Response, pages 48 *et seq*.

A proportionate share of all outstanding obligations needs to be covered by an exit fee. Why? Because, as also stated in our 2020 Response to LAFCO:

> Should provisions not be made to cover the revenue shortfall created by the detaching agencies no longer using the water supplies all parties planned for and the facilities built, that cost burden would be shifted to the then remaining agencies, each of which is already paying its own proportionate share of costs.

Any exit fee less than the full amount of obligations incurred to meet the base load water demands of the detaching agencies means that other Water Authority member agencies' ratepayers are being forced to pay for the obligations established for water supplies now being used to serve Fallbrook and Rainbow customers, including the imposition of increased water rates on lower income water ratepayers in other parts of San Diego County. That is simply not fair, and contradicts the above-noted legislative goals and legal requirements.

We also call to your attention the disruptive impact of detachment, not only on the Water Authority and its member agencies but potentially on many other municipal utilities, irrigation districts and local governments – even if a full exit fee is paid. As explained in our 2020 Response to LAFCO at pages 62 *et seq*., the ratings agencies may see any detachment very unfavorably, which would increase borrowing rates for our agency, our member agencies and potentially, many other municipal water suppliers. This concern is greatly exacerbated by the potential impacts of the drought currently gripping the western United States.[4]

3. Determining the "Exit Fee"

As stated in the Water Authority's September 2020 Response, net obligations of $20 billion+ were identified. Partially updating the numbers to reflect newer reserve balances and one year less remaining on existing supply obligations, *the current calculated net liabilities of the Water Authority are $20,551,593,209*.[5]

As you correctly stated a few months back, water supply contracts are viewed as a fixed cost and thus a contractual obligation. Therefore, the above figure includes roughly $18.5 billion in contractual supply obligations stemming from a discounted cashflows analysis, and

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[3] The precise number would need to be calculated near the time of actual detachment, as required by the above laws.

[4] *See Could the Western U.S. Drought Threaten Municipal Credit Stability?*, S&P Global Ratings, August 18, 2021, at [Could The Western U.S. Drought Threaten Municipal Credit Stability? | S&P Global Ratings (spglobal.com)]

[5] The final calculation of net liabilities should be reflected as of the specific date of detachment.

approximately $2 billion in other obligations such as bonds, CalPERS underfunding, etc. The utilized discount rates for the supply obligations reflect the historical low-rate environment and potential for significant disruptions over the long-term. A higher discount rate causes disruptions to have little impact on the analysis in terms of value today. Given the significant uncertainty, a lower rate appropriately insulates the remaining member agencies from the risks associated with the existing supply obligations caused by the detaching member agencies.

It should be noted that both the County Water Authority Act and the LAFCO statutes cited above do not predicate the basis of an "exit fee" on "damages," but rather, on a proportionate share of existing obligations. In other words, upon detachment – which completely severs an agency's financial responsibility – the Legislature's intent is to divide actual payment obligations, and not get into a speculative guessing game as to what the future may or may not hold (i.e., "you are not harmed," or "you may need the water anyway.") The future always has risk, and by dividing existing payment obligations between the detaching agency and the remaining ones, the risk created by the detaching agencies is placed on them alone and eliminated for those who remain accountable for rates and charges to pay for obligations previously incurred.

Based on the relevant law and legislative objectives, it is the Water Authority's position that Rainbow and Fallbrook must pay their proportionate share of all existing Water Authority obligations. What is that share? As noted on page 63 of our September 2020 Response: "Fitch's June 29, 2020, New Issue Summary states at page 3: 'Two of the CWA's members, Rainbow Municipal Water District and Fallbrook Public Utility District, [are] accounting for 3.9% and 2.1% of revenues.'" These revenue figures are on the lower end of average revenue from these agencies, which generally fall in the 6-7% range.[6] The Water Authority believes it would be reasonable to use these numbers of 3.9% for Rainbow, and 2.1% for Fallbrook, to represent a proportionate share total of 6% as stated by Fitch, as a condition of detachment, resulting in the following if the detachment were taking place now[7]:

Full Net Liabilities

	Revenue Percentages from Fitch	Water Authority Net Liabilities	Net Liabilities Pro Rata Share
Rainbow	3.9%	($20,551,593,209)	($801,512,135)
Fallbrook	2.1%	($20,551,593,209)	($431,583,457)
	6.0%	**($20,551,593,209)**	**($1,233,095,592)**

The Water Authority understands that there are no financing terms under which payment of the above requisite exit fee is likely possible as a practical matter, even though such terms could be structured to roughly match when obligations became due.[8] Yet – also as a practical matter – the

[6] Rainbow and Fallbrook have together accounted for nearly 7% of Gross Water Sales revenues for the Water Authority over the past decade (FY 2012 – FY 2021), so 6% is less than could be argued.

[7] All numbers would have to be updated to reflect obligations at time of detachment, per the above statutes.

[8] *See* Government Code section 57354 cited above ("amounts which become due").

applicants themselves have unilaterally created this need for an exit fee by seeking to detach. It is not a situation caused by the Water Authority.[9]

4. Potential Cascading Impacts on Water Authority, MWD and MWD Member Agencies, Disrupting Long-Term Water Resource and Financial Planning and Governance

A number of Water Authority Board members have inquired whether the exit fee that may be established in this detachment process – a detachment advocated by Fallbrook and Rainbow with the apparent concurrence of MWD's former General Manager[10] – will also apply to the Water Authority should its Board ever propose to detach from MWD.[11] Similarly, MWD Board members and member agency managers, many of whom we believe have only recently learned of this LAFCO proceeding, have asked whether a precedent is being established that would allow an MWD member agency to annex customers of another, without any accounting or responsibility for costs incurred to provide a water supply. The Water Authority agrees these are important questions with potentially negative and cascading impacts on MWD and other California public agencies. Indeed, these concerns are precisely why the Legislature enacted measures to provide for coverage of existing obligations upon detachment.

5. Conclusion

It has not been demonstrated during this LAFCO process that detachment would deliver the water supply or cost-saving benefits promised by these agencies to their Fallbrook and Rainbow ratepayers – the applicants' extensive public relations campaigns notwithstanding. To the contrary, the water supply reliability of Fallbrook and Rainbow customers will be negatively affected, while no meaningful long-term rate savings have been demonstrated. Further, the proposed detachment would violate state water law and policy by increasing reliance on water supplies from the State Water Project and Bay Delta, and detachment would reduce San Diego County's voting power at MWD, putting at unnecessary risk all ratepayers and property owners in San Diego County. Finally, unless an appropriate exit fee is established and paid as described in this letter, this LAFCO decision could disrupt long-term planning and financial decisions across Southern California and beyond.

The Water Authority is available to address any further questions or issues related to this matter. We also specifically request that LAFCO reach out to MWD's General Manager, copied below, to ascertain the MWD Board and member agencies' position on these important policy issues.

[9] Although Fallbrook and Rainbow have failed to demonstrate the merits of detachment during this process, they continue to engage in a public relations campaign telling their ratepayers their water supply will be equally reliable under detachment (it will not); that it will cost less (this has not been demonstrated); and that the Water Authority has unfairly overcharged them for water (it has not). This kind of negative campaign by public water suppliers is especially misguided at this time, as the entire region, state and western U.S. are grappling with severe drought.

[10] The MWD communications and positions taken in this LAFCO proceeding appear to have been solely by MWD's former General Manager. To date, there has not been any consideration by the MWD Board of Directors of the policy issues and financial impacts of these proposed detachments.

[11] While the Water Authority has had policy differences with MWD over the years, mainly centering around MWD's rates and charges, neither Water Authority management nor its Board of Directors has ever proposed detachment.

As always, we thank you for your thoughtful consideration of our comments and the issues presented by these applications.

Sincerely,

Mark J. Hattam
General Counsel
Enclosure

cc via email:

Keene Simonds, Executive Officer, San Diego County LAFCO
Adam Wilson, Moderator, San Diego County LAFCO
Holly Whatley, Counsel, San Diego County LAFCO
Sandra L. Kerl, General Manager, San Diego County Water Authority
Kristina Lawson, Counsel, San Diego County Water Authority
Jack Bebee, General Manager, Fallbrook PUD
Paula C. P. de Sousa, Counsel, Fallbrook PUD
Nick Kanetis, Deputy General Manager, Eastern MWD
Tom Kennedy, General Manager, Rainbow MWD
Alfred Smith, Counsel, Rainbow MWD
Water Authority Board of Directors
Adel Hagekhalil, General Manager, Metropolitan Water District of Southern California
Marcia Scully, General Counsel, Metropolitan Water District of Southern California

RESOLUTION NO. 2020-06

A RESOLUTION OF THE BOARD OF DIRECTORS OF THE SAN DIEGO COUNTY WATER AUTHORITY ADDRESSING POTENTIAL DETACHMENT OF FALLBROOK PUBLIC UTILITIES DISTRICT AND RAINBOW MUNICIPAL WATER DISTRICT AND ANNEXATION OF THOSE DISTRICTS INTO EASTERN MUNICIPAL WATER DISTRICT-06

The San Diego County Water Authority ("**Water Authority**") is a county water authority established in 1944 under the County Water Authority Act ("**Act**"), that has provided water to its member agencies throughout San Diego County since World War II.

The Fallbrook Public Utilities District ("**Fallbrook**") was a founding member agency of the Water Authority in 1944 and Rainbow Municipal Water District ("**Rainbow**") has been a member agency of the Water Authority since 1954.

In March 2020, Fallbrook and Rainbow filed applications with the San Diego County Local Agency Formation Commission ("**San Diego LAFCO**") seeking detachment from the Water Authority and annexation into Riverside County's Eastern Municipal Water District.

The proposed detachment will affect water users and ratepayers in Fallbrook and Rainbow, as well as other member agencies and their ratepayers throughout the County of San Diego.

NOW, THEREFORE, the Board of Directors of the San Diego County Water Authority resolves the following:

1. Given the significant and unprecedented nature of the proposed detachments, and in order to protect ratepayers in Rainbow, Fallbrook, and the remainder of the Water Authority's service area, the Water Authority recommends that San Diego LAFCO conduct a comprehensive evaluation of the impacts of the detachment proposals, including financial, water supply reliability, governmental, and environmental impacts, and ensure that the public and all affected agencies have a meaningful and balanced opportunity to engage in the evaluation process.

2. Given the Water Authority's obligation to provide an adequate, reliable, and affordable source of water for all of San Diego County, the Water Authority will oppose detachment by Rainbow and Fallbrook unless:

a. It can be determined by what means Rainbow and Fallbrook can guarantee that all obligations as promised to their own ratepayers are met;

b. It can be demonstrated that detachment will not adversely affect other Water Authority member agencies and San Diego County as a region financially or environmentally;

c. It can demonstrated that detachment and then annexation into Riverside County's Eastern Municipal Water District will not increase reliance on the Bay-Delta; and

d. It can be demonstrated that detachment will not result in a diminution of the Water Authority's voting power at MWD to represent the interests of all San Diego County ratepayers and property owners.

PASSED, APPROVED, and ADOPTED this 28th day of May, 2020 by the following vote:

AYES:	Unless noted below all Directors voted aye.
NOES:	Bebee and Kennedy.
ABSTAIN:	None.
RECUSAL:	Ayala and Cate.
ABSENT:	Boyle, Simpson, Steiner, and Preciado (P).

Jim Madaffer

Jim Madaffer, Chair

ATTEST:

Christy Guerin

Christy Guerin, Secretary

I, Melinda Nelson, Clerk of the Board of the San Diego County Water Authority, certify that the vote shown above is correct and this Resolution No. 2020- 06 was duly adopted at the meeting of the Board of Directors on the date stated above.

Melinda Nelson

Melinda Nelson, Clerk of the Board