



February 15, 2022

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**VIA EMAIL**

RE: Comments on Final Hanemann Report

We have reviewed the final version of the report produced by Dr. Hanemann that was released on January 14<sup>th</sup> (Report). We are pleased to have this final version completed as it was a long process. We look forward to LAFCO staff using this information to develop recommendations for the Commission's consideration.

This letter highlights some areas of the Report which are inaccurate or inconsistent with state law. However, before getting into specific items from the Report, we must reiterate again that relative to the determination of a "departure fee," Dr. Hanemann admittedly performed his work without consideration of the relevant statutes and other applicable California laws (such as the California constitution) that apply to the Districts' reorganization applications. Both our Districts and members of the special Ad-Hoc Committee have requested information on how these laws should guide any analysis, and we again request that LAFCO provide clarity to the applicants, the Ad-Hoc Committee, the Commission, and the public on how the Report's conclusions may be in conflict with a number of applicable California laws. Our legal counsel will provide a more detailed response in this area under separate cover.

**Specific Comments**

**Water Costs**

In several areas of the Report, Dr. Hanemann calculates the actual "all in" rates of SDCWA and MWD, but appears to rely on incorrect information from SDCWA, which incorrect information was included in his analysis. Specifically, Dr. Hanemann applies the MWD Capacity charge, which is approximately \$137/AF to only MWD water (which he calls "M-water") when the charge is based on all water deliveries to SDCWA including exchange water ("E-water"). This artificially inflates the "all-in" cost of MWD water and decreases exchange water. This miscalculation, used by SDCWA in the past,

has been questioned many times at SDCWA Board meetings. Again, it appears that this method of calculation was included in the Report, perhaps as a result of SDCWA not providing a proper accounting of how MWD calculates and charges the MWD capacity fee.

When looking at total costs of MWD versus SDCWA supplies, Dr. Hanemann did not include the Infrastructure Access Charge of \$119/AF in the “all in” SDCWA rate or the Readiness-To-Serve charge and Capacity fees, even though these are real costs paid by member agencies for SDCWA supplies. A spreadsheet showing the actual true method of calculation was sent to Adam Wilson on January 31, 2022. We would be happy to discuss the math here as it is pretty straightforward and leads to an accurate calculation of the actual “all-in” SDCWA rates paid by all SDCWA member agencies. Please see the table below.

(\$/AF)	Hanemann Report "All-in"	IAC*	MWD Fixed*	Actual "All-in" CWA Rate	"All-in" MWD
SDCWA Treated	\$ 1,474	\$ 119	\$ 42	\$ 1,635	\$ 1,319
SDCWA Untreated	\$ 1,269	\$ 119	\$ 42	\$ 1,430	\$ 975
PSAWR Untreated	\$ 1,295	\$ 119	\$ 42	\$ 1,456	\$ 975
*\$/AF estimated based upon CY 2021 supply mix					

Dr. Hanemann goes on to opine that it makes sense that SDCWA’s rates are higher as it has infrastructure to operate and maintain that adds to the cost. We don’t dispute this, but in fact we operate our systems without the use of nearly all of the SDCWA system and yet have to pay for it. This was essentially the conclusion that was expressed in the London Moeder Report. If Dr. Hanemann’s assessment is that the majority of the additional cost is for investments in SDCWA infrastructure and the Districts do not use this infrastructure, then a conclusion from the Report that could also be drawn is that although the rates are legal, they are not fair for our agencies.

## Water Reliability

We agree with the ultimate conclusion reached by Dr. Hanemann regarding reliability: moving to EMWD will not have any significant impact on actual supply reliability and that cost of water, reliability, and water use are all connected.

We do want to point out that the discussion about SDCWA’s QSA supplies being superior to MWD’s supplies misses several points. First, MWD is a contractor with the Department of Interior, while SDCWA is not – giving MWD a status on the river to secure additional agreements for supplies that SDCWA does not enjoy. Second, in addition to MWD’s 500,000 AF of supply, MWD also hold contracts for 130,000 AF of water from Palo Verde Irrigation District (whose rights are superior to IID) and an additional 110,000 AF rights under contract with IID, bringing the total to 785,000 AF of water on the Colorado River.

In addition, MWD has direct access as a contractor on the State Water Project, which provides higher quality water, although it is subject to periodic curtailment in drought years. MWD mitigates this by having over 1.5 million AF of water banked in Lake Mead and well over 500,000 AF stored within in-system reservoirs like Diamond Valley Lake.

Finally, SDCWA finds itself with only one source of supply dominating its deliveries – over 80% as calculated by Dr. Hanemann. Being so dependent on one source of supply that serves six states and a foreign country, and which supply has a well-studied long-term over allocation problem carries more risk than having a diversified portfolio of supplies should that source face curtailment in the future. SDCWA also has no long-term guarantee to IID supplies past 2035 as it must navigate a complex price reset negotiation on the IID Transfer supplies in order to retain its ability to receive 200,000 AFY of E-water. Pat Mulroy, former General Manager at the Southern Nevada Water Authority, has reviewed the Hanemann Report and observes that “the ultimate irony is that when IID is required to reduce its Colorado River use and it consequently reduces what it sends to SDCWA, the only source of reliability SDCWA has is MWD.”

### **Financial Impact of Detachment**

Dr. Hanemann’s analysis on the financial impact to SDCWA member agencies has changed several times over the last 8 months based on his receiving incorrect information from SDCWA. In June 2021, Dr. Hanemann calculated a net revenue loss of just under \$10M based on his analysis and the information he had then received. In his draft report from October 2021 he estimated annual costs up to ~\$45M per year based on data he received from SDCWA. The final Report was in the range of ~\$10-\$12M per year, which while in the ballpark, excludes some key one-time savings. It is important to consider that SDCWA has an annual budget in the \$850M range, so this amounts to ~1.2%-1.4% decrease in that amount. Even if you only consider operating revenues of about \$700M, this estimated revenue decrease is still only between 1.4% and 1.7%. Note that SDCWA’s operating revenues vary from year to year due to weather by a much greater percentage than this (averaging ~7% net variance since FY08/09), so the impact of detachment is well within the routine margin of error for SDCWA’s ability to predict revenue.

Dr. Hanemann also does not include the real world savings of \$35M that SDCWA will realize upon detachment. This money comes from the long promised, but never constructed, final phase of SDCWA’s Emergency Storage Project which includes two pump stations to serve FPUD and RMWD. These facilities were to be built and operated by FPUD and RMWD but paid for by SDCWA. If we detach, SDCWA saves \$35M instantly. If we don’t then SDCWA will need to pay for those facilities. Because SDCWA, in an email to Dr. Hanemann, indicated that the projects would be cash funded, we are puzzled and find it odd that his analysis on the financial impacts to SDCWA did not reflect these savings. The projects are included in the adopted SDCWA capital budget and, if FPUD and RMWD detach, they will be removed and the \$35M payment from SDCWA to RMWD and FPUD will not be required.

## Exit or Departure Fee

On Report page 62 Dr. Hanemann discusses the fairness of SDCWA rates and concludes that *“Whether or not one agrees with this, it is worth quoting what the California Court of Appeal has stated: ‘Rates established by the lawful rate-fixing body [of a water agency] are presumed reasonable, fair and lawful.’”*

As to that issue, Dr. Hanemann seems to agree that the law and courts need to be considered when it comes to matters regarding water agency finances. And here, Dr. Hanemann also seems to apply the law and court decisions to that part of his analysis. Unfortunately, as noted above and in a separate letter from our legal counsel, Dr. Hanemann’s analysis was conducted independent of applicable California law and precedent when evaluating what a “departure fee” would or could be – even though it is clearly outlined in law and has been applied to previous detachments from SDCWA.

A fundamental incorrect assumption in Dr. Hanemann’s analysis is contained on Report page 76, where he indicates that SDCWA does not supply water to its member agencies on a PayGo basis. This statement is incorrect. As approved by the SDCWA Board in every one of its Official Statements when it issues debt, no SDCWA member agency has any obligation to purchase any amount of water, and member agencies are only subject to the rates and charges in place at the time of the purchase. While SDCWA purports to have “fixed” rates, these are actually based on volumetric purchases averaged over 3 and 5 years. If any member agency took its purchases to zero, the member agency’s obligation (apart from the small IAC charge) would also go to zero in three to five years. While few will get to zero deliveries due to local supply development, several agencies either have developed or will soon develop local supplies that will have significant financial impacts on SDCWA as they roll off.

Dr. Hanemann recognizes this in the Report where he describes the financial impact of the development of large local supplies by other member agencies. He states on Report page 103 *“However, the difference between detachment and roll-off may turn out not to be that large in practice: both phenomena are financially detrimental to SDCWA.”*

Dr. Hanemann estimates that every 1,000 AF per year of drop in demand will have a net impact of roughly \$940,000 in revenue reduction for SDCWA. Here is how this compares to other upcoming activities by local agencies applying his calculations on the impacts of detachment.

Member Agency Activity	SDCWA Demand Reduction	SDCWA Net Revenue Impact (million \$)
FPUD Detachment (Hanemann Calculation)	4,100	\$3.90
RMWD Detachment (Hanemann Calculation)	14,000	\$8.30
Phase I Pure Water City of San Diego	33,600	\$31.58
East County Advanced Purification Facility	12,882	\$12.11
Pure Water Oceanside	10,080	\$9.48
Phase II Pure Water City of San Diego	59,360	\$55.80
<b>Total</b>	<b>134,022</b>	<b>\$121.17</b>
<b>Roll off</b>		<b>\$108.97</b>
<b>Detachment</b>		<b>\$12.20</b>

This shows that local supply projects which will be coming on-line over the next decade will have an impact of about \$100M per year on SDCWA or 9 times the impact of detachment.

SDCWA's Board has on numerous occasions considered how to deal with the financial challenges posed by the combination of conservation and local supply development. The implementation of an actual fixed charge or commitment for water purchases has been debated and rejected by the SDCWA Board more than once. Even though nearly two decades ago the SDCWA Board established rates that roll-off to allow SDCWA to make necessary adjustments when demands change, Dr. Hanemann pursued an entirely different approach when calculating his recommended "departure fee," which approach is based on establishing an on-going future commitment to pay for water based on past usage. We note again that this approach is inconsistent with applicable California law.

Dr. Hanemann used QSA supply costs as the benchmark from which to calculate a "departure fee." While he mentions the challenge of stranded assets in other parts of the Report, the fact is that the detachment of FPUD and RMWD will not strand any physical assets or strand the supply assets of QSA water. Post detachment, all physical and supply assets will continue to be enjoyed exactly as they are now.

An additional problem with Dr. Hanemann's method of analysis in the Report is the imposition of a "departure fee" based on water supply where the party that pays the fee **does not get the water**. The final Report for the first time states that the real basis for the "departure fee" is for "payment for obligations incurred by having received water in the past" and "not a payment for water to be received currently." We find this new basis surprising and a bit unsettling, as it implies that all SDCWA member agencies are indebted currently to SDCWA for having received water in the past. We believe this concept fails the tests of legality under a number of statutes and does not acknowledge that the County Water Authority Act has a specific section on fees to be paid for detaching from SDCWA.

Dr. Hanemann's calculated "departure fee" also greatly exceeds his own calculation of the financial impact of the detachment. It is hard for us to understand how SDCWA could actually profit from a detachment process, in which it would be divested of the obligation to provide any services to the Districts.

As we have indicated in multiple documents sent to LAFCO over the last several months, should LAFCO decide to ignore the County Water Authority Act, which already establishes that upon detachment, the property within the Districts continue to be taxed for the purposes of paying down debt outstanding or contracted for at the time of detachment and until the debt has been satisfied, and look for a "fair" way to calculate a departure fee, LAFCO need look no further than SDCWA's own rates and charges and treat the detaching agencies just like SDCWA will treat the agencies listed above where their "fixed" charges decline over a 3-5 year period. This process has been in place for nearly two decades and applies to all member agencies. There is no reason for LAFCO to arbitrarily select a different method.

There are a number of other technical inaccuracies in the report that may have been generated from information provided by SDCWA, but most are not germane to the work that LAFCO has in front of it. Since the Ad-Hoc Committee has been tasked with evaluating the three main items discussed above, we felt that it would only distract LAFCO from the task at hand by detailing those inaccuracies and irrelevant information. We would be happy to meet with LAFCO staff to discuss those items as needed.

We look forward to the discussion this week at the Ad-Hoc Committee meeting and the subsequent completion of the processing of our applications. We are very near the two year mark from when RMWD's and FPU D's applications were submitted and hopefully all parties agree that there has been ample input and discussion during this time. We feel that the time is right for LAFCO staff to complete the processing of the applications and prepare recommendations for the Commission.



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