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

October 25, 2021

VIA EMAIL

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

RE: Water Authority Response to Draft Report

Dr. Hanemann:

Earlier today the Ad Hoc Advisory Committee received a letter from our General Manager, Sandy Kerl, regarding your draft report of October 11. You were copied on that letter. In it, GM Kerl noted that our staff had some responsive comments on the draft. Those are attached to this letter as Exhibit A. We ask that this letter and its attachment be provided to the Advisory Committee and to all LAFCO Commissioners (it is copied to Keene Simonds and Adam Wilson, so we ask that they do so).

Thank you for your consideration of these Water Authority staff comments on your draft.

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 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

EXHIBIT A

WATER AUTHORITY COMMENTS TO
DR. HANEMANN OCTOBER 11 DRAFT REPORT
(10/25/2021)

Water Authority staff provides these comments to Dr. Hanemann's draft report ("Draft").

In regards to water supply reliability issues, Dr. Hanemann has correctly pointed out the risks in Fallbrook and Rainbow moving from the Water Authority's supplies to those of MWD (via Eastern). We do not comment further on that issue here, except to say that it is vitally important that the customers served by Fallbrook and Rainbow be provided with this information since they have been assured otherwise by the Agencies' extensive PR campaigns.

We cover here just a few items that may have been missed, and then some issues related to the departure fee issue. Regarding the latter, we comment notwithstanding the fact that the important supply reliability findings should moot any need to ever reach the question of a departure fee.

1. Missing Items

Earthquake Water Supply: Page 11 of the Draft states:

> "There are two distinct threats to supply reliability for FPUD and RMWD. (1) Their wholesale supplier, SDCWA or EMWD, lacks sufficient water; or (2) it (temporarily) lacks sufficient connectivity due to a physical break in a pipeline. Here, I focus on the former." Draft, p.11.

No answer is provided in the Draft as to the second category. We assume this means Dr. Hanemann did not believe it to be in his scope. If that is the case, then LAFCO and its staff will still need to address it. This was a major issue raised in our September 18, 2020, Response to LAFCO (*see* pages 85 *et seq*.), and Dr. Hanemann identifies it as a "distinct threat" if there is a detachment.

London Moeder: Another matter not addressed in the Draft is the analysis Dr. Hanemann did on the London Moeder report submitted by Rainbow and Fallbrook. Dr. Hanemann has clearly already done all the work on the issue, as he presented it in detail to the Advisory Committee. This work should be included in some manner in the final report. Dr. Hanemann accurately showed that the methods used in that report were in error. The LAFCO Commissioners and public, including the customers served by Fallbrook and Rainbow, are entitled to Dr. Hanemann's opinions on this subject. The omission is easily rectified by including a short section summarizing the opinions, or alternatively just attaching Dr. Hanemann's earlier powerpoint on the subject as an exhibit incorporated into the report.

Bay Delta Reliance: In Dr. Hanemann's Powerpoint to the Committee in August he stated: "If FPUD and RMWD switch from SDCWA to EMWD, they will switch from relying on SWP water for 24% of their supply to relying on SWP water for 63% of their supply." This conclusion, which is important to many groups across the State, should be included in the report.

Title of Report: The title of the Draft starts with, "Report to Ad Hoc Advisory Committee." However, we believe it is important to note that the report is to the San Diego LAFCO, not just to the Advisory Committee. Dr. Hanemann's engagement, as detailed in his contract, was to provide expert opinions to LAFCO. This is a simple fix, such as a title of, "Report to San Diego LAFCO," or even "Report to San Diego LAFCO and its Ad Hoc Advisory Committee."

2. Departure Fee Issues[1]

We cover here a few issues related to departure/exit fee. The Draft states two possible exit fee scenarios: a cash payment based on 10-year QSA obligations (called "Option 1" here); or a limited compelled sale approach ("Option 2"). Though there are material issues with each, Option 2 is the most problematic *<u>and we believe that it should be removed</u>*. Therefore, we cover that option first.

A. Option 2

What is Option 2? It is a proposal that instead of paying an exit fee such as presented in Option 1 (below), Rainbow and Fallbrook instead purchase water from the Water Authority during a 10-year period, but only when the Water Authority drops below sales volumes such that it reaches its two take-or-pay contract amounts (QSA and desalination), and then only at the standard Water Authority per-acre-foot volumetric rate. Because such a volume drop is not projected to occur in the 10-year period, the proposal is really just a $0 exit fee, a premise that undercuts the entirety of the opinions stated by Dr. Hanemann in the rest of the Draft.

Here are some issues with Option 2, done in a Q&A format similar to the Draft:

Q: Does Option 2 set an exit fee?

A: No. What Option 2 does is shift the financial burden of the detachments to the Water Authority and its remaining member agencies by creating a speculative "obligation" in which Rainbow and Fallbrook pay nothing towards any current outstanding debt or obligations of the Water Authority. Instead, they act as very limited conditional water purchasers. If the Water Authority's sales, in the 10-year period following detachment, ever fall below the take-or pay contract amounts from QSA/desalination, then Rainbow and Fallbrook would buy water (up to a maximum). However, as the Draft acknowledges, "The analysis just presented suggests that SDCWA will be able to deliver its committed purchase of 320,700 AF every year through 2034, but would fail to do so in 2035." Thus, if the projections are correct and Fallbrook and Rainbow detach before 2025, they would not pay a single dollar to the Water Authority for any of its

[1] The Water Authority's September 18, 2020, Response notes important legal requirements for any potential departure fee. Dr. Hanemann has noted he is not an attorney, and his remarks on departure fee issues thus admittedly do not take the law into account. The Water Authority's comments here are only as to Dr. Hanemann's Draft, and they in no way waive or dilute the critical legal issues identified in the Response and other Water Authority submittals.

obligations. This idea is fundamentally inconsistent with Dr. Hanemann's own clear finding that there is a sound economic justification for imposing a financial obligation on Rainbow and Fallbrook to cover a portion of Water Authority debt incurred to serve their customers.

Q: Does Option 2 contradict any of the Draft's conclusions?

A: Yes, at least the following:

- Rainbow and Fallbrook should pay for departing. (Draft, p.10)
- Water Authority investments in supply and infrastructure have benefitted Fallbrook and Rainbow. (Draft, pp.10 and 45)
- When the Water Authority's sales volume reduces, it loses $935 an acre-foot. (Draft, p.10)
- If Fallbrook and Rainbow detach, demand on the Water Authority will reduce over 20,000 AF per year. (Draft, p.21, Table 1)
- Reduced demand means that the remaining members must face increased rates. (Draft, p.9)
- The Draft states as the purpose of imposing a financial obligation on detachment: "*The purpose is to cover SDCWA's own financial obligations that are fixed, ongoing and unavoidable after the departure for the duration of a period of adjustment*." (Draft, p.44; emphasis added.) Option 2 does not accomplish this purpose. It does not cover the Water Authority's existing fixed financial obligations at all, but rather in fact potentially excuses Fallbrook and Rainbow from all of them unless something unanticipated occurs, and then only covers a small delta of costs.

Q: Is Option 2 based on any false assumptions?

A: Yes, at least the following:

- Option 2 implicitly assumes that the Water Authority suffers no loss from departure that needs coverage (even for 10 years) unless the take-or-pay limit is breached. But the Draft repeatedly acknowledges this is not true, and that any reduction in demand will result in major losses for the Water Authority, driving up rates for the rest of the members. Option 2 provides no coverage for the *actual* losses caused by detachment, even for a 10-year period. Instead it only provides limited coverage for a *speculative possible loss*.
- Option 2 assumes that the Water Authority can cover losses caused by detachment by selling water to somebody somewhere: "[O]ne mechanism by which SDCWA might recoup lost revenue is to sell water that otherwise would have been delivered to FPUD and RMWD to a non-member water agency. Logical possibilities are to sell water to MWD itself or to individual member agencies served by MWD." Draft, p.49. In

addition to this being pure speculation, it is belied by the Draft's own facts. The Draft points out that both MWD and the Water Authority have been experiencing materially reduced sales over the past decade. The fact that sales have dropped over the years for both wholesale agencies shows that transactions to generate new sales to replace the lost volumetric demands are not always economical or possible. Moreover, efforts to sell water in the MWD service area have been frustrated for decades by MWD wheeling rates which have been the subject of extensive and ongoing litigation. While the Water Authority agrees that "Southern California as a region would be better served if there could be a more open and collaborative relationship between MWD and SDCWA," (Draft p. 49), it does not reflect the realities of the situation. Indeed, the proposed detachments, which would allow MWD to increase its own water revenues at the expense of one of its own member agencies (its "largest single customer") (Draft p. 49), belie any such ideology.

- Option 2 assumes that the Water Authority and its member agencies should cover for losses caused by a Fallbrook/Rainbow departure unless take-or-pay limits are reached. However, no equitable or economic justification is provided for reversing the standard assumption that one who causes a loss must pay, or Dr. Hanemann's base finding that there is a sound economic justification for imposing a financial obligation to cover the infrastructure investments and contractual commitments made by the Water Authority to serve Fallbrook/Rainbow customers.

- Option 2 assumes that if the Water Authority just reduces MWD (variable supply) purchases, it suffers no loss, but only reaches a loss when take-or-pay limits are breached. This is an economic misassumption. It is contradicted by the Draft's own conclusions that: (a) lower Water Authority demand causes a loss of $935 AF; and (b) a key driver of higher rates over the past decade has been reduction in overall sales, <u>*none of which occurred when the take-or-pay contract limits were reached*</u>. In other words, even though take-or-pay limits were never reached, the Water Authority's losses still occurred and were passed on to the remaining members in higher rates. Detachment will do exactly the same thing, and Option 2 fails to address the loss in any manner.

Q: Would Option 2 result in material rate increases for remaining member agencies?

A: Yes. It would result in reduced sales of tens of thousands of acre-feet per year, with each acre-foot being $935 lost, per the Draft's own analysis. These losses would drive up rates for remaining members, just as they have in the past.

B. Option 1

What is Option 1? It is an exit fee formula based on 2021 sales projections and QSA obligations covering 10 years, with no allowance for any non-QSA obligations of the Water Authority, no allowance for QSA obligations exceeding 10 years, and no allowance for increased costs (such as MWD transportation rates) over the 10 years. It is proposed that for 10 years Rainbow pay between $6,985,202 and $11,043,689 per year, and that Fallbrook pay between $1,931,388 and $3,276,017 per year.

Unlike Option 2, Option 1 does address, to a limited extent, Water Authority losses, albeit over just ten years. Here are some issues with Option 1, again done in a Q&A format similar to the Draft:

Q: Is the use of 2021 sales projections a reasonable basis for determination of an exit fee?

A: No. Real water purchases for multiple years should be used in this kind of method. Historical demands provide a greater correlation between the benefit received and the cost of providing that service. Additionally, projected demands are highly subjective. The use of 17,500 AF as a 2021 projection is under-projected. In FY '21 Rainbow alone was delivered 16,972 AF with an additional 8,969 sold to Fallbrook. A reduction from that 25,941 AF in *actual sales* to 17,500 AF in *projected sales* represents a 33% unjustified reduction. Option 1 thus deflates actual Water Authority losses by unnecessarily using a one-year estimated projection, rather than using any form of actual historic water sales, data which is readily available.

Q: Is the exit fee calculation in Table 7 consistent with the Draft's previous conclusions?

A: No. As stated in the Draft, the annual financial net loss to the Water Authority from detachment of $16.4 million seems reasonable. When viewed over a multi-year basis, the median impact grows to $33.9M. These findings are further backstopped by the calculation of an estimated $935 fiscal imbalance for every acre-foot of sales reduction. Yet these are not fully covered in Option 1. When viewed collectively, the $9M - $14M annual exit calculation represents a major discount. If Rainbow and Fallbrook receive a discount in cost payments, that necessarily means that the remaining members agencies would face a rate increase.

Q: What is left out of the Option 1 calculation that causes this discount?

A: The defined fee only includes variable costs associated with QSA supplies, and only for 10 years. It does not include other capital investments and contractual commitments made to serve Fallbrook and Rainbow customers and all member agencies. Any costs not recovered through an exit fee will result in rate increases to the remaining member agencies, and will encourage further detachments to receive similar discounts. Significant further analysis is required before any exit fee may reasonably be determined, which must include consideration of the precedent being established, including whether Eastern and MWD agree that the Option 1 approach would be reasonable for purposes of coverage of MWD obligations should agencies choose to detach there.

3. Conclusion

Dr. Hanemann's draft report provides thoughtful analysis of a few of the many issues raised by the detachment applications. We believe consideration of the above comments may benefit the Draft. We appreciate Dr. Hanemann's review of the items discussed above.