

**RESPONSE
TO
ISSUES**

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April 5, 2011

TO: President Rosen, Board of Directors, and General Manager

FROM: Fran Farina, General Counsel

RE: RESPONSES TO ISSUES CONCERNING DRAFT DOCUMENTS,
AGRICULTURAL RATES, AND CACHUMA WATER

Is the public entitled to communications with consultants, legal opinions, draft documents and models prepared in conjunction with the cost of service study?

The public is entitled to the benefit of our best work, not our initial drafts, and the District is entitled to thoughtful support from its consultants and its legal counsel.

Therefore, it is the District's position that these communications concerning the District's business are treated as preliminary drafts, notes and memoranda not retained in the ordinary course of business. The public is not entitled to every draft version, every draft model, or communications concerning these matters until they have been made public or shared with a quorum of the Board of Directors.

These communications are protected under the work product doctrine, attorney client privilege and deliberative process exemptions recognized in Government Code sections 6254 (a) and (k) as well as 6255.

Does the proposed rate structure provide different treatment for *Wright* Judgment farmers who gave up their wells in exchange for District service?

The *Wright* Judgment provides "When the Private Overlying Owner receives Exchange Service, Water District shall bear all maintenance and operation costs, including all utility charges, and Water District shall assume all liability arising out of management of said well and it agrees to indemnify the Private Overlying Owner against any liability regarding said well. *Private*

Overlying Owners shall pay regular Water District rates and terms and conditions of water use shall be in accordance with Section 24 of this Judgment.” See Amended Judgment, Paragraph 22 (b) at page 114.

Section 24 of the *Wright* Judgment provides, “Any Exchange Service, other than Managed Service or Augmented Service provided to any Overlying Owner by the Water District *shall be on an equal basis with all other Water District customers and applicants for service insofar as rates, terms and conditions of water use are concerned including any reduced extraction and customer consumption required to bring the Basin into Hydrologic Balance.* In no event shall an Overlying Owner pay more than the rate paid by persons of like class who were customers of the Water District as of October 3, 1973.”

Do the District’s agricultural customers have a contractual priority in Cachuma water which exempts them from needing State Water and from paying the New Water Supply Charge?

The Reclamation Act of 1902 was a land settlement act which helped open up the arid west. In justifying the Cachuma Project in 1949, the United States Department of the Interior Bureau of Reclamation noted that the lands and inhabitants within the Santa Barbara County Water Agency “are *in critical need of additional water for municipal, domestic, and irrigation uses.*” This recital appears before one which also notes the “need of additional water for irrigation....”

The 1949 Master Contract defined terms in no particular order but “Municipal water” was listed before “Irrigation water” and “Irrigation water” was defined as “water furnished or to be furnished to member units to be used or used for beneficial purposes other than those specified in subdivision (d) of this article. Municipal water was subdivision (d).

The Master Contract is the agreement of the parties. While irrigation water may be listed first in certain paragraphs or cost less, there is no specific quantification for agricultural uses within a member unit’s service area to support the assertion of priority.

A statement has been made that since the Cachuma Project is a federal project through USBR, it is not subject to state law. This is incorrect. Cachuma is permitted by the State Water Resources Control Board (SWRCB) which has continuing jurisdiction over the Project. The operating procedures continue to be refined and various orders have been issued by SWRCB against USBR.

The SWRCB is responsible for Article X, section 2 of the California Constitution which reads in part, “It is hereby declared that because of the conditions prevailing in this State the general welfare requires that the water resources of the State be put to beneficial use to the fullest extent of which they are capable, and that the waste or unreasonable use or unreasonable method of use of water be prevented, and that the conservation of such waters is to be exercised with a view to the reasonable and beneficial use thereof in the interest of the people and for the public welfare....” The SWRCB cites to the California Water Code in carrying out its responsibilities.

Finally, it should be noted that when the moratorium was declared in December 1972, the total amount of Cachuma water available to the District was 10,731 acre feet and even with groundwater, a deficit of 4,000 acre feet for the water year was projected. The then consumer demand was 17,800 acre feet. The Board declared a water shortage emergency “until such time

as the District's available water supplies are augmented to an extent sufficient to meet its projected demands." (Resolution No. 714) Ordinance 72-1 and 72-2 implementing the moratorium made no special exclusion for agricultural customers other than for those who had begun constructing water works prior to December 7, 1972.

The conclusion is that by the end of 1972, all developed water that was available was being used, including the District's entire Cachuma entitlement. Therefore, any new use or expanded use would have to be served by the District's new water supply projects for which the New Water Supply Charge was enacted in 1996. (Ordinance No. 96-3)

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MEMORANDUM

TO: President Rosen and Members of the Board of Directors
Goleta Water District
4699 Hollister Avenue
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FILE NO: 37008-0002

FROM: Michael G. Colantuono, Esq.
Mark E. Mandell, Esq.

DATE: April 6, 2011

RE: Legal Issues Regarding the District's Current Rate-Making Process

As your staff requested, we write to comment on a number of legal questions that have arisen during the District's current rate-making process. This memorandum is written with the understanding it will be shared with the public.

Thank you for the opportunity to assist. If there is more we can do to be helpful, please let me know.

A. What Law Governs the NWSC?

1. *Government Code § 66013 Applies to Capacity Charges such as the NWSC*

The NWSC is a "capacity charge" governed by Government Code § 66013. Pursuant to Government Code § 66013(b)(3):

"Capacity charge" means a charge for public facilities in existence at the time a charge is imposed or charges for new public facilities to be acquired or constructed in the future that are of proportional benefit to the person or property being charged, **including supply or capacity contracts for rights or entitlements**, real property interests, and entitlements and other rights of the local agency involving capital expense relating to its use of existing or new public facilities. A "capacity charge" does not include a commodity charge. (Emphasis added.)

By this definition, the NWSC is a capacity charge. Therefore it is subject to Government Code § 66013 and exempt from the other provisions of the Mitigation Fee Act.

2. *Government Code §§ 66000 - 66008 Do Not Apply*

Because the NWSC is a capacity charge subject to § 66013, it need not comply with Government Code § 66000 - 66008, which are applicable to development impact fees.¹

3. *Article XIII D, § 6 of the California Constitution Does Not Apply*

The NWSC also need not comply with the rules set forth in Article XIII D, § 6 of the California Constitution for so-called “property-related fees.” In considering requirements of this Constitutional provision, which was added to the Constitution in 1996 by Proposition 218, the Supreme Court held in a case Michael argued for the victorious local government:

[A] water service fee is a fee or charge under article XIII D if, but only if, it is imposed “upon a person as an incident of property ownership.” A fee for ongoing water service through an existing connection is imposed “as an incident of property ownership” because it requires nothing other than normal ownership and use of property. But a fee for making a new connection to the system is not imposed “as an incident of property ownership” because it results from the owner’s voluntary decision to apply for the connection.²

Because the NWSC is a charge for new service connections, it is not subject to the requirements of Article XIII D, § 6 (Proposition 218).

4. *Article XIII C, § 2 of the California Constitution Does Not Apply*

Government Code § 66013(a) provides that:

Notwithstanding any other provision of law, when a local agency imposes fees for water connections or sewer connections, or imposes capacity charges, those fees or charges shall not exceed the estimated reasonable cost of providing the service for which the fee or charge is imposed, unless a question regarding the amount of the fee or charge imposed in excess of the estimated reasonable cost of providing the services or materials is submitted to, and approved by, a popular vote of two-thirds of those electors voting on the issue.

¹ See Government Code § 66013(h) [“Fees and charges subject to this section are not subject to the provisions of Chapter 5 (commencing with Section 66000)...”].

² *Richmond v. Shasta Community Services District* (2004) 32 Cal.4th 409, 427.

So long as the District complies with this requirement, and establishes a reasonable basis in the record of your action to adopt it that the NWSC does “not exceed the estimated reasonable cost of providing the service for which the [NWSC] is imposed,” the District need not comply with the tax election requirements of Article XIII C, § 2 of the California Constitution (another part of Proposition 218). Those requirements apply only to taxes; and Article XIII C, Section 1(e)(2), which was added to the Constitution by Proposition 26 at the November 2010 election, excludes from the definition of “tax”:

a charge imposed for a specific government service or product provided directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the local government of providing the service or product.

B. Is A Separate Fund Required To Account For The NWSC?

Government Code § 66014(c) provides:

A local agency receiving payment of a [capacity] charge ... shall deposit it in a separate capital facilities fund with other charges received, and account for the charges in a manner to avoid any commingling with other moneys of the local agency, except for investments, and shall expend those charges solely for the purposes for which the charges were collected. Any interest income earned from the investment of moneys in the capital facilities fund shall be deposited in that fund.

Therefore, a separate fund should be established for NWSC proceeds. Given our understanding that the District has previously devoted the NWSC to fund the District’s obligations for State Water Project supplies, and that the cumulative cost of those supplies has exceeded cumulative proceeds from the NWSC in every year, any failure to maintain a separate fund in the past would be a harmless error. Moreover, there may have been no funds to account for to the extent the District had advanced rate funds to cover SWP costs and used NWSC funds to repay that loan. The purpose of the separate fund accounting requirement is, of course, not to ensure work for accountants but to ensure the funds are properly expended. Of course, we recommend the District comply with this fund accounting requirement going forward.

C. What costs may be recovered by the NWSC?

The purpose of a capacity charge is to give new customers a chance to “buy in” to existing improvements and water supplies that will be used by the new customer and to fund future improvements and water supplies that will be needed by the new customer. Like a capital charge for a new member of a private club or a new partner in a business, it serves to put new and old ratepayers on an even playing field and not to give newcomers a “free ride” on the capital value contributed by existing customers in the past through their rate payments and

otherwise. Therefore, pursuant to Government Code § 66013(b)(3), a capacity charge can be imposed for:

public facilities in existence at the time a charge is imposed or ... new public facilities to be acquired or constructed in the future that are of proportional benefit to the person or property being charged, including supply or capacity contracts for rights or entitlements, real property interests, and entitlements and other rights of the local agency involving capital expense relating to its use of existing or new public facilities.

Thus, a capacity charge **may be charged** to recover the costs of **existing public facilities and supply rights** so long as the amount of the charge does not exceed the proportional benefit of those facilities and supply rights to a new customer. As these costs have already been incurred by the District, they need not be reflected in a capital improvement plan setting forth the District's planned future improvements. Nor is it material how the existing facilities were funded – the District need not credit new customers for the portion of its existing capital facilities that were funded by grants, contributions from developers or otherwise.

Because a purpose of such a charge is to fund a new customer's proportionate share of existing facilities and supply rights, it is appropriate to charge the new customer not only for a share of future installments on a supply rights contract, but also for their "fair share" of prior installments. This practice is sensible because, just it is common for an agency to build "oversized" facilities to accommodate future demand; it is common for agencies to acquire water supply contracts that are large enough to serve future demand. In that event, a portion of the oversized contract is not needed by existing users and is fairly charged to new users. Again, the analogy to a buy-in fee for a private club or a small business is apt – the newcomer to be on equal footing with prior customers and thus must pay is or her proportionate share of the entire capital value accumulated by those prior customers.

Government Code § 66013(b)(3) places a ceiling on the costs that may be recovered through the NWSC, but not a floor – the District may choose as a matter of policy not recover all eligible costs. Therefore, it is permissible for the District to change the scope of the fee from time to time. For example, the fact that the District has not, in the past, used the NWSC to recover costs associated with facilities, does not bar the District from including those costs in the NWSC now.

D. How Must the District Account for Past Costs? May Estimates be Used?

Government Code § 66013(a) requires that a capacity charge not exceed "the estimated reasonable cost of providing the service for which is imposed." This language recognizes that

fees can be based on an **estimate** of reasonable costs.³ So long as the NWSC reflects a reasonable estimate of the value of the District's assets and assigns only an appropriate portion of that value to new customers, it is lawful and the law does not specify one means to arrive at that estimate. Historic values adjusted for inflation, book values, appraised values or other means may be used provided that the resulting estimation is reasonable and supported by some evidence in the record before the District's Board when it adopts the rate. To put it differently, fairness is a range, not a point, and courts will defer to the Board's rate-making judgments provided they are supported by reason and some record evidence. In our judgment, CDM's reports provide both a rationale and evidence to support any NWSC up to the amount that report proposes. Indeed, to the extent CDM excludes contributed capital funded at no cost to the District's ratepayers, its recommendation is more conservative than the law requires.

E. Can the NWSC Include an Inflation Adjustment?

Inflation adjustments are commonly used by public agencies to reflect changing costs. This ensures that new customers pay their fair share no matter when they pay the fee. However, the NWSC should be reevaluated periodically to ensure that the CPI adjustments accurately reflect the change in value of the District's assets. The rationale for this is simple: there is a cost to the detailed cost accounting CDM has recently performed for the District and the ratepayers must, of course, fund that cost. There is no need to repeat that exercise until there is reason to believe that the District's costs have meaningfully changed. So long as the inflation adjustment index reasonably approximates changes in the District's costs (the CPI or the ENR Construction Cost Index are commonly used), the District has a reasoned basis to rely on it. Cf. Government Code § 53756 (authorizing use of CPI to adjust utility service charges for up to five years before new Proposition 218 hearing required).

F. May Agricultural Customers be Protected from the High Cost of State Water Project Water Supplies?

To the extent agricultural customers benefit less than urban customers from a facility or water supply, the two classes of customers need not be charged the same rate. For example, the District may lawfully conclude that agricultural customers receiving interruptible water service have no need for the State Water Project supply. Similarly, if agricultural customers use water in a manner that recharges the ground water basin, the District may lawfully conclude that their water use actually contributes the availability of water to other customers or at least is less costly to local water supplies than use of water by others.

The District's General Counsel interprets the District's contract with the Bureau of Reclamation to distinguish agricultural from other uses of water only for purposes of price. We are not water lawyers and have not reviewed the Bureau of Reclamation contract and therefore

³ Any accounting of future costs is necessarily an estimate or projection because we cannot foresee the future with precision.

defer to her opinion on this issue. However, based on this interpretation, agricultural customers do not have priority over urban users for Lake Cachuma water, which priority might serve as a basis for finding the agricultural users have reduced (or no) need for the State Water Project supply.

The fact the agricultural water consumption may be decreasing in the District also is of no bearing in this analysis. Each new customer of the District, whether urban or agricultural, represents a new demand for water that must be served from the District's available water supply. The fact that existing agricultural customers may be reducing their water use (and freeing up supplies) does not entitle a new agricultural user to "claim" benefit of a "freed up," lower cost water sources.

This same reason applies to the District's water service rates which are limited to the proportionate cost of serving each customer not by Government Code § 66013(b)(3) but by Proposition 218 and other law.

G. Must the District Offer Reduced Rates For Low-Income Housing?

Government Code § 66013(b)(3) limits capacity charges to facilities and water supplies "of proportional benefit to the person or property being charged." Thus, if the District reduces the NWSC for low income residential below the proportional share of the benefit from the District's facilities and water supplies attributed to those customers, the District cannot recover the lost revenue by increasing the NWSC for other customers above their proportional share.

The District has no legal authority to alter its rates to reflect a basis other than proportional cost. Again, this same reasoning applies to the District's service charges, which are limited to proportional cost of service by Proposition 218 and other law.

The District does have an obligation to preserve capacity for new affordable housing developments. However, the legal responsibility to promote housing affordability lies with land use authorities (i.e., the County of Santa Barbara and the City of Goleta), not with the District.

Thank you for the opportunity to assist. If we can provide further advice or assistance, please let us know.



Memorandum

*To: Matthew Anderson
Administrative Manager/CFO
Goleta Water District*

From: Grant Hoag, P.E.

Date: April 6, 2011

Subject: Responses to Public Comments on CDM Financial Analysis

Purpose

The purpose of this memo is to comment on the statements and questions sent to you following the public distribution of our technical memorandums on the New Water Supply Charge (NWSC) Updates, the Cost of Service Findings and the Financial Plan. This memo is organized by summarizing comments received, followed by our response.

Comment

When calculating NWSC levels, capital contributions made by developers should be subtracted.

CDM Response

The District has correctly included the contributed capital assets in its NWSC calculations. The District's special attorney has advised that under state law the developer contributions may be recovered in the updated NWSCs. However, CDM has made certain assumptions regarding these contributions and has updated the NWSC on that basis. Specifically, CDM has followed the AWWA Manual M1 calculation of System Development Charges (SDCs, or connection fees) using the buy-in method.

Some developer contributions are likely to have been credits against the District's hookup fees, since the alternative to them contributing the asset would have been that the District built the infrastructure and impose a higher connection fee to recover those costs. In any case, developer contributions of assets must be depreciated so that only the residual undepreciated value is netted against the original asset values used in the SDC calculation. The developer contributions are attributed to the original customer meters and the service connections. As such, CDM concluded that these original contributions are mostly depreciation and in many cases already replaced with District assets.

Finally, the AWWA Manual M1 and State law allows for the valuation of assets using either the original or replacement costs when calculating SDCs. CDM has provided calculations using the former, while the later would result in SDCs approximately 50 percent higher. If further consideration of an appropriate facilities value for the NWSC update is requested CDM suggests that all methods be presented for the Board's consideration.

Comment

As structured, all customers, urban and agricultural, obtaining a new water meter are being asked to pay twice for State Water Project water.

CDM Response

The NWSC reimburses the "loan" made by existing customers on the behalf of future customers. All existing customers have paid for available facility capacity and funded water supply capacity beyond their current needs. When new customers pay a NWSC, they are repaying existing customers (through the District) for this "loan." These NWSC payments result in lower rate increases for existing customers, thus repaying the "loan." New customers then receive the same service rate as all other customers, and are in turn "repaid" from additional new customers when NWSCs are received by the District. Thus, there is no paying twice since after paying a NWSC, a customer's ongoing rates will have been reduced commensurate with the amount of NWSC paid.

Comment

The NWSC is incorrectly calculated, as the \$151 million used for allocating state water project costs (the numerator) is inflated, as it includes both the prior years' payments as well as the present value of all future payments. Furthermore, the figure of 3,800 AFY as the denominator is too low as it is less than the full the whole of the District's state water supply.

CDM Response

It is appropriate to include the full \$151 million for both past and future state water payments. The combined total represents the total present value of the District's state water entitlement. This is ultimately the amount to be collected in NWSCs. To collect only the value of historical payments would deprive existing rate payers of the credit they are due for continuing to carry these costs until new customers join.

The 3,800 AFY figure is the appropriate denominator in this calculation, as it represents the number of parts representing the whole. In this case, the "whole" is the entire amount of water that eventually can be allocated. Per the SAFE ordinance, the District shall plan for the delivery of 3,800 acre feet per year (AFY) of water as the amount of firm average long-term yield. Because 3,800 AFY is the maximum that can be allocated for growth, and not more, it is the correct denominator. Using a larger denominator would artificially reduce the unit cost and prevent full recovery of State Water Project costs.

Comment

The NWSC for Agricultural customers should exclude SWP supply costs because the history of the USBR and the Cachuma Project indicates there is ample capacity in Cachuma to satisfy agricultural water needs into the future.

CDM Response

Based upon the position of the District as described by its General Counsel, the NWSC for Agricultural customers includes SWP supply costs. Local supplies are fully allocated, and the only water supply available for new customer demand serving any customer is from the SWP supplies.

Comment

The cost of service analysis uses as its base period the financials and data from the GWD for the fiscal year 2008-09. This use of a period of time which is not the most recent time period i.e. the fiscal year 2009-10, raises the question as to why the prior period was selected.

CDM Response

Fiscal Year 2008-09 was the most recent complete fiscal year when the study commenced. It is important to separately distinguish the Cost of Service study and the Financial Plan study. In the former, CDM used fiscal year 2008-09 to correctly verify the proportionality of costs and rates by customer class. For the latter, CDM did not use FY 2008-09. Rather, the sources and uses of cash method was used to determine the District's rate-based revenue requirements. The findings of the cost of service analysis do not influence the calculations of the District's annual revenue requirements as developed in the Financial Plan.

Comment

The 2010 audit report continues on for several additional pages discussing the multitude of accounting problems and recording errors as to the FY 2008-09 financials used by CDM. There is no explanation or rational reason why the patently defective old financials were used for the collection of the relevant data required for a cost of service analysis except for the possibility the use of the old data from FY 2008-09 gave a "better" result for the District in justifying higher rates.

CDM Response

As shared in the previous comment, the FY 2008-09 audit report was not used in developing the District's rate-based revenue requirements, and was irrelevant to CDM's recommendations regarding rate increases. The rate-based revenue requirements of the financial plan are based on the projected, not audited, sources and uses of cash.

Concerning the use of FY 2008-09 statements for the cost of service study, all audit adjustments made to restate the FY 2008-09 fiscal year were non-cash adjustments to fixed

assets, depreciation and post-employment liabilities and therefore do not influence the Financial Plan analysis

Comment

The analysis will not generate required revenues, and consideration of the proposed rate is premature until this is an expert report on the elasticity of demand for consideration of the Directors.

CDM Response

Based on our experience, we believe the opposite is the result of our recommended rate increases. Given the District's financial condition, this point is especially important since District revenue must increase immediately.

Inclusion of the effects of demand elasticity on costs, if any credible and material elasticity values were available, would result in rates in the future years that are higher than those currently proposed; this is because the demand elasticity of price, if any, has a long-term, not short-term, effect on the volume of water sale revenues. Finally, the variation in water demands resulting from the economy, the annual variations in weather and the District's conservation messages have a far more profound impact on water use than demand elasticity.

Comment

The Study has inaccurately identified the number of customers on the Goleta West Conduit (GWC), and has failed to correctly identify the exact amount of GWD water used by the customers located on the GWC. To include wheeling/conveyance customers and the amount of water they used would be improper and is an artificial inflation of the Water actually used on the GWC. This inclusion causes an overstatement of the amount of GWD water used by the GWC customers. Thus the analysis and computations used by CDM are not accurate as to the true cost of service for the customers on the GWC.

CDM Response

CDM used actual billing records of the District to identify the customers and water use specific to the GWC. The GWC contains 27 active meters, two of which are conveyance agreement customers to arrive at a net 25 non-conveyance customer count. It is important to note that regarding these conveyance meters, no State Water supply costs associated with a conveyance customer were included in the data. Conveyance customers pay their own supply costs directly to the Central Coast Water Authority (CCWA), not via the District.

Regarding non-supply costs, the cost of service analysis properly allocated costs of conveying water, regardless of source or use, to the system customers based on their individual demand patterns using the methods developed by AWWA. Use of costs allocated by water supply and other functions correctly segregates the supply costs from system delivery costs to each

Matthew Anderson
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customer class on each system, so the COS results are correct as stated. The above comment misunderstands the purpose of the cost-of-service study, which is to properly recognize that a conveyance customer must pay its portion of operating costs. To ignore a conveyance customer's use of the GWC would only increase the unit cost of other GWC customers.

Comment

CDM, in its cost of service analysis, selected to use the water consumption figures based on fiscal year (FY) 2008-09 and not the average amount of water consumed for the last three fiscal year period. The use of one year water consumption is an unreliable amount since the records of the GWD show that the total amount of water has had significant fluctuations in the total amount of water used from one year to the next year. Thus, the use of a three year average gives a truer picture of the usual consumption pattern of the customers. To over inflate the amount of water on the GWC increases the amounts of expenses chargeable to the GWC.

CDM Response

As previously stated, FY 2008-09 was the most recent year available at the start of the analysis, and cost of service analysis requires that all elements of the analysis, including District costs and assets and customer water use and bills, be based on the same period. The suggested overstatement of water use would result in lower, not higher rates, as the costs to be recovered would be allocated to less use and the unit rates therefore higher. Nonetheless, it is important to note that it is the financial plan, not the COS analysis, that is used to determine the unit rates by year and the use of a given year for this exercise is rational as any differences in weather will likely affect customers within a class similarly.

Close

If you have any questions regarding this memo, please contact me.