

July 3, 2023

VIA EMAIL

LAFCO Commissioners
Keene Simonds, Executive Officer
San Diego County Local Agency Formation Commission
2550 Fifth Avenue, Suite 725
San Diego, CA 92103
(keene.simonds@sdcounty.ca.gov)

Re: Fallbrook/Rainbow Proposed Reorganizations

Dear Commissioners and Mr. Simonds:

You are again preparing to hear the applications for the Fallbrook/Rainbow reorganizations on July 10. This letter from the Water Authority is provided to update you on two important financial matters determined by our staff.

First, as to the exit fee issue, your staff has recommended using lost revenue figures from Dr. Michael Hanemann for a proposed exit fee. You are well aware that the Water Authority does not agree with all the numbers calculated or methods, nor with staff's attempt to use a lower net lost revenue amount rather than Dr. Hanemann's substantially higher exit fee, and to also then use only five years instead of the up-to 10 years he felt was reasonable. However, the numbers used by LAFCO staff are also now years old and based on demonstrably wrong projections and thus should not be currently relied upon. The issue of using out-of-date numbers was called out some time ago in your Advisory Committee meeting on August 11, 2022, by member Kim Thorner, who stated: "[It] would be a simple calculation that LAFCO staff could do to maybe true up those numbers to today's dollars whenever they do take it to the Commission." See [Advisory Committee on Rainbow-Fallbrook Meeting - August 11, 2022 - YouTube](#) at 41:25.

Staff has not yet issued such an update, though it is necessary. Our staff has done this analysis and provides it to the Commission with this letter (see attached). Our staff took all of Dr. Hanemann's numbers from his 2021 report (2022 adopted rates and estimated CY 2022 demands) and trued them up to today's status (2024 adopted rates and actual CY 2022 demands). The end result is clear and meaningful: Dr. Hanemann's 2021 annual number of \$12.58 million which staff is using in its recommendation is now actually \$18.90 million for a potential 2024 detachment. Without a proper true-up, LAFCO is proposing to shortchange the proposed detachment fee by over 50%. We believe this is critical information for your consideration.

MEMBER AGENCIES

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

Additionally, the Commission requested two additional analyses regarding the proposed exit fee: the effects of longer exit fee (7 to 10 years), and application of an ESP pump station credit. As to the first, using the trued-up net-revenue impact, Water Authority finance staff calculated the requested scenarios (which are also attached). A trued-up exit fee (without ESP offset) would be as follows: \$132 million at 7 years; \$151.2 million at 8 years; \$170.1 million at 9 years; and, \$189.0 million at a full 10 years. As to a potential credit for the future ESP North County Pump Station, while LAFCO staff proposes a full credit of \$38.6 million for the yet to be built facility, Water Authority Finance staff estimated the annual debt service payment to be \$2.5 million. Because the Water Authority does not have \$38.6 million in its PAYGO fund, construction of the project would necessitate future debt funding. This matches industry funding and cost of service standards for new facilities. Thus, the number of years for an exit fee would be reduced by ESP offset of \$2.5 million per year; i.e., a 10-year exit fee would be reduced by \$25 million, etc. In other words, the offset should match the exit fee years allowed.

Second, we spelled out to LAFCO in our 2020 detailed response that the Water Authority has various facilities and infrastructure that will require meaningful engineering costs to address if a detachment were to be granted. Our Engineering Department prepared a lengthy analysis for LAFCO that was presented on pages 103-123 of our Response in 2020. The cost estimate in August 2020 dollars was \$3,936,000 (Response, p.123). Based on CPI data provided by the Bureau of Labor Statistics, our finance staff estimates that would be approximately \$4,620,000 in today's dollars (May 2023). Without full compensation for these facilities, our legal team concurrently by separate letter informs LAFCO that it and Eastern will violate Cal Pub. Util. Code § 1503 and Cal. Pub. Util. Code § 1505.5. LAFCO must include compensation for such facilities or it and Eastern will be responsible for a taking without compensation. We have raised this engineering issue to your staff repeatedly over the years, all with no response.

Thank you in advance for your review of the above issues. If you have any questions, please let me know and I will be happy to arrange for our staff to discuss these issues with LAFCO.

Sincerely,



Dan Denham
Acting General Manager

Attachments

cc via email:

Holly Whatley, LAFCO General Counsel
Adam Wilson, Ad Hoc Committee Moderator
David Edwards, General Counsel, San Diego County Water Authority
Mark Hattam, Special Counsel, San Diego County Water Authority

LAFCO

July 3, 2023

Page 3 of 3

Claire Collins, Special Counsel, San Diego County Water Authority

Pierce Rossum, Rate and Debt Manager, 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

San Diego County Water Authority Board of Directors

Eastern Municipal Water District Board of Directors

Dr. Michael Hanemann

Attachment #1 – True-Up of Dr. Hanemann’s 2021 Calculations

The following tables make three critical updates to Dr. Hanemann's 2021 calculations, using his same methodology: First, earlier estimated demands for calendar year 2022 have been replaced with actual demands. Dr. Hanemann expressed the challenges with forecasting the future and he was correct, demonstrating the need to use real, actual data now available. Second, the then future 2022 rates have been updated to reflect the already enacted 2024 rates and charges. Last, the “Other Revenues” have also been updated to reflect FY '22 actual number, rather than Dr. Hanemann’s earlier estimates.

Table 16 of the 2021 Hanemann Report details the “revenue reduction” expected by the detachments of Fallbrook and Rainbow. For comparison purposes, two columns have been added to detail the change in dollars and as a percentage basis. Not only did the actuals acre-feet increase by 32% (matching Fallbrook and Rainbow’s 3yr and 5yr averages), but the mix of those sales were significantly weighted to M&I rather than the estimated “AG” (PSAWR) water which purportedly has been the focus of the detachment. The net result is an 47% increase to the revenue reduction.

Table 16 - With True-Up

SDCWA Revenue Reduction									
	Adopted CY 2024 Rate	AF	FPUD Revenue	AF	RMWD Revenue	AF	Combined Revenue	\$ Change	% Change
M&I Water Supply									
Water Supply	\$1,200	5,808	\$6,969,600	12,536	\$15,043,080	18,344	\$22,012,680	\$11,418,180	108%
Transportation	\$189	-	\$0	11,118	\$2,101,208	11,118	\$2,101,208	\$1,686,008	406%
Treatment	\$400	5,808	\$2,323,200	12,536	\$5,014,360	18,344	\$7,337,560	\$4,082,560	125%
AG Water Supply									
Water Supply	\$903	1,312	\$1,184,465	4,253	\$3,840,820	5,565	\$5,025,285	(\$1,047,115)	-17%
Transportation	\$189	-	\$0	-	\$0	-	\$0	(\$1,314,800)	-100%
Treatment	\$400	1,312	\$524,680	4,253	\$1,701,360	5,565	\$2,226,040	(\$129,960)	-6%
Subtotal - Volumetric			\$11,001,945		\$27,700,828		\$38,702,773	\$14,694,873	61%
Customer Service Charge			\$578,390		\$1,144,874		\$1,723,264	\$103,852	6%
Storage Charge			\$1,071,929		\$1,727,199		\$2,799,128	\$185,780	7%
Supply Reliability Charge			\$746,541		\$1,157,325		\$1,903,866	\$242,106	15%
Infrastructure Access Charge			\$622,021		\$792,953		\$1,414,974	\$53,874	4%
Subtotal - Fixed Charges			\$3,018,881		\$4,822,351		\$7,841,232	\$585,612	8%
Subtotal Charges Paid by Member Agency			\$14,020,826		\$32,523,179		\$46,544,005	\$15,280,485	49%
Other Revenues									
Property Taxes			\$178,502		\$215,118		\$393,620	\$43,620	12%
Availability Standby Charge			\$290,064		\$479,744		\$769,808	\$48,498	7%
Capacity Charges			\$116,905		\$1,102,714		\$1,219,619	\$285,181	31%
Total Without Property Tax			\$14,427,795		\$34,105,637		\$48,533,432	\$15,614,164	47%
Total With Property Tax			\$14,606,297		\$34,320,755		\$48,927,052	\$15,657,784	47%

Table 18 of the 2021 Hanemann Report details the “expenditure reduction” expected from the detachments of Fallbrook and Rainbow. For comparison purposes, two columns have been added to detail the change in dollars and as a percentage basis. Along with the higher demands, the expenditure reduction also increases between 44% and 44%.

Table 18 - With True-Up

SDCWA Expenditures Reduction CY 2022

	CY 2024	FPUD		RMWD		Combined		\$ Change	% Change
		AF	Expenditure	AF	Revenue	AF	Expenditure		
M-Water, Full Service Tier 1, Trd	\$1,256	7,120	\$8,942,343	16,789	\$21,087,361	23,909	\$30,029,704	\$9,341,404	45%
MWD RTS Charge - Short Run	\$0	7,120	\$0	16,789	\$0	23,909	\$0	\$0	n/a
MWD RTS Charge - Long Run	\$88	7,120	\$626,534	16,789	\$1,477,458	23,909	\$2,103,992	\$511,192	32%
Total Reduction - Short Run	\$1,256	7,120	\$8,942,343	16,789	\$21,087,361	23,909	\$30,029,704	\$9,341,404	45%
Total Reduction - Long Run	\$1,344	7,120	\$9,568,877	16,789	\$22,564,819	23,909	\$32,133,696	\$9,852,596	44%

Finally, Table 19 of the 2021 Hanemann Report details the “net revenue reduction” expected from the detachments of Fallbrook and Rainbow. For comparison purposes, two columns have been added to detail the change in dollars and as a percentage basis. Focusing on the change in net revenue (short run with property tax loss), which is used by LAFCO staff, a true-up results in a \$6,316,380 increase to the annual impact. Thus, there is a 50% increase using actual rather than projected water sales and updated Water Authority rates and charges.

Table 19 - With True Up

SDCWA Net Revenue Impact CY 2022

	FPUD	RMWD	Combined	\$ Change	% Change
Reduction in Revenue					
Without Property Tax Loss	\$14,427,795	\$34,105,637	\$48,533,432	\$15,614,164	47%
With Property Tax Loss	\$14,606,297	\$34,320,755	\$48,927,052	\$15,657,784	47%
Reduction in Expenditure					
Short-Run	\$8,942,343	\$21,087,361	\$30,029,704	\$9,341,404	45%
Long-Run	\$9,568,877	\$22,564,819	\$32,133,696	\$9,852,596	44%
Change in Net Revenue					
Short-Run					
Without Property Tax Loss	\$5,485,451	\$13,018,276	\$18,503,728	\$6,272,760	51%
With Property Tax Loss	\$5,663,954	\$13,233,394	\$18,897,348	\$6,316,380	50%
Long Run					
Without Property Tax Loss	\$4,858,918	\$11,540,818	\$16,399,736	\$5,761,568	54%
With Property Tax Loss	\$5,037,420	\$11,755,936	\$16,793,356	\$5,805,188	53%

Attachment #2 – Exit Fee Scenarios

The following tables address the Commission’s request for additional analysis and evaluation of the LAFCO staff’s recommended 5yr, \$24.3 million exit fee. Water Authority staff has utilized both LAFCO staff’s use of Dr. Hanemann’s outdated 2021 Net Revenue Impact as well as the True-Up value presented in attachment #1. Without a fair and appropriate exit fee, the LAFCO commission will shift as much as \$140 million to remaining rate payers over just the first 10-year period.

Below are LAFCO staff’s recommendation as well as the analysis of adding either two or five years to the currently proposed 5-year exit fee. Under this approach, the value of the ESP credit remains fixed at the full amount, with the net amount only changing based on years of net revenue impact.

	LAFCO Staff Recommendation	7 Years (LAFCO + 2 years)	10 Years (LAFCO + 5 years)
Exit Fee			
Annual Cost	\$12,580,964	\$12,580,964	\$12,580,964
Term (yrs.)	5	7	10
Total Exit Fee	\$62,904,820	\$88,066,748	\$125,809,640
ESP Adjustment			
Annual Cost	\$38,600,000	\$38,600,000	\$38,600,000
Term (yrs.)	n/a	n/a	n/a
Total Adjustment	\$38,600,000	\$38,600,000	\$38,600,000
Net Total	\$24,304,820	\$49,466,748	\$87,209,640
Net Annual	\$4,860,964	\$7,066,678	\$8,720,964

The tables below show the results of replacing the outdated numbers with the new true-up values from Attachment 1. This maintains the approach of providing the full ESP credit. In all cases it results in an annual increase of \$6.3 million over LAFCO staff’s recommendation.

	5yr True-Up (Full ESP)	7r True-Up (Full ESP)	10yr True-Up (Full ESP)
Exit Fee			
Annual Cost	\$18,897,348	\$18,897,348	\$18,897,348
Term (yrs.)	5	7	10
Total Exit Fee	\$94,486,739	\$132,281,435	\$188,973,479
ESP Adjustment			
Annual Cost	\$38,600,000	\$38,600,000	\$38,600,000
Term (yrs.)	n/a	n/a	n/a
Total Adjustment	\$38,600,000	\$38,600,000	\$38,600,000
Net Total	\$55,886,739	\$93,681,435	\$150,373,479
Net Annual	\$11,177,348	\$13,383,062	\$15,037,348

Finally, the Water Authority evaluated an alternative and cost-of-service based approach to providing a full credit for the ESP project. The project would not be funded with cash (as insufficient cash is available), thus providing a full credit is inconsistent with cost of service and industry standard capital funding approaches. Instead, the Water Authority considered an approach that scales with the selected term of the “exit fee” and is valued at the associated annual debt service cost of the project (30yr bond issuance at 5% rate). As detailed below, the total provided adjustment for the ESP project more appropriately reflects the value of avoiding construction of the new facility. The value only would reflect the full project value at the end of the 30-year life of the asset (and bond issue).

	5yr True Up + 5yr ESP Credit	7yr True Up + 7yr ESP Credit	10yr True Up + 10yr ESP Credit
Exit Fee			
Annual Cost	\$18,897,348	\$18,897,348	\$18,897,348
Term (yrs.)	5	7	10
Total Exit Fee	\$94,486,739	\$132,281,435	\$188,973,479
ESP Adjustment			
Annual Cost	\$2,510,985	\$2,510,985	\$2,510,985
Term (yrs.)	5	7	10
Total Adjustment	\$12,554,927	\$17,576,898	\$25,109,854
Net Total	\$81,931,812	\$114,704,537	\$163,863,625
Net Annual	\$16,386,362	\$16,386,362	\$16,386,362

The table below provides a summary of the above evaluated alternatives against the maximum 10-year exit fee period recommended by Dr. Hanemann. The final column of the table details the potential burden the LAFCO Commission will force on the rest of the county without a full and appropriate exit fee when compared to full recovery over the 10 years. LAFCO staff, as did Dr. Hanemann, acknowledged the continued shift of millions in financial burden to remaining ratepayers, regardless of the proposed exit fee (see LAFCO Staff Report Attachment 10). The amounts provided below do not include these additional and well-known ratepayer impacts.

	Net Revenue Impact	ESP Credit	Net Total	Net Annual	Cost to Remaining Ratepayers over 10yr Period
LAFCO Staff Recommendation	\$62,904,820	\$38,600,000	\$24,304,820	\$4,860,964	\$139,558,805
7 Years (LAFCO + 2 years)	\$88,066,748	\$38,600,000	\$49,466,748	\$7,066,678	\$114,396,877
10 Years (LAFCO + 5 years)	\$125,809,640	\$38,600,000	\$87,209,640	\$8,720,964	\$76,653,985
5yr True-Up, Full ESP	\$94,486,739	\$38,600,000	\$55,886,739	\$10,705,446	\$107,976,885
7r True-Up, Full ESP	\$132,281,435	\$38,600,000	\$93,681,435	\$12,911,160	\$70,182,190
10yr True-Up, Full ESP	\$188,973,479	\$38,600,000	\$150,373,479	\$14,565,446	\$13,490,146
5yr True Up + 5yr ESP Credit	\$94,486,739	\$12,554,927	\$81,931,812	\$15,914,460	\$81,931,812
7yr True Up + 7yr ESP Credit	\$132,281,435	\$17,576,898	\$114,704,537	\$15,914,460	\$49,159,087
10yr True Up + 10yr ESP Credit	\$188,973,479	\$25,109,854	\$163,863,625	\$15,914,460	\$0