

August 17, 2022

Attention: Board of Directors

**Update Regarding Fallbrook and Rainbow LAFCO Reorganization Applications
(Presentation)**

Purpose

To provide the Board of Directors and public an update on activities at San Diego LAFCO (“LAFCO”) in regards to the potential detachment of member agencies Fallbrook Public Utility District (“Fallbrook”) and Rainbow Municipal Water District (“Rainbow”), because hearings at LAFCO may soon commence.

Background and Discussion

a. History of Proceedings

In 2019, the Water Authority was told by Rainbow’s General Manager that both Fallbrook and Rainbow would be filing applications at LAFCO that would seek to: (a) allow the agencies to detach as members of the Water Authority; and (b) allow them to join Eastern Municipal Water District in Riverside County (“Eastern”) as member agencies there. Subsequently, the Water Authority learned that Fallbrook and Rainbow had been working with Eastern and with LAFCO to pursue this action for awhile, without notice to the Water Authority.

Later in 2019, the Otay Water District (“Otay”) filed suit against Fallbrook and Rainbow, contending that the agencies had not properly done CEQA compliance for their LAFCO reorganization application decisions, including review of effects on the Bay-Delta by their proposed changes. That suit was settled in March 2020 by stipulated orders entered by the San Diego Superior Court, which stated that the CEQA Notices of Exemption by the agencies could not be “utilized or relied upon by the San Diego LAFCO” in regard to their reorganization applications.

Fallbrook and Rainbow filed their reorganization applications in March 2020. The applications stated that both agencies were seeking to leave the Water Authority and to join Eastern in Riverside County. Their applications also made clear that they were *not* seeking to become retail members of Eastern, which would allow them access to Eastern’s own local water supplies and infrastructure, but instead would become wholesale customers of Eastern, and thus as to imported water be 100% dependent on MWD water.¹ For the right to solely get MWD water, and to not access Eastern’s own water or storage or infrastructure, they would pay Eastern a nominal \$11 per acre-foot administrative fee.

The result of the applications, if granted, would be that the agencies – and more importantly, their retail customers – would no longer have any access to the Water Authority’s independent supplies, such as QSA and seawater desalination water, or any of the Water Authority’s storage system. They

¹ Metropolitan Water District of Southern California (“MWD”).

would not be able, in case of earthquake or other emergency, to access water from both the north and south, as they could if they stay with the Water Authority, but would only have access to MWD water from the north. In summary, they would have no access to any independent water supplies or storage from Eastern and would become reliant for imported water on MWD, and on MWD alone. The agencies have claimed to their retail customers that they would receive “the same water” with detachment as they currently receive from the Water Authority. They have further asserted that their water supply and service will be equally reliable to that which they receive from the Water Authority. These water supply claims have been rejected by LAFCO expert Dr. Michael Hanneman, as discussed below.

In May 2020, the Water Authority Board of Directors adopted Resolution 2020-06, which stated that the Water Authority would oppose detachment unless four issues were all shown to be satisfied during the LAFCO process:

- 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.²

The Water Authority staff and consultants performed extensive work and submitted a comprehensive Response to the applications in September 2020.³ Additionally, numerous local governmental agencies submitted letters of concern to LAFCO. These included the cities of San Diego, Oceanside, Carlsbad, Escondido, and National City, and retail water suppliers Otay, Helix, Sweetwater Authority, Lakeside, Rincon del Diablo, Santa Fe, Olivenhain, and Vallecitos.⁴

LAFCO engaged an independent expert to help it address issues about water reliability and water rates. The expert it hired, with unanimous consent from the parties, was Dr. Michael Hanemann, a well-known water scholar currently at Arizona State University. His report was finalized in late 2021 and is discussed below.

² To date at LAFCO none of these conditions has been satisfied, and all work to date indicates none of them will be satisfied.

³ This Response (the “Response”) can be found at the LAFCO website at <https://www.sdlafco.org/home/showpublisheddocument/5104/637362842268270000> and is critical reading for the Board and the public.

⁴ All can be found at <https://www.sdlafco.org/resources/major-proposals/fallbrook-pud-rainbow-mwd-wholesaler-reorganization-2020>

LAFCO also created an ad-hoc advisory committee made up of representatives from Fallbrook, Rainbow, Eastern, the Water Authority, SANDAG, County of San Diego, LAFCO Cities Advisory Committee, and LAFCO Special Districts Advisory Committee. This Ad Hoc Committee has met periodically, mainly to review Dr. Hanemann's work. The Committee's concluding status is discussed below.

b. Dr. Hanemann's Conclusions

LAFCO expert Dr. Hanemann's independent report⁵ reached a number of conclusions of importance to our Board, to our member agencies, to LAFCO, and to the public. Some of his main points were these:

- If "FPUD and RMWD become members of EMWD this will not bring them access to any of EMWD's local supply" -- Report, p.14.
- Fallbrook and Rainbow have "benefited from all the financial obligations incurred by SDCWA" – Report, p.75.
- There is "no evidence that SDCWA has charged members unfairly, or that FPUD and/or RMWD were paying an excessively large share" – Report, p.10.
- The "superior [water] reliability of SDCWA has benefited FPUD and RMWD in the past" -- Report, p.14.
- "Q. Has the distinctive reliability of SDCWA's supply portfolio actually made any difference? A. Yes. It would have made a difference if SDCWA had QSA water in the 1991 drought, it did make a difference that SDCWA had QSA water in the 2007-2009 drought, and it made a difference that SDCWA had desal water in the 2015-2016 drought." -- Report, p.84.
- "It is not clear that MWD yet has the practical capacity to sustain more severe and prolonged drought, especially on the Colorado River" – Report, p.16.
- If they move to Eastern, Rainbow and Fallbrook "would NOT be receiving the same water as they receive as member agencies of SDCWA" – Report, p.28 (capitalization in original).
- "FPUD and RMWD are taking something of a gamble on supply reliability if they switch from SDCWA to Eastern [as they may have to pay more in a drought than they expect]" – Report, p.16.
- "RMWD could be especially vulnerable in a shortage of MWD water" – Report, p.97.

⁵ <https://www.sdlafo.org/home/showpublisheddocument/6068/637777538812570000>

- “There will be a recurring annual loss of net revenue for SDCWA once the detachment occurs” -- Report, p.71.
- The SDCWA revenue loss caused by detachment would be \$12.2-12.6 million a year in the short term, and between \$10.6 and \$11 million a year after a decade – Report, p.68.⁶
- A detachment “exit fee” is appropriate – Report, p.73.
- The “question confronting LAFCO” is whether FPUD and RMWD should “be allowed to walk away scot-free” – Report, p.73.

LAFCO expert Dr. Hanemann also took to task the purported expert report by London Moeder Advisors (“LMA”) which Fallbrook and Rainbow submitted.⁷ In the following chart are just some of the contentions by LMA which Dr. Hanemann showed were incorrect:

Assertion by London Moeder Advisors	Dr. Hanemann’s Rejection of Assertion
<p>“Using this [meter] method the fair share payment by FPUD and RMWD would have been approximately \$34.5 million in total between 2010 and 2019. This translates to an overpayment of approximately \$21.5 million based on meter equivalents.” LMA Report, p.7.</p>	<p>“LMA note that had FPUD and RMWD’s share of all SDCWA member agency fixed charges been the same as their share of meter equivalents (2.8%), FPUD and RMWD would have paid a total of \$34.5 million in fixed charges to SDCWA over the period 2010 – 2019, instead of \$56 million. LMA imply that FPUD and RMWD paid more than their fair share of SDCWA fixed charges. <i>I disagree. . . . FPUD and RMWD customers use more water per meter equivalent than do customers of the other SDCWA member agencies.”</i> Hanemann Report, p.106. (Emphasis added and in original.)</p>
<p>“We have determined that the appropriate share of funds is not being used to the benefit of FPUD and RMWD. [with assumptions of MWD/SDCWA usage]” LMA Report, p.9.</p>	<p>“The LMA report equates the degree to which FPUD and RMWD benefit from their membership in SDCWA to the share of their water supply not “received from” MWD. . . .</p>

⁶ This figure is meaningfully low, as Dr. Hanemann used 2022 *estimates* from Fallbrook and Rainbow that their combined orders from the Water Authority would total about 18,000 acre-feet, when in fact they are about 25,000 acre-feet. Using the actual numbers increases the lost revenue significantly. Attachment 1 shows the impact ranges of an uncompensated detachment to each member agency calculated by the Finance Department using Hanemann’s proposed detachment exit fee numbers, as submitted by the Finance Department to LAFCO in June of 2022. The actual losses would be higher, as detailed in the Response at pp.48 *et seq.*

⁷ Indeed, Appendix A to the Hanemann report is a refutation of the entire LMA analysis.

	<i>This argument is not correct.</i> ” Hanemann Report, p.107 (emphasis added).
“In total, over the past ten years FPUD and RMWD have subsidized the remaining member agencies by \$49.5 million.” LMA Report, p.3.	“[T]he estimate in the Report that FPUD and RMWD have subsidized the remaining member agencies by \$49.5 million over the period 2010 – 2019 <i>lacks foundation and is incorrect.</i> ” Hanemann Report, p.108 (emphasis added).
\$5.6 million per year “represents the hypothetical amount that SDCWA will have to re-allocate to the remaining member agencies in order to avoid an increase in variable water rates.” LMA Report, p.15.	“LMA’s estimate of \$5.6 million for the annual financial impact of de-annexation on the remaining SDCWA member agencies <i>is a significant understatement.</i> ” Hanemann Report, pp.108-109 (emphases added.)

In addition to all the above points, Dr. Hanemann also expressed his own longstanding concern with MWD and Water Authority governance structures as related to fixed cost recovery – a position he has taken for decades as to MWD. The detachment advocates are using his comments on this issue to argue that LAFCO’s planned future Municipal Service Review (MSR) of MWD and the Water Authority could empower LAFCO to impose some form of “roll-off” penalty by using a detachment “exit fee” formula. Water Authority General Counsel Mark Hattam has written a white paper on this issue, showing that LAFCO has no such authority under an MSR, and that only the respective boards of directors of MWD and the Water Authority have the power to determine and set water rates and charges. That white paper is attached to this memorandum as Attachment 2.

In summary, Dr. Hanemann concluded that Fallbrook and Rainbow’s detachment would cost the Water Authority’s remaining member agencies \$10-\$12 million a year, and that they would be trading a more reliable water supply for a less reliable one, with no certainty what it would cost in the future.

c. Still Unaddressed Issues

It is important to note that Dr. Hanemann’s scope of work did not address many other issues of major concern to the Water Authority. These issues include:

- Detachment would reduce the Water Authority’s voting rights at MWD, and give them to Eastern, an agency which has regularly fought against San Diego County water ratepayer interests and is currently advocating for the imposition of fixed charges in lieu of volumetric water rates, a position opposed by the Water Authority, and many other MWD member agencies. This is a critical issue because important votes at MWD, including decisions relating to billions of dollars in water supply investments it is now contemplating, are currently at very close margins.

- Detachment would create increased pressure on the fragile Bay-Delta watershed, because it would create increased reliance on MWD.⁸
- There has been no environmental review under CEQA of the reorganizations, which is important because matters such as the Bay-Delta effects have not been properly considered.
- There is risk of precedent being set for detachment.
- SANDAG would continue to include in its regional growth forecast the projections for land use, population, and growth in Fallbrook and Rainbow's service areas, but the Water Authority would no longer include Fallbrook and Rainbow's water demands in its UWMP. As a result, water supply planning and decisions to serve future developments in San Diego County would be ceded to decision-makers in Riverside County.
- There has been no review of the impact of earthquakes on reliability should detachment occur, particularly on the Elsinore Fault.
- Rainbow has alluded to over \$15 million in new infrastructure costs to serve its service area with a detachment, but has provided no details.
- It has not been specified what representation (if any) Rainbow and Fallbrook customers will have at Eastern. It does not appear they would have their own representatives on the Eastern Board, as they do at the Water Authority.
- Because the detachments will affect all ratepayers in the Water Authority service area, they should all be allowed to vote on the matter.

These and other issues are addressed in more detail both in the Water Authority September 2020 Response, and in the letter from General Manager Kerl to LAFCO dated February 25, 2022, a copy of which is appended to this Board memo as Attachment 3.

d. Recent Events

LAFCO has informed the parties it would like to have a hearing on the reorganization applications by the end of this year. Also, the LAFCO Ad Hoc Committee met on August 11, and it was determined that it would not meet again until LAFCO circulated its draft staff report to the various subcommittees for review.

⁸ The Bay-Delta Watermaster, Michael Patrick George, informed that the proposed detachments would increase reliance on the Bay-Delta, a point the Water Authority has made at LAFCO many times and to which there has been no substantive response by detachment advocates. He said in an e-mail to Fallbrook on May 19, 2022: "switching from reliance on SDCWA's portfolio to exclusive reliance on MWD's portfolio will increase FUD's relative mix of Delta-origin water." He also stated, "FUD will shift its external supplies from a leaner to a richer mix of water from the Delta."

Board of Directors

August 17, 2022

Page 7 of 7

Given that LAFCO will soon be going to a hearing on the proposed reorganizations, Water Authority members should now start preparing to make submittals to LAFCO this Fall, indicating where they stand on the issues raised by the proposed detachments and the impacts detachment will have on their ratepayers. Staff believes it is critical for LAFCO to hear from Water Authority member agencies in order to make a fully informed decision.

In addition to these developments at LAFCO, MWD informed its Board of Directors last week to plan for possible mandatory water supply cutbacks before the beginning of next year. MWD staff is currently in the process of polling its member agencies to identify Human Health and Safety needs such as are now being implemented in its State Water Project dependent area. In addition to mandatory cutbacks on residential users, 100% of agricultural water supplies would be at risk as they are not included as part of HHS water supplies. Yet, this is the supplier Fallbrook and Rainbow propose relying upon for all their imported water.

Based on the Board's prior direction in Resolution 2020-06, it is expected the Water Authority will oppose detachment because the Board's conditions have not been satisfied.

Prepared by: Mark J. Hattam, General Counsel

Approved by: Sandra L. Kerl, General Manager

Attachment 1: Estimated (Hanemann) annual financial impact of detachment, with member agency breakdown by Finance

Attachment 2: General Counsel White Paper

Attachment 3: February 25, 2022, Letter to LAFCO

The following table defines the forecasted rate impact of detachment, using escalated figures of those defined in Dr. Hanemann's Final Report. The results reflect a high-level approximation. Should detachment be approved, and once final financials are known, the Water Authority foresees the need to complete a comprehensive cost-of-service and rate structure study, validated by an independent cost of service consultant, to incorporate the millions in added rate burden.

Detachment Impact	'22 Estimated Revenue Share	Detachment Impact		Detachment Impact (5-year)		Detachment Impact (10-year)	
		Low	High	Low	High	Low	High
		\$13,900,000	\$18,500,000	\$69,500,000	\$92,500,000	\$139,000,000	\$185,000,000
Carlsbad M.W.D.	4.02%	\$559,125	\$744,159	\$2,795,624	\$3,720,795	\$5,591,249	\$7,441,590
Del Mar, City of	0.27%	\$37,758	\$50,254	\$188,792	\$251,270	\$377,584	\$502,540
Escondido, City of	3.28%	\$456,123	\$607,070	\$2,280,615	\$3,035,351	\$4,561,230	\$6,070,702
Fallbrook P.U.D.							
Helix W.D.	6.60%	\$917,784	\$1,221,511	\$4,588,918	\$6,107,553	\$9,177,836	\$12,215,106
Lakeside W.D.	0.99%	\$138,085	\$183,782	\$690,425	\$918,911	\$1,380,850	\$1,837,822
Oceanside, City of	5.94%	\$825,251	\$1,098,356	\$4,126,256	\$5,491,780	\$8,252,513	\$10,983,560
Olivenhain M.W.D.	4.91%	\$682,514	\$908,382	\$3,412,568	\$4,541,908	\$6,825,137	\$9,083,815
Otay W.D.	9.27%	\$1,288,829	\$1,715,348	\$6,444,144	\$8,576,739	\$12,888,288	\$17,153,477
Padre Dam M.W.D.	3.17%	\$441,105	\$587,082	\$2,205,524	\$2,935,410	\$4,411,048	\$5,870,820
Pendleton Military	0.01%	\$1,782	\$2,371	\$8,908	\$11,856	\$17,815	\$23,711
Poway, City of	2.57%	\$357,201	\$475,412	\$1,786,006	\$2,377,059	\$3,572,012	\$4,754,117
Rainbow M.W.D.							
Ramona M.W.D.	1.27%	\$176,686	\$235,158	\$883,430	\$1,175,788	\$1,766,860	\$2,351,577
Rincon Del Diablo	1.60%	\$222,570	\$296,227	\$1,112,852	\$1,481,134	\$2,225,704	\$2,962,267
San Diego, City of	39.79%	\$5,531,072	\$7,361,498	\$27,655,359	\$36,807,492	\$55,310,718	\$73,614,985
San Dieguito W.D.	1.07%	\$148,126	\$197,147	\$740,632	\$985,733	\$1,481,264	\$1,971,467
Santa Fe I.D.	1.78%	\$247,737	\$329,721	\$1,238,683	\$1,648,607	\$2,477,366	\$3,297,214
Sweetwater Authority	1.17%	\$162,854	\$216,749	\$814,272	\$1,083,743	\$1,628,544	\$2,167,487
Vallecitos	3.51%	\$487,635	\$649,010	\$2,438,173	\$3,245,051	\$4,876,347	\$6,490,101
Valley Center	4.84%	\$672,362	\$894,871	\$3,361,811	\$4,474,353	\$6,723,622	\$8,948,706
Vista I.D.	2.57%	\$356,694	\$474,736	\$1,783,468	\$2,373,680	\$3,566,936	\$4,747,361
Yuima M.W.D.	1.32%	\$184,095	\$245,019	\$920,477	\$1,225,095	\$1,840,953	\$2,450,189
Contract Water	0.03%	\$4,612	\$6,139	\$23,062	\$30,693	\$46,123	\$61,387

**LAFCO CANNOT USE AN MSR REVIEW TO USURP THE STATUTORY
GOVERNANCE RIGHTS OF THE WATER AUTHORITY AND
MWD BOARDS OF DIRECTORS**

By San Diego County Water Authority General Counsel Mark Hattam
(August 2022)

1. Introduction

In the pending reorganization process at San Diego LAFCO (“LAFCO”) regarding potential detachments of the Fallbrook Public Utility District (“Fallbrook”) and Rainbow Municipal Water District (“Rainbow”) from the San Diego County Water Authority (“Water Authority”), there have been intimations that the “exit fee” analysis being done at LAFCO for purposes of detachment proceedings may somehow empower LAFCO to create a “rolloff” charge or other rate impacts should LAFCO perform a Municipal Service Review (“MSR”) of the Water Authority and Metropolitan Water District of Southern California (“MWD”) in future years.

LAFCO has no authority – whether via an MSR or otherwise – to determine how these water agency Boards of Directors lawfully assess and collect revenues from their member agencies, and thus in turn from ratepayers. Certain comments in a report by Dr. Michael Hanemann as to the governance of MWD and the Water Authority (the "wholesalers") are being misused, and are not a legal authorization for LAFCO to make cost recovery choices for the agencies.

Here are the points explained in more detail below:

- Detachment exit fees are completely distinct matters from “roll-off” issues, even though both may result in reduced revenues.

- Dr. Hanemann’s remarks go to the wholesalers having fixed costs, but more limited fixed income. The wholesalers’ respective Boards have generally favored volumetric rates and charges as their main cost recovery method, as opposed to fixed member agency charges or contracts. This concern is fundamentally a governance issue, as admitted by Dr. Hanemann.
- For both MWD and the Water Authority, the Legislature has vested all governance decisions, including cost recovery choices, in their respective Boards of Directors.
- LAFCO, under its MSR review authority or otherwise, has no ability to dictate to the Water Authority or MWD Boards how they lawfully allocate their cost recoveries from their member agencies.¹
- To the extent LAFCO, or detachment advocates, wish to alter the authority granted to the Water Authority and MWD Boards by the Legislature to allocate cost recovery from their members, they must seek statutory changes. LAFCO and detachment advocates have no ability to take such legislatively-granted powers away under the guise of an MSR.

This paper provides a public, general analysis of these issues, so that the Water Authority and MWD Boards of Directors and all interested persons are aware of these LAFCO developments and can have a general understanding why a LAFCO MSR cannot affect the governance structures created by the Legislature as to the decision-making powers of the Water Authority and MWD Boards.

2. What Is a Detachment Exit Fee?

The Water Authority has previously presented a detailed analysis of a detachment “exit fee” -- a payment to cover financial impacts caused by a member agency leaving (“detaching”)

¹ In the rest of this paper all references to the rights of the Water Authority and MWD Boards to determine methods of cost recovery assume otherwise lawful methods. In other words, though the agency Boards have the general power to use rates and charges and other methods to recover agency costs, they must follow all applicable laws in doing so. Of course, the remedy for a complainant should they not act lawfully is determined by the judiciary, not by a LAFCO. This paper takes no position on what cost recovery methods or mixes the Water Authority or MWD Boards should or should not utilize, rather simply showing that it is a choice in their discretion per statute.

from the wholesale agency -- in its September 2020 formal response submittal to LAFCO (the “Response”).² Some of the key points are these:

- The Legislature embedded in the County Water Authority Act (“Act”) the requirement that a service area which leaves a county water authority must cover their share of the “bonded and other indebtedness” which is “outstanding or contracted for” at the time of detachment. Act, Section 45-11(a)(2).³
- The Legislature included comparable language in regards to a LAFCO’s ability to impose lost funding for the abandoned agency in detachments. Government Code Section 57354.
- The Legislature also gave LAFCOs powers to impose numerous financial conditions on reorganizations, such as are stated in Government Code Section 56886.

Therefore, the detachment fee issue is clearly covered by statutory pronouncements from the Legislature, and is a process that LAFCO must address in a reorganization proceeding such as that instituted by Fallbrook and Rainbow. That is not the case with a “roll-off.”

3. What is a Roll-off?

The term “roll-off,” in the context used here, is simply a general way of saying that water orders from a member retail agency to its wholesaler (MWD or the Water Authority) are reduced, often because of lower water purchase needs caused by member agency independent

² Readers who are interested in a more detailed discussion than set out here can read the Response on the LAFCO web site at [637362842268270000 \(sdlafco.org\)](https://www.sdlafco.org) . See pages 152 *et seq.*

³ See also Metropolitan Water District Act at Section 452 for similar text regarding MWD detachments.

supply development. The corollary, or a “roll-on,” would be when the member agency needs more water from the wholesaler, often because of dry weather or a local water supply problem which thus increases its water orders.

The subject of rate design is complex. Ultimately, the question how best to balance the recovery of a water supplier’s costs depends on the specific facts and circumstances of individual agencies and the exercise of judgment by a board of directors or other governing body. Having said this, the central points as to “roll-off” are these:

- There is nothing unique about retail water agencies “rolling off” (i.e., buying less water), or “rolling on” (buying more water). Like any customer, they make decisions as to how much of a commodity they need at any given time.
- Unless a provider’s pricing structure is regulated by a statutorily created entity such as the California PUC, the water supplier makes its own choices about how its cost recovery is done subject only to the requirements of law. As shown in a later section, such decisions at MWD and the Water Authority have been vested in their Boards of Directors by the Legislature. These agencies may raise or lower volumetric charges, raise or lower fixed charges, or create other lawful methods of cost recovery consistent with cost-of-service and other legal requirements as they decide. They manage how the continuing, and fluctuating, “roll-off” and “roll-on” needs of their customers are met, and how any associated costs should be recovered.

Of course, not everyone agrees with how boards of directors choose to recover costs for their agencies. Dr. Michael Hanemann, an expert engaged by LAFCO, volunteered his opinions to LAFCO. His views are covered next, because detachment advocates are arguing

that his opinions give LAFCO some kind of authority to impose cost recovery mandates on the Boards of Directors of the Water Authority and MWD.

4. What Concerns Were Raised by Dr. Hanemann?

Dr. Hanemann was engaged by LAFCO to study various water reliability and pricing issues related to the reorganization applications by Fallbrook and Rainbow. In addition to providing his report on such assigned tasks, however, Dr. Hanemann also *volunteered* some personal comments regarding MWD and Water Authority governance issues, summarized as follows by Dr. Hanemann:

Just as SDCWA's fiscal model is essentially the same as that of many other water agencies including MWD so, too, its *governance model* is not particularly different from that of other water agencies, including MWD. Under this common model, member agencies are represented on the Board of Directors, and the Board decides infrastructure investments through some form of majority voting. But investment decisions are made without any upfront commitment by member agencies to take and pay for the water that will be generated. This strategy commits current resources without guaranteeing the future revenues to pay for new investments. Almost thirty years ago, this was flagged as a problem for MWD by a 1993 Blue Ribbon Task Force. . . . ***This is ultimately a problem of governance.***" (Hanemann Report, p.103; emphases added).

Dr. Hanemann advocates that MWD and the Water Authority should use a method to guarantee revenues, such as by requiring member agencies to sign binding water purchase agreements in order to create a fixed revenue stream. While Dr. Hanemann is entitled to his own personal academic opinions about water agency governance, such opinions do not transmute into any form of legal authority for LAFCO to second-guess the MWD and Water Authority Boards of Directors – many of whom are elected officials – or to impose cost

recovery or rate design methods under the pretext of performing an MSR, or otherwise.⁴

Whether fixed charges, or supply contracts with member agencies, or any other mechanisms are to be used is a matter for the MWD and Water Authority Boards to decide, under their operative statutory enactments and state law, as addressed below -- not by LAFCO.

5. Does LAFCO Have Authority to Address the Governance Concerns Raised by Dr. Hanemann Via an MSR⁵?

LAFCO has no authority to dictate to the MWD and Water Authority boards its own views of water agency governance via an MSR, or otherwise. It can of course make recommendations, but it cannot impose its views contrary to statute. In this section we walk through the nature of an MSR, and compare its nature to the express authority granted by the Legislature to the Water Authority and MWD Boards of Directors.

a. The Legislature Did Not Give a LAFCO the Right To Make Agency Cost Recovery Decisions Via an MSR

Because the governance and financing structures of the Water Authority and MWD are provided by statute, these structures can only be changed through modifications of the governing statutes. No MSR performed by LAFCO can grant the LAFCO a right to modify these statutes.

⁴ Notably, Dr. Hanemann made clear up front in his report that that *his views have no legal basis*: “I was engaged to address these topics as an economist. I was not engaged to conduct legal analysis or offer legal advice on the issues I addressed, and I do not offer any legal opinions.” (Hanemann Report, p.3) Unfortunately, detachment advocates who support LAFCO taking *ultra vires* action via an MSR, or otherwise, do not share his commendable candor.

⁵ This paper does not address in detail LAFCO’s general authority to do an MSR of either the Water Authority or MWD, and no issues are waived. Rather, for purposes of this analysis the paper assumes the ability of LAFCO to do an MSR.

Government Code section 56425(g) allows a LAFCO to review and update the spheres of influence for the agencies within their purview every five years. The purpose of a LAFCO's development and modification of spheres of influence is "to carry out [LAFCO's] purposes and responsibilities for planning and shaping the logical and orderly development and coordination of local governmental agencies subject to the jurisdiction of the commission to advantageously provide for the present and future needs of the county and its communities...." (Gov't Code § 56425(a).) A LAFCO is required to update spheres of influence by conducting a "service review of the municipal services provided in the county or other appropriate area designated by the commission." (Gov't Code §56430(a).)

A LAFCO's statutory mandate to update spheres of influence through performance of periodic MSRs is specifically limited to carrying out its statutory purpose within its jurisdiction. While the service areas of the Water Authority and portions of MWD are located within San Diego LAFCO's physical jurisdiction, their governance and organization are not set by LAFCO but by statute. Each of these agencies makes independent legislative decisions about water supply and pricing, as discussed below.

The LAFCO statute regarding sphere of influence review, under which MSRs are performed, does not authorize a LAFCO to make rate-setting or cost recovery determinations for local agencies. See Government Code sections 56425 *et seq.* When a LAFCO acts beyond its statutory authority, it commits a prejudicial abuse of discretion that will be overturned by the courts. *See, for example, Tillie Lewis Foods, Inc. v. Pittsburg* 52 Cal.App.3d 983 (1975).

As stated in *City of Ceres v. City of Modesto* (1969) 274 Cal.App.2d 545, 550: "A local agency formation commission, commonly referred to as LAFCO, is a creature of the Legislature and has only those express (or necessarily implied) powers which are specifically

granted to it by statute.” LAFCO decisions are subject to judicial review when there are "attempts by the LAFCOs to go considerably beyond their express statutory grant of authority." (Note (1972) 23 Hastings L.J. 913, 924 [fn. 119].)

San Diego LAFCO has previously recognized the limits of an MSR for the Authority and MWD. The last MSRs performed by San Diego LAFCO for the Authority and MWD were completed in September 2013. These MSRs were largely conclusory and noted that the spheres of influence of both agencies were coterminous with their member agencies' boundaries. These MSRs simply recognized this fact and affirmed the existing spheres without any further analysis. These spheres have not changed in any material way since the time of that report. To the extent the Water Authority's sphere may change via detachment of Fallbrook and/or Rainbow, that is being handled in the current reorganization. LAFCOs can require certain conditions for detachment or annexation, including conditions necessary to address financial impacts from a detachment or annexation; but LAFCOs do not have separate authority to dictate governance or financial changes absent an action for reorganization.

b. The Legislature Gave the Water Authority and MWD Boards the Right To Make Cost Recovery Decisions

Though the Legislature did not give LAFCOs the right to determine agency rate policy via an MSR, in contrast it *did* give such authority to the Water Authority and MWD Boards of Directors, subject only to other requirements of law. In this section we address some of those statutorily-granted rights.

1. *The Water Authority:*

The County Water Authority Act sets out express grants of authority by the Legislature to the Water Authority Board of Directors to determine governance issues such as recovery of agency costs. The following are just some of the grants of such authority:

- Act Section 45-6(a): “All powers, privileges, and duties vested in or imposed upon any authority incorporated under this act shall be exercised and performed by and through a board of directors. The exercise of any and all executive, administrative, and ministerial powers may be delegated by the board of directors to any of the offices created by this act or by the board of directors acting under this act.”
- Act Section 45-6(i): “The board of directors, so far as practicable, shall fix such rate or rates for water as will result in revenue which will pay the operating expenses of the authority, provide for repairs and maintenance, and provide for the payment of the interest and principal of the bonded debt. [If insufficient, taxes may be assessed by the Board].”
- Act Section 45-3: [County water] authorities shall exercise the powers herein expressly granted, together with such implied powers as are necessary to carry out the objects and purposes of such authorities.”
- Act Section 45-5: Acting through its Board, the Water Authority has rights to, *inter alia*: (a) enter into contracts; (b) borrow money, incur indebtedness and issue bonds; (c) levy and collect taxes on all property within the service area; and (d) acquire, store, transport and sell and deliver water.

2. *MWD:*

The Legislature has given similar grants of authority to the MWD Board of Directors in the Metropolitan Water District Act (“MWD Act”):

- MWD Act Section 50: “All powers, privileges and duties vested in or imposed upon any district shall be exercised and performed by and through a board of directors.”
- MWD Act Section 61: “The board may make and pass ordinances, resolutions and orders necessary for the government and management of the affairs of the district, for the execution of the powers vested in the district and for carrying

into effect the provisions of this act.”

- MWD Act Section 133: “The board shall fix the rate or rates at which water shall be sold. Such rates, in the discretion of the board, may differ with reference to different sources from which water shall be obtained by the district.”
- MWD Act Section 120: “The district may exercise the powers expressly granted by the Act, together with such powers as are reasonably implied from the Act and necessary and proper to carry out the objects and purposes of the district.”
- MWD Act Sections 122-124, and 130: Acting through its Board, MWD has the right to, *inter alia*: (a) enter into contracts; (b) borrow money, incur indebtedness and issue bonds; (c) levy and collect taxes on all property within the service area; and (d) acquire, store, transport and sell and deliver water.

6. Conclusion

Should LAFCO, after an MSR or otherwise, try to impose a cost recovery method on either the Water Authority or MWD such as fixed supply agreements with member agencies, it would be directly usurping the rights of the Water Authority and MWD Boards to make decisions about their own cost recoveries and rates. This would flatly violate the statutes crafted by the Legislature, and go far beyond any authority given to LAFCO. Contrary to the statements by detachment advocates, the LAFCO “exit fee” decisions in the reorganization process, which have their own separate statutory plan, have zero impact on any “roll-off” issues at the Water Authority or MWD, which are within the exclusive province of their respective Boards subject to law.

February 25, 2022

MEMBER AGENCIES

Carlsbad
Municipal Water District
City of Del Mar
City of Escondido
City of National City
City of Oceanside
City of Poway
City of San Diego
Fallbrook
Public Utility District
Helix Water District
Lakeside Water District
Olivenhain
Municipal Water District
Otay Water District
Padre Dam
Municipal Water District
Camp Pendleton
Marine Corps Base
Rainbow
Municipal Water District
Ramona
Municipal Water District
Rincon del Diablo
Municipal Water District
San Dieguito Water District
Santa Fe Irrigation District
South Bay Irrigation District
Vallecitos Water District
Valley Center
Municipal Water District
Vista Irrigation District
Yuima
Municipal Water District

OTHER
REPRESENTATIVE

County of San Diego

VIA EMAIL

Mr. Adam Wilson, Moderator
San Diego County LAFCO
(adwilson858@yahoo.com)

Re: Additional Significant Items To Be Considered By Ad Hoc Committee

Dear Mr. Wilson:

This letter is in response to your request regarding additional issues the parties would like to bring before the Ad Hoc Committee for further discussion. In this letter we spell out the items we believe require further review by the Committee. We ask that this letter be provided to the Commissioners and LAFCO staff.

Before getting into the substance of the issues, here are important introductory comments:

- In your letter to the parties you used the phrase “peripheral issues.” We are concerned that LAFCO staff incorrectly believes that issues beyond those assigned to Dr. Hanemann are “peripheral.” *Nothing could be further from the truth.* Dr. Hanemann was assigned certain important water issues to review that were outside the scope of LAFCO expertise, and thus understandably required third party expert review. However, that does not make the other issues involved in these LAFCO proceedings in any respect peripheral, or secondary. Indeed there are many other issues raised by this first-in-kind proceeding that are of critical importance to the deliberation by LAFCO of the Fallbrook and Rainbow applications.
- In this letter we do not raise all matters LAFCO must deal with, but only those we believe the Committee should further review. At your request, we do not include legal issues such as CEQA review, violation of the State’s Bay-Delta legislation, LAFCO’s ability to deny the applications or impose conditions, the scope of the County Water Authority Act, the still-missing procedural requirements for a completed LAFCO application, and similar matters.
- As we go through the issues below, we do not here try to prove every detail with citations to all applicable facts and law. Rather, we simply spell out for LAFCO and the Committee what the issues are, and what they mean, so they can be scheduled for consideration as requested.

With those caveats, we here summarize what we see as the six issues that the Committee should review and discuss:

1. Loss Of San Diego County Voting Rights At MWD

Perhaps the most critical aspect of the proposed reorganization applications is that they would result in moving San Diego County's voting rights at the Metropolitan Water District of Southern California (MWD) to Riverside County and Eastern Municipal Water District (Eastern). This occurs because weighted voting rights at MWD are set by statute, and are based upon the assessed value of lands in member agency service areas.

Right now, Rainbow and Fallbrook are in the Water Authority's service area. This means that the assessed value of their lands are counted for the Water Authority, and thus for San Diego County, in weighted voting at MWD. Should they move into Eastern, the assessed value of land in the Rainbow and Fallbrook regions would no longer go to San Diego County's voting interests via the Water Authority, but instead would shift to Riverside County and Eastern. *By allowing detachment, LAFCO would be ceding San Diego County voting rights at MWD to a Riverside County agency.*

Why does this matter? Because water rates in San Diego County are greatly affected by MWD rates. MWD not only sells water to our area, it also provides the transportation for our QSA water from the Imperial Valley. The Water Authority and MWD have been engaged in litigation for a decade over MWD rates because they critically matter for San Diego County ratepayers. Indeed, the Water Authority has recovered more than \$80 million to date from MWD, which it has returned to its member agencies (including Fallbrook and Rainbow, who in the past two years received about \$3.8 million from such recovery).¹

For these and other reasons, every vote at MWD matters to the pocketbooks of our County's ratepayers. Fallbrook and Rainbow claim that these voting rights are small because they are small agencies. But any loss to San Diego County is important because: (1) San Diego County loses the vote; (2) the vote is given to Eastern, which has a long and consistent history of fighting against the interests of San Diego County water ratepayers and taxpayers, thus doubling the impact of the lost vote; and (3) the assessed values of lands in Rainbow and Fallbrook are increasing rapidly, making their voting rights even more valuable as they rise due to development.

Under the current voting rights allocation, assessed values of lands in Fallbrook and Rainbow represent approximately 1.69% of the Water Authority's vote at MWD (a loss of 0.284% voting rights at MWD, or reducing from 17.26% to 16.98%). Should the agencies move to Eastern, they would immediately increase Eastern's weighted vote at MWD by about 10.11% (increasing from 2.81% to 3.09%).

However, the Rainbow and Fallbrook service areas are not static. As their service area lands continue to urbanize, that assessed land valuation increases meaningfully. Just by

¹ A fact ignored by Fallbrook and Rainbow when they complain about water rates, as they do not factor in such significant rebates, which effectively reduce the Water Authority rates.

way of example, the Meadowood annexation into Rainbow is about 375 acres.² The complete Tri-Pointe (formerly Pardee) development is for 844 single-family homes with values (a year ago, and thus even higher now) estimated up to \$700,000 each.³ All such increased development will cause assessed land values – and thus voting rights at MWD -- to increase over time.

Today, small percentages in votes at MWD matter more than ever. MWD's current General Manager was selected with 50.42% support, a bare .42% over the required threshold—with Eastern and the Water Authority on different sides of the vote. This vote symbolizes the divide on the MWD board on policy issues and the vision of MWD's role in the future. There have been other close votes, one with an even smaller margin of 0.284%, in recent years that also reflect the MWD board's policy divide. It is not lost on Eastern that even a small change in the vote entitlement could alter the outcome of important policy and fiscal votes that the MWD board will consider, including but not limited to participating in the Bay-Delta tunnel project, pursuing the Regional Recycled Water Program, and potential modifications to MWD's rate structure. The implementation of these projects, how they are funded, and any modifications to MWD's rates would have material impacts on the Water Authority and San Diego County ratepayers and taxpayers.

There is no way for LAFCO to change this voting rights issue. It is set by the Legislature. The LAFCO Commissioners, and the Committee, must ask whether from a regional planning perspective it is in the best interests of San Diego County to lose influence at MWD on the water rates and property taxes our County's residents pay.

2. Loss Of Regional Land Use And Water Planning By SANDAG And The Water Authority, And Water Supply Assessment (WSA) Decisions Being Made In Riverside County

In 1988, voters in San Diego County approved a measure to strategically address core issues related to regional planning and growth management. Proposition C, the “Regional Planning and Growth Management Review Measure”, was passed and sought to develop a strategic plan to resolve regional problems associated with development and planning of transportation, water supply, wastewater treatment, water quality, housing and economic prosperity, among many other issues for the San Diego region.

To formalize the water supply planning element of SANDAG's Regional Growth Management Strategy, and to indicate its intent to participate in the implementation of the Strategy's Water Supply chapter, in 1992 the Water Authority entered into a Memorandum of Agreement (MOA) with SANDAG. (Water Authority September 2020 Response, Exhibit 13). The intent of the MOA was to “assure consistency between the plans, policies and ordinances of the cities and County, and the plans and programs of the Authority.”

² See Item 13 on LAFCO list at [Microsoft Word - 4-5-21_AgendaItem5g_CurrentProposals.docx \(sdlafco.org\)](#)

³ [Ground Broken for New Fallbrook Community, Citro, With Model Homes Set to Be Unveiled by Fall - Times of San Diego](#)

As part of the 1992 MOA, the Water Authority agreed to utilize SANDAG's most recent regional growth forecasts as part of development of its long-range water demand forecast for the region, which is provided in the Water Authority's Regional Urban Water Management Plan (UWMP). In turn, SANDAG utilizes the Water Authority's long-range water demand forecast in the water supply chapter of its Regional Growth Management Strategy.

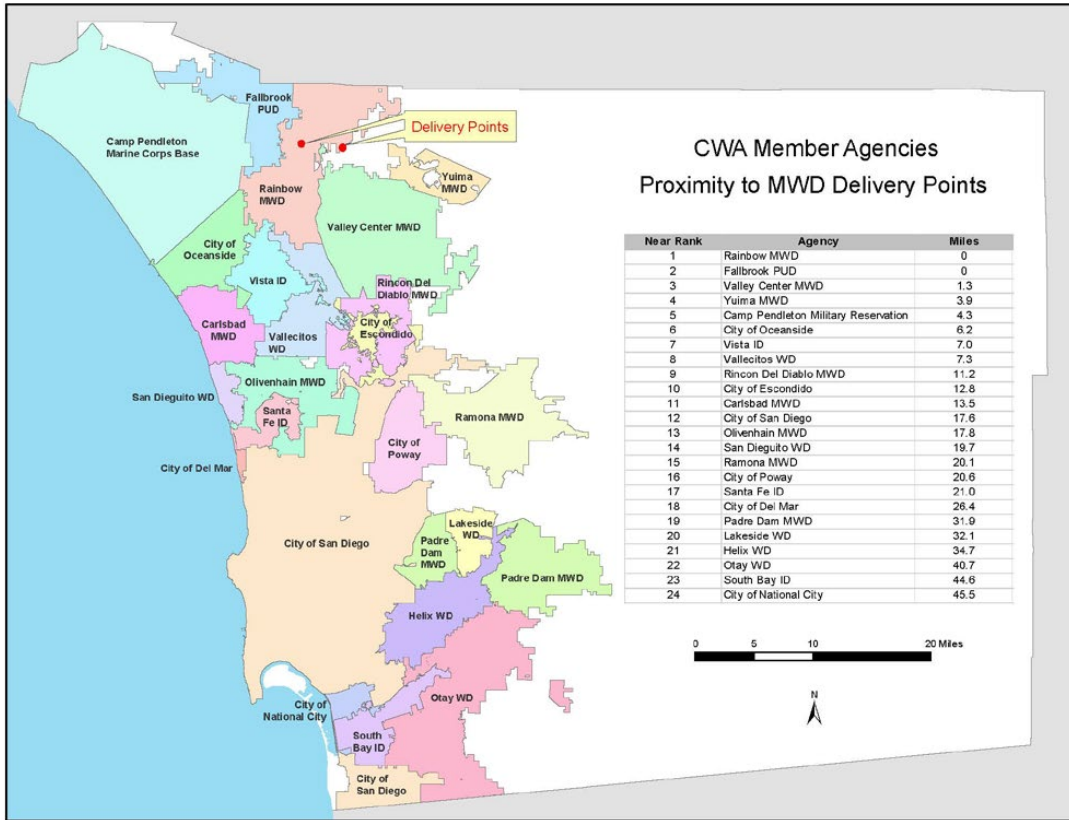
This collaborative approach, linking regional land use planning and regional water supply planning, has worked well for SANDAG and the Water Authority and was years ahead of SB 610 and SB 221. Those two bills, effective in January 2002, improved the link between water supply availability and certain land use planning decisions made by cities and counties. Both statutes require detailed information regarding water availability to be provided to city or county decision-makers prior to the approval of large development projects. This is performed using water supply assessments (WSA) requested by the developer/local government agency of the water agency to affirm via written verification of sufficient water supply. WSAs are then provided to local governments for including in the environmental documentation for any large development project. The foundational document of compliance with SB 610 and 221 is the UWMP. As mentioned above, the 1992 MOA has linked the Water Authority's UWMP to SANDAG by utilizing SANDAG's most recent regional growth forecast, the base of which is the cities and county's General Plans.

Should Rainbow and Fallbrook detach, it would undermine and unravel the longstanding close regional collaborative planning efforts between land use and water supply in San Diego County. SANDAG would continue to include in its regional growth forecast the projections for land use, population, and growth in Fallbrook and Rainbow's service areas, however the Water Authority would no longer include Fallbrook and Rainbow's water demands in its UWMP. As a result, water supply planning and any WSA decisions to serve future development would be ceded to decision-makers in Riverside County.

With such a split between counties on land use planning and decisions and water supply planning, it is unclear how the process on WSAs will be carried out. More discussion and understanding is needed with respect to this matter.

3. Risk That Other Agencies May Seek To Detach, With Associated Impacts

Rainbow and Fallbrook assert that they are the only Water Authority members which currently draw water directly from MWD's pipes that extend into San Diego County. However, as explained in our September, 2020, Response to LAFCO (the "Response") at pp. 62-65, there are various Water Authority members which are not located far from the MWD pipelines. Here is the graphic we used in our Response:



The above is not intended to intimate that any particular other agencies are now planning to seek detachment, but just to show that physically there are multiple agencies close to the MWD pipes. If LAFCO were to allow detachment, particularly detachment without appropriate financial conditions, it would send a dangerous message to such agencies (if not set a precedent), one that could harm all remaining Water Authority member agencies by increased borrowing costs. The action would also send a message across the entire MWD service area as its member agencies and sub-agencies may also seek to detach. Further detachments would also further erode our County’s MWD voting rights.

The rating agencies have called out this significant risk regarding the pending detachment applications. In January of this year Moody’s published Credit Opinion on the Water Authority stated under Factors That Could Lead To A Downgrade: “Detachment of member agencies that significantly reduces projected consumption levels.” Similarly, S&P Global’s rating report this year says (emphasis added):

In our view, the potential effects of the detachment include the possibilities of having to spread fixed costs over a slightly smaller base that could potentially increase the cost burden and pressure affordability for the overall member base. In addition, long-term political risk might exist, in our view, especially if an approved detachment sets a precedent if members can easily detach from the authority.

Again, there is no reason to believe that the precedential affect of action by LAFCO will be limited to the Water Authority or San Diego County.

4. Water Supply Risk Of Potential Earthquake, Particularly On The Elsinore Fault

As members of the Water Authority, Rainbow and Fallbrook will be able to receive water from both the north and the south. This is because the Water Authority has desalinated water and stored water which will be able to be sent north to the Fallbrook and Rainbow service areas, as well as being able to bring them QSA and MWD water from the north.

What Rainbow and Fallbrook propose, however, is to receive water only from the north, from MWD. This ignores the risk that there could be a break on the MWD pipeline, most notably on the Elsinore Fault, thus cutting Rainbow and Fallbrook off from all imported water, and from all wholesaler water storage. We cover this in detail in our Response at pp.85-90, and at p.21.

Rainbow and Fallbrook's position is that MWD has a plan that shows a pipeline break due to an earthquake on the Elsinore Fault would be repaired in two weeks. However, as noted in our Response at p.85, this plan has never been presented and is not credible:

The Fallbrook and Rainbow detachment applications both reference an unproduced MWD emergency planning document ("Emergency Response Plan") describing MWD's intent to complete repairs on facilities that cross the Elsinore Fault within 14 days of a seismic event and restore service to at least the 75% level. So far, the Water Authority has been unable to obtain or review this referenced document, as it was not included in the Fallbrook and Rainbow plan of service submittals. Even if MWD did publish such a claim, the Water Authority is very concerned that a 14-day repair time significantly understates the time and resources that would be required to repair the large-diameter pipelines damaged by an earthquake on the Elsinore Fault at a time when many other pipe breaks could also occur in the region competing for the same resources for repair.

Indeed, the Water Authority told LAFCO that it needed to investigate this issue and require Rainbow and Fallbrook to submit this supposed MWD "14-day plan," yet to our knowledge nothing has been done, and Rainbow and Fallbrook have ignored our request stated on pages 148 and 150 of the Response (question 10 for each agency).

5. Requisite Infrastructure Changes, Particularly In Rainbow's Service Area

Rainbow has stated that it will need to create new infrastructure to serve a portion of its service area if detachment occurs. In its "Supplemental Information Package for Reorganization Application," Rainbow stated that the detachment and annexation will require it to accelerate the construction of "improvement projects" for which the cost estimates total \$10-\$15 million. (See pp. 5-6.) Although these projects are generally described in that package as necessary to serve some higher elevation areas in the southern part of Rainbow's service area, no substantial details or environmental analysis was identified with respect to these projects.

Again, the Water Authority told LAFCO that this issue needed to be investigated, and Rainbow must be required to provide real information as to what would be necessary for this work – and what real current cost estimates would be. *See*, for example, our Response at pp. 183 and 147-148 (questions 2 and 4). Again, Rainbow has provided *nothing* to LAFCO on this topic that the Water Authority has seen, yet it is a critical area of inquiry.

6. Potential Voting On The Detachment Issue Throughout The Water Authority Service Area, And Not Just In Fallbrook And Rainbow

Any detachment by Rainbow and/or Fallbrook would have serious consequences for all of San Diego County. Voting power would be lost at MWD, reduced revenues at the Water Authority would increase water rates, and credit risks could create higher borrowing costs.

Given that this is an issue of County-wide concern, the Water Authority Board of Directors asked LAFCO to require a County-wide vote on the matter. In our Response, we explained at pp.169-170 how this is allowed under the LAFCO statutes.

We believe that the Committee should discuss this issue and – without addressing legal issues – state whether it believes a County-wide vote would be appropriate and prudent, if for any reason detachment were to be allowed by LAFCO.

In conclusion, we again point out that there are many matters not addressed in this letter which LAFCO must consider. The above items are the matters we think the Committee should discuss, and we ask that further meetings be set to address them. Thank you for your consideration of these items.

Sincerely,



Sandra L. Kerl
General Manager

cc via email:

Keene Simonds, Executive Officer, San Diego County LAFCO
Tom Kennedy, General Manager, Rainbow MWD
Jack Bebee, General Manager, Fallbrook PUD
Nick Kanetis, Deputy General Manager, Eastern MWD
Holly Whatley, Counsel, San Diego County LAFCO
Lloyd W. Pellman, Counsel, Rainbow MWD
Paula C. P. de Sousa, Counsel, Fallbrook PUD
Water Authority Board of Directors